

The Week

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Bad news sometimes creates good value

During the past month, investor confidence dropped sharply following the downgrade of the U.S. debt rating and ongoing financial problems in Europe. However, at the same time, companies that make up the S&P 500 reported generally good earnings for the second quarter. The decline in the stock market when earnings are increasing creates an attractive valuation in U.S. equities, if the U.S. economy does not fall into recession.

We believe that a recession watch condition currently exists. That means that some of the pre-conditions for a recession currently exist, but a recession may not occur. In other words, the economy is growing slowly and there has been a shock to confidence that could dampen consumer and business spending. If this summer's shock to confidence is a temporary problem brought on by a confluence of bad news, the economy may not suffer too much. After all, corporate earnings are rising, not falling as they usually do during a recession.

History shows that over time, the ups and downs in the stock market reflect the rise and fall of corporate earnings. When earnings are going down, stock prices often go down. However, sometimes stock prices go down when earnings are rising. When this occurs, investors are concerned about future economic prospects rather than current conditions. During the past month, investors have worried that the economy is not as healthy as the recent earnings numbers indicate. Consequently, stock prices have declined relative to earnings. If these worries are overblown, the decline in the stock market creates an attractive valuation in stocks.

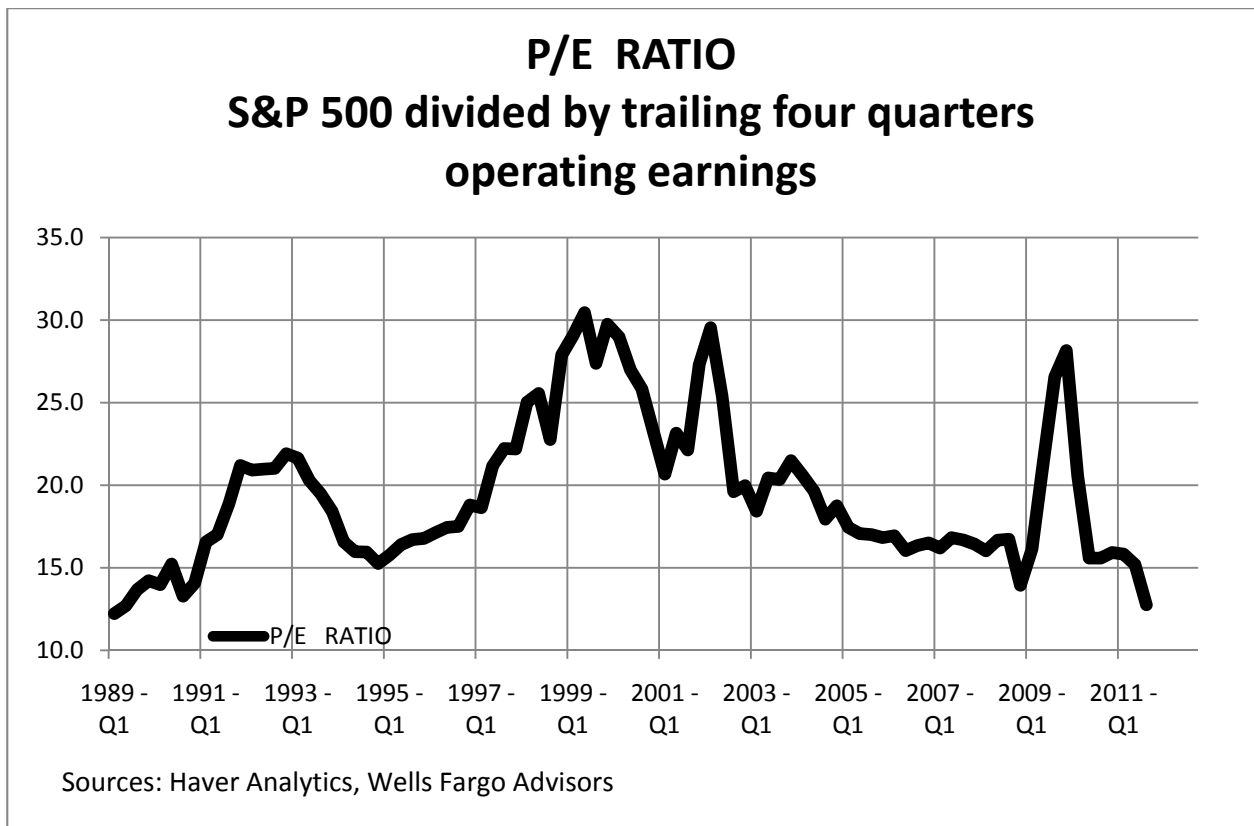
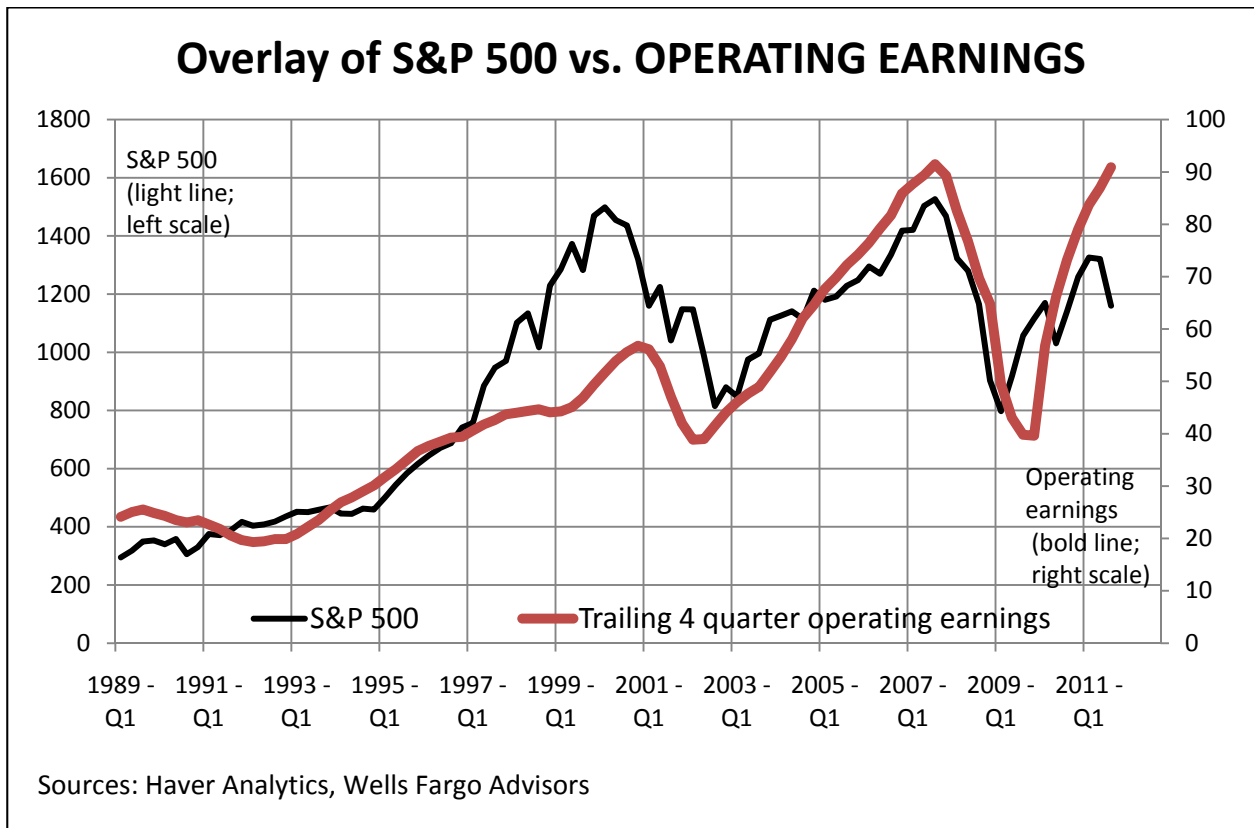
This week's report includes two charts that compare stock prices to earnings. The first chart on page 2 is an overlay of the quarterly closing price of the S&P 500 index, compared to the four-quarter trailing sum of operating earnings shifted one quarter to coincide with the timing of the earnings reports. The second chart on page 2 is

the P/E ratio of stock valuations as measured by the ratio of the end-of-quarter S&P 500 index to the four-quarter trailing operating earnings numbers.

The overlay chart shows the stock market increased more than earnings rose in the 1990s because investors were optimistic about the future. This greater increase in stock prices than earnings is represented by a rising P/E ratio in the second chart. During the past decade, stocks have not increased as much as earnings have grown. This weakness in stocks relative to earnings is represented by the decline in the P/E ratio in the second chart. As stock prices declined during the past two months, valuations dropped to their best level in 20 years. Stock prices are not as low as they were in the depths of the recession, but earnings are much higher. As a result, the P/E ratio is lower. By this measure, investors are more pessimistic now than they were at times during the recession.

Investors are negative because of concerns about the debt and deficit as well as the lingering high unemployment rate. Nevertheless, earnings have recovered substantially from the recession lows despite these problems.

Investors were not kind to companies during the latest earnings reporting season that started in early July. If a company reported bad numbers, its stock price often dropped sharply. If a company reported good numbers, its stock price also often dropped, just not as sharply.



Fortunately, the earnings numbers were more often good than bad. The number of companies reporting increasing earnings for the second quarter outnumbered the number of companies reporting decreasing earnings by almost 4-to-1. In addition, more companies raised guidance about future earnings than reduced guidance. Nevertheless, the drop in the stock market during the positive earnings season suggests that investors are worried that the good earnings may not continue in the future.

Another important indicator that market valuations are becoming attractive is an increasing number of corporate insiders are reporting that they are buying their own company's stock. Increased insider buying is often a sign that the market may have over-reacted to bad news, pushing stock prices down below levels that accurately reflect current business prospects.

Last week, Fed Chairman Bernanke spoke at the annual Jackson Hole gathering of policymakers. He said that the economy is recovering from the recession although the recovery is disappointing. He also said that the banking system is much healthier now than it was in the 2008 recession

while households and businesses are improving their balance sheets. This restorative process is likely to promote economic recovery over time. The Chairman's message did not sound as negative as the statement released after the last Open Market Committee meeting on August 9, shortly after the downgrade of the U.S. credit rating. Chairman Bernanke did not announce any new stimulus for the economy but left the door open to further stimulus in the future. He said the Fed "is prepared to employ its tools as appropriate to promote a stronger economic recovery in a context of price stability." The market was initially disappointed that the Fed did not ride to the rescue of the economy, but later responded positively to the constructive long-term outlook.

In summary, stock valuations are near their best levels in twenty years. If the U.S. economy does not fall into recession, stocks appear to be a better value than bonds which rallied sharply during the past two months in a flight to perceived lower risk assets. In order for the stock market to recover, the economy needs to continue to expand and sentiment needs to improve. Earnings are not falling as they did in bear markets of 2001-2002 and 2008-2009, and stock prices are already low relative to earnings.

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