

NOTES FROM THE NORTH: MARKET OUTLOOK

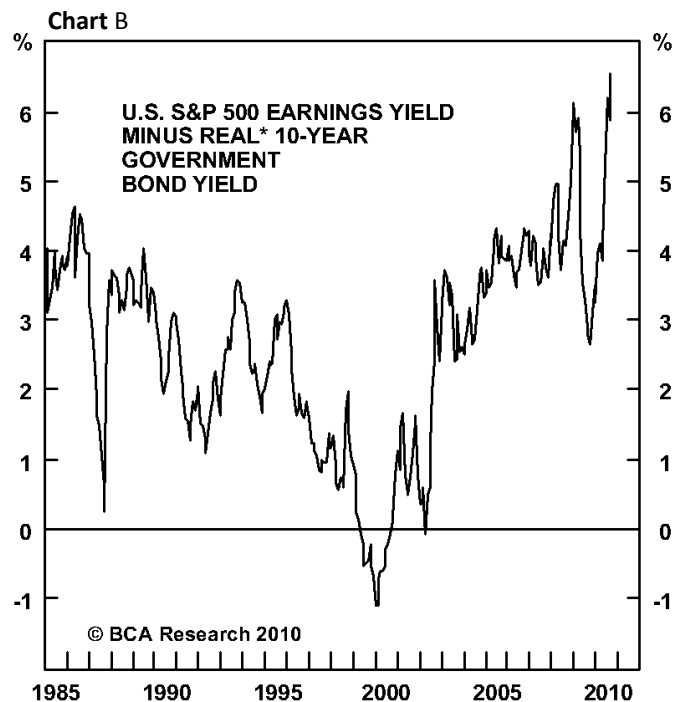
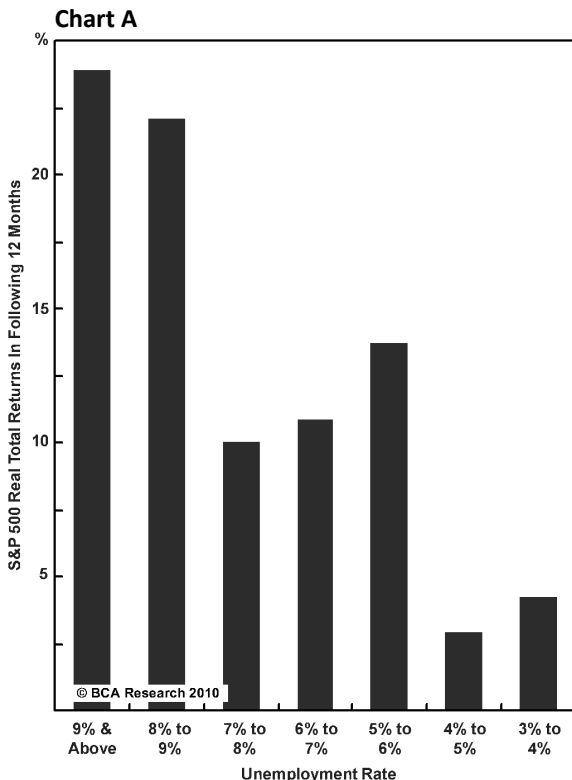
September, 2010

After months of disappointing economic news, we finally are getting some reports that have exceeded expectations. In the first week of September, new unemployment claims fell 27,000 to 451,000. (Economists had predicted a decline of just 2,000.) Also reported recently, the July trade deficit narrowed significantly (partly reflecting big gains in exports of U.S.-made airplanes). These reports support the idea that the U.S. is experiencing slow growth, but is not headed toward a double-dip recession.

Discouraged equity investors have recently been citing the high unemployment rate as a reason not to buy stocks. Ironically, history tells us that investors should *buy* stocks when unemployment is high. Note the returns achieved by stocks purchased when unemployment was over 8% (see chart A, below) versus returns on stocks purchased when unemployment was 5% or less. While it's true that high unemployment will discourage consumer spending, which is the primary driver of the U.S. economy, perhaps the critical factor is not unemployment, but that these concerns have driven the equity risk premium to record levels.

Chart B outlines the trend in the difference between the S&P 500 earnings yield and the yield on a 10-year government bond, a figure often used as a proxy for the "risk premium." As is clearly demonstrated in the chart, the equity risk premium has reached 25-year highs! It has even nudged higher than the level seen at the height of market turmoil at the end of 2008 and early 2009. From a risk premium perspective, 1999-2000 (the height of the technology bubble) was clearly a bad time to buy equities. From this perspective, 2010 is clearly a relatively good time to buy equities.

Retail investors are so risk-adverse today that they are buying bonds with lower yields than the dividend yield of the same company. Last month, for instance, Johnson and Johnson sold 10 year bonds with a yield of 2.95%. Johnson and Johnson's common stock yields 3.6% and the dividend is expected to increase roughly 8% per year. Warren Buffett recently doubled his holdings of J&J's common stock. Johnson & Johnson is not the only company whose common stock



Market Outlook, continued

has a higher yield than its bonds, but it is certainly a great example of the good relative values available in the stock market.

We, too, are concerned about an unemployment rate of 9.6% and a U6 figure of over 16%. (The U6 unemployment figure includes under-employed workers, such as part time workers who would like to be working full time.) Politicians like to blame those corporations that have shifted some of their jobs overseas to reduce costs, but other factors are also at work. Improved technology has increased productivity and labor-intensive manufacturing operations account for an ever decreasing share of GDP. Private employment has remained relatively static since 1999 and no quick fix is

likely. However, looking at the decline in productivity last quarter, our guess is that if we are right about slow-growth and no double-dip, corporations will in fact need to begin to slowly increase hiring.

It would appear that these less than robust macro-economic statistics have been thoroughly incorporated into the market risk premium, and investors may be overlooking the strength of corporate profits. Chart C illustrates the strong rebound already witnessed in profits (during a period of rising unemployment). Bottoms-up estimates made by security analysts call for a 15% gain in operating earnings in 2011. We think those estimates are overly optimistic, but we do expect further gains next year (which would raise earnings yields even higher). While traders are guessing what other traders are going to do in the next day, hour, or minute, *investors* are buying a share of those earnings, the related cash flows generated by the companies and the dividends which will be paid by those earnings.

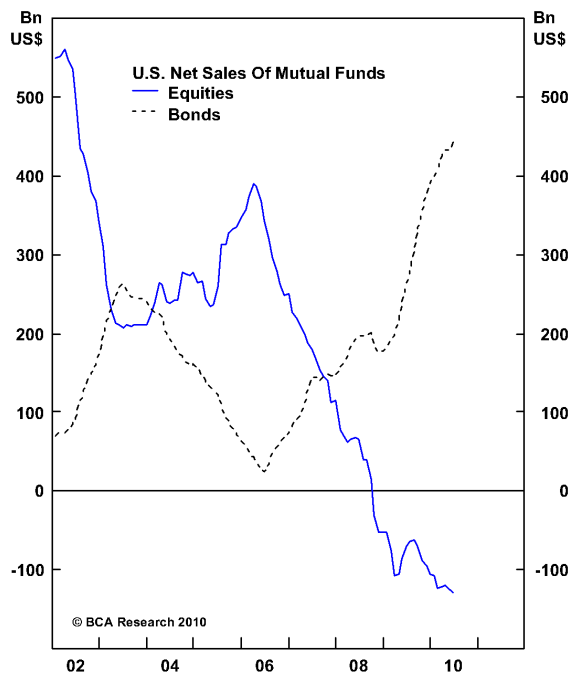
How much good news will be required before retail investors are once again willing to invest in equities? While that question is better answered by a professional trader, Chart D clearly shows the degree of fear present in the relative net sales of equity versus bond mutual funds. (Note that both series are 36 month moving averages.)

Of course, stocks can always go lower, but unless we are headed for a truly disastrous decline in corporate profits, at today's prices, good quality stocks offer much better value than bonds and should provide better total returns over a 5-10 year time frame. Neither bonds, money-market funds, nor real estate promise equally high returns.

Chart C



Chart D



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