FVCM

U.S. Market Report

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12 January 2011

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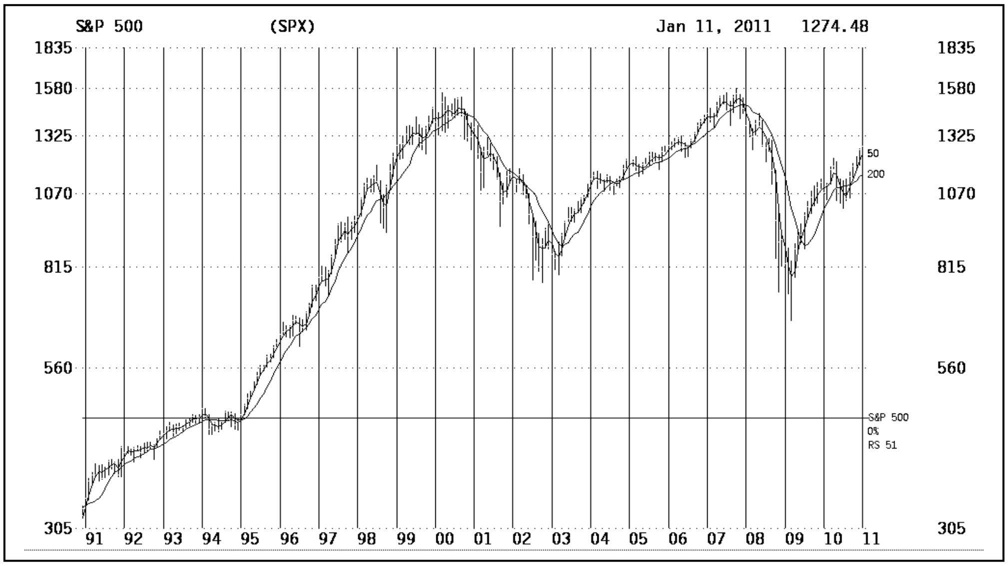


OPPORTUNITY

The S&P 500 returned 15.5% in 2010 on top of the 26.5% return for 2009. It has become a common opinion among technical analysts that people have become too bullish and that the market is ready for a correction. While we would never discount the possibility of a 5% to 10% pullback in stock prices, we have more doubts than most that a correction is imminent and believe the outlook for stock returns remains very positive. Our Bullish outlook for the stock market reflects the same confluence of factors that we have been writing about since early 2009:

- The economy suffered a deep recession that included a severe collapse in capital spending and employment. The rebound has started off at a moderate pace (the year-to-year growth in real GDP has been 3.2%), and there is still lots of room for expansion ahead in terms of real resources like unused factory capacity and labor.
- There is very little inflationary pressure because of slow growth in nominal spending (nominal GDP has risen at an average rate of only 1.4% during the past three years). This is great for equities because stock valuations, like bond values, are highest when inflation is low.
- The Federal Reserve is expected to keep interest rates low for at least the next several quarters and has recently initiated a new $600 billion liquidity program dubbed QE2. One of the oldest and wisest expressions on Wall Street is “don’t fight the Fed.” We wouldn’t.

- Even after the recent gains, we believe the S&P 500 remains about 20% undervalued based on normalized earnings and the current low level of inflation.
- S&P 500 cumulative ten year returns for the ten years ended in 2008 and 2009 were negative. This has been only the third time in the past century that ten year cumulative returns have been negative and likely reflects a generational low in stock returns.

RISK

While we think that, on balance, the outlook is heavily skewed toward the upside, there are still risks that equity investors must face:

- The Fed's $600 billion QE2 program, where it is buying that amount in U.S. treasury securities and thereby increasing the money supply by an equal amount, is scheduled to end in June. Stock prices may face a period of weakness without the liquidity injections. Longer-term, the Fed will have to withdraw the excess liquidity as spending growth rebounds on a sustained basis. Otherwise, inflation could become a threat down the road.
- The U.S. Federal budget deficit is now running at 9% of GDP and Federal debt held by the public is running at more than 60% of GDP. Expectations for action on spending and deficit reductions were raised with the Republican victories. Failure to achieve material improvement in the budget deficit could put upward pressure on interest rates and downward pressure on stock prices.
- Financial "contagion" in European sovereign debt or the banking system would have a negative impact on investor confidence and world trade. U.S. equities would be vulnerable if financial conditions in Europe are not stabilized.
- China is experiencing a rising level of inflation, which is a by-product of its cheap currency and mercantilist trade policies. The Chinese government is simultaneously trying to promote growth and exports with the cheap Yuan, and cool inflation by increasing required bank reserves, higher interest rates and, price controls. It is unclear how long these policies can be sustained. China has become such a huge part of global trade that any major disruption in their growth will affect all markets.

Over the next one-to-two years, we think the chances are good that the S&P 500 will revisit the old highs of about 1500. The best time to accumulate stocks is when valuations are attractive and business has begun to expand from recessionary depths. While there are still plenty of risks to consider, the opportunities remain stronger, in our opinion. Especially with monetary policy geared toward promoting the appreciation of risky assets, we think the chances are good that stock prices will trend higher through at-least mid-2011 before any meaningful correction occurs.

ECONOMIC GROWTH

Current forecasts call for the US to experience real growth of between 2.5% and 3.0% in 2011. We think those figures will prove to be too low. We're looking for 4% growth. Firstly, the impact of the Fed's monetary policy is probably being underestimated. The new liquidity being provided is having a first order effect of driving stock prices higher. And as we saw in 2008, changes in household net worth have a tremendous impact on spending. With stock prices rising, spending should follow. And, indeed, retail sales increased a more than expected 0.8% in November. And September and October's figures were revised sharply higher. Housing and construction remains weak, but on balance the signs are pointing up because Americans are looking at their portfolios and are feeling wealthier again.

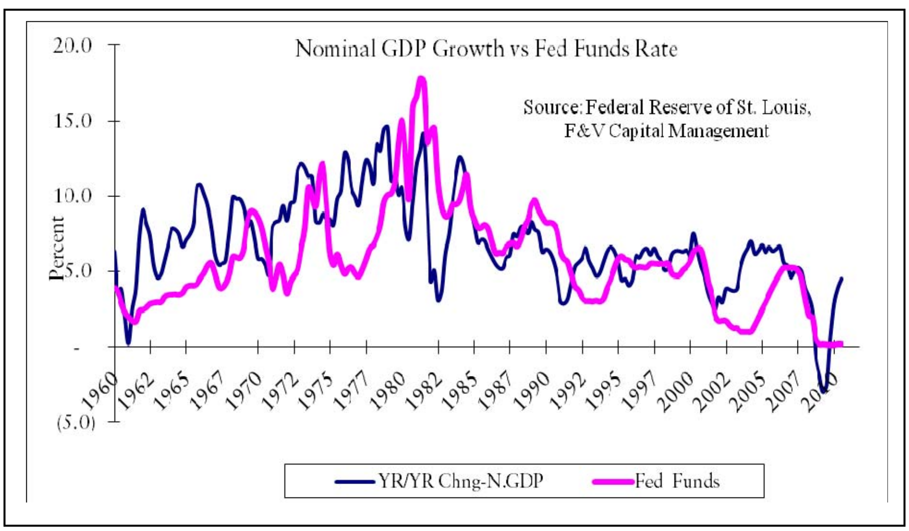
The Obama/Republican tax agreement has quite positive implications. The top marginal tax rate on ordinary income ("Bush" tax rates) will remain at 35% rather than rise to 39.6%, and the 15% tax rates on capital gains and dividends will remain. Continuance of these lower rates will remove uncertainty and enhance incentives for businesses to expand and hire new employees. Furthermore, a prominent feature of the tax deal allows businesses to immediately expense 100% of qualifying 2011 capital expenditures. This will boost corporate cash flows by an estimated $150 billion in 2011, or roughly 8%. These incentives will likely result in more capital spending and faster growth than currently expected.

There are early signs that the labor markets are beginning to positively react to rising demand and the recovery will become "self-sustaining." Initial claims for unemployment payments from the government have been trending downward. The average for the four weeks ended January 1, 2011 was 410,750, the lowest level since mid-2008. And, while the economy adding an average of only 94,000 jobs per month in 2010, this pace is expected to accelerate. Indeed, the 94,000 figure comes from the "establishment survey" of roughly 400,000 businesses. It has been argued that the establishment survey underestimates the number of jobs created early in an economic upturn because it does not count new businesses. As the labor markets recover, national income rises and helps fuel ongoing growth.

INTEREST RATES

Short term interest rates are likely to remain low through mid-2011. The Fed controls short term interest rates by its ability to supply liquidity through the purchases and sales of securities. The Fed has telegraphed quite clearly its intention to provide monetary stimulus to the economy through the purchase of treasury securities, and has explicitly expressed a policy of leaving short term rates low for an extended time. Keep in mind: Short term interest rates like the "Fed Funds" rate tend to lag behind growth in nominal spending (see Chart 1). As members of the Fed become convinced that spending growth is on a sustainable upward path, votes will change and the Fed Funds rate will rise. Exactly when that will happen is uncertain, but given our Bullishness on the economy we suspect it could be sometime in 2011.

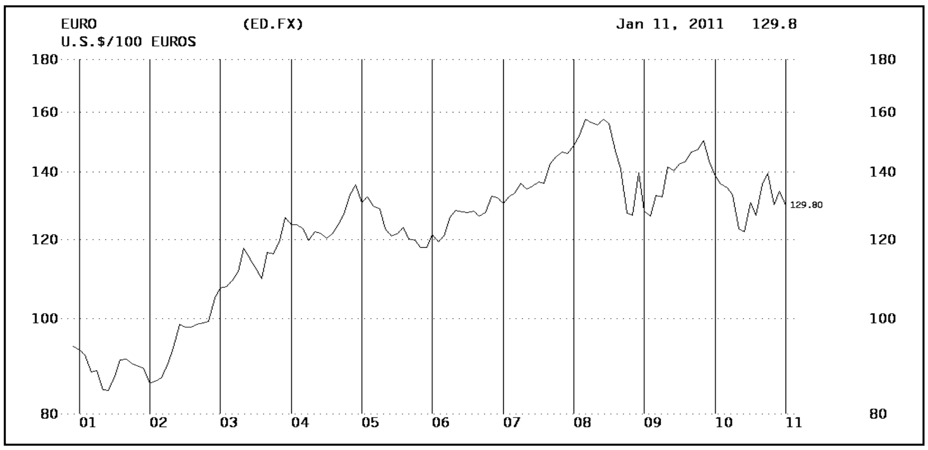
Chart 1



Long term rates are likely to continue to trend higher in the months ahead. Unlike short-term rates, long term interest rates are determined by the market and reflect expectations for growth and inflation. Higher real growth suggests higher demand for capital and upward pressure on real lending rates. Furthermore, increasing rates of nominal spending are an intermediate step toward inflation. As inflation expectations rise, so do long term interest rates. Given our expectation that real growth and spending will accelerate in 2011, it should be no surprise that we expect long rates to trend higher from the abnormally low rates experienced since the recession. Ten year treasury yields of 5% are quite conceivable in the year ahead.

CURRENCY

While the dollar and the euro are roughly in-balance on a purchasing power basis, the dollar looks to be strengthening against the euro over the next year. Estimates vary, but the fair value of the dollar/euro rate based on each currencies purchasing power is somewhere in the 1.2 to 1.3 range. While purchasing power parity determines the exchange rate of major convertible currencies over periods measured in decades, and it exerts a point of central tendency, it is not useful for near term forecasts. Indeed, currencies are notoriously difficult to forecast. Nonetheless, it is useful to note that the euro has been in a declining trend against the dollar since early 2008. The chances that this trend will continue look reasonable given our expectation for better than expected US growth in 2011 and the prospect for higher interest rates.



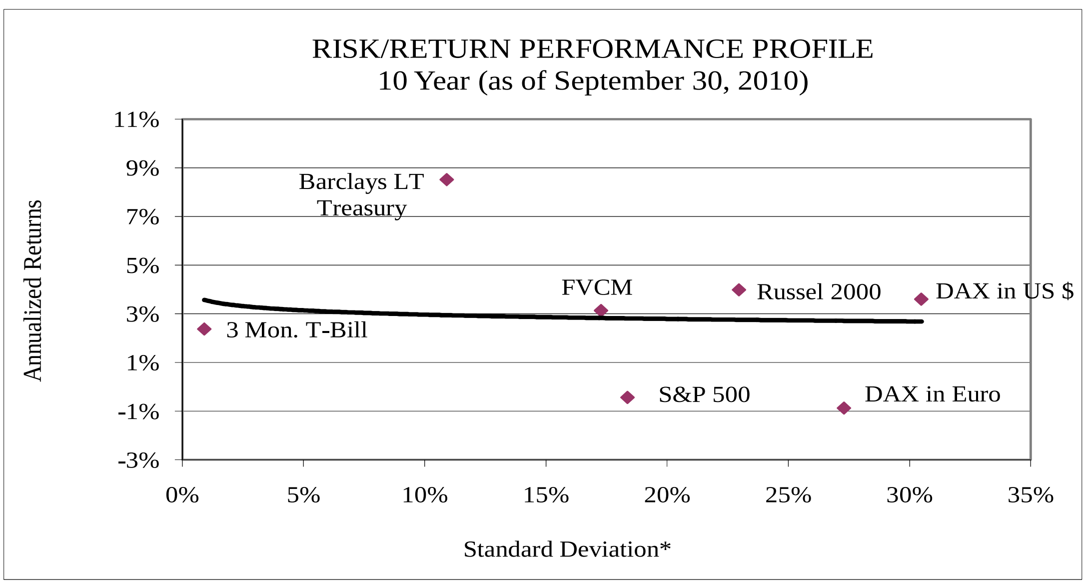
COMMODITY PRICES

Commodity prices are expected to continue to trend upward. A stronger recovery in the US should help propel commodity prices upward, but the biggest factors may be the continued strength in China, as well as growing demand for commodities as a speculative investment. China has become the elephant in the living room. Because of its heavy growth in industrial production, a booming building sector, and heavy spending for infrastructure, China has become the largest consumer of many, if not most commodities. The fact that China produces twice as much steel as the US, Europe and Japan combined gives some indication as to the speed of development there and the demand for oil, iron ore, copper, etc by the Chinese. Also, as the Chinese become wealthier, their demand for gold has begun to grow sharply. But accumulation of gold and other commodities has been enhanced globally through the use of exchange traded funds (ETFs). It is now relatively easy to speculate in gold and other commodities through the purchase of ETFs and this source of demand seems likely to only grow in the years ahead.

Perhaps the greatest risk to commodity prices is the growing inflation problem in China. Like elsewhere in the world, food and energy prices have been rising in China. However, whereas overall inflation is low in North America and in Europe, the overall price level is rising at a rate of more than 5% in China because of its cheap currency (the Chinese Yuan may be 40% to 60% undervalued on a purchasing power basis). The Chinese policy of pegging the Yuan to the dollar at such a distorted rate makes their exports very price competitive on the international markets, but it also has internal costs. In order to maintain the peg, the Chinese central bank has to purchase dollars and issue domestic currency in payment. Despite efforts to "sterilize" the transactions necessary to maintain the peg, the Chinese money supply is growing at a rate that is expected to approach 20% for 2010. This growth in the money supply is the ultimate source of the Chinese inflation and it is hard to see it getting under control until the mercantilist trade and currency policies are ended, and that doesn't look to happen very soon. So bullishness on commodities continues to look reasonable for now. But, as we saw in the US back in the 1970s, problems with inflation have a way of spinning out of control. If that happens in China, the central bank will have to take drastic action in terms of reducing money supply growth and raising interest rates. When that day approaches, we plan to be very sharply reducing our exposure to all commodities.

US INVESTMENTS

Bonds now look unappealing in the U.S. Over the past ten years bonds have been the best place to be. Following the peak of the tech bubble in 2000, stocks have had a ten year return of negative 0.43% (annualized, through the quarter ended September 30, 2010—see chart below). In contrast, the Barclay's long term treasury index had a return of positive 8.51% annualized. This is an upside down world because, both as a matter of theory and common sense, risky assets like stocks should reward holders with higher returns than safer securities like U.S. treasury bonds. But this ten year period occurred because of the excesses of the 1990s. This is only the third time in a hundred years that the S&P 500 has had a negative ten year return and we think it reflects a generational low in stock returns. Going forward, the world is expected to return to normal and the curve in the chart should revert to an upward slope where the safest assets have the lowest return and the risk assets have the highest. But to get back there, bonds have to act poorly and stocks have to do well. We are already on our way. Since peaking on August 31, 2010, the Barclay's long term treasury index declined 10.0% while the S&P 500 rose 19.9% (data as of December 31, 2010). Expect more of this in the quarters and years ahead.



Sources: Baseline, Bloomberg, Marshall & Ilsley Corp.
* 10 Years Std. Dev. of Quarterly Returns, Annual Rate.

Stocks continue to look very attractive. Stocks are still at an extraordinarily good point in the business cycle, partly due to the varying lag times that monetary policy has on different variables.

For example, monetary policy affects demand, real growth and corporate profits in periods measured in months, or perhaps quarters. However, it is only in periods measured in years that monetary policy affects inflation. The ideal environment for stocks is high profit growth and low inflation, and that is where we are today! The Fed's monetary policy is now at the early stage of boosting demand and corporate profits. It may be only years from now when inflation becomes an issue that depresses stock valuations. And that should only happen if the Fed does not withdraw stimulus as the economy picks up. As of November 2010 the consumer price index was up only 1.1% year-over-year and the so-called core rate, which excludes food and energy, was up only 0.7%. With inflation below 2%, the "fair P/E ratio" on the S&P 500 would be about 17, based on historic data. The consensus estimates for S&P 500 "operating earnings" is 83.44 for 2010 and 92.69 for 2011. We use the more conservative GAAP earnings in our models and we are forecasting 77.58 and 87.07, respectively. If the S&P 500 hits our target of 1500 by the end of 2011, the index would be trading at 17 times trailing earnings based on our estimate. This, we think, is reasonable given the low inflation.

We continue to focus on the material and industrial sectors and expect continued strength in stocks that are producing earnings growth. Many stocks in these two groups have done well this year thanks to the rebound underway in the economy and the high degree of operating leverage these businesses have. One area that we didn't focus on in 2010, and should have, is the consumer discretion sector (this includes the auto sector, hotels & resorts, retail, etc). We were overly focused on the likelihood that the U.S. consumer would be cutting spending for a protracted period. While spending has not come back very strongly yet, the stocks have. The outperformance of the consumer discretionary stocks reflects the fact that they had been beaten down so severely during the financial crisis and recession and that they have a lot of fixed costs and operating leverage that will allow earnings to rebound sharply even with only a modest pickup in demand. There's probably still plenty of upside in this sector as economic growth accelerates. Other growth stocks, including those in the technology sector also look attractive. P/E ratios are depressed for many stocks that continue to have very good growth prospects. And with inflation and interest rates so low, stocks with a long duration (i.e., lots of cash flow out in the future) look best.

Defensive stocks in sectors like healthcare, utilities and consumer staples are expected to continue to underperform in the months ahead. Investors are likely to stay focused on those businesses with the most operating leverage and highest growth prospects. Down the road, once expectations have caught up with the business outlook, when the Fed starts to tighten monetary policy in a meaningful way, or when the Chinese go into a significant inflation fighting mode, we'll get more defensive. But we don't anticipate that period to come until perhaps 2012 or 2013.
