

- The **S&P 500** is the world's largest, and, such things being relative, best regulated capital market. What happens there creates an echo elsewhere. And where that market is heading, is subject to a fair bit of debate. The **Globe & Mail** provided a useful summary of opinion last week. In a nutshell here it is:
- **Vincent Delisle (Scotia Capital)** and **George Vasic (UBS Securities)** are both upbeat based on forward earnings estimates and history. They forecast that 2010 per share earnings are rising to \$80-\$81 - a level consistent with a modest recovery - and that the index today is trading at a forward price-to-earnings ratio of 13.7 - 13.9, below the historic average of 14.7 - 15, suggesting that the market is undervalued. **Delisle** comments that, "people who are raising the red flag about markets being overvalued (the **S&P 500** is up 50% since March lows) are those who missed the rally." The market went from pricing a deep depression to pricing a modest recovery, and stung by the sharp rebound in markets, these investors can't accept that. **Delisle** points to the recovery in earnings with 80% of **S&P 500** companies exceeding analysts' expectations in Q3, the second quarter in a row that this has now happened. Sales are starting to rise on a sequential basis, typical of the late stages of a recession. **George Vasic** points out that "next year's earnings represent the early stages of the economic recovery ... there's still room to grow" and with ongoing assistance from the government stimulus "I would say the coast is clear, certainly for the next year or so."
- **Myles Zyblock (RBC Dominion Securities)** is a little less sanguine. He looks at the 10 year average P/E and sees a 19.7 ratio today, a chunk higher than the 16.3 historic average. But, according to **Zyblock**, that doesn't mean it's a bad time to invest or that a collapse is in the offing. Rather this mildly higher P/E rate means that returns over the next several year will be moderate, ranging from 5.7% - 7.9% but at the same time the prospect of significant losses is diminished. He also highlight that the **TSX's** 10 P/E currently stands at about 16.4, only a touch higher than the average of 16.14, which means in a relative terms, Canada should be more attractive.
- **David Rosenberg (Gluskin Sheff)**, whom I had the pleasure to meet recently, is the bear of the bunch: " ... by some measures the **S&P 500** is already trading at valuation levels that would ordinarily be consistent with an economic expansion that is five years old as opposed to a recovery that, at best, is in its infancy stages." Forward estimates in his view are rubbish so he puts his trust in 12-month trailing P/E ratios which stand at 27.6 on an operating basis - one of the highest on record suggesting the market is well ahead of itself. The market is "overvalued, overbought, overextended" so be selective if you buy equities and expect a correction in the **S&P 500**.
- While we're as guilty as anyone of using quantitative measures (and BTW a lagging P/E in our view doesn't work because it overstates prior losses and markets are forward-looking anyways), what these technical points of view lack is a theme or story that explains in fairly plain terms what is going on and how events are likely to unfold for the companies that form the **S&P 500**. So here's our story: part 1 is **cyclical** (short term) and part 2 is a **secular** (long term) trend.
- **Part 1: Cyclical growth** - On a market capitalization basis, the fifty largest companies that are part of the **S&P 500**, represent approximately 50% of the entire market capitalization of the index. What happens to these companies matters for the whole index. On a cyclical basis (that means short term) the consensus view is underestimating the earnings recovery (hence the 80% wrong earnings forecasts), especially of the new mega-financials, now banks and not just trading houses, for example **Goldman Sachs** (Q3 profit U.S. 3 billion) and **JP Morgan Chase** (Q3 profit U.S. \$3.6 billion). Importantly too, in 2010 as economic conditions improve, loan loss provisions for the big boys will fall and earnings will rise concomitantly. Yes, some 123 regional banks in the U.S. are failing, but **TARP** is there to see that these fleas don't upset the elephants, and as they exit the market, the big banks may move in. On a cyclical basis, other sectors too are experiencing a rebound (for example automotive production is fit to burst) as a new inventory cycle begins and in the short-term productivity gains mean outsized earnings gains. Yes, unemployment is horrendous, but the flip side of that story is that 89% of the workforce is very productive. On this basis alone, a forward 2010 P/E of \$80 or more, is reasonable given the scale and breadth of growth in cyclical earnings. This is good news, but as many point out: this sort of earnings growth is not sustainable at the same rate beyond 2010, so on to Part 2 of the story.
- **Part 2: Secular growth** - Foreign sales as proportion of total **S&P 500** sales have been steadily growing from 41% in 2003 to almost 48% in 2008 in tandem with the falling U.S. dollar. Not only has the U.S. dollar lost value sharply in 2009, and is likely to fall some more and remain relatively cheap in 2010 and beyond, but some of the very things that the U.S. supplies --- technology, pharmaceuticals as well junk food and entertainment --- the global economy demands in growing quantities (especially from emerging markets) and are uniquely the strengths of U.S. **S&P 500** listed giant multi-nationals, such as, **Pfizer**, **IBM** or **McDonald's**. To put it another way, in this view, **S&P 500** earnings growth will increasingly be driven by *non-domestic factors* so that concerns about U.S. government debt, inflation, housing, consumer confidence and unemployment while real, are less relevant. These factors will continue to spook some investors and may make markets volatile, but will not derail continued earnings growth. Interestingly, there is an inverse

global correlation between the U.S. dollar and the **S&P 500** and for Canadian investors who use currency hedged **ETFs** like **XSP**, there's no penalty to risking their Canadian dollars in the U.S. market. Conversely the sharp rise in the **Euro** is making non-U.S. large cap investments less attractive. On a final note, **TSX** forward earnings estimates according to the **TD Securities**, are healthy but lagging U.S. expectations by about 10%. The **TSX** remains attractive (though risky for being so narrow) as a proxy for emerging markets and for the stability of its financial players.

- If one considers these cyclical and secular developments together, the reasonable conclusion is that strong **S&P 500** earnings growth in 2010 is sustainable and likely. The economic story matters: analysts and investors need a broader economic context for their number crunching and hunches to make sense.

- The last time **S&P 500** edged over \$82/ operating EPS (October 2007) the index hit 1,540. While such a valuation is a sure-fire reason to sell, today's 1,100 is a sure-fire reason to buy and hold for a while.

- **Balance and patience:** putting all your eggs in one basket ramps up the risk, so no matter how great the story, I know very well we do not predict the future, so stock positions in our balanced approach never exceed 35% in any one market and for most clients, U.S. exposure is limited to 20 - 25%. With an investment theme like this, we're also prepared to wait out the market (i.e. for other investors and analysts catch up to the story we've outlined here today).

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