



THE GREAT TRANSITION

2009: The Year that Wasn't

2009, the last year of the first decade of the 21st century, nearly became the first year of a modern dark age, the ramifications of which make the Great American Depression pale by comparison. Our modern age is like no other in that the developed world no longer has the collective skills to cope with economic ruin and the resulting social upheaval. This understanding frightened us to the core as the utter helplessness of our situation became increasingly apparent. The 2008 economic meltdown affected nearly every aspect of American life or severely testing our assumptions about prosperity and financial security.

In the end, 2009 was the year that wasn't as the fears of a Second Great Depression dissipated and became simply the Great Recession leaving behind a damaged economy and scarred political and corporate leaders and citizenry alike. Fortunately, policy makers have vast experience in handling recessions be they great or small. Although the methods employed by global monetary officials and governments have been controversial, the synchronized attack on the crisis finally stopped it in its tracks and in March the fears began to recede. Not surprisingly, as the global economy moved back from the abyss, world equity and credit markets began to recover at a dizzying pace. So much so that most investors refused to believe the turn was real and sustainable. At the end of 2009 however, the S&P 500 closed up 26.5% and a stunning 68% from its March 6th low. Similarly, the MSCI World ex USA Index posted a 33.7% return for the year and nearly 78% from its March 6th low. Unfortunately, many investors burned by 2008 bailed and missed out on the second best year for the S&P 500 during the decade bested only by the 28.7% return in 2003.

The Great Recovery

The Great Stabilization is the term used by *The Economist* magazine to describe our current position in this historic era arguing that the global patient while stable is at best frail.¹ But is this characterization influenced by the traumatic events of the past two years? Is the patient truly frail and subject to a relapse? Despite the 2007 - 2009 recession being the worst in a generation, it is nonetheless

a recession ultimately dictated by the rise and fall of the business cycle. And, yes, all recessions are different—led by the consumer, capital spending or credit—but in the end this recovery is playing out in a classical manner. Although myriad challenges remain and surely new ones will arise, 2010 is more likely to be the year of the *Great Recovery*.

While the range of opinions remains as broad as ever, the unfolding Great Recovery is firmly grounded in current economic fundamentals, namely recoveries in employment and corporate profits as well as surging government spending. Most economists and market commentators have pronounced that any recovery, particularly in the developed world, will be similar to that in 2002: jobless. Indeed, many expect that unemployment will not peak until later this year and remain elevated for years to come. This presumption, however, does not necessarily square with the depths of the economic downturn. The rising risks of a catastrophic economic downturn panicked corporate America and companies slashed jobs by the millions hunkering down to survive the worst. Yet, the worst never occurred and too many workers were eliminated. Corporate managers have been enjoying the profitability leverage the cost reductions have brought but the jobs must begin to return to satisfy growing demand. The latest unemployment claims released on January 7 certainly are encouraging with new jobless claims rising by only 1,000 and the four week moving average dropping to the lowest level since September 2008. The recent data reflects a healing employment market although we do not expect the data to be perfect. Indeed December employment figures showed further job losses and a steady unemployment rate, but we believe that job gains should become the norm during the first quarter of 2010.

Not coincidental with the challenging employment picture is that of surging profits. Employers vastly reduced their cost structures at the height of the downturn and have been slow to add jobs. Corporate profits began to improve during the second and third quarters of 2009 even as revenues moved lower. We feel that most companies will report vastly improved profitability into 2010 as revenues turn higher on a cost structure that remains constrained.

As profitability improves, the resulting virtuous circle leads to higher employment and capital spending, further improving demand, which improves employment and capital spending. While the range of estimates for earnings gains in 2010 and 2011 remain large, most expect to see significant earnings growth over the next two years. As shown in Table 1, current earnings expectations for 2010 are around 35% with another 13% to 26% increase expected in 2011.

Table 1

	S&P 500 EPS	EPS % Change	S&P 500 Price at Year-End	Forward P/E Ratio
2011	85 to 95	13% to 26%		
2010	75.3	34.6%		14.8
2009	55.9	12.9%	1115.1	16.2
2008	49.5	-40.0%	903.3	29.7
2007	82.5	-5.9%	1468.4	17.2
2006	87.7	14.7%	1418.3	14.2

Source: Standard & Poor's Corp.,
Optique Capital

The Obama administration has taken much flack for its \$787 billion stimulus package approved in early 2009. The critics focused on how too little money was being spent in 2009 when many believed it was needed the most. Ironically at the time the stimulus package was approved, the economy was already in a bottoming phase and its current trajectory was mostly set regardless of the size and timing of the stimulus plan. The question in our minds has and continues to be one of economic growth *sustainability*. According to Recovery.gov over \$400 billion of the \$787 billion stimulus package—approximately 3% of GDP—is to be spent in 2010 which will support reported real GDP growth in 2010. Granted not enough money is being spent on infrastructure and other public investment projects. Of the total \$787 billion, only 35% of

\$275 billion has been dedicated to government contracts and grants; certainly more could have been done here. Lost in the noise, however, is that fact that nearly \$300 billion of the stimulus plan is allocated to tax cuts, most of which directly benefits middle income tax payers in 2010 and 2011. The Obama administration is betting that an improved economic outlook for 2010, along with an improving employment picture, will spur a recovery in consumer and investment spending returning the US economy back to its longer-term growth potential.

Barring any unforeseen exogenous shock, our belief is that 2010 should be a surprisingly strong year for the US and global economies. But what of the equity markets? With last year's market bounce, investors appear to be fully pricing in the economic recovery we have described. As summarized in Table 1, the year-end S&P 500 earnings multiple stood at 14.8x forward earnings, in line with the 15x historic average. On the basis of an additional 13% to 26% earnings growth in 2011, the 2011 forward multiple is around 12x to 13x earnings. Given the multitude of investor concerns that overhang this market, is it possible to see earnings multiples expand beyond their historic average? Not likely, suggesting that the markets are locked into a range of subpar returns during 2010 with double digit gains possible in 2011. This is of course unknowable until we understand more about the longer-term sustainability of the current economic recovery.

As we sit today, we believe investors will shy away from higher beta market plays and focus more on revenue growth, earnings stability and dividend yield. 2010 may well be a year where dividend income represents most of the total return opportunity. While there seems little chance that the impressive returns of 2009 can be repeated this year, we are hopeful that a stronger economy will protect the market from material downside risk and leave room for modest appreciation.

¹ The Economist, December 19, 2009, p. 15.



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