U.S. Market Update

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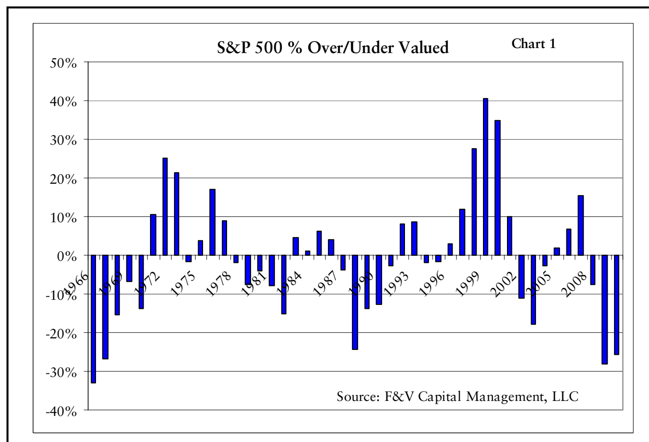
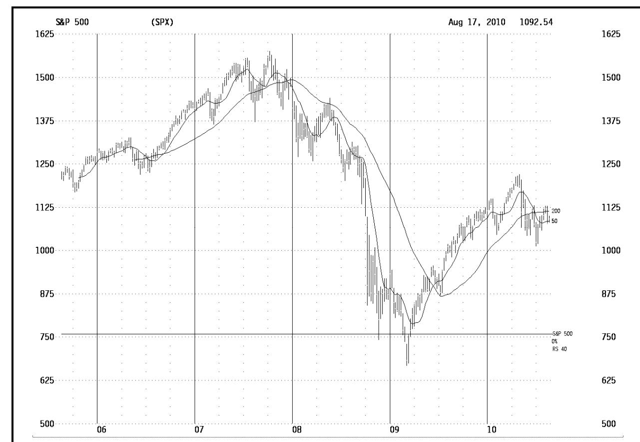
The ideal conditions for equities are low inflation, an expanding economy and earnings, low interest rates and an expansionary monetary policy. Another indicator that the time is good to buy equities is a high level of pessimism that usually indicates that the weak knees have left the dance. Right now we have it all.

There is no doubt that the level of pessimism among investors is high. Cash has been flowing out of equity mutual funds and investors have been buying put options at levels not seen since the March 2009 low. The current situation is almost the precise opposite of conditions in early 2000 when cash was flowing in torrential currents into stock funds and the call option was king. Naturally, stock valuations are now as depressed investors' moods, whereas valuations and euphoria were at all time record levels in 2000.

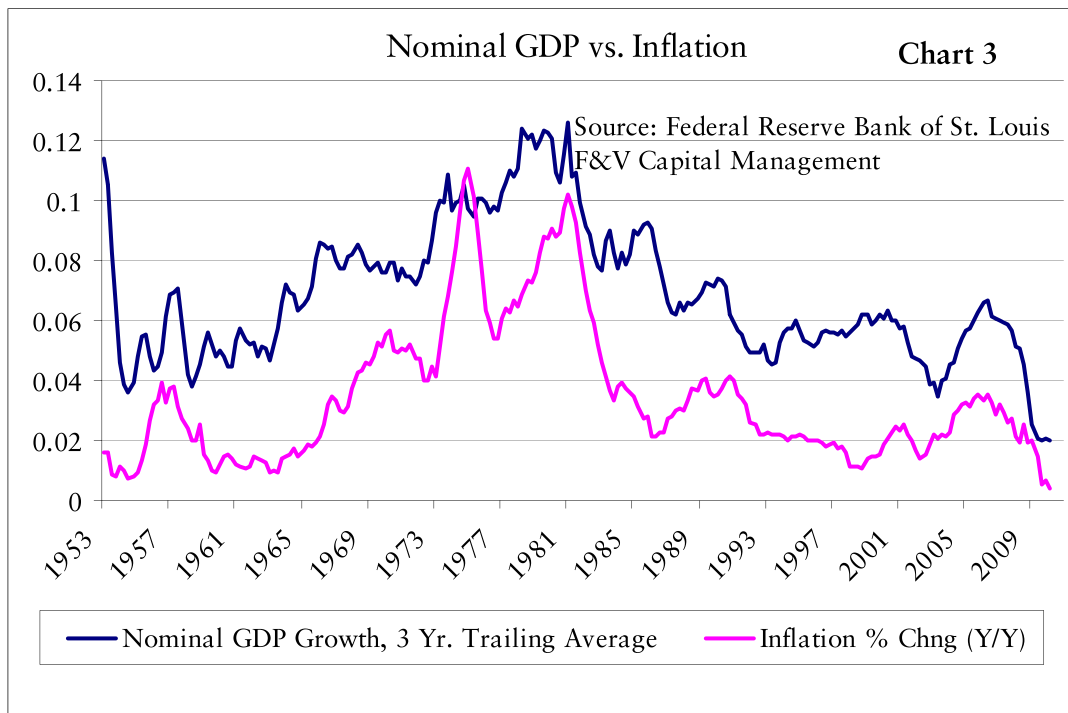
From our perspective, these are exciting times because the opportunity exists to purchase world class businesses like Corning, Exxon and Oracle at the lowest multiples of earnings in a generation. Our regression model, which normalizes earnings by taking a trailing ten year average and incorporates inflation expectations, indicates that the S&P 500 is currently 25% to 30% undervalued (see Chart 1; Chart 2 shows the S&P 500).





Depending on the news article you are reading, there seems to be dueling, yet incompatible worries that the economy is at the edge of either deflation or inflation. But the actual facts show relative price stability and we see no signs of change in the near future. A month or so ago, all we ever heard was that the huge increase in the monetary base, which consists mostly of bank reserves, would inevitably result in massive inflation. Now, there seem to be just as many people concerned that the U.S. is entering a period of deflation and stagnation similar to the Japanese experience.

With the money supply and nominal GDP increasing at a moderate pace (see Chart 3), there is certainly no risk of inflation in the pipeline. As for deflation, the risk would seem quite small. Fed Chairman Bernanke is a student of the deflation of the 1930s and we do not believe there is any chance that the Fed would allow the money supply and spending to decline as it did at that time. This is evidenced by the fact that the Fed has already increased the monetary base by more than 100%, whereas at the peak of Japanese "quantitative easing," the base was never increased more than about 35%.



As for real growth, we believe that the data and history demonstrate that government spending as part of a so-called Keynesian stimulus program is counter-productive, and is one of the reasons growth in this recovery thus far has been sub-par. People who create jobs in the private sector need low taxes and stability in government policy before they will take the risk of adding to payrolls. Because of public discontent with Obama's big government programs and intervention in the private sector, it has become increasingly likely that the Republicans will take back a substantial number of seats in the Congress in the election on November 2nd. We expect this political shift will lead to reductions in Federal spending, a continuation of the tax cuts passed in 2003, and reform of corporate taxes. This is all expected to be very positive for economic growth, corporate profits and stock prices. The U.S. is not going to follow the Japanese example huge, ongoing Keynesian spending programs that pushed Japan's public debt to nearly 200% and smothered private enterprise. U.S. culture simply will not allow it.

We have been down a similar path before. There were the big budget deficits early in the Reagan years and a savings and loan financial crisis that led to the recession of 1990-1. For decades, we have heard remarks that this time U.S. growth will slow to the 1% to 2% rates commonly seen in Europe and Japan, rather than the 3% growth experienced over the previous 50 years. But, U.S. population is still growing and Americans still embraces a culture of innovation, openness to new ideas, entrepreneurship and wealth creation. As growth rates rebound, the current depression in stock values is unlikely to continue and returns should justly reward those who assume the risk.

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