

SPECIAL REPORT

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INSIDE THIS ISSUE

FEATURES

"HALF TIME" IN THE SECULAR BEAR MARKET

- **"Half Time" In The Secular Bear Market**
 - It is always fascinating to me that after a decade of near no returns that people still quickly fall into the trap that, somehow, "this time is different".
- **Valuations Matter In The Long Run**
 - *"There are many ways to measure the valuation of the stock market, but relatively few ways that have value when they are applied across many types of bull and bear markets. Over the past year we have focused on the price-to-earnings measure popularized by economist Robert Shiller, which uses a 10-year average of earnings. Since earnings have at times fluctuated wildly in the short run, a 10-year average captures a much more reliable snapshot of the long-term profitability of public companies."*
- **Earnings Growth Unsustainable**
 - It is very hard to increase sales, the topline of the income statement, when consumers, which make up 70% of GDP, have no job and very little income.
- **A P/E You Can Believe In**
 - Investing, like life, is a marathon not a sprint. Sometimes the prudent thing to do is sit on the sidelines waiting for better opportunities, even if it means enduring cat-calls and taunts from those who do not have any understanding of risk or history.

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“Half Time” In The Secular Bear Market by Lance Roberts



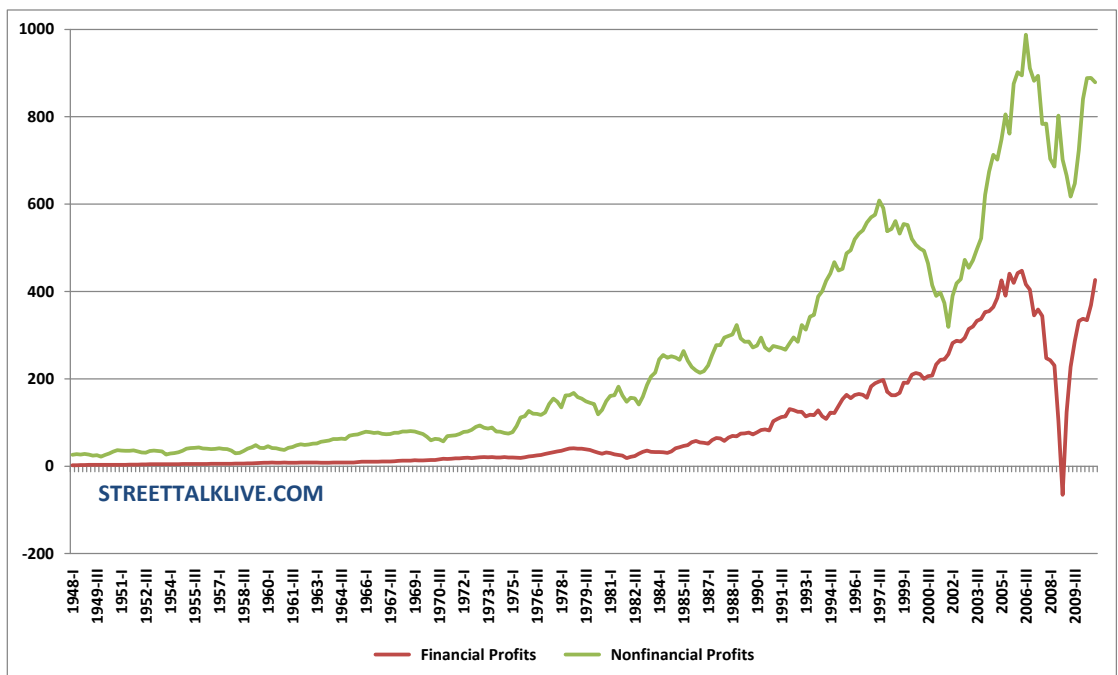
It is always fascinating to me that after a decade of near no returns that people still quickly fall into the trap that, somehow, “this time is different”. The financial markets go through cycles just like the seasons or the economy. Market cheerleaders keep ratcheting up expected earnings, failing to note that much of the recent earnings growth has come from areas that are completely unsustainable:

- Earnings in all sectors are on margins outside historical norms due to
 - Cost cutting
 - Increasing productivity
 - Outsourcing
- Federal stimulus has been a huge driver but will eventually end
- Accounting gimmickry ESPECIALLY in the **financial sector** where
 - Assets are not marked-to-market
 - There are insufficient loan loss reserves as banks have taken money from those reserves to plug the holes in their actual earnings.
 - Fed and FASB (Financial Accounting Standards Board) have repeatedly modified accounting rules and postponed changes for the benefit of the banks and brokerage firms.
- Rising input costs due to rising inflationary pressures (which may likely be exacerbated by fallout (not literal) from Japan.

While the financial sector has by FAR been the biggest beneficiary of artificial life support we may well have seen the peak in this current profit margin cycle as shown by the chart below.

As you will see it looks like non-financial profits may have already peaked while financial profits have not (*Quantitative Easing and Permanent Open Market Operations still in place – for now*) just yet.

Going forward from here, the impact of rising input costs due to inflationary pressures will become harder and harder to pass along to the average consumer. Therefore, non-financial profits are most likely going to be the first casualties of this economic cycle.

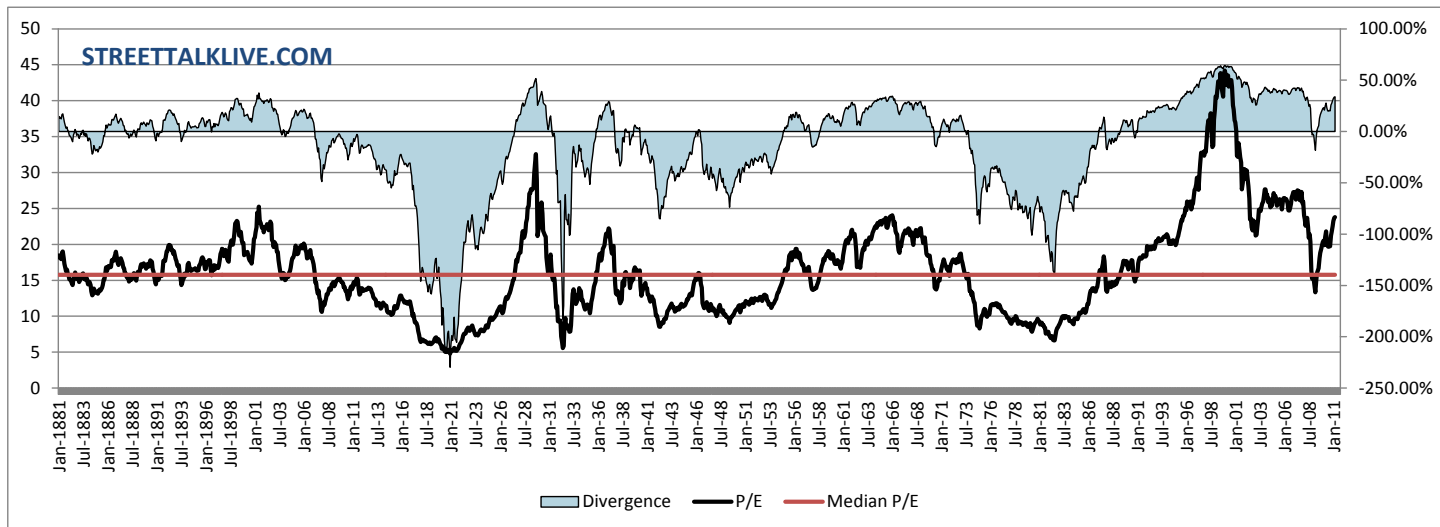


However, it is not just profitability that factors into the continuation of this cycle. Profits and earnings are certainly an important aspect of stock market growth, but let us not forget, that the stock market tends to extrapolate the current input of information into the future. In other words, the stock market is NOT efficient in the short term which is why we have bubbles and busts. This process has continued fairly unabated since 1900 and will continue into the future as it is driven by, as we have written about previously, human psychology.

We have written several times about market cycles in the past and, for investors that have 20 years or less to retirement it is critically important to understand that it very much matters whether the starting valuation (PE) is high or low when one starts to invest.

Where individuals get trapped is that in any given year (or even for several years), stock market returns may do random things. In other words, just because a market is richly valued does not mean it cannot get more so. Likewise, just because a market is cheaply valued, does not mean it cannot get cheaper. This is the effect of human psychology interfering with the markets on a short term basis. However, in the longer term valuations ALWAYS rule the day.

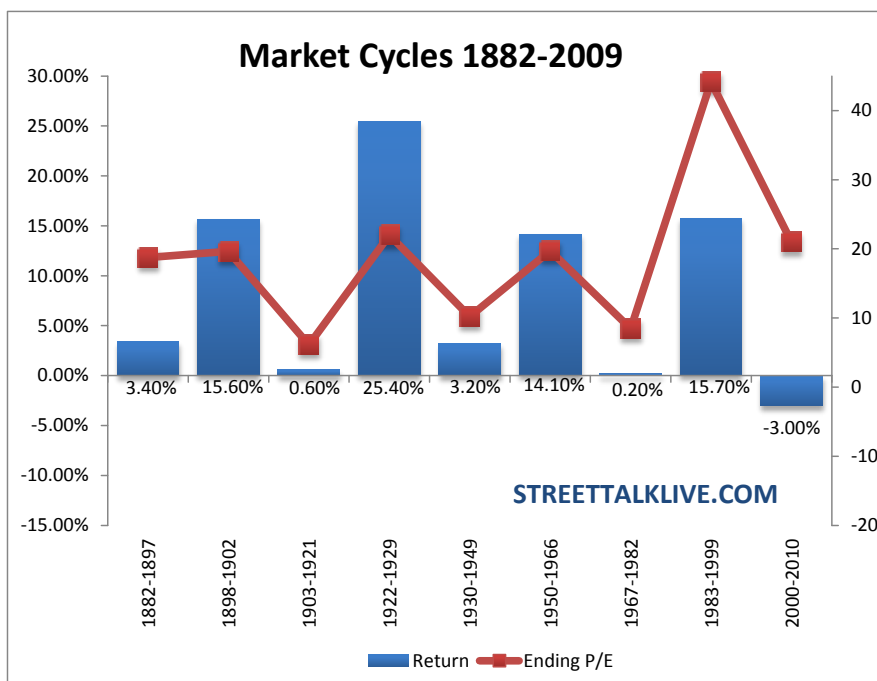
As a result of the preceding point, many think that returns are random. While that may be true in a given year, over a sufficient period of time, expected future returns are anything but random. The stock market fluctuates over long periods of time, between low and high PE valuations.



As you can see in the chart above these cycles can last up to 20 years, and in that timeframe, people are apt to forget or ignore long-term cycles of PE expansion and PE compression. This has been deadly to investors.

Here is the point that you need to understand as shown in the chart to the right. **The bulk of stock market gains frequently come from PE expansion, not from improved earnings.** Therefore, it is critically important to know where in the cycle one is (whether PEs are in a state of expansion or contraction) when investing for your retirement.

During periods of valuation contractions, as we are in now, returns tend to be very low. While the media pundits keep preaching about the fact that valuations are at their long term average they are missing two VERY critical points. Refer back to the chart above – 1) valuations tend to correct beyond their long term mean (as identified in the deviation graph) and 2) you want to be an investor when you are significantly below the long



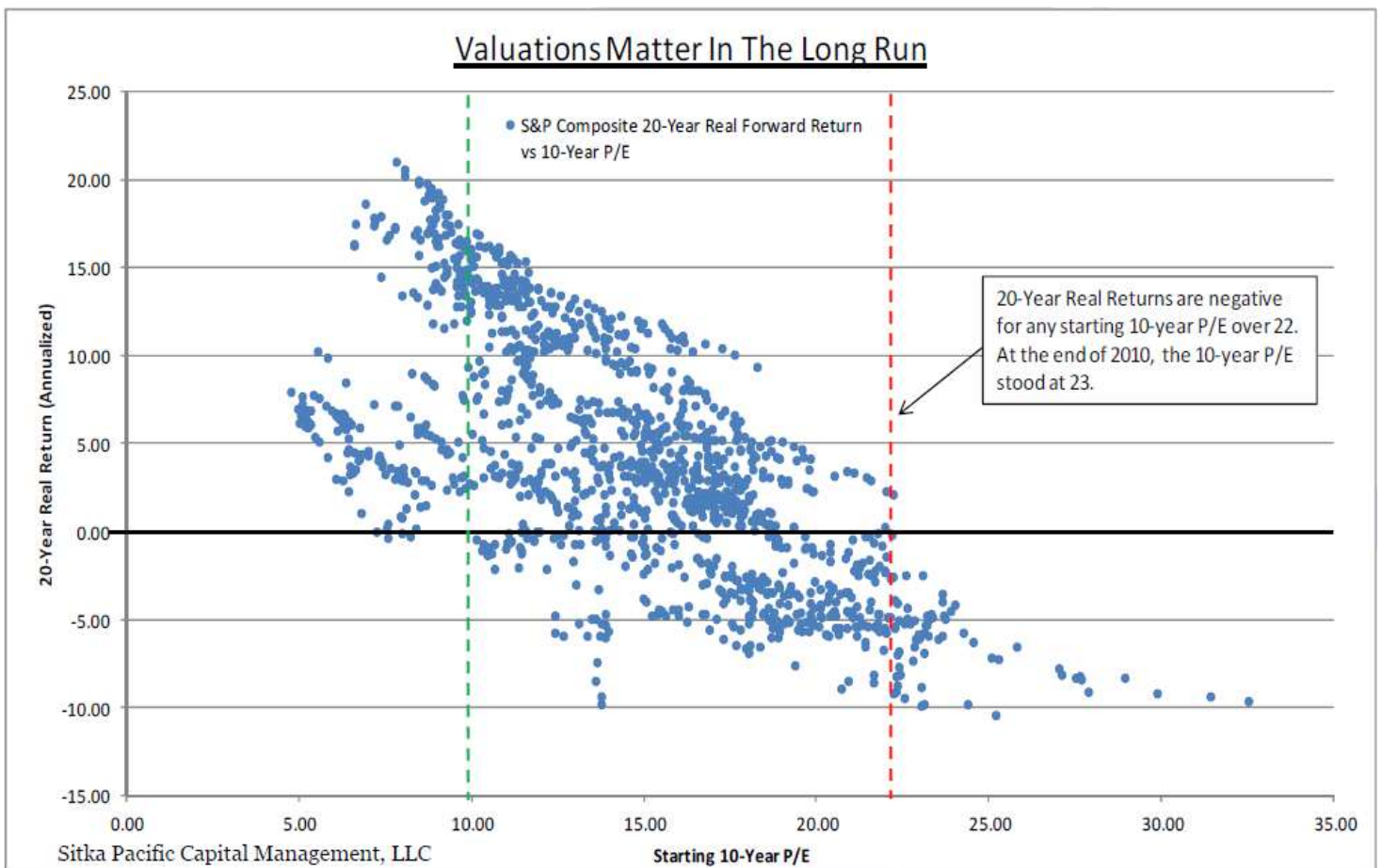
term average and we just haven't reached that point yet. Most likely, had the Federal Reserve and the current Administration not completely freaked out by a larger than normal recession and responded by flooding the system with liquidity, market valuations would have corrected well below their long term means and we would now be talking about what a great time to invest it is. However, for now, that has been put on hold and most likely over the next decade we will continue to grind our way lower through a series of market booms and busts that are artificially driven.

Valuations Matter in the Long Run

Consider this from Sitka Pacific: *“Depending on how closely you follow the financial markets, it may be surprising to learn that profits are at new highs even though stock prices, as measured by the S&P 500, are still 20% below their highs. In other words, new highs in profits haven't translated into new highs in stock prices. If we go back even further, after-tax corporate profits soared 175% from the first quarter of 2000 through the second quarter of 2010. However, during that same time, stock prices fell roughly 15%.*

In fact, there is nothing novel about a period of falling stock prices and rising earnings. Since the end of World War II, corporate profits have more or less trended continuously higher, with only minor interruptions during recessions. However, stock prices have gone through long periods in which they trended sideways or down, even though earnings continued to rise. From 1966 to 1980 after-tax corporate earnings rose 244%, but the price of the S&P 500 rose only 18% during that period. In contrast, earnings grew only 112% during the next 14 years from 1980 to 1994, but the S&P 500 rose 327% over that time.

Although very short-term returns are influenced by corporate earnings, beyond the short-term it is not trends in earnings but valuations and trends in valuations that determine stock market returns. In short, when valuations are low and increasing, long-term stock market returns are high. When valuations are high and decreasing, long-term stock market returns are low—even negative at times of peak valuations.



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There are many ways to measure the valuation of the stock market, but relatively few ways that have value when they are applied across many types of bull and bear markets. Over the past year we have focused on the price-to-earnings measure popularized by economist Robert Shiller, which uses a 10-year average of earnings. Since earnings have at times fluctuated wildly in the short run, a 10-year average captures a much more reliable snapshot of the long-term profitability of public companies.

As you probably know, the stock market peak 10 years ago was the largest bubble in this country's history. Previous bull markets ended with a 10-year P/E ratio in the 23–33 range, with the high point being the peak in 1929 at 33, just prior to the Great Depression. However, the bull market that ended in 2000 recorded a peak 10-year P/E ratio of 44, a valuation that was 33% higher than in 1929.

To really understand on a practical level how high valuations were at the peak in 2000, it helps to look at market returns from different valuation levels before the bubble in the 1990s. The chart below has a blue dot for every month from 1881 through 1990. The horizontal axis at the bottom shows the 10-year P/E of the S&P Composite during that month, and the vertical axis to the left shows the subsequent 20-year inflation adjusted return of the market.

Prior to 1990, each month in which the 10-year P/E was under 10 (to the left of the green line) had a positive inflation-adjusted return over the next 20 years. That means that at those low valuations, you could confidently buy-and-hold stocks for the long term and know that the market would beat inflation over time—often by a significant amount.

However, for 10-year P/E ratios above 22 (to the right of the red line), there is not a single month between 1881 and 1990 in which the market had a positive inflation-adjusted return in the subsequent 20 years. And for P/E ratios above 25, past returns have approached –10% annualized, a rate of return that gives an 88% inflation-adjusted loss over 20 years.

Since 1995, the market had been above 10-year P/E valuations of 22 for 13 consecutive years, until July 2008. After a brief decline in 2009 into valuations that would be considered “average” historically, the market ended 2010 with a 10-year P/E of 23. Although this is about half of the peak valuation in 2000, it is still above valuation levels that have produced positive inflation-adjusted returns in the past.

With a peak 10-year P/E ratio of 44 in 2000, it is no mystery why returns over the past decade have been poor. On a consumer price index adjusted basis, the S&P 500 ended last year 31% below its 2000 peak, for an annualized return of –3%. Although we'll have to wait another 10 years to see the S&P 500's 20-year inflation-adjusted return from its record P/E of 44, it is almost certain to be a negative number, and probably a large negative number.”

Earnings Growth Unsustainable

Now that we have done a quick recap of market cycles – let's talk about the two parts that make up valuations - Price and Earnings (P/E's). Price to

Earnings is the basic measure of valuation – many others have been used since the 1980’s such as Price to Cash Flow, Price to Free Cash Flow, Price to Sales, etc., however, Price to Earnings (P/E) is the grandfather of them all and is most relevant to our conversation today since we are talking about “earnings” and the growth of those earnings going forward.

There is also a key consideration in looking at valuations. You can NOT compare price to “forward” operating earnings today to historical price to earnings valuations because the historical valuations are based on REPORTED earnings – here is the difference from S&P:

Operating Earnings: *“This measure focuses on the earnings from a company’s operations. It is usually defined by As Reported Earnings with certain charges reversed to exclude certain corporate or onetime expenses. The major drawback is the lack of a generally accepted definition. The use of Operating Earnings seems to come from internal management controls used when a business unit manager is not responsible for managing corporate-level costs.”*

As Reported Earnings: *“Earnings including all charges except for discontinued operations and extraordinary items, as defined by GAAP. This is the broadest measure of corporate performance of the three considered here. It is also the traditional measure with a long history. It has been used for the S&P 500 and for company analyses for decades.”*

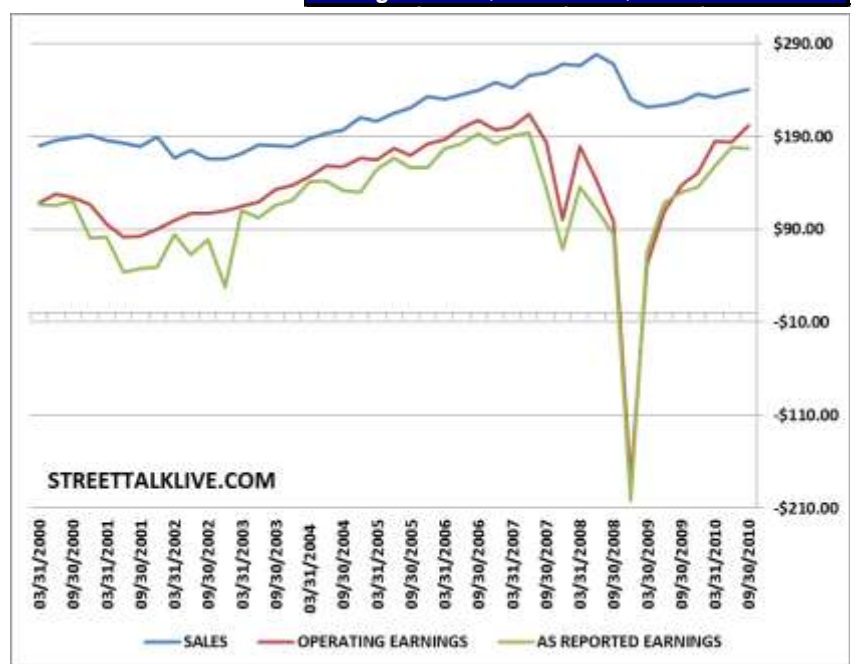
The real problem with Operating Earnings is the “one-time expenses” category which has basically become a dumping ground for accounting expenses every year. In other words, the problem is stated in the very definition by S&P: *“...used when a business unit manager is NOT responsible for managing corporate-level costs.”*

As you will notice in the chart to the right there has been a very big discrepancy between operating and reporting earnings. Primarily this discrepancy occurs at two periods in time. Analysts tend to extrapolate current earnings growth currently into the future without taking into account the normal cyclical nature of the economy and earnings. Second, they tend to stay optimistically biased even when faced with severe economic corrections. I have highlighted these issues in red. These are the periods leading up to and during the economic recessions.

	OPERATING EARNINGS PER SHR (ests are bottom up)	REPORTED EARNINGS PER SHR (ests are top down)	% DIFF BETWEEN OPERATING AND REPORTED
2010	\$83.76	\$77.34	8.30%
2009	\$56.86	\$50.97	11.56%
2008	\$49.51	\$14.88	232.73%
2007	\$82.54	\$66.18	24.72%
2006	\$87.72	\$81.51	7.62%
2005	\$76.45	\$69.93	9.32%
2004	\$67.68	\$58.55	15.59%
2003	\$54.69	\$48.74	12.21%
2002	\$46.04	\$27.59	66.87%
2001	\$38.85	\$24.69	57.35%
2000	\$56.13	\$50.00	12.26%
Average	\$63.66	\$51.85	41.68%

Notice that at the peak of an economic cycle, and consequently the peak of a bull market – the difference between operating and reported earnings is the narrowest. The last time that the difference in measures was this small was in 2006.

The next chart is one that we have showed you before. The blue line is SALES. In other words, at the top line of the earnings statement is sales. This is where the revenue is derived. After all the expenses such as rent, salary, benefits, costs of goods, etc. we wind up with what is left over and is reported as earnings. The red line is the more liberal interpretation of operating earnings and the green line is GAAP based reported earnings.



There are TWO very important points to take away from this chart. 1) Sales have not grown in relation to the recovery in earnings. This is proof that most of the earnings recovery is in the cost cutting side of the balance sheet which is unsustainable in the long term; and 2) notice the reported earnings have already started to show a slight decline while operating earnings are still up ticking.

Also, it is important to notice that from 2000 to 2007 – sales and earnings grew at roughly the same rate. The correlation makes a lot of sense as sales are at the top of the income statements and net income is at the bottom – these two items should be correlated. However, notice the disparity between these during the recent financial crisis. Eventually these items will realign themselves.

There are, of course, several big drivers that come into play here.

- Federal stimulus that is being poured into the banking sector via QE and Permanent Open Market Operations.
- Inflationary pressures due to rising commodity costs – particularly basic materials, food and energy.
- Wages
- Employment

As shown in the very first chart in today’s report the Federal stimulus programs have concentrated themselves primarily in the financial sector driving those profits higher. The banks have now deluded themselves into thinking they are a profitable business model again, and as of late, have begun taking money OUT of loan loss reserves to pad their earnings, pay dividends and buy back stock. Without accounting gimmickry, FASB support of market-to-myth accounting and massive injections on a daily basis from the Fed these very same banks would be auction block – and most likely will be at some point in the future.

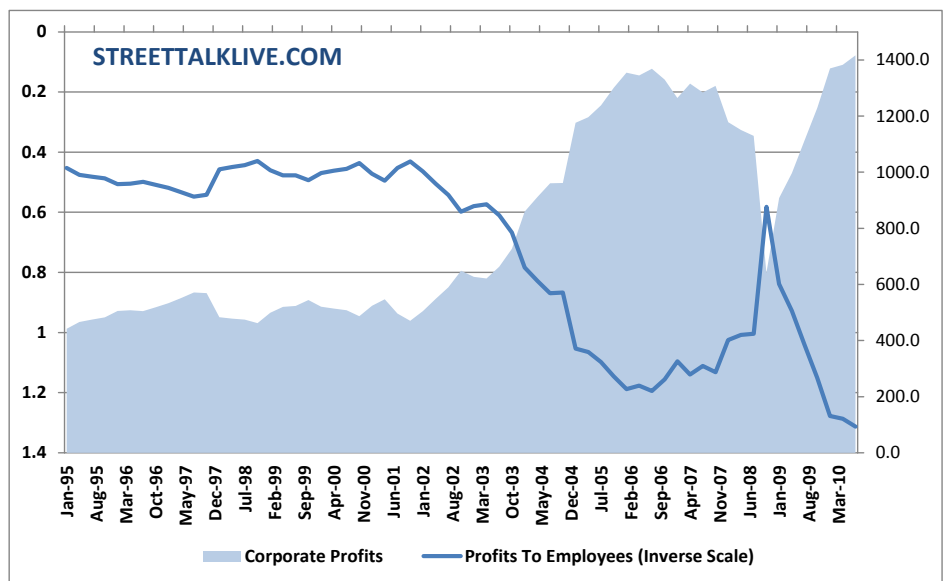
But I digress – the chart also shows that non-financial profits have already begun to turn down. This will prove to be very hurtful for analysts who are still pegging earnings in the mid-\$90 per share for 2011. The reason for the downturn in non-financial profit margins, which is going to most likely accelerate later this year, is the rise in input prices for production and manufacturing of items. As the cost of basic materials and energy rise, the cost of producing an item is also higher. Therefore, in order to keep the same profit margin the producer has to raise his selling price.

In an economy with high unemployment and lower wage growth this could become problematic.

The next two charts to the right demonstrate this very clearly.

The first shows wages to corporate profits. As profits have soared over the last couple of years; wages have declined sharply and not recovered. The second chart shows corporate profits to the number of employees; likewise there has been no recovery here either.

It is very hard to increase sales, the topline of the income statement, when consumers, which make up 70% of GDP, have no job and very little income.



This becomes even more critical when more and more of that income is eaten up by higher living costs as shown in the chart on the following page.

The Billion Prices Project from MIT tracks the daily changes of 5 million individual items in 70 countries and just about everything from supermarkets to electronics, apparel, furniture, real estate and more.

While the consumer price index is massaged and “hedonized” by government manipulation – the Billion Prices Project daily online price index just raw price data that the consumer feels at home every day.

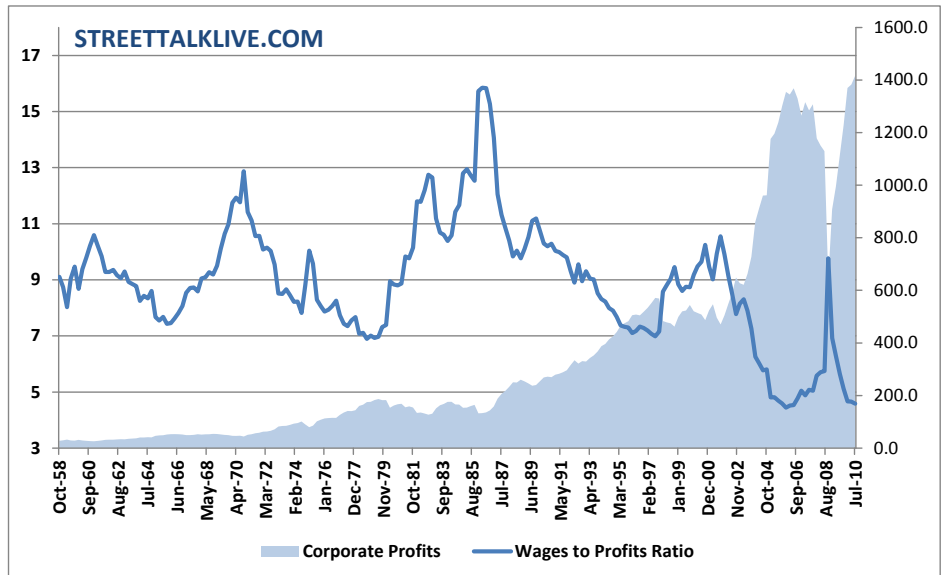
As you will notice there has been a marked rise (almost 3%) in inflation pressures in just 2011 alone. This in turn impacts already right discretionary budgets at home which will ultimately translated in lower volumes of sales and sales of reduced price items affecting higher end retailers.

All in all none of these issues portend well to the optimistic analysts’ projections that we are currently seeing. As the projections are revised downward this will ultimately put pressure on prices.

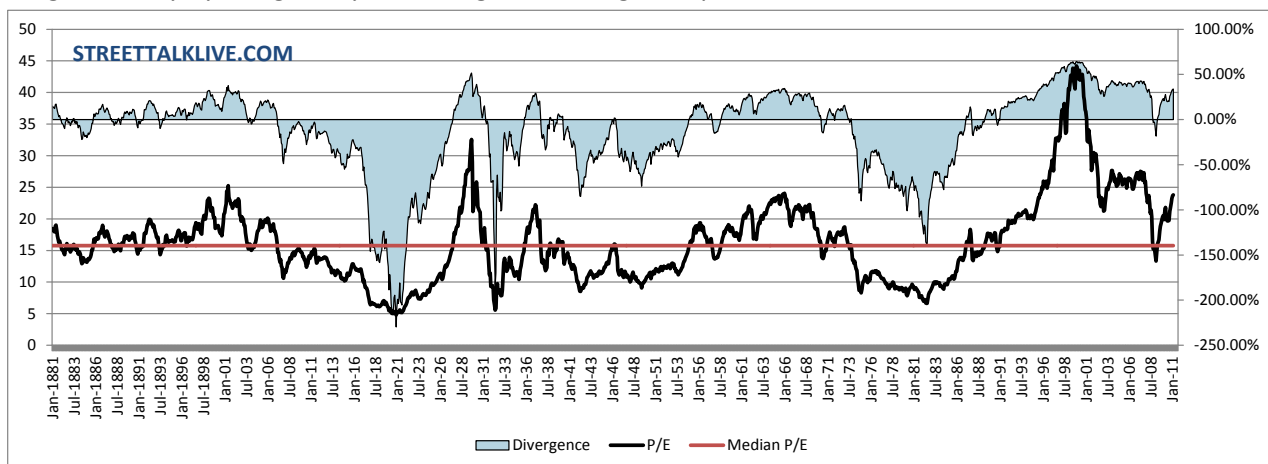
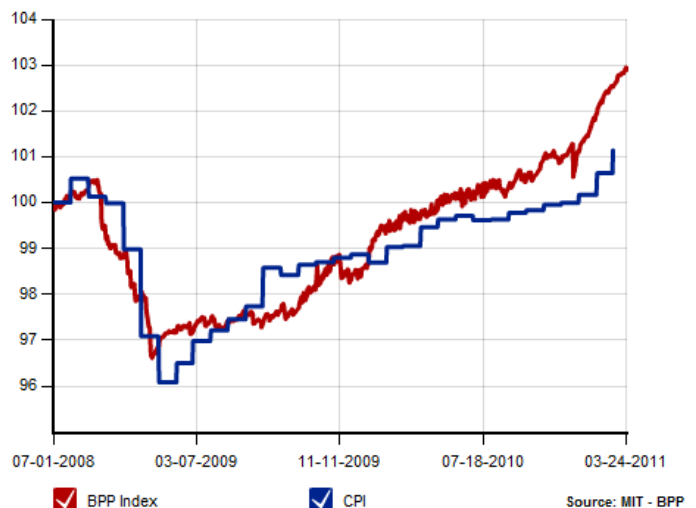
The Only P/E You Can Count On

All of this conversation leads us to this one final point. When looking at P/E’s in terms of valuations and where we are within the current market cycle – we can only rely on and use reported trailing earnings. This way we are all working off an apple to apples comparison of the current market versus where we have been in the past.

As we showed you in the P/E chart above, a convention produced by Dr. Robert Shiller, was to smooth the P/E over time to reduce the volatility of year over year market swings and earnings volatility by using a 10 year average of earnings and price.



DAILY ONLINE PRICE INDEX



As you can see from 1901-1918, 1929-1951, and 1965-1983 were all periods where valuations were contracting. Consequently the return from holding stocks during these periods was close to zero. Opposed to this are the other periods where valuations are rising and consequently holding stocks during these periods was hugely profitable.

Today, with valuations near 23x earnings and still declining from the peak in 2000 we are currently at the half-way market of this secular bear market.

Hopefully you now realize that expectations of rising earnings being tremendous for the stock market are a fallacious construct. Such talk ignores high valuations, the long-term trend in valuations, and demographics. Moreover, it's debatable if earnings are likely to rise much further in the first place.

With that in mind, people chasing this market, as well as those fully invested; do not realize how lucky they have been.

I receive emails from someone almost daily who fears being out the market. I heard the same thing in 2007. I suggest people ought to fear being fully invested with no hedges or at least not having some portion of the portfolio in fixed income to help weather a large correction in the market.

However, I do not know where the market is headed this year, nor does anyone else. 2011 may turn out like 1998 or it may turn out like 2008. Either way, history strongly suggests that 10-year and 20-year returns looking ahead are likely to be low, if not negative.

Investing, like life, is a marathon not a sprint. Sometimes the prudent thing to do is sit on the sidelines waiting for better opportunities, even if it means enduring cat-calls and taunts from those who do not have any understanding of risk or history.

As we always say – it is much easier to make up a lost opportunity than lost capital.

Hoping you had a terrific weekend.

Lance Roberts

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Lance Roberts
Director of Fundamental & Economic Analysis

Michael Smith
Director of Alternative Investments

Hope Edick
Compliance

Leah Miller
Operations

Lynette Lalanne
Streetwork Insurance Group

Office Location:
One CityCentre
800 Town & Country Blvd.
Suite 410
Houston, TX 77024

Tel: 281-822-8800

Web Sites:
www.streetworkadvisors.com

Email: (For More Information)
Streetwork@streetworklive.com

For Appointments Contact
Kim Standing kim@streetworkadvisors.com

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