



Mud or Stars?

A humble case for long-term optimism regarding U.S. equities

Updated April 2009



Muddy Outlook May Signal Upside Opportunity

“Two men look out the same prison bars;
One sees mud, the other stars”

- Frederick Langbridge

- Abysmal investor sentiment indicates that most see “mud” in early 2009
- Contrary to consensus, equities offer strong long-term upside potential
 - Economy faces painful deleveraging process
 - But everyone knows this
 - And:
 - Trajectory of economic downturn has gone from vertical decline to something more moderate
 - Some leading economic indicators ticking up
 - Potential economic trough in 2H 2009?
 - Widespread disbelief in market rally since early March 2009
 - Among professionals, performance anxiety could fuel intermediate-term rally
 - Among individuals, sub-1% returns on money markets could become tiresome
- Very important to focus on where stocks are going and *not* where they’ve been (although this is easier said than done)
- History offers strong basis for longer-term optimism



Nothing in this presentation is intended as an offer or a recommendation to purchase or sell securities.

The Irony of Consensus: 2000 versus 2009



“ ... Time to celebrate. This month, the current economic expansion became the longest in U.S. history. The boom has done more than create millions of new jobholders and stock owners. It has also restored the public’s confidence and given more people than ever a shot at the American Dream. We tell the story in HOW PROSPERITY IS RESHAPING THE AMERICAN ECONOMY.

- **BusinessWeek**
February 14, 2000



“ ... The crash of 2008 continues to reverberate loudly nationwide—destroying jobs, bankrupting businesses, and displacing homeowners. But already, it has damaged some places much more severely than others. On the other side of the crisis, America’s economic landscape will look very different than it does today. What fate will the coming years hold for New York, Charlotte, Detroit, Las Vegas? Will the suburbs be ineffably changed? Which cities and regions can come back strong? And which will never come back at all?

- **The Atlantic**
February 12, 2009



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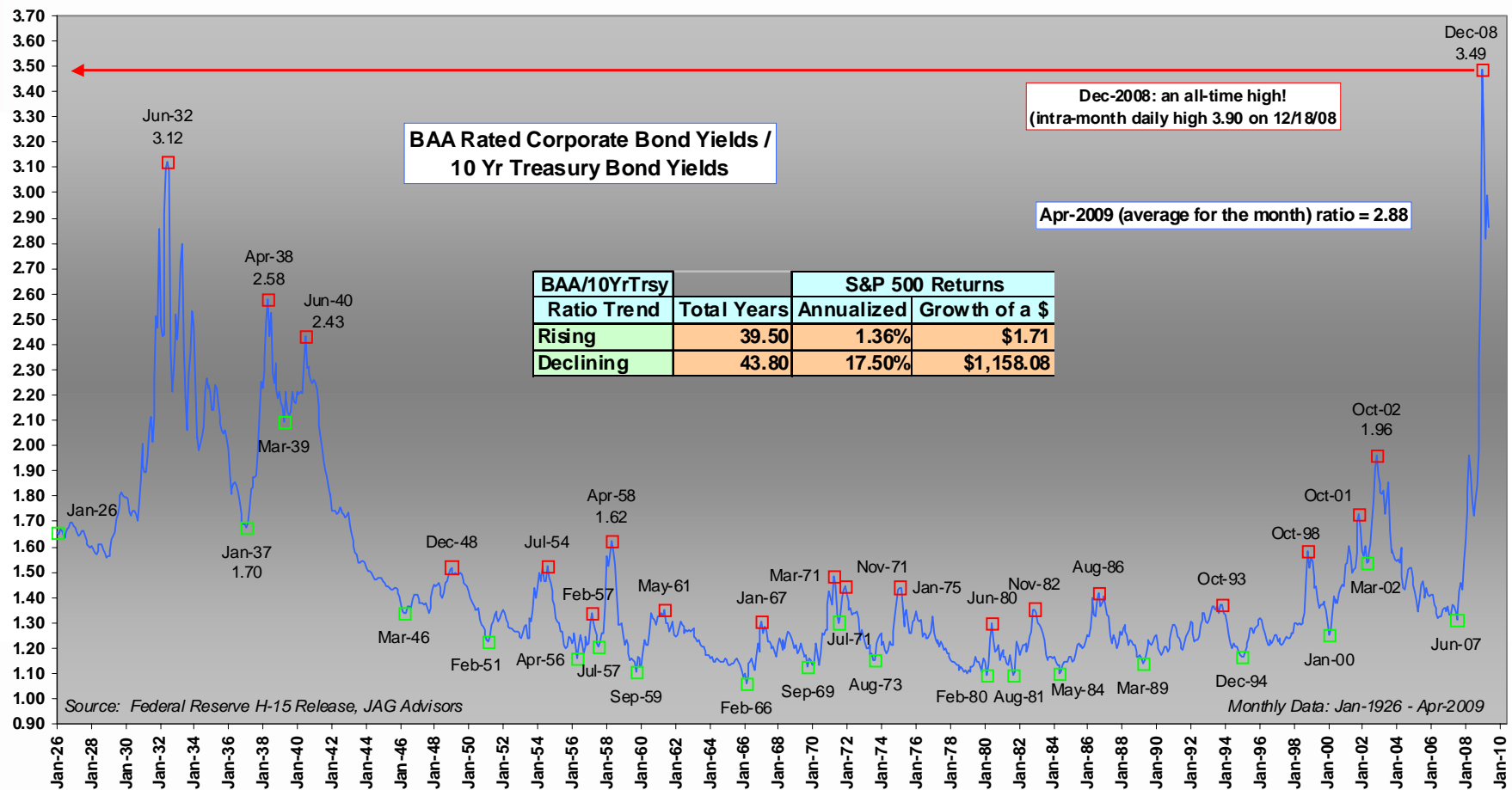
Credit Markets Are Key to 2009/2010

- Credit spreads provide insight into market's overall appetite for risk
 - Top of capital structure (bonds) must function more normally *before* equities can post a sustained rally
 - Equities (common stocks) tend to struggle when risk appetite falls (i.e. when credit spreads rise)
 - Conversely, when risk appetite increases (i.e. credit spreads tighten), equities tend to generate outsized gains
- The bad news...
 - Credit spreads still show signs of dislocation and risk aversion
 - Investment-grade spreads remain wider than pre-Lehman levels
- The good news...
 - Spreads have tightened meaningfully since early/mid-December
 - If this improvement continues into summer 2009, it would bode well for equity performance



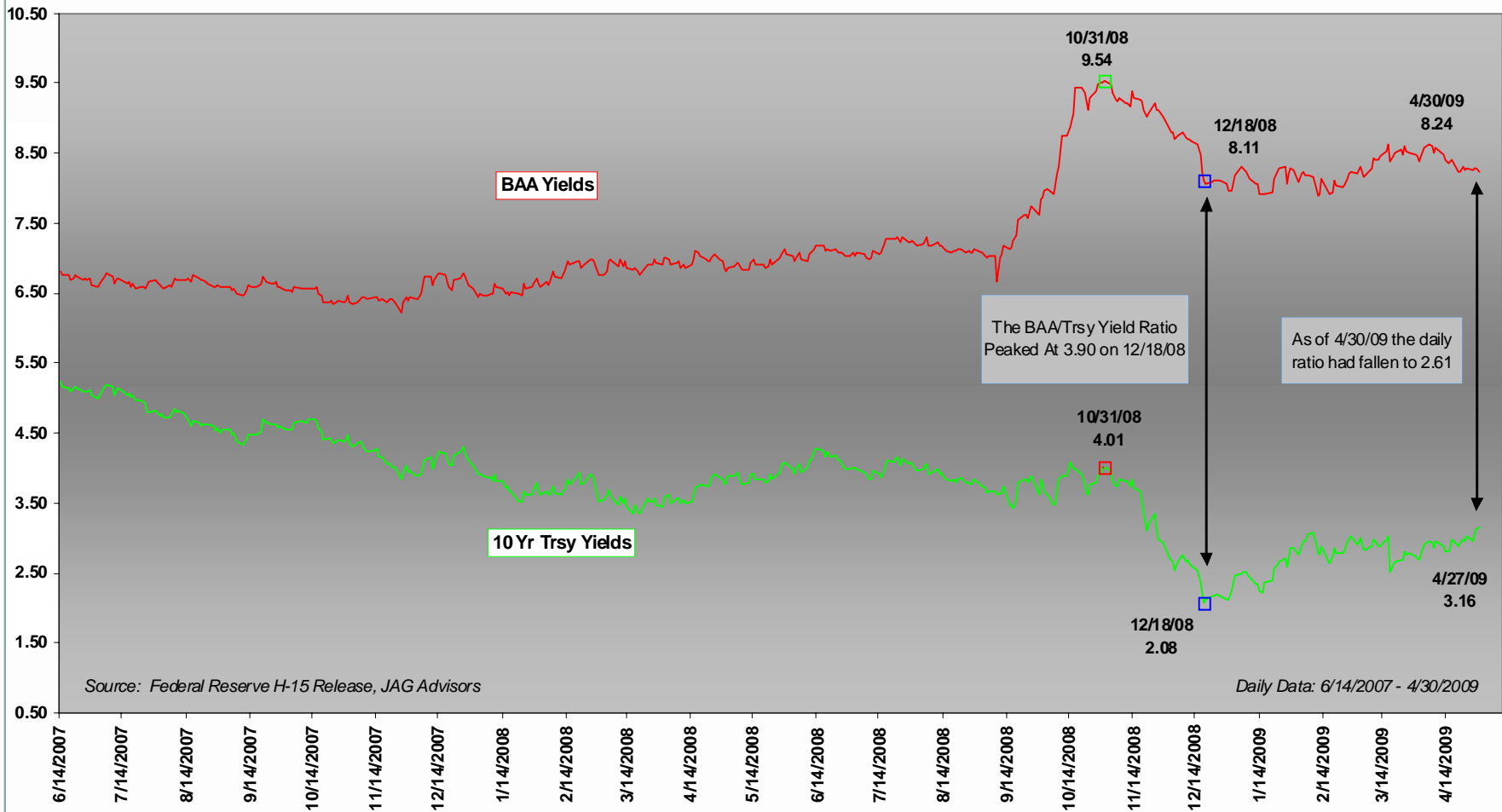
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Declining Yield Ratios A Plus For Stocks



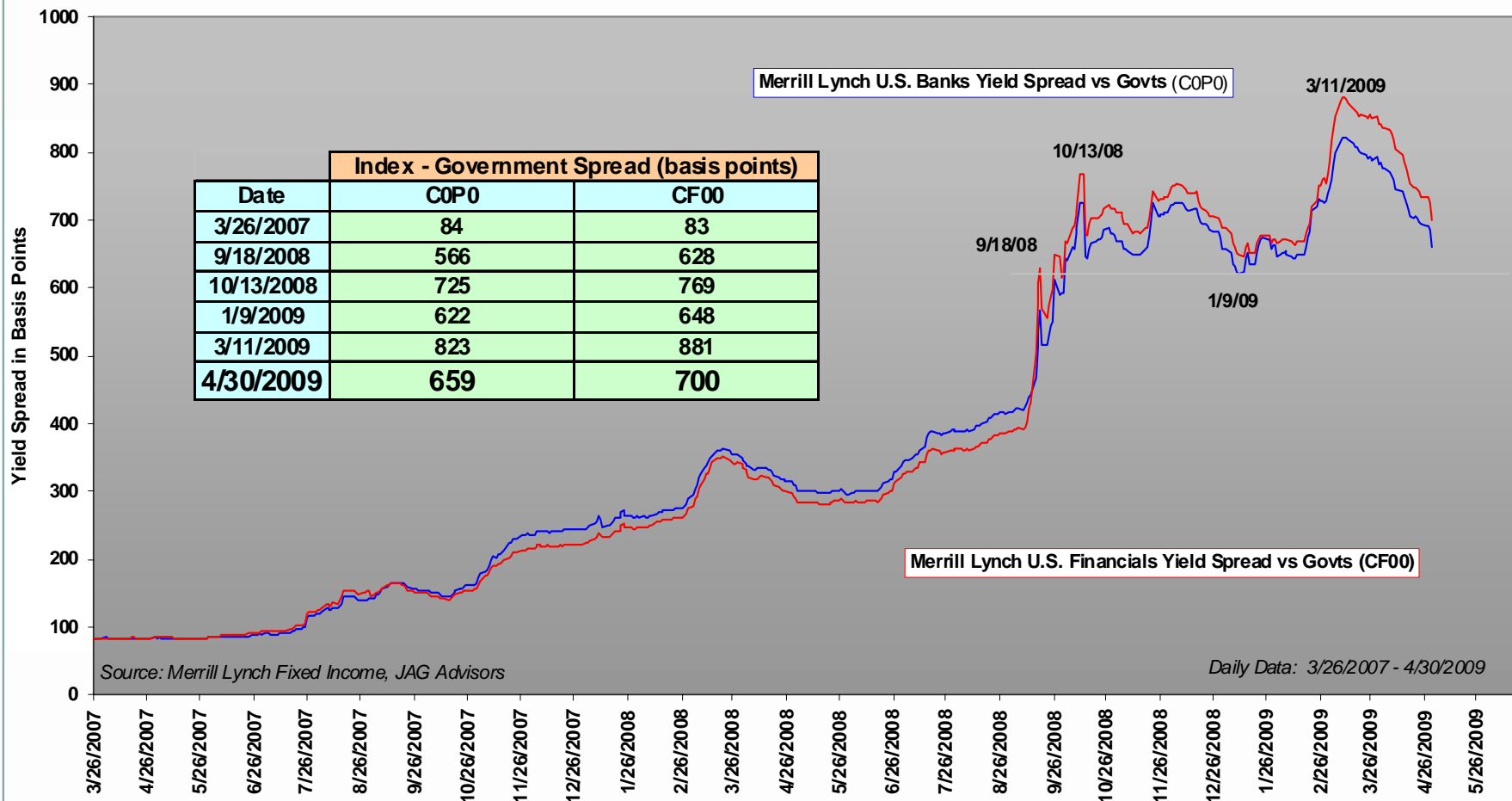
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Baa Yields Are Down, Treasury Yields Are Up



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Recent Tightening In Financial Debt is Bullish



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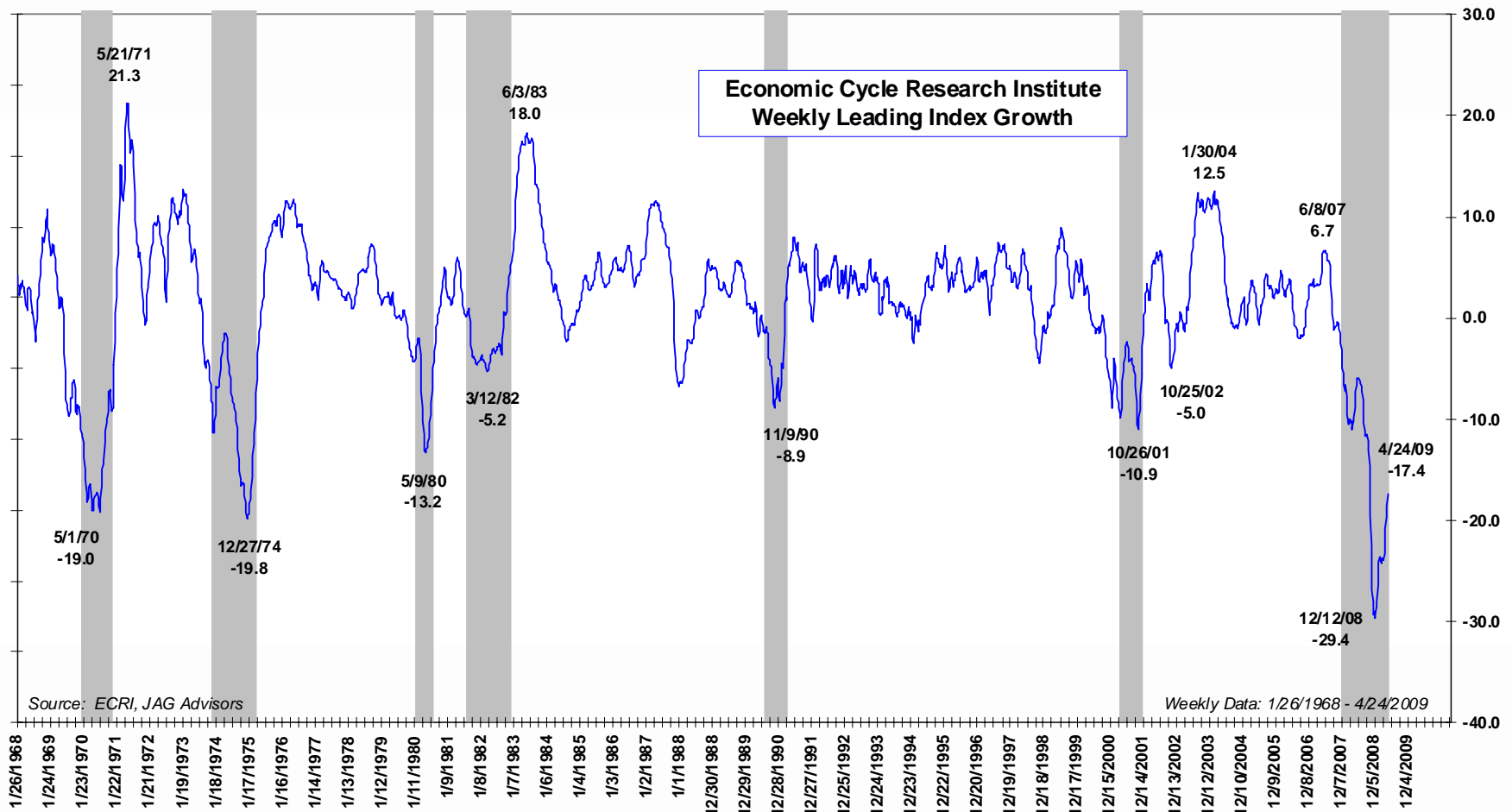
Economic Outlook: From Worse to Bad

- Downward trajectory of economy is flattening out
 - The delta between a “straight down” economic trajectory and “slowing rate of decline” is worth *some* higher multiple on stocks
 - If economy bottoms before year-end 2009, current capital market rally will turn out to have been justified
 - Potential signs of economic trough by 2H 2009:
 - Leading economic indicators are ticking up
 - Jobless claims losing velocity
 - Commodity price increases are signaling potential reflation
 - Higher shipping activity could point to global demand improvements
 - Real estate prices showing (small) signs of life



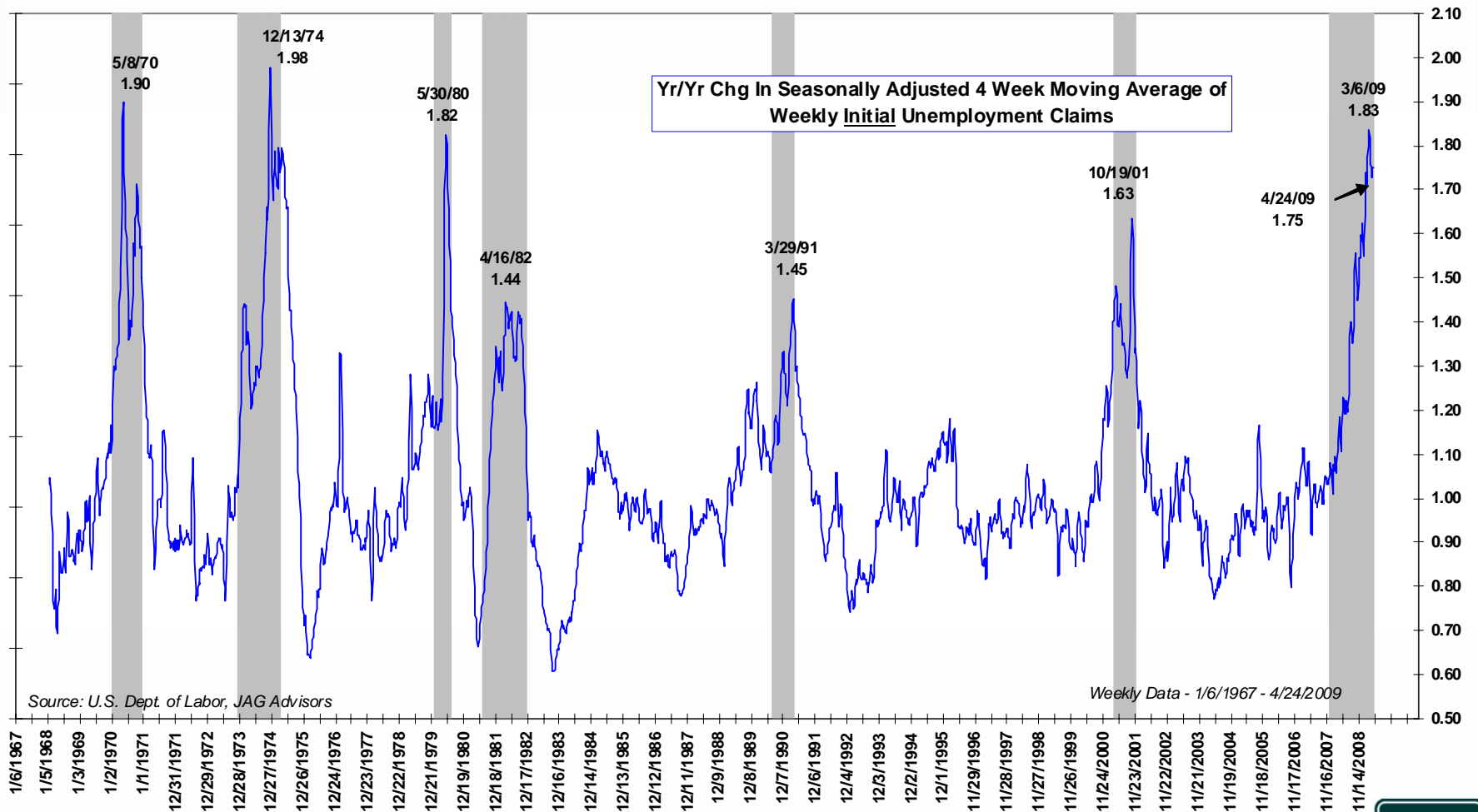
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Uptick in Leading Indicators



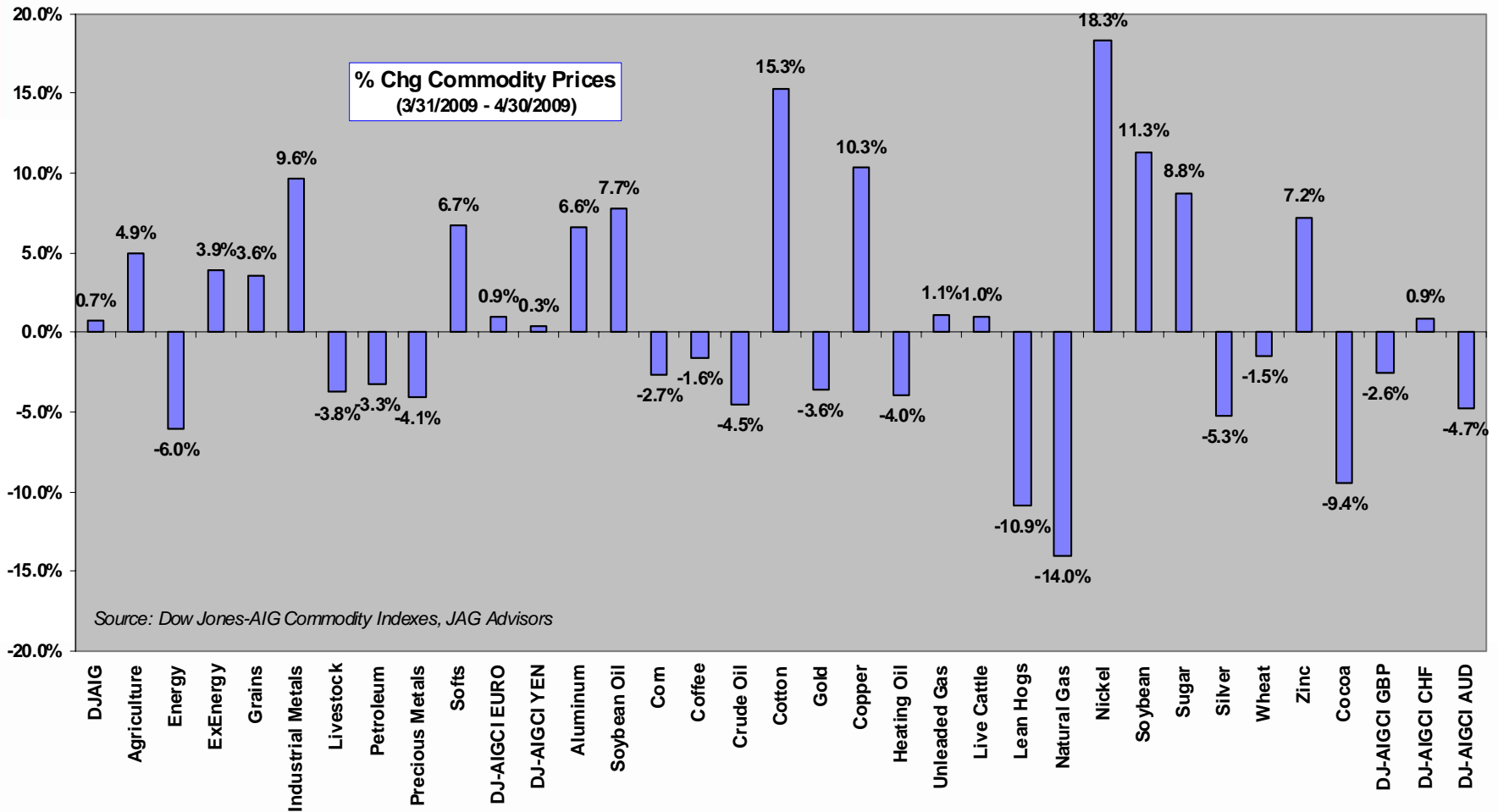
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Jobless Claims Peaking?



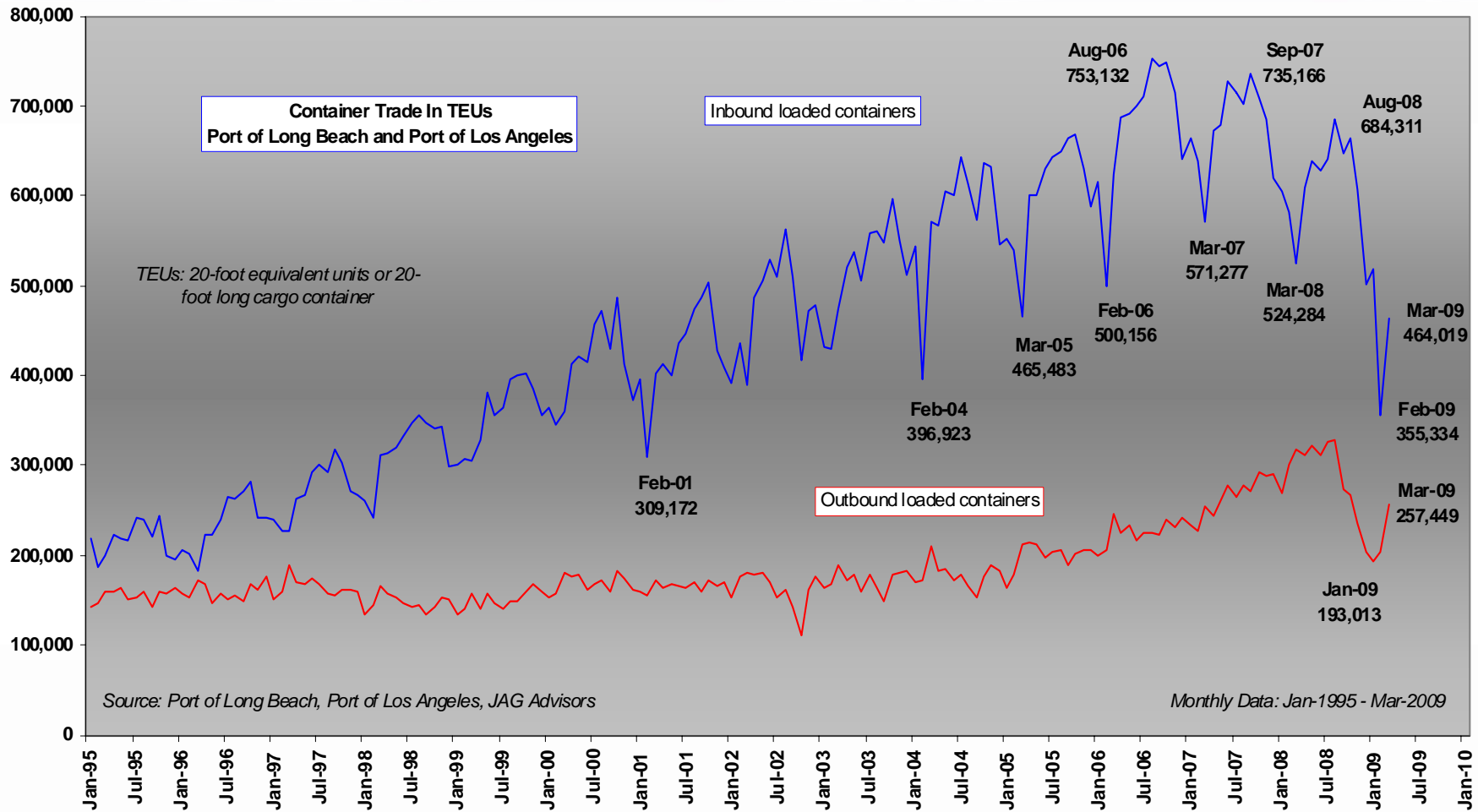
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Signs of Life in Commodity Prices



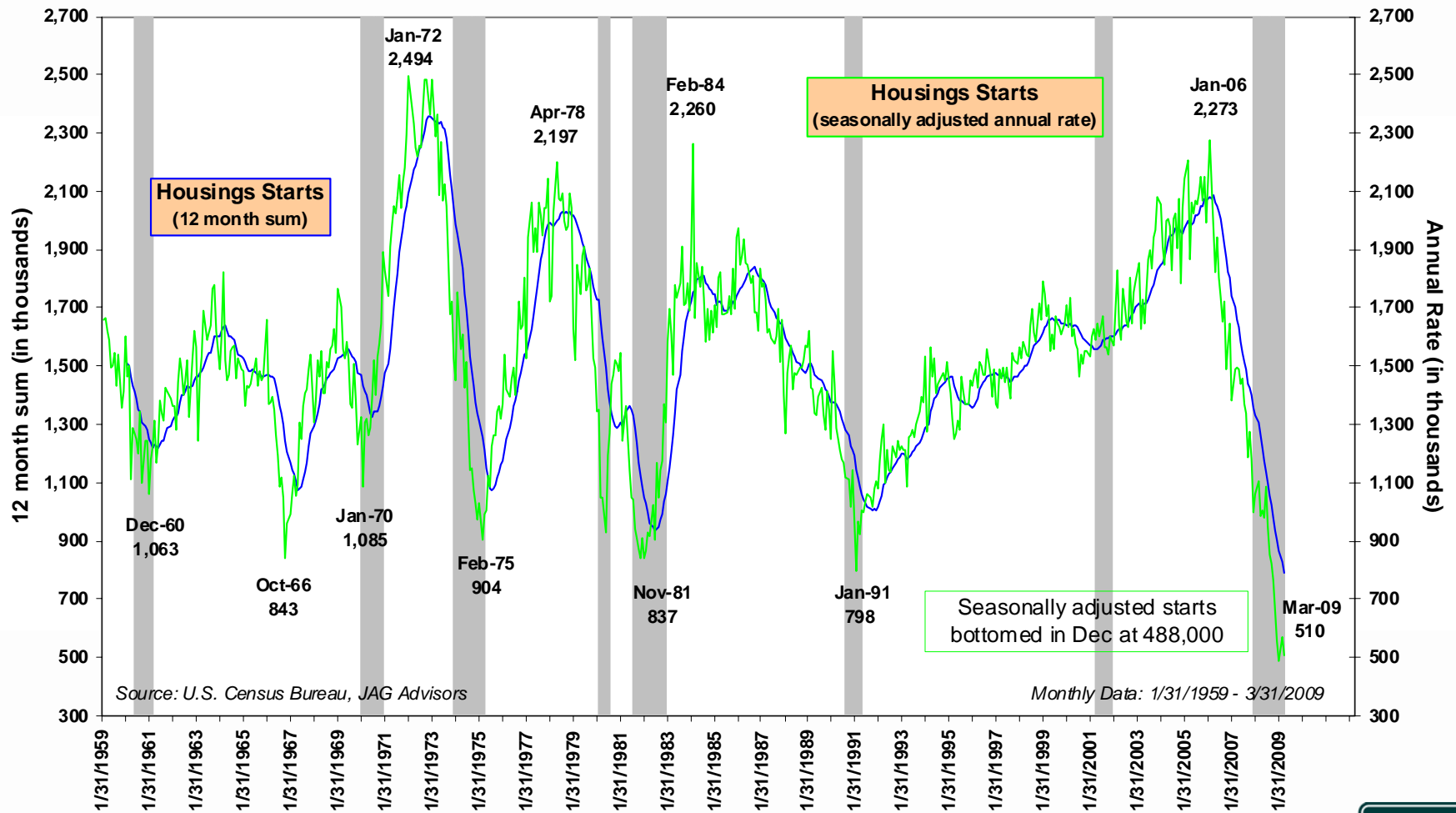
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Container Activity Ticking Up



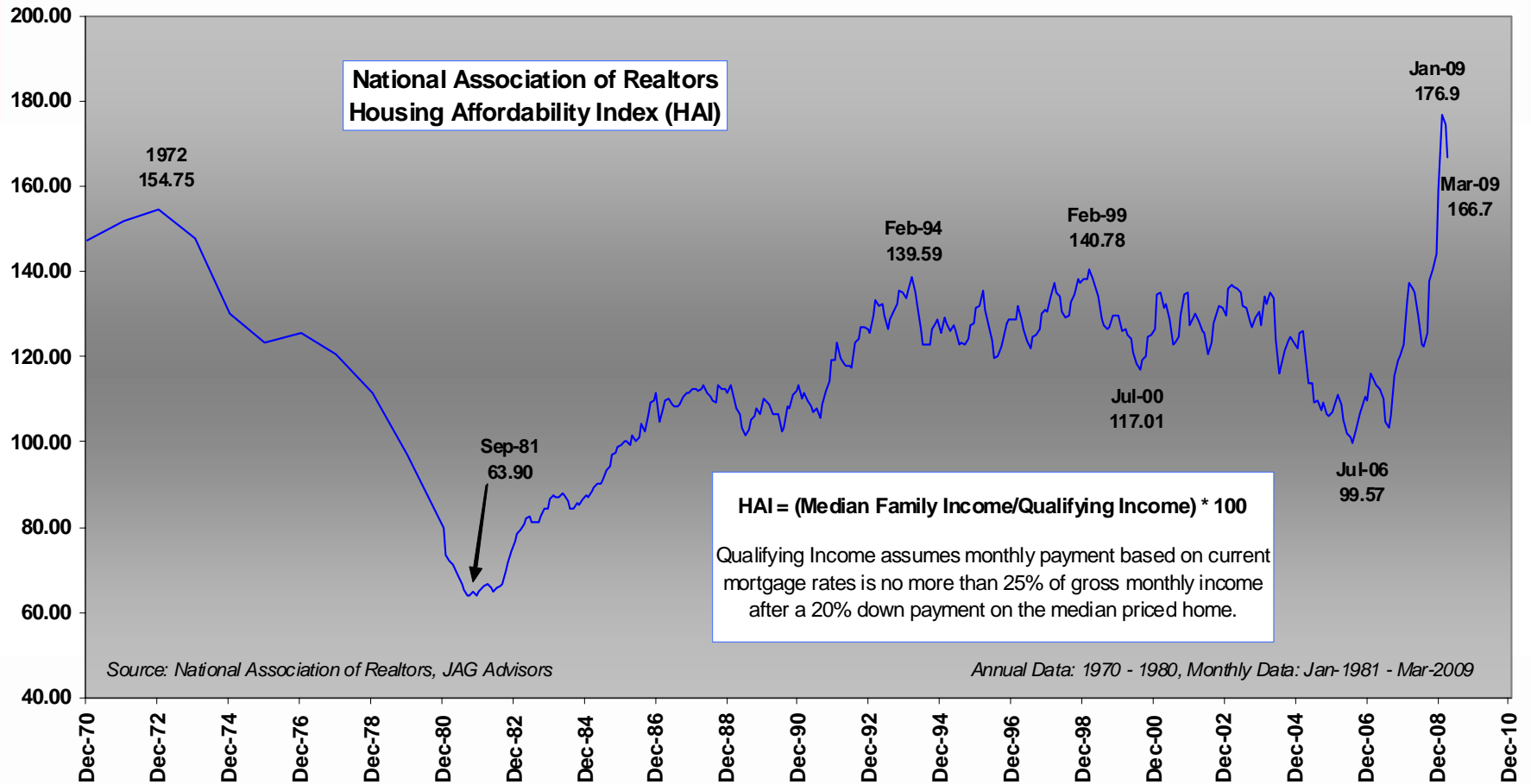
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Potential Multi-Decade Bottom in Housing Starts



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Seeds of A Recovery - Homes More Affordable Than Ever



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Technically Speaking, Current Rally May Have Legs

- Market breadth is a widely used type of technical indicator that tracks the number of stocks advancing and declining in price each day
- One measure of market breadth is called the 10 day Advance/Decline Ratio (10d A/D Ratio)
- This simple indicator is calculated by dividing the sum of advancing stocks by the sum of declining stocks over rolling 10 day periods
- Higher ratios are bullish as they indicate broad participation in a rally
- Ratios above 2 are rare and have been followed historically by strong up moves in stock prices



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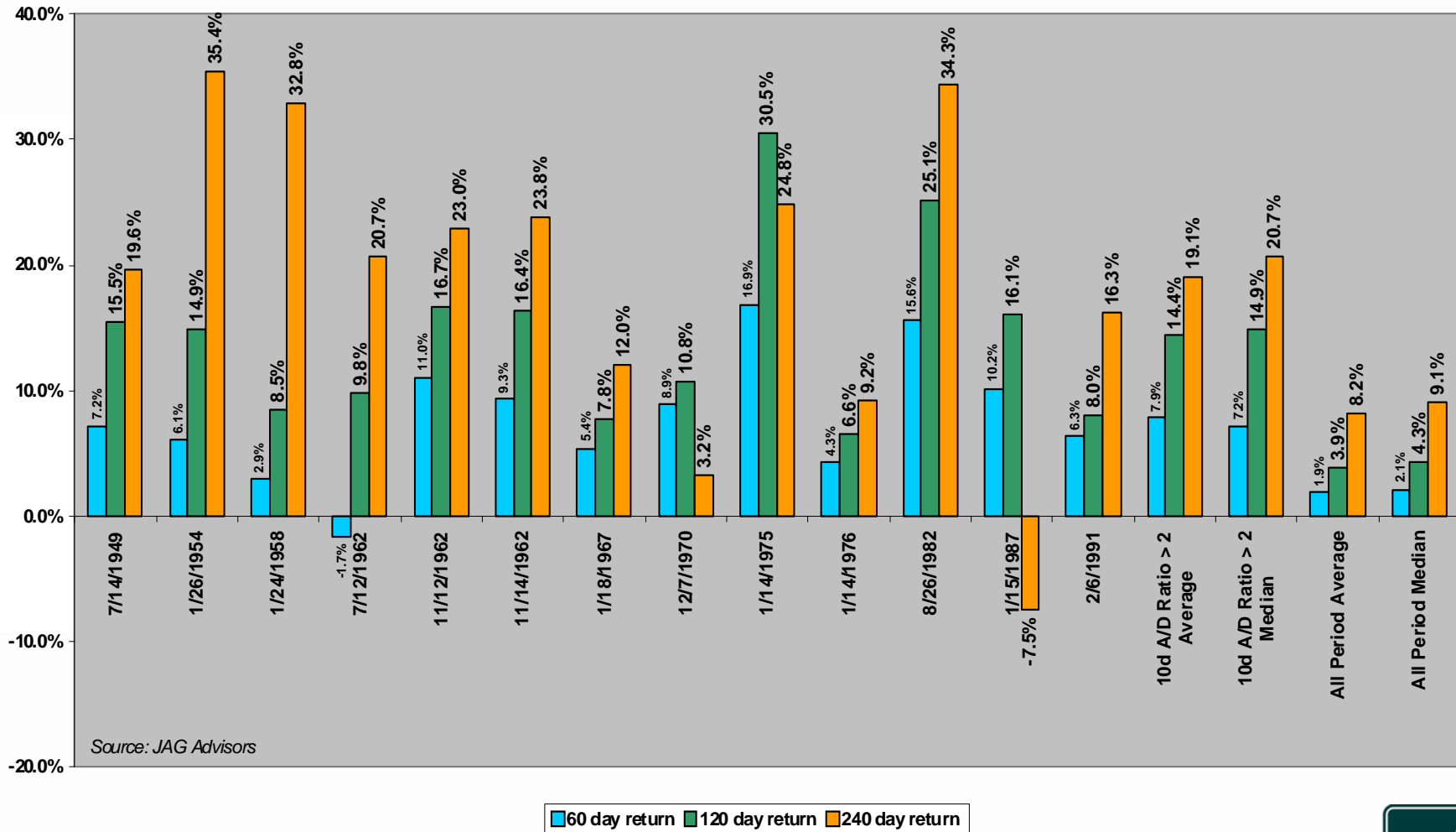
Rare Technical Signal Shows Market's Strength

#	Date	10d A/D Ratio	SP500 % Chg (after 10 day A/D Ratio* > 2)		
			~ 3 mos.	~ 6 mos.	~ 1 yr.
1	7/14/1949	2.07	7.2%	15.5%	19.6%
2	1/26/1954	2.01	6.1%	14.9%	35.4%
3	1/24/1958	2.00	2.9%	8.5%	32.8%
4	7/12/1962	2.28	-1.7%	9.8%	20.7%
5	11/12/1962	2.50	11.0%	16.7%	23.0%
6	11/14/1962	2.12	9.3%	16.4%	23.8%
7	1/18/1967	2.14	5.4%	7.8%	12.0%
8	12/7/1970	2.12	8.9%	10.8%	3.2%
9	1/14/1975	2.46	16.9%	30.5%	24.8%
10	1/14/1976	2.53	4.3%	6.6%	9.2%
11	8/26/1982	2.68	15.6%	25.1%	34.3%
12	1/15/1987	2.36	10.2%	16.1%	-7.5%
13	2/6/1991	2.17	6.3%	8.0%	16.3%
14	3/23/2009	2.21	?	?	?
After 10d A/D Ratios > 2		# of Observations	13	13	13
		Average	7.9%	14.4%	19.1%
		Median	7.2%	14.9%	20.7%
		% Up	92.3%	100.0%	92.3%
		% Dn	7.7%	0.0%	7.7%
		Best	16.9%	30.5%	35.4%
		Worst	-1.7%	6.6%	-7.5%
All rolling 60, 120, 240 day periods since 7/14/1949		# of Observations	15,038	15,038	15,038
		Average	1.9%	3.9%	8.2%
		Median	2.1%	4.3%	9.1%
		% Up	64.4%	68.3%	71.2%
		% Dn	35.6%	31.7%	28.8%
		Best	38.9%	41.6%	65.5%
		Worst	-41.3%	-45.4%	-50.4%



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10 Day A/D Ratio > 2 Bullish For Stocks



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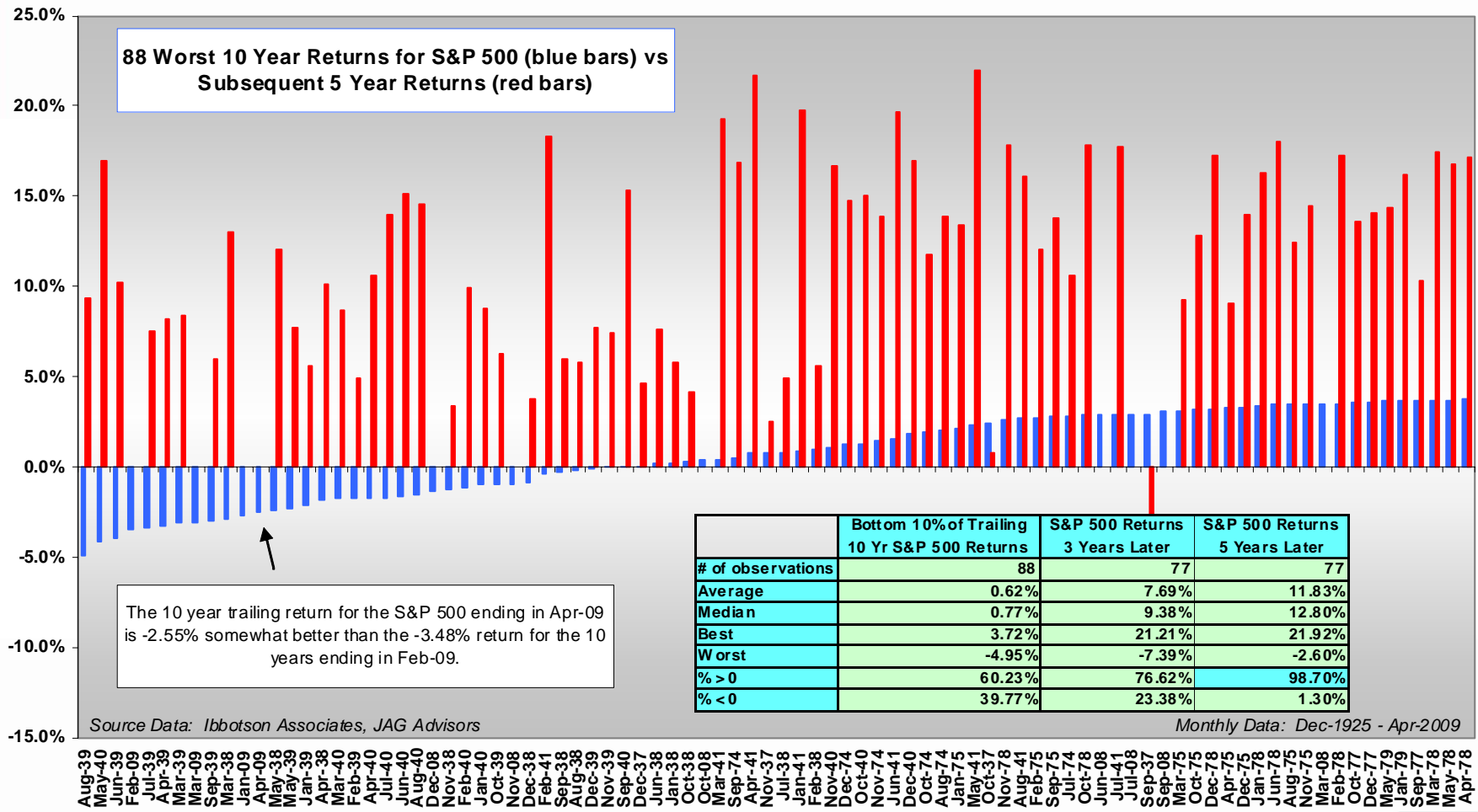
(Thankfully) Mean Reversion Works Both Ways

- The last ten years of U.S. equity performance has been horrific
 - The nominal trailing ten-year return of the S&P 500 for the period ending 3/31/09 was the worst since 4/30/1939
 - In real terms, the last ten years were the worst ever
- However, market history gives strong justification to optimism
 - If history is any guide, the next three to five years *should* be much better
- We examine mean reversion through several prisms:
 - Rolling total returns (nominal and real)
 - Total return wealth index
 - Deviation from inflation-adjusted trend line
- Bottom line: stocks are likely to post much better nominal and real returns over the coming years
 - Clients are hiding in low-return cash assets because of “sunk cost” bias and myopic loss aversion
 - Cash is likely to move from “King” to “Trash” in coming years
 - Especially if inflation ramps up!



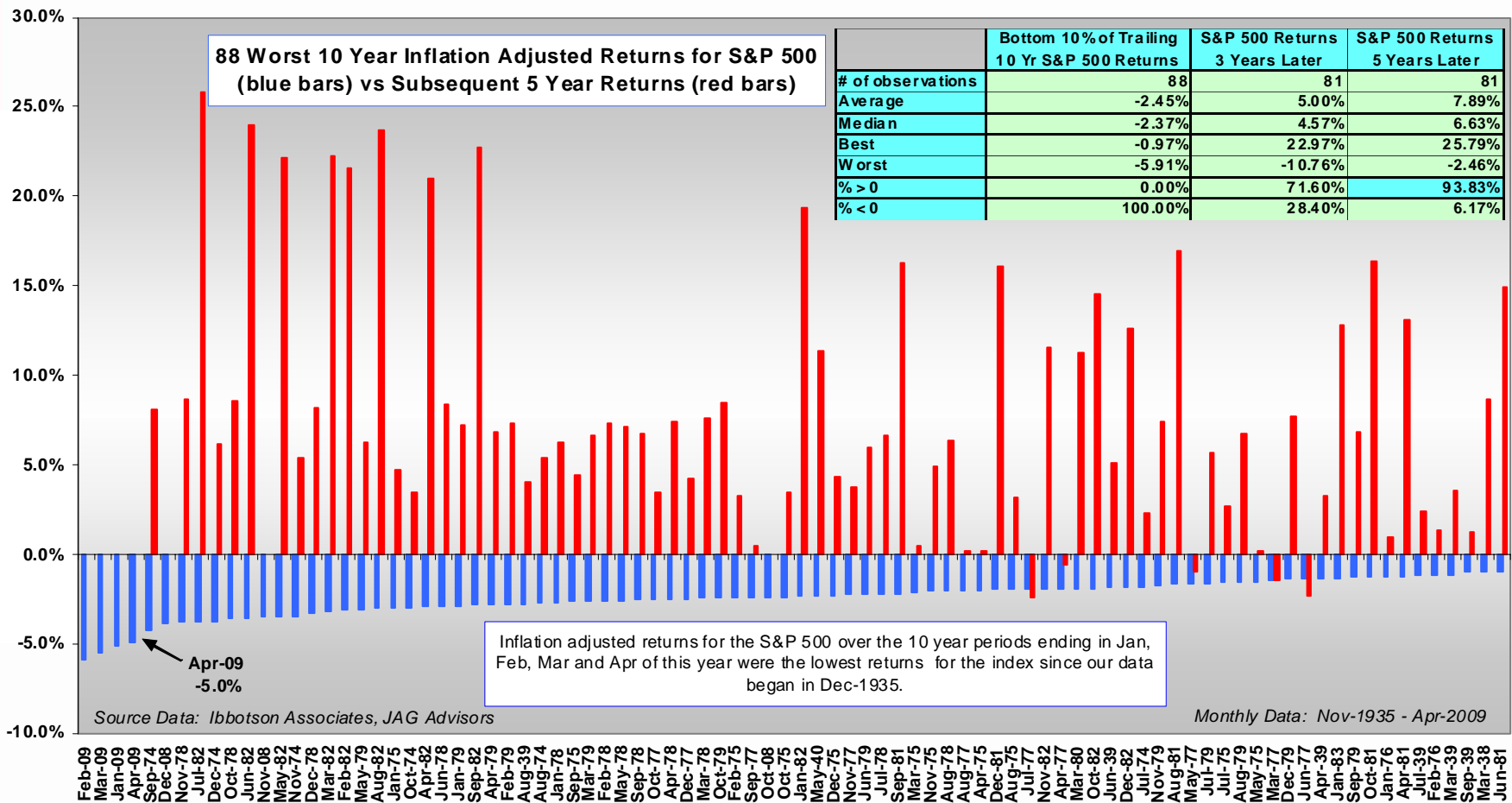
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In Nominal Terms, Good Follows Bad 99% of the Time



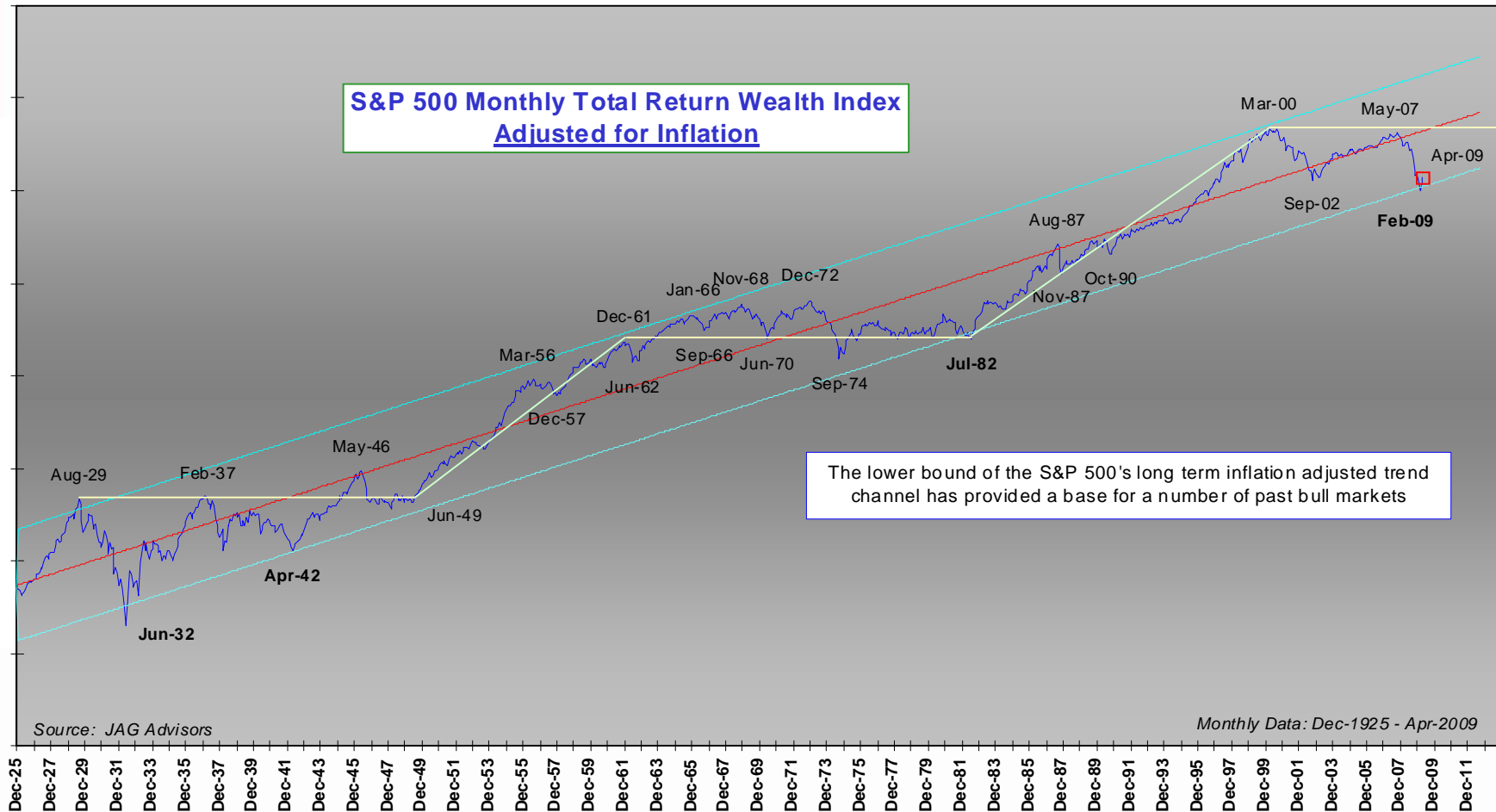
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Adjusting For Inflation, Good Follows Bad 94% of the Time



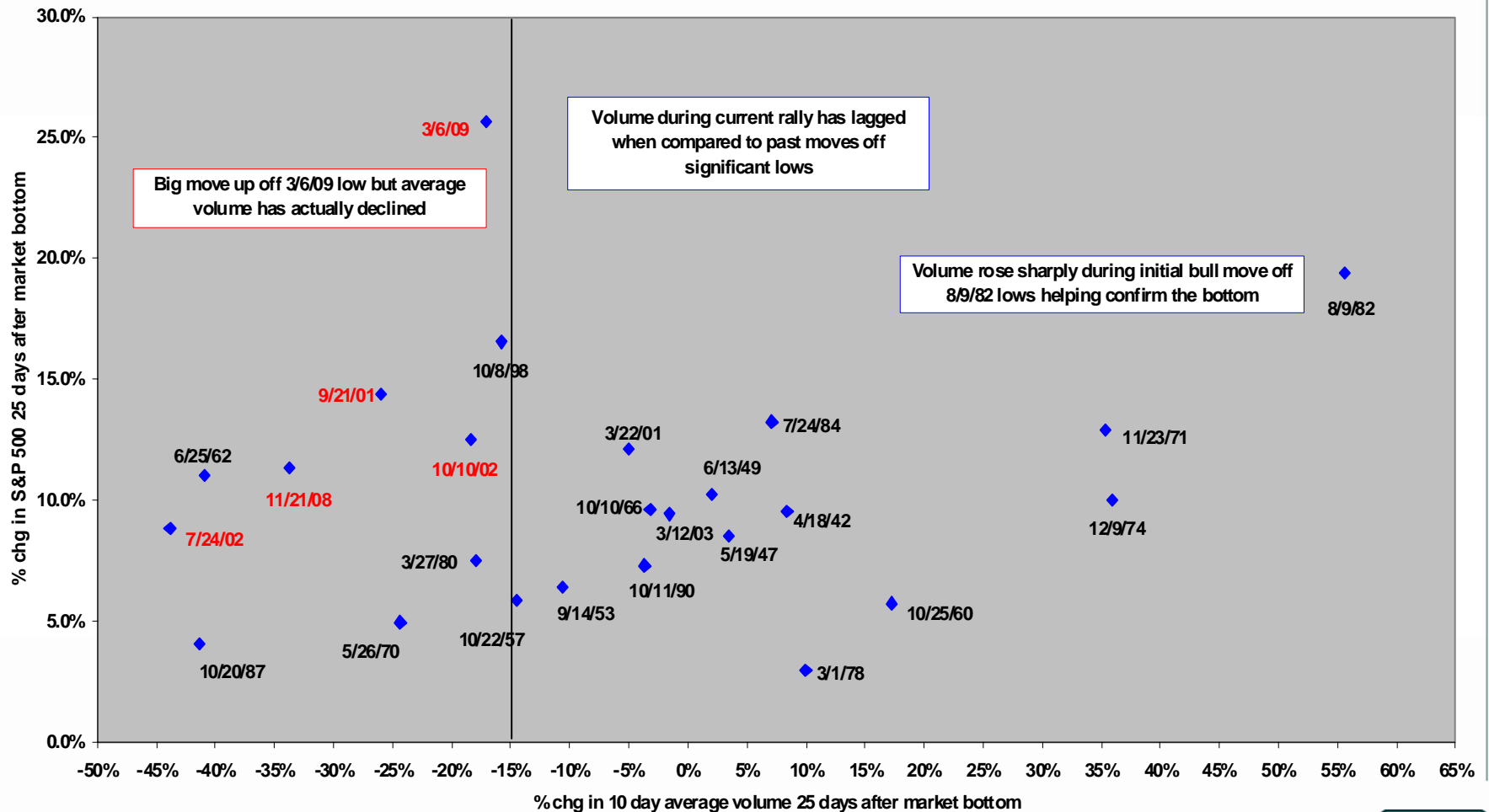
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Lower Channel Provides Support



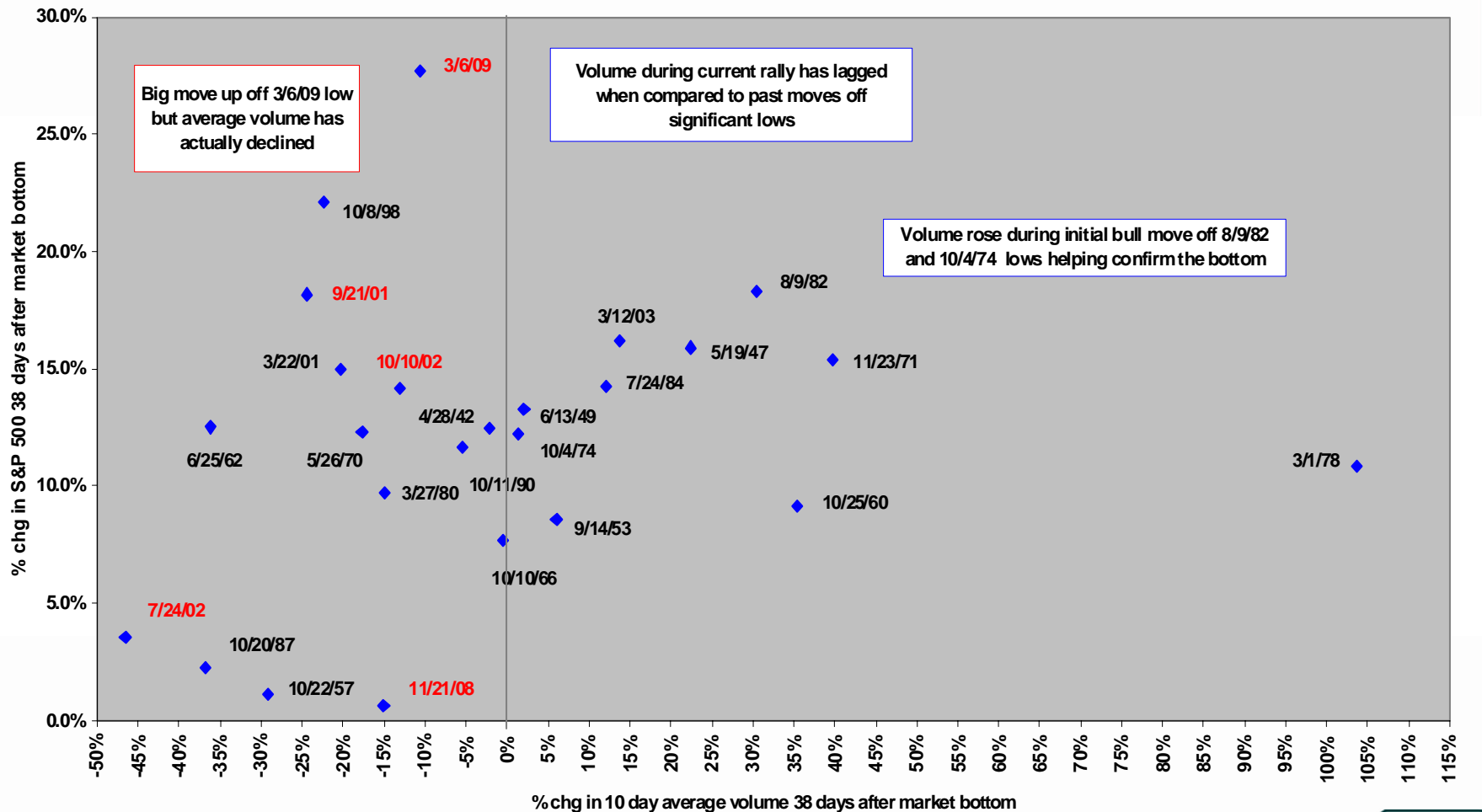
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Big Rally But It Isn't Perfect – Volume Lags



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Big Rally But It Isn't Perfect – Volume Lags



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Conclusions

- Short term is uncertain (as always)
- Investors need to focus on long term (as always)
- Long term outlook for equities is favorable, if history is any guide
 - This does not mean that a raging bull market is imminent
 - It *may* mean that markets will improve before most expect them to
- Sunk costs are sunk
 - The equity markets have turned every \$1 invested into \$.50 or \$.60 over the past 15 months
 - The question is: “Where do I put that \$.50 or \$.60 to realize an attractive potential return net of inflation?”
 - We think equities are part of the answer
 - (Although we realize that many would not agree with us!)
- No need to “bet the farm”
 - **OBVIOUSLY** investors should avoid leverage and tread cautiously into structured investments
 - Prudent asset-allocation rebalancing, over a period of months, is probably the right thing to do... Radical portfolio shifts are **NOT** advisable



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