

The Market's Message

Douglas Porter and Robert Kavcic

The 50% bounce in the S&P 500 in the five months since its March low has prompted plenty of catcalls and profound scepticism whether equities have gone too far, too fast, in what has been deemed the least loved bull market in history. Many wonder openly about the wisdom of paying near-normal valuations for stocks when the recovery is only in its infancy and is thus fragile, and when the almost universal view is that economic growth will be, at best, sub-par even as the recovery fully gets under way. But one could turn the logic on its head: just as stocks did a great job of first signalling the depth of the Great Recession, then acting as an early warning sign in the spring that the worst was nearly over for the economy, they may now be pointing to a stronger-than-consensus recovery in growth.

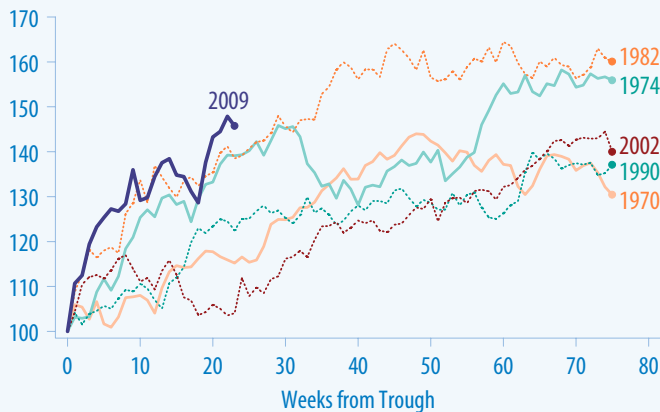
The S&P 500 surge from its March low is now the strongest post-recession stock rebound of the postwar era. Indeed, the 50% bounce in a mere 23 weeks outperforms all other post-recession rallies, and is rivalled only by those in 1982 and 1974 (*Chart 1*). Interestingly, those two economic recoveries were decidedly strong, with U.S. real GDP surging as much as 6.2% y/y in the wake of the 1974 bottom and a massive 8.5% in the year following the 1982 equity market recovery. Equities are seemingly posing a serious challenge to the consensus view on growth.

However, another possible reason for the charged rally could be the extreme nature of the prior sell-off, which was similarly the worst of the postwar era (*Chart 2*). The S&P 500 shed more than half of its value in little more than 70 weeks, far outdoing the nasty 1970s bear markets and the tech-wreck in terms of both speed and depth. As a result, at least part of the recent resurgence in stock prices likely reflects the unwinding of depression-risk valuations.

Valuations have indeed expanded with the recent run-up in stock prices, but most metrics remain about in-line with their long-term averages. One preferred measure, the ratio of the S&P 500 to trend earnings, reached the lowest level since 1985 in March, but has since rebounded to about 18-times—right in-line with the long-run average (*Chart 3*). Interestingly, March's ratio of 15-times trend earnings just so

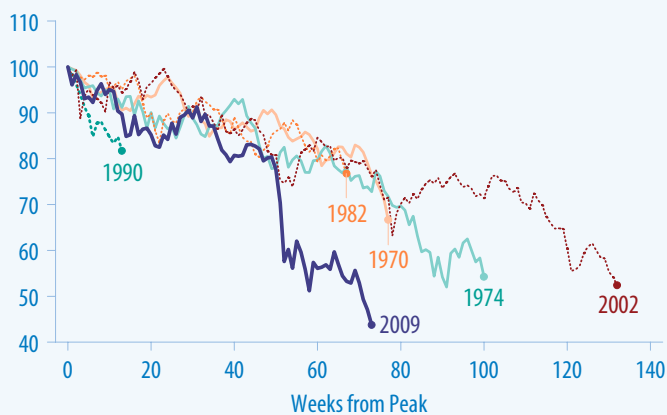
**CHART 1
COMPARING THE RECOVERIES**

S&P 500 (trough = 100)



**CHART 2
COMPARING THE RECESSIONS**

S&P 500 (peak to trough : peak = 100)



**CHART 3
VALUATIONS IN CHECK**

S&P 500 Price/Trend Earnings (\pm one standard deviation)

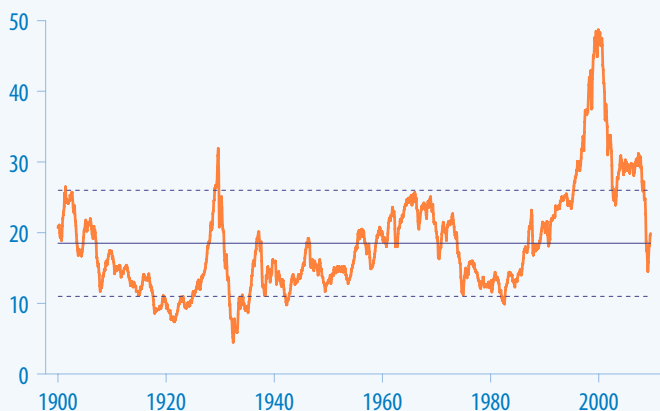


CHART 4
S&P 500: AVERAGE RETURN BY MONTH
 1950 to present (percent)

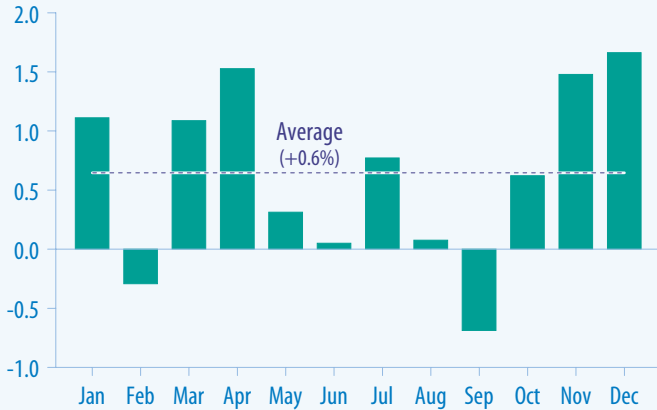


CHART 5
OECD LEADING INDICATOR – TURNING THE CORNER

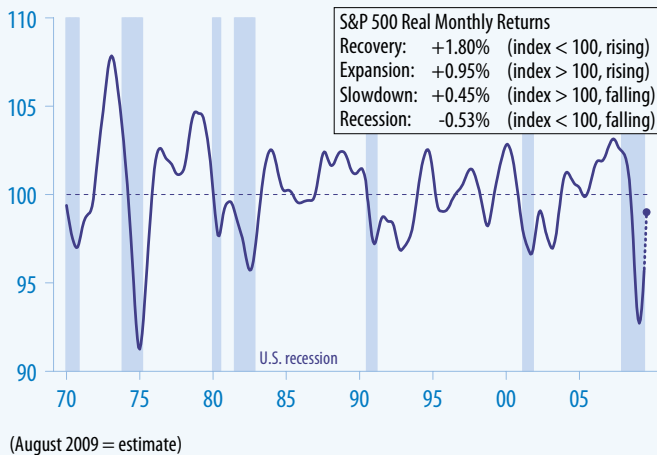


CHART 6
RECOVERY: IN SOME SECTORS
 U.S. ISM Manufacturing Index



happened to match the postwar average recession trough valuation. A fair point is that it may not be appropriate to assign normal valuations in an environment where profits could take years to return to normal. But a counterpoint would be that the current extreme lows in interest rates should allow for higher-than-normal P/E ratios—10-year bond yields are less than half the average of previous postwar valuation troughs. Thus, while equities are not a screaming bargain (i.e., valuations have not fallen a full standard deviation below their mean, as they have at the end of past secular bear markets), valuations are not a major hurdle to further upside in stocks either. Equity markets appear to now be pricing in at least an average profit recovery. Applying a forward p/e multiple in the 15- to 18-times range suggests earnings expectations of between \$55 and \$66 over the next 12 months for the S&P 500—that would be as much as 50% upside over the past year.

Perhaps the biggest challenge for the equity market lies not so much in where it has been, but where it's going—right into the heart of the most dangerous part of the calendar. September and October have an extremely well-deserved reputation as a graveyard for many bull markets, a reputation that was all but cemented forever by last year's events. However, it's worth noting that over the past 40 years, there have been as many positive returns for the S&P 500 as negatives in those two months, and October's average returns are actually quite reasonable over time (Chart 4). One oft-cited reason for September weakness is that investors take a second, sober look ahead to next year's prospects after summer, and often find the outlook wanting. That may very well be turned on its head this year, as economic prospects for 2010 are being quietly nudged higher in many corners of the globe, but most notably for the U.S. economy.

Looking beyond the near-term seasonal headwinds, the bigger cyclical picture looks friendly for equities. Using the OECD leading indicator as a rough guide to the broad economic cycle, equities tend to perform best just as growth first begins to recover after a recession, which fits in extremely well with the experience of the past few months (Chart 5). But even as the recovery morphs into a more mature expansion phase, equities have continued to perform relatively well, even if not quite as robustly as during the initial recovery phase. The real problem for

equities only develops late in the cycle, after the expansion is fully mature—suffice it to say, we are a long way from that stage.

While few forecasters would dare call their outlook for recovery “V-shaped”, that’s exactly what a number of leading indicators are starting to look like. For instance, the U.S. ISM for manufacturers has quietly chalked up some impressive rebounds in both the production and new orders components (*Chart 6*). However, there are clearly a wide variety of measures that are much more “U-shaped”, such as home sales, exports and imports, and even auto sales.

Bottom Line: While stocks may face some important seasonal challenges in coming months, we do not see the market rebound as particularly overdone. Most valuation measures are far from stretched, the stage of the cycle is friendly for equities and, after one of the most vicious bear markets on record, the scope of the recovery is hardly shocking. However, it is fair to conclude that the easy gains have been made, and further advances will have to be earned the old-fashioned way—through a solid recovery in earnings.

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