

*By Stephen F. Oakes*

## **Happy Days Are Here Again?**

*“The individual investor should act consistently as an investor and not as a speculator.” –Benjamin Graham*

Cautious optimism during the previous quarter swiftly morphed into a euphoric mindset as investors sang to the tune “Happy Days Are Here Again.” In the end, continued price appreciation materialized, lifting the Dow Jones Industrial Average by 13.49% while the S&P 500 posted a 19.26% total return year-to-date. Despite advances in the S&P 500, the index has declined roughly 30% from its peak and remains lower than a decade ago.

While many anticipated a deep pullback in what had historically been the worst performing month for the markets, gains made in September diverged from the norm when the Dow ascended 2.27%. Historically, the months of September have not been kind. For example, investor wealth plunged by 15% in '30, then 30.7% a year later in '31, another 12% in '74, an additional 11% in '02, and a 9% drop on the heels of the Lehman Brothers Bankruptcy in '08.

Evidence clearly reflects a “flight to risk” as such investment vehicles have rewarded investors with substantially higher YTD returns. For example, diversified emerging markets are up 61.03% and junk bonds have soared 38.74% while the “blue chip” large-cap value sector has gained 18.5%. The more defensive healthcare and utility sectors have trailed even more, advancing 15.8% and 10.9%, respectively. Investors electing to stay on the sidelines in money markets have received a miniscule .22% return. On the bond side, the benchmark 10-year Treasury yield dipped 22 basis points to 3.31% which should have aided mortgage refinancing. Instead, continuing high unemployment trumped the favorable rate environment as foreclosure filings spiked 71%.

Although the stock market has traditionally been a “leading indicator,” we are concerned about the seeming disconnect between the market resurgence and the still fragile economic underpinnings. Since the beginning of the recession in December '07, unemployment in the U.S. has risen from 7.6 million to over 15.1 million with initial monthly jobless claims stubbornly continuing above 500,000. The statistics from Main Street show 17% of the labor force either unemployed, partially employed, or seeking employment with some 937,840 properties receiving foreclosure filings in just the last 90 days. And due to the combination of stimulus spending and dwindling tax revenues, the Congressional Budget Office (CBO) now estimates that the U.S. federal budget deficit for 2009 will total a staggering \$1.4 trillion which, at 11.2% of Gross Domestic Product (GDP), will be the highest since World War II. While the market run up has been enjoyable, these numbers suggest caution.

A closer look at Wall Street casts even greater suspicion on Mr. Market. Consider that, during the third quarter, Goldman Sachs reported trading and investment revenue of \$10.03 billion, a 55% gain from Q2, while net revenue streams from their core businesses of underwriting, asset management and securities were down 15%, 29% and 48%, more consistent with the weak economic conditions. Could it be that Goldman capitalized on its newly acquired access to the Fed discount window, utilized the “near zero cost” taxpayer provided funds and leveraged them into stunning stock market profits? While difficult to track, we do know that Goldman Sachs and other high frequency trading operations made up 73% of all U.S. equity trading volume. Whether or not this trading activity has been responsible for pushing the markets to new heights, the current S&P 500 price-to-earnings ratio, based on “reported” data stands at a nose-bleed 140.76. When compared to the average P/E of 15.60 since 1935, one can only ponder as to whether or not this is a sign of ominous times to come. As we know all too well, even irrationality has boundaries and current valuation levels would seem to suggest that ultimately, either market prices will adjust or corporate earnings must soar.