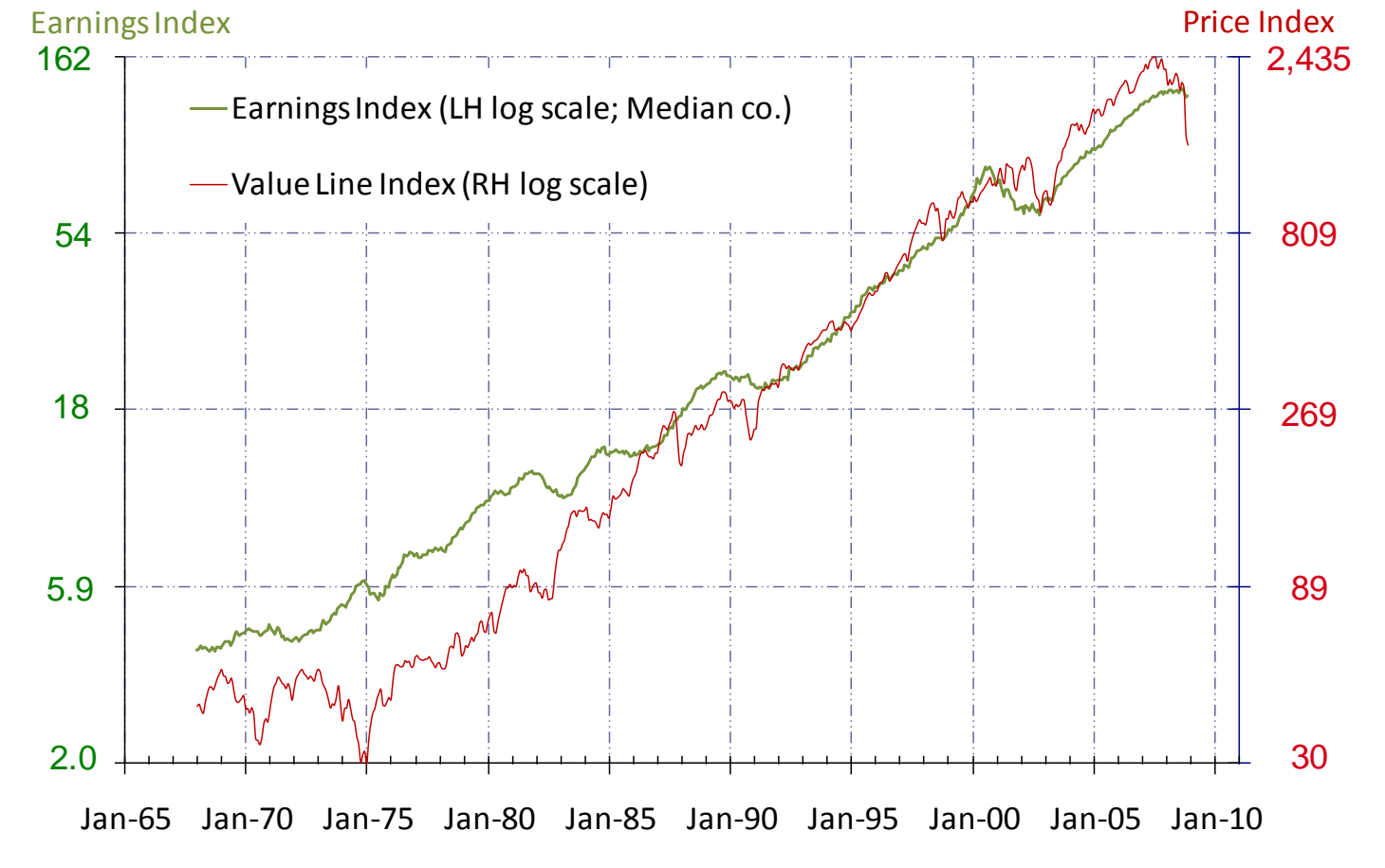


Keep an Eye on Longer-Term Trends

- Last week's closing low of 1,252 on the Value Line Arithmetic index is a few points below October's low close of 1255, but still measurably higher than the intraday lows seen on Thursday. It took only six trading days to unwind the "Obama Bounce," a five day rally that took the index up 24 percent from the lows early in the trading session on October 28th. The Value Line comprises a very broad selection of 1,700 companies, including large-, mid- and small-caps, but it differs from many popular indexes in its construction: the components are equally weighted.
- We believe an equal-weighted index like the Value Line provides a better measure of stock market performance. Consider the last bull market cycle, beginning in October, 2002. Over the course of that advance, the jumbo-sized companies that dominate the Dow Industrials and the Standard & Poor's 500 were outpaced by scores of smaller and medium sized companies, together with international stocks from both developed and emerging markets.
- Currently, the Value Line index (VLE) is still a good deal higher (about +50 percent) than its October 2002 low of 820. That works out to seven percent per annum, even without including dividends. But that is a difficult comparison, as it would have required great luck to acquire stocks during the brief period when the index was below 900. Investors are rewarded for their fortitude – not luck – so we believe it makes more sense to mark the lows at a level where one could have acquired (or liquidated) a large portfolio.
- From June 2002 through March of 2003, the VLE averaged about 1,000, as it was in a bottoming process over that nine month period. By comparison, the index averaged 2300 over the course of 2007. Using these figures, the bull market lasted about five years and provided a gain of about 130 percent – about 18 percent per annum before dividends – using conservative estimates as to where you might have gotten in or cashed out.
- Using the same approach, the VLE average level since the end of September is about 1,500 (or 1,400 if you figure the average since the middle of October). On that basis, the bear market has taken back about 40 percent in roughly a year, after a five year gain of 130 percent. What remains at this point is a much smaller gain than previously anticipated, a gain that is either barely positive, or perhaps in the mid-single digits, on an annual basis.
- This result is not unusual to those who have studied market history. Over time, stock prices tend to track earnings growth (see figure overleaf) and the broad economy. Gross domestic product (GDP) in the U.S. has been rising about six percent per year before inflation adjustment since 1980, while the earnings growth trend shown on our chart is about nine percent. Of course, a contraction in the economy pulls both GDP and earnings lower, and a severe recession may interrupt these trends for several years.
- But economic growth depends importantly on growth in population and productivity, and it is reasonable for investors to continue to rely on these trends. A recovery, when it occurs, will provide an opportunity for earnings and the economy to grow faster than the long-term trend, probably for several years.
- Consensus forecasts for GDP (before inflation adjustment) in 2009 have fallen from +4.8 percent at the start of this year to +1.6 percent at the beginning of November, and our own economics team is somewhat less optimistic. Earnings expectations have likewise been falling; anticipated growth of +7 percent in January has given way to an expected decline of -2 to -5 percent, using published estimates. The sharp decline in stock prices this year suggests that equity analysts – and the companies that guide them – have more work to do cutting their forecasts.

Corporate Earnings are Rolling Over Again After a Multi-Year Run; Eventual Recovery Depends on How Long and How Deep the Earnings Decline Will Be



Note: Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment. Source: Value Line.

The chart provides a 40-year perspective of equity market appreciation in the context of earnings growth. The two vertical axes have been scaled so that the price/earnings multiple is exactly 15x whenever the two lines are crossing. Note that stocks have risen faster than earnings over the period, as the P/E ratio has risen significantly since the mid 1970s. Note also how stocks typically anticipate changes in the earnings trend, both on the way down and again on the way up.

We believe that investors seeking capital appreciation in the stock market should keep a few important points in mind:

- 1) Stocks historically tend to provide an average annual return in the high single digits, including both bull and bear markets.
- 2) Identifying market bottoms and tops with any precision is impossible, so we track a variety of indicators, and we try to ignore the short-term volatility through the use of an averaging process.
- 3) Bull markets historically tend to last several years and have often provided investors with significant gains from the lows.
- 4) Bear markets are typically short and brutal, but we continue to believe they provide an opportunity for investors to position themselves for the next up leg.

Tom McManus

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The Value Line Arithmetic index is an unmanaged, unweighted index of 1700 stocks providing a broad indicator of price movement. Individual investors cannot directly purchase an index. Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation and political and economic changes. This may result in greater price volatility. The prices of small cap stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that these movements or trends can or will be duplicated in the future.

Additional Information Available Upon Request

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