

A Report Card for the Market ... & Why We Use It

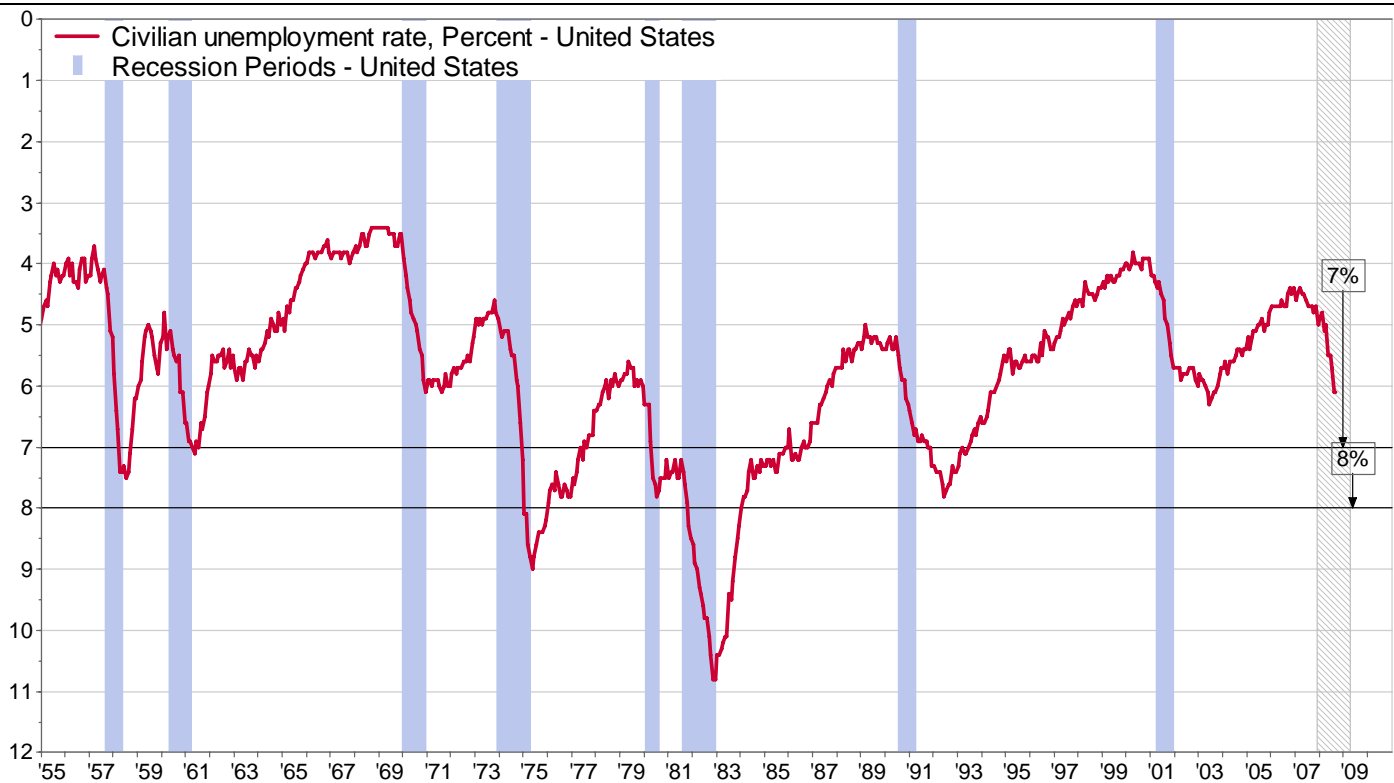
- Some time ago, we developed a market “report card;” a tool that conveys a qualitative rating of the market in four major “subject areas.” While many of our models and indicators are quantitatively based, our cumulative assessment of each of them is more difficult to quantify – thus we assign letter grades like a student may receive in school. The subjects are 1) the Macro-Economy; 2) Asset Valuation; 3) Market Liquidity; and 4) Investor Sentiment. The simple letter grade we apply (on a scale from A+ to F, with the average at B-) is based on conditions in the relevant sphere and its contribution – positive or negative – to the market generally.
- Today, we assign grades of D; A; D; A. We will refer to it as “DADA:” Economy: D; Valuation: A; Liquidity: D; and Sentiment: A.
- History shows that grades like we assign now are not at all unusual at times like these ... when we are mired in a bear market. Near the bottom of a bear market, the economy’s performance is typically sub-par. A slowdown is seen for both growth and productivity; sensitive commodity prices – and the cost of carriage – decline. The outlook is for more of the same, and those forecasting an improvement have difficulty building a strong case.
- Likewise, stocks are often attractively priced – especially when compared to the recent past – in a bear market. That is why we use “normalizing” techniques – e.g. comparing a stock’s price to an average of the company’s earnings over the course of an entire economic cycle – when we assess valuation.
- Liquidity is often quite scarce in the midst of a bear market, so the *existence* of difficult conditions in the credit markets today is not unusual, even though the *extent* of today’s problems probably is.
- Finally, investors are typically downbeat after a drubbing like we have experienced. Meanwhile, consumers tighten their belts as they try to protect their wealth, as they navigate through the downturn. We assign a higher-than-average grade to sentiment when investors are very pessimistic and when consumers are loathe to spend. Sentiment gets an “A” now, because once the current conditions ameliorate, an improvement in consumers’ and investors’ confidence will likely push valuations higher ... even relative to a rising earnings trend.
- In contrast, at the top of the market, the economy normally appears terrific. Earnings – even after they have risen past the “normal trend line” – are often expected to continue expanding at an “above normal” rate for each of the next few years. Plenty of money is available, at interest rates that are unchallenging when compared to expected returns. People get drunk on liquidity at market tops, you may even hear them singing about a “shortage of equity.” Despite the protestations of some for whom no price is too high to pay, valuation is typically stretched at market tops, especially if you have some respect for normalized profits. Complacency among investors turns into hubris – where traders and other kibitzers profess great respect for “the trend,” which is a fickle friend indeed.
- By keeping close tabs on the market and how it rates in these four key “subject areas,” we aim to recognize the changing contribution of various factors and thus improve our asset allocation decisions. We continue to believe it makes sense for equities to be overweight in accounts utilizing an opportunistic approach to asset allocation. Last week’s Op-Ed piece by Warren Buffett in The New York Times “Buy American. I am” underscores our view.

U.S. Equity Market: Our Qualitative "Report Card"

- **Macro-ECONOMY** **D**
- **Asset VALUATION** **A**
- **Market LIQUIDITY** **D**
- **Investor SENTIMENT*** **A**

Note: * Revised range: A+ = Most Bullish. Normally interpreted in a contrary fashion. Source: Wachovia Securities estimates.

U.S. Unemployment Rate



Note: Reverse scale. Hatched area presumes recession from December '08 through March '09. Source: Bureau of Labor Statistics.

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