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Market Comments

S&P 500 1375
10 Year Yield 1.47%

July 31, 2012

Capital Markets Valuations and a Case for Much Higher Stock Prices

We thought it might be useful to set out the key elements that we believe could lead to significantly higher stock prices over the next 3-5 years.

Before getting to those elements, we will recite those factors that some investors point to as justification for why equity valuations currently are well below historic norms (S&P 500 P/E is currently about 12-13x estimated 2012 earnings, and 11-12x estimated 2013 earnings, versus a long term historic average P/E of 15-16x):

1) the U.S. economy's recovery out of the 2007-09 recession is trending well below historic norms and unemployment remains stubbornly high

2) the U.S. faces unprecedented federal government budget deficits that are growing, which limits the range and potentially the effectiveness of future policy choices

3) the U.S. political process appears to be exceptionally rancorous making it difficult for decision-makers to agree on policy, much less effectuate it; there is uncertainty regarding the outcome of the November elections which affects the willingness of investors to risk capital

4) Europe faces significant sovereign debt defaults and recessionary economic conditions

5) Economic growth in emerging markets, especially China, appears to be slowing

6) The need to reduce debt by definition means a slowing in consumption, which negatively impacts global GDP growth

While this list is not a complete recitation, the factors outlined above: 1) create uncertainty, 2) appear to be significant in their collective impact on economic growth, and 3) resolution to the problems could potentially take years.

That said, it is probable that, because these risk factors are both evident and widely discussed by capital markets participants, much of their potential impact is currently discounted in capital markets valuations.

These negatives have combined to 1) drive interest rates to historically low levels, as many investors have sought a safe haven in U.S. Treasuries, and other "safe" fixed income investments (short duration and high-quality debt instruments); and 2) depress equity valuation levels such that current valuations are not much higher than the valuations that were reached coincident with the late 2008-early 2009 market lows.

We believe that there is potential for much better equity market returns over the next few years, based on the following elements.

1) U.S. equity valuations are well below historic norms: the S&P 500 currently trades at about 13x estimated 2012 earnings, and roughly 11.5x estimated 2013 earnings, compared with a long term historic P/E average of 15-16x earnings

2) U.S. corporate earnings have been, overall, pretty solid, especially given a tough economic climate. S&P 500 earnings have roughly doubled since late 2008, and while quarterly comparisons are becoming more difficult, have shown decent progress over the past twelve months

3) Interest rates are very low – which has two important ramifications for investors: 1) fixed income valuations are VERY high, and 2) the net present value of future cash flows is high (i.e., stock valuations are attractive). . .the range of big picture scenarios that would allow rates to stay at current levels, or move lower, is narrow, and from a probability standpoint would appear to be facing long odds (i.e., common sense notions of "reversion to the mean" would argue for interest rates to move higher over time, back toward long term norms; to believe that interest rates will stay at current levels, or move even lower for an extended period of time, is to make the "this time it's different" bet, a bet that almost always is a loser based on history. This bet also would be at odds with the notion that policy makers are far more likely to look for ways to reflate the global economy out of its current malaise than to pursue restrictive monetary policies; if successful, the reflation strategy by definition would be likely to drive higher inflation expectations on the part of investors, resulting in higher interest rates and a period of flat or negative returns for bondholders. For equity investors, low interest rates mean that the net present value of future cash flows is high, which combined with low current valuation levels, makes stocks very attractive both in an absolute sense, and relative to both historic equity valuation levels and other asset class valuations at present.

4) If economic conditions over the next 3-5 years split the difference between "current" and "a return to normal", then it is highly likely that rates will rise to 3-4% on the 10-year Treasury, corporate earnings will expand significantly, and presumably, equity valuations will get at least half of the difference between the current level; – 12x earnings – and long-term norm – 15-16x earnings. The total return implications of a return toward "normal" would be negative for all but the shortest duration fixed income assets, and very positive for equities. Earnings growth of 6% annually between 2012 and 2017, and a P/E of 14x at year end 2017, would equate to a level of 1900-2000 for the S&P 500, roughly 40% above current levels. Should earnings grow at 7% over the next five years (the long-term average for the S&P 500) and equities be valued at 16x at year end 2017 (16x is the long term average P/E for the S&P 500), the S&P 500 would be at 2300-2400 by year end 2017, or about 70% higher than current levels. A 16x multiple for the S&P 500 seems reasonable assuming 7% earnings growth and 4% interest rates.

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5) Far more capital has fled to the bond market than entered the equity market since 2007. Capital eventually needs to earn a competitive return – with nominal yields of 0-2%, and the threat of rising rates, it is possible, maybe even highly likely, that significant amounts of capital will eventually gravitate back toward equities, reversing the weak supply-demand situation for equities that has persisted for the past 3-4 years . . .the baby boom generation is staring down the barrel of retirement over the next 5-20 years. In the wake of weak equity market returns over the past decade, and low prospective fixed income returns, investors may eventually have to move toward higher return (and higher risk) assets such as equities and high yield debt, or else run the risk that their retirement capital will not be able to meet their needs in retirement. Most investors chase asset class returns; as fixed income returns flatten out and return to more normal levels (because interest rates reach the point where bond coupons are low and interest rates cannot move much lower), and as equity returns improve, there is significant room for supply/demand conditions to drive capital into the equity market and move stock prices and valuations materially higher in coming years.

The case for materially higher stock prices is based on a number of things going right. In essence, many things have gone wrong in the capital markets since 2006, which has led to high levels of investor pessimism, historically high valuations for "safe" investments, and low valuations for "riskier" assets such as equities. While it will likely take time, we believe that the potential for equity returns to surprise investors on the upside is significant, and the current low valuations to some degree mitigate the impact of macro conditions deteriorating before they eventually have sustained improvement.

Dividend yields for many companies exceed the current yield on their debt and corporate balance sheets are in very good condition (many companies have significantly higher cash levels than they need for working capital and cap-ex requirements). Most of the companies that we hold have excess liquidity that provides managements with a wide range of avenues to enhance shareholder value through dividend increases and/or share repurchases. Our companies should be able to grow the value of their franchises at solid rates in coming years, and if economic conditions eventually improve, it is likely that valuations will improve as well, which should provide very good returns to shareholders.

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