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DHJ&A

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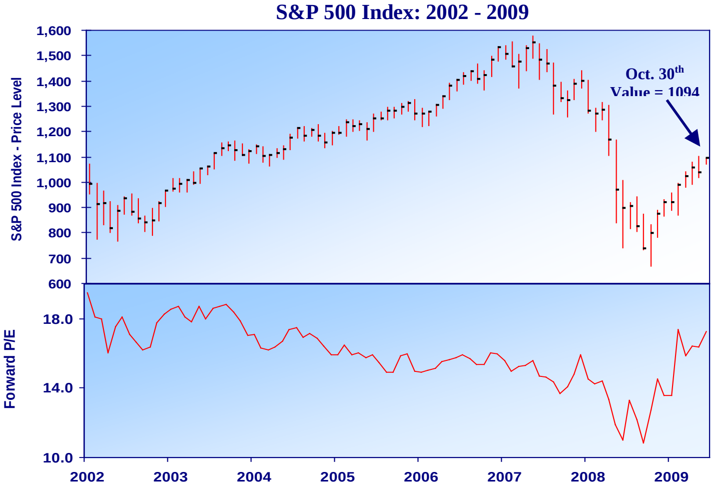
Now Earn It!

"We make money the old-fashioned way. We earn it." These were the reassuring words voiced by actor John Houseman in a memorable series of Smith Barney commercials back in the early Eighties. How apropos these same words are today in the context of the market's advance-to-date and what it will take for stocks to keep moving higher from here. The market has come a very long way in a very short period of time, up 60% since the bottom in early March. To this point, the advance has been largely the result of a "return to risk" trade that has seen investors pile into low quality and small-cap stocks. The fuel for which has been a mixture of raw hope, second derivative economic improvement (i.e., readings that are "less bad"), and stabilization of the recently imperiled credit markets. Though there is no guarantee that the advance will continue, further upside would appear to be a very strong possibility. However, from here stocks are going to have to start doing it the John Houseman way…by getting back to delivering good, old-fashioned, bottom-line earnings growth. Fortunately, it looks like that might be just what's in store.

As measured on the S&P 500, the stock market's forward price-to-earnings multiple, as low as 11X earlier this year, now sits at 17X. Though by no means cheap at current valuations, stocks are also not overly expensive when the combination of 2009 likely marking the trough for earnings delivery in this cycle and the current subdued interest rate environment are taken into account.

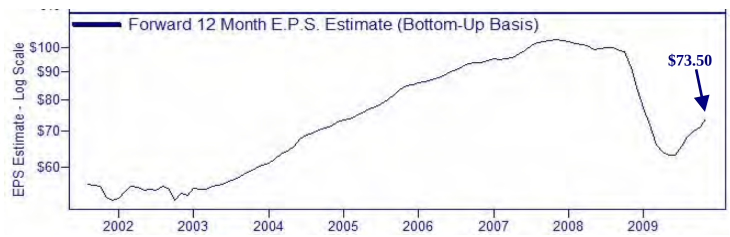
S&P 500 Index: 2002 - 2009



Source: Thomson Baseline

However, with the easy money already made and stocks best described as fairly valued at current levels, further upside will have to be driven by actual growth in underlying earnings not continued multiple-expansion. Despite a very tough first half of the year, recent earnings delivery and more importantly, rising forward expectations are supportive of this occurring.

As shown in the chart and table that follow, calendar 2009 earnings expectations fell off a cliff in the first half of the year. Expectations on December 31, 2008 were for the companies that comprise the S&P 500 to deliver 6% earnings growth in 2009 relative to 2008. Given the dramatic fall-off in business and consumer activity as the year began, public companies and the analysts that follow them aggressively lowered expectations for earnings delivery in 2009. By mid-year, consensus earnings expectations had dropped to a year-over-year decline of 17%.



Sources: Thomson Financial, Barron's, DHJA research

As the current year progressed, the worst-case scenarios that many companies were factoring in did not play out. As most companies moved very aggressively to cut expenses, the better-than-feared environment has allowed these companies to exceed conservative street expectations over the past two quarterly reporting periods. The better results were delivered despite the fact that top line revenues have remained disappointing for just about every economic sector with the exception of Information Technology. These recent earnings beats, improving order activity, and the translation benefit from the weakening of the U.S. dollar relative to other currencies have created the opportunity for significantly better earnings delivery in 2010. Resulting optimism is reflected in the current consensus bottom-up estimate for 26% earnings growth.

S&P 500: Projected Earnings Growth Rates

	2009 vs 2008					2010 vs 2009		
SECTOR	12/31/08	3/31/09	6/30/09	9/30/09	10/29/09	6/30/09	9/30/09	10/29/09
CONS DISCRETION	23%	-27%	-8%	-1%	2%	46%	37%	36%
CONS STAPLES	4%	0%	-2%	-1%	0%	10%	8%	8%
ENERGY	-30%	-54%	-57%	-58%	-58%	46%	48%	48%
FINANCIALS	344%	2031%	1669%	279%	287%	84%	77%	70%
HEALTH CARE	7%	1%	0%	0%	1%	10%	9%	8%
INDUSTRIALS	-9%	-28%	-33%	-35%	-34%	10%	12%	13%
INFO TECH	-4%	-19%	-15%	-11%	-7%	24%	26%	25%
MATERIALS	-34%	-57%	-69%	-62%	-57%	163%	119%	88%
TELECOM	1%	-23%	-19%	-21%	-25%	6%	5%	7%
UTILITIES	5%	-1%	-3%	-4%	-4%	8%	8%	7%
UNIVERSE AVG ($WGT)	**6%**	**-15%**	**-17%**	**-10%**	**-8%**	**28%**	**27%**	**26%**

Source: Thomson Baseline

Though this 2010 year-over-year growth rate expectation appears lofty, it is largely due to the easy comparisons created by the dramatic downturn this year. Also rather encouraging is the fact that 2010 earnings growth is expected to be broad-based across economic sectors. Given aggressive cost actions within all industries, any improvement in revenues above current expectations should add significantly to earnings delivery.

Even if expectations were to prove a bit too optimistic, the market's current price/earnings multiple of 17X on a $70 2010 earnings number would still equate to an S&P of roughly 1200, over 100 points above its current level. A value of 1200 would only get the S&P back to where it was trading at in September of 2008, prior to the meltdown in the credit markets and the massive selloff that resulted. It is also important to remember that this level was itself meaningfully lower than the late 2007 high, a reflection of the unfolding economic recession.

Yes, the market has already come a long way in a very short time and no, it is not cheap. Yes, there is still a lot of uncertainty and no, this is not likely to change anytime soon. However, despite all this, there is definite reason to believe the market can continue its advance. Now it will just be doing it the old-fashioned way, by earning it.

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