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WELLS FARGO ADVISORS

The Week

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Worth noting

- Investor sentiment continues to focus on negative factors rather than positive ones. As a result, the U.S. equity market has trended downward since peaking in April.
- On the negative side, the pace of economic recovery is slowing down. On the positive side, the U.S. economy is still expanding, not contracting like it did during the 2008-09 recession.
- Investors who are cautious and defensive now need to remember that short-term market weakness may create favorable long-term market valuations.

Negative sentiment creates attractive valuation

During my recent vacation, I had an opportunity to visit many beautiful places, and like most people, I took a lot of pictures. However, when I reviewed those pictures later, I realized that they just didn't capture the whole view. This is a problem with photography. When you focus on one or two things, you don't always see the bigger context in the individual shots.

Focusing on individual factors and missing the bigger picture is not just a problem in photography. Investors often experience this same problem. We get caught up in the day-to-day string of events and worry about short-term market fluctuations. As a result, we often forget about the bigger picture. Of course, it is important to pay attention to daily news, because some market fluctuations can be significant. However, it is equally important to remember the long-term fundamentals. We continue to believe that there is further downside risk in equities during the next few months, as the markets work off the excesses of the 13-month, 80% rally from March 2009 through April 2010. That's because the economic news is not as strong now as it was earlier this year. However, the bigger picture still looks favorable for U.S. equities.

This report focuses on the bigger picture. The U.S. economy has gone through two recessions during the past decade, and American companies have had to deal with many problems along the way. Fortunately, American businesses have succeeded in growing profits through these ups and downs. In fact, total after-tax corporate profits have rebounded to hit a new record high as of the first quarter of this year.

Investors wanting to compare the long-term potential gains equities with the risks need to review how investors are valuing profits generated by American companies. This week's chart shows the growth in market value of domestic corporations versus total after-tax corporate profits during the past 55 years. Both measures have increased over time as the U.S. economy has grown and expanded. There were set-backs along the way when the economy went into recession. However, innovation, productivity growth and a growing labor force have pushed the economy, profits and market values up over the long run.

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A review of the chart also shows that market values, as measured in the upper line, are about the same level that they were in 1999. At the same time, after-tax corporate profits, as indicated by the lower line, are significantly above their 1999 level. This comparison shows that the market has not been weak during the past decade because companies have failed to perform. Rather, the market has been weak because investors have been pessimistic and not willing to pay as much for profitability.

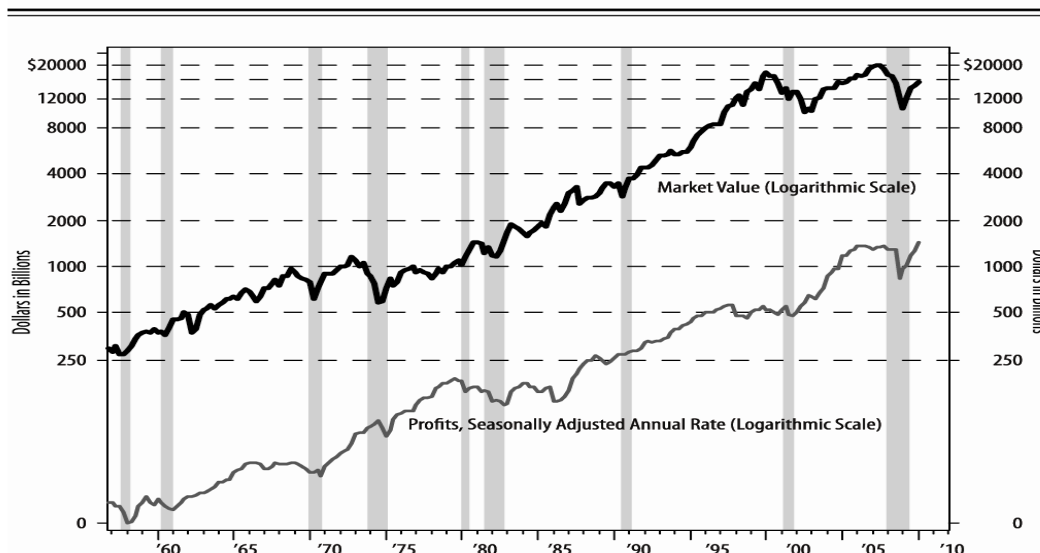
There would be much more downside risk if profits were lower than they were in 1999, and investors were ignoring the bad performance, pushing the market value of equities to new highs. This is not what has happened. In fact, the opposite is true. The equity markets are not over valued versus profits. Instead, after-tax corporate profits are at a record high and while the market value is below previous highs. This creates a favorable long-term valuation for stocks.

Companies are just beginning to report second-quarter 2010 earnings this month. Therefore, the official government figures on after-tax profits presented here will not be available until September. Nevertheless, individual company reports to date suggest second-quarter after-tax profits could be another record high. Profits will not increase every quarter, but we expect this upward trend is likely to continue, despite many hurdles that are likely in the years ahead.

This comparison of market values to after-tax corporate profits indicates that equity market valuations in the first quarter of 2010 were still near their 2009 lows and close to their lowest levels since 1990. This suggests that the long-term prospects for the stock market remain favorable, despite short-term downside risks based on concerns about a slower economic recovery.

We remain long-term positive on equities but near-term cautious. Our equity strategy team's year-end target for the S&P 500 is 1100-1140. Further out, we look for the S&P 500 to be near 1200 by the middle of next year. History indicates that the first leg of recovery from recession is usually the strongest, as was the rally from March 2009 through April 2010. This strong recovery is often followed by a pull back and consolidation when traders worry that the economic recovery could falter. However, if the recovery continues, the second leg of the market rally is likely to be more modest than the first leg. Long-term valuations remain favorable, and we look for the stock market rally to resume later this year, provided there are no major unexpected shocks that derail business and consumer spending.

Market Value of Domestic Corporations Versus Total After-Tax Corporate Profits



Sources: FRB; Haver Analytics

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After-tax corporate profits were at a record high in the first quarter, far ahead of their 1999 level. However, the total market value of domestic corporations was still near 1999 levels in the first quarter, even though profits are much higher than a decade ago.

The problem is not that American companies cannot do well in this environment. The problem is investors are pessimistic and do not want to pay as much for corporate profits. This hurts the market now but creates a long-term attractive valuation.

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