

By Christopher E. Grant

Forecasters Hedge On '09

On the One Hand...On the Other Hand

For the past three years, we have devoted our winter newsletter to setting the investment stage for the coming year by publishing the stock market predictions of a variety of experts.

Three Strikes You're Out

Recalling the results from 2006, the 15.8% total return for the benchmark S&P 500 outpaced the expectations of 14 of the 16 cited gurus. **However, that year's predictions by Steve Leutold, Marc Faber and John Mauldin for double-digit losses as well as Jordan Netburn's forecast for a Dow 14,000 were all "off the charts."**

At the end of '07, we reported on a broader study of market forecasts covering the years 1997-2007, only to discover that the annual "expert" forecasts were off by 5%-30% (too high or too low), with an average absolute error of 16.3%. Interestingly, during this entire timeframe, a consensus forecast for a decline in the index occurred only once. Perhaps **more embarrassing was the fact that a mechanically calculated forecast (using the average annual S&P 500 index gain from 1951 through the year preceding the forecast year) actually beat the experts' average six times, tied twice and lost only twice.**

This brings us to the results from last year's newsletter, "Pundit Prognostications." Topping the list of bulls was Elaine Garzarelli, president of Garzarelli Capital, known for her prescient prediction of the 1987 market crash. Not so for '08, as she predicted a year-end S&P 500 target of 1,780 or a 21.25%

gain. David Bianco of UBS AG, Kevin Gardiner at HSBC Holdings PLC and Johnathan Golub of Bear Stearns all targeted the S&P at 1,670 or a 16% gain, with Tobias Levkovich, chief U.S. equity strategist for Citigroup, only a bit less optimistic with his target at 1,750 or a 14% increase. Among the minority were Ben Inker, Director of Asset Allocation at Boston-based GMO who foresaw a 2% dip and "mega-bear" Robert Arnott, Chairman of Research Affiliates who called for an 8% decline to 1,350. **Bottom line; S&P 500 at December 31, 2008, 903.25, down 38.5%. Range of error; 30%-60% too high.**

Before you cry foul with "Nobody could have predicted..." our point is not to ridicule these professionals who perennially place their necks on the chopping block in hopes of gaining notoriety for their powers of prediction. There is no doubt that everyone on the above list modified his/her outlook multiple times as the events of 2008 unfolded.

The real purpose of this performance review is to remind investors that January stock market forecasts, while entertaining and even persuasive at the time, have historically been as successful as New Year's resolutions to join a gym and lose weight.

Probably Partly Cloudy, A Chance of Clear Skies... Or a Storm

Stock market forecasts traditionally tend to be sunny, and 2009 is no exception, as exemplified by the fact that **all ten participants in this year's Barrons Roundtable are calling for gains of**

15-20%. However, after a year of unmatched volatility, marked by a near collapse of the world's financial system, the worst recession in nearly 30 years and the biggest stock market decline since 1937, many investment "crystal ballers" appear to have learned their lesson, as they are hesitant to declare with any certainty that stocks will even end 2009 on the plus side of ledger.

With so much of the recession/recovery yet to play out, they are instead opting to add best and worst cases to their "most likely" scenarios. For example, Abhijit Chakraborti of Morgan Stanley presents his base case, a 975 year-end close for the S&P 500 index, or an 8% '09 gain. However, he also felt the need to lay out a bear-case scenario with a projected decline of 56%, as well as a super-optimistic bull case, calling for a 32% gain.

A recent Citigroup survey of institutional investors reflects a similarly wide disparity of potential performance outcomes. More than 20% expect the S&P to rise between 11% and 22%, while 15% of respondents think that stocks could fall as much as 39%, while an equal number believe that stocks could post gains of up to 55%.

With plausible 2009 outcomes for the S&P 500 ranging from 400 to 1,400, it is clear that economically, we are in uncharted waters. Thus, understanding and preparing for each of several possible scenarios is clearly more important than pretending to know the direction and magnitude of the next market move.

Consensus Opinion: Muddle Through

The base case, or **consensus opinion on Wall Street, assumes an economic**

recovery beginning around mid-year, resulting in S&P 500 gains between 8% and 22% despite the current lack of consumer confidence as exemplified by a pathetically weak holiday shopping season and fast-rising trend in unemployment. The mainstream opinion is that the unprecedented government intervention that began in late 2008 augmented by the projected \$825 billion stimulus plan working its way through Congress (with passage anticipated by mid-February), will generate visible signs of economic recovery including the thawing out of the credit markets. **Given that the stock market is "forward-looking," with the beginning of a rebound normally preceding an economic recovery by a number of months, "expectations" of positive, market-driving events will trigger stock price advances.**

On a valuation basis, Morgan Stanley's Chakraborti argues that stocks are already priced attractively after their 38% decline in 2008. Based on analysts' 2009 profit projection of \$77.35 for the S&P 500, the market is trading at 11.7 times its forward 12 months' earnings stream, below the long-term historical price-earnings ratio of approximately 15. Even if a far more conservative prediction on earnings of \$53 is plugged into the formula, Chakraborti sees the market as "supportive," at 17 times forward earnings.

For those who track market sentiment, public confidence is justifiably at an all-time low. Nightly reports of blatant public corruption and losses from a \$50 billion Ponzi scheme only add to investors' skepticism of a near-term economic recovery. This level of pessimism arguably increases the chances for a contrarian "upside surprise" if things don't turn out as bad

as the doom-and-gloomers warn. **Critical signals to monitor include the continuation of low gas prices, visible impact from the fiscal stimulus, housing price and foreclosure stabilization and a viable solution to the banking crisis.** Because some of these short-term signals will sometimes be contradictory, we should be prepared for a continuing market “see-saw,” as we are likely to experience a number of false starts before a sustainable upward trend can be mounted.

The Bear Case, 2008 Redux

Making the case for a repeat of 2008 is Peter Schiff, president of Euro Pacific Capital who argues, “The bad news is that our economy is broken, and there is nothing the government can do to fix it.” **Schiff expects another leg down in the depressed housing market, igniting a new wave of job losses, home foreclosures, bank losses and failures, and no relief from the frozen credit markets.** Such a repeat of 2008 (a 38% decline) would leave the S&P 500 at the 560 level. Morgan Stanley’s Chakraborti “low road” scenario is even more negative as he puts a 25% probability on an S&P low of 400, a shocking loss of 56% from year-end 2008.

Such a bear case is predicated on further weakening of economic growth along with outright deflation. Under this scenario, GDP (Gross Domestic Product) would actually decline 2-3% from the already depressed levels of 2008, which would be the first year of economic contraction since 1991.

Since the U.S. is still the world’s largest economic engine, a contraction here could easily cause a domino effect on the once surging emerging markets such as China and India. **The worst case would**

involve a new round of forced selling of stocks by financial institutions such as hedge funds and mutual funds that need to raise cash quickly to meet redemption demands from investors. LPL Financial chief market strategist Jeffrey Kleintop warns, “Such a sell-because-you-have-to-sell frenzy could spark a vicious downward spiral, like the kind experienced in October when stocks were in free fall.”

The Bullish Case: Wishful Thinking

So how are the markets going to get so well so fast after the worst performance since the Great Depression? **The case is simple in that it represents the consensus opinion on steroids. The turn in the economy, credit markets and corporate profitability comes faster, the rebound is bigger and pessimism turns to euphoric optimism.** The 2008 infusions along with the balance of the TARP funds and the “to be enacted” stimulus plan turn out to be just what the doctor ordered.

Also critical to this scenario is the continuation of low interest rates, successful new job creation, a bottoming in home prices and a return to normal credit markets – all in the immediate future. While we remain skeptical of this scenario, it does paint the picture of recovery, even if it plays out at a more modest pace.

Should all the economic tools prove effective, the psychological impact on investors would be monumental. Investor and consumer confidence would receive an immediate boost. Consumers now fixated on holding cash for fear of losing their jobs would begin

to spend again, propelling a rebound in corporate profitability. And risk-averse investors holding 0% return Treasuries would begin to take greater risk in search of higher returns. The mountains of cash now sitting on the sidelines would pour back into stocks, creating a demand for shares that has been absent since the financial panic broke out last fall. **Such a bullish case, should it come to fruition, would reward investors with huge profits. In fact, with all the stars aligned, Kleintop's and Chakraborti's high-end S&P targets are 1365 and 1190, gains of 51% and 32%, respectively.**

Reality, Patience and Confidence

As we have demonstrated over the past three years, the stock market forecasting game is a treacherous one. Given the myriad uncertainties impacting today's global economy, even those prognosticators that have been willing to go on the record in the past are resorting to three legged scenarios. **The reality is that, as both institutions and households deleverage from their past excesses, the economies of the world are going to shrink.** When they eventually reach a new point of equilibrium, the recession will end and these economies will once again begin to expand, grow, hire new workers and prosper. How long it will take and which path they will follow is yet to be determined.

While we remain cautious in the short term as the recession runs its course, we are also optimistic and confident about the future. We are in agreement with manager and financial author John Mauldin who reminds us, "In 1978, in the midst of high inflation, bear markets, and malaise about all our jobs going overseas, the correct answer to the question,

"Where will all the needed new jobs come from?" was 'I don't know, but they will.' That is the correct answer today. **That is what free markets and capitalism do. They find a way to make new paths and new businesses where none existed before. And it will happen again. Just with a little lag this time."**

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