

## **Heard Off The Street: Investing – More than a Numbers Game**

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*The Investment Strategy Group provides regular updates on economic and financial conditions. In this commentary, we focus on the performance of the financial markets relative to that of the economy.*

Investors sometimes forget that, although closely intertwined, the stock market and the economy are not interchangeable. But the differences become quite clear when you compare market performance with economic activity.

Over the past several years, financial markets have been reasonably strong. The S&P 500 Index, for example, returned 26% in 2009, 15% in 2010 and 6% through the first half of this year. In contrast, even after the economy climbed out of recession in mid-2009, growth has been slow, averaging just 2.8% for the most recent seven quarters.

### **Factors at Play**

That means that even though it is important to assess how economic trends and developments affect the financial markets, it's not enough. Other factors that play a significant role in market behavior include fiscal, monetary and government policy; technical market indicators including momentum and sentiment; corporate productivity; and the increasing globalization that affects virtually all sectors of society.

So, while the economy has been relatively weak, a number of other influences have provided considerable incentive for a more bullish investment stance. For example, stock market momentum has been reasonable and monetary and fiscal policy has been reflationary, while valuations have ranged from attractive (several years ago) to simply fair (now). Globalization has supported a relatively high level of trade for large exporters and big-brand companies. Emerging market economies have fared well, doing their part for globalization. And here at home, productivity has been a driving force behind strong corporate profit growth.

In recent months, we have noticed a slight shift in many of these factors. For example, growth in emerging markets and even developed markets has slowed, partly in response to monetary tightening in countries including China, India, Brazil and Australia. If we throw in the sad fact that much of Europe is verging on fiscal crisis, then we must confront worries about the sustainability of global growth. In addition, neither the central bank nor the Treasury can allow today's extraordinarily low interests rate to prevail indefinitely. At some point, the proverbial punch bowl will disappear.

## Loss of Momentum

Productivity gains will be harder to extract from US industry, while labor upgrades will be increasingly necessary if corporate America is to stay competitive. Finally, while technical market factors ebb and wane, they show few signs of driving ongoing momentum-driven rallies.

No analysis of the markets would be complete without a valuation checkup. Of course, the stock market offers all sorts of valuation metrics for analysis, including an array of price-to-earnings (P/E) ratios, based upon a number of calculations. Taking the average of earnings over long cycles (say, 10 years) and comparing the results to stock prices provides a gauge called the cyclical P/E. Using this measure, stocks look a bit expensive. But a quicker snapshot, looking at only the past year, provides a reading of P/E that makes stocks appear fairly attractive relative to other assets such as bonds.

Looking at what analysts expect corporations to earn over the next year or so and comparing those figures to prices yields a more significant measure – forward P/E. This ratio also looks reasonably attractive, even though it relies heavily on estimates, which – especially at market turning points – are notoriously inaccurate.

## Neither Here Nor There

So, even though P/E ratios are looking more attractive now than they were a year or two ago, the results are not persuasive enough to produce much in the way of confidence. All we can reasonably conclude is that stocks are neither egregiously overvalued nor dramatically undervalued. A still closer look leads us to conclude that although we can make no definitive judgment about equities as a whole, dividend-paying high-quality blue chips represent the most attractively valued segment of the stock market.

Overall, however, our current analysis – taking into account more than just the economy – has become less bullish in recent months. This view may be a prelude to an increasingly bearish stance on equities in the months ahead. For now, however, we remain almost fully invested. We will, of course, keep you posted if and when our views – and our strategies – change.

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