



ATLANTIC CAPITAL MANAGEMENT

## **A MARKET PAUSE FOR REALITY**

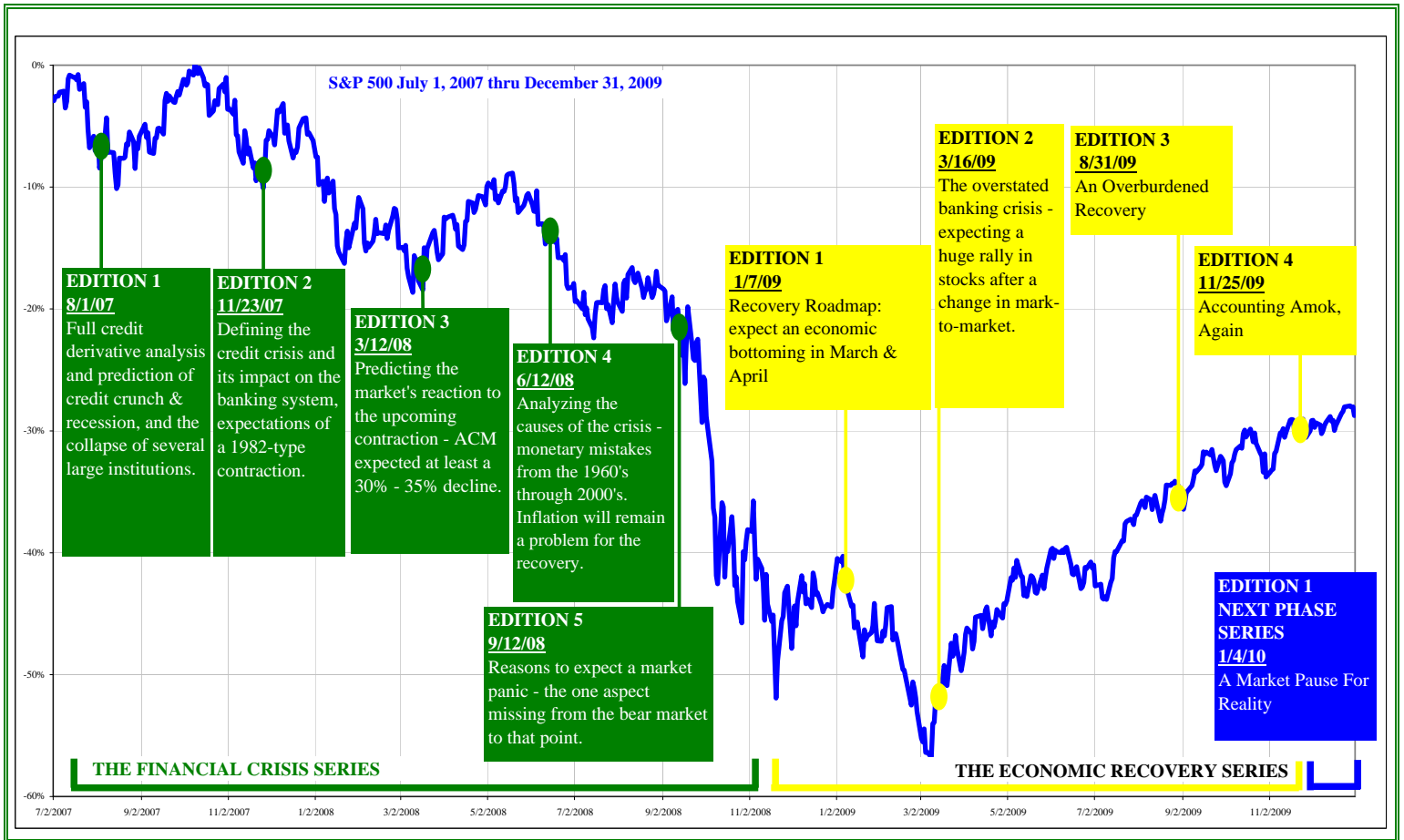
**Some Indications For 2010**

SPECIAL INVESTMENT RESEARCH REPORT

January 4, 2010

EDITION 1 **THE NEXT PHASE SERIES**

Written By  
Jeffrey P. Snider, President



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- Edition 1** "Finding Profit In Corporate America"  
*Efficiency, Flexibility, and Sustainability Dictate the Fall, and the Rise*

Pages 1 & 2	<b>Introduction</b> The market has rallied farther and faster than any previous relief rally. Every relief rally has featured a correction or pause after rising rapidly. We examine the market's current technical and fundamental properties to estimate both the timing and depth of any reversal.
Page 3	<b>Part 1 – Technically Speaking</b> Data on the average correction length and depth. Explaining a Money Flow Indicator.
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## INTRODUCTION

### A MARKET PAUSE FOR REALITY

#### Some Indications For 2010

The stock markets have moved higher in rapid fashion since the March 2009 lows. Much of the move has been without regard to fundamental valuations. This has been the relief rally to end all relief rallies.

Sentiment back in the spring was decidedly negative as much of the Western world was preparing for a rerun of the early 1930's. With the banking system broken and broke, there was little to no hope of recovering from what the "experts" saw as a downward spiral to zero. The "stimulus" was sold to the public under that exact scenario – if the government does not make up for lost spending then nothing will.

The recovery since that point has had little to do with governments (outside of some distortions, like "cash for clunkers") and everything to do with processes. The processes we detailed in January and March 2009 have occurred much as we predicted.

Similarly, economic recoveries and corresponding market rallies also occur as processes. The first step is the relief rally – relief that the worst case is defined and that the sun will rise again. In that first step there is little concern over exactly when the rising will come. Who has time for details when the world has been miraculously saved from fiery disaster?

After the relief fades, there is a pause and a new market phase. In addition to consolidation, the markets refocus on the fundamentals of the economy (making sure the recovery is on track) and of the markets' pricing of those fundamentals.

We believe the relief rally that has driven the market well beyond even the rosier of expectations (markets always overshoot) is beginning to fade. There are both technical and fundamental reasons, which we will detail.

Beyond the relief rally, our underlying economic expectations for a second contraction have not changed. In fact, the date of reckoning seems to have been moved forward as events begin to accelerate the negative economic forces. If the market is entering a new phase, a sustained pause, then a refocus on fundamentals will not end as many now hope.

We have identified a number of important, negative economic and geopolitical forces that still exist and, in our opinion, will persist throughout 2010 and beyond:



- Significant current stock market over-valuation (bordering on extreme) based on historical fundamental and technical valuation analysis, as well as on 2010 and 2011 operating earnings estimates.
- Nonexistent US corporate revenue growth.
- Credit contraction.
- The persistence of extremely high US unemployment levels along with unprecedented numbers leaving the workforce.
- New tax mandates coupled with changing tax environments.
- A distinct lack of options or funding sources for households.
- Unprecedented US and foreign government borrowing.
- The specter of rising inflation and interest rates.
- The real possibility of the first US sovereign debt downgrade in history.
- The potential for as yet unknown financial and geopolitical risks, similar to the Dubai restructuring news.

All of these negative factors are ignored by the mainstream media, producing a huge disconnect between economic reality and market euphoria.



## Part 1 Technically Speaking

The S&P 500 index has risen more than 63% since its March low. Looking at the market from a technical standpoint it becomes increasingly clear that this rally is getting long in the tooth. We are not market technicians, but technical indicators can be useful to help determine market trends, or trend reversals.

In every recovery rally since 1957 (seven total) the stock market has moved quickly higher followed by a pause. The pause has been a sideways to lower movement over an extended period. While the pause in 1975 was only 77 days, the average pause has been 233 calendar days, or just over seven and a half months. During those pauses, the market has corrected an average of 12.5% (reinforcing the perception of a 10% correction). Four of the seven corrections were close to the average decline (83-84, 75, 71, 59-60) while 2004 saw a total drop of nearly 8%. The two outliers were in 1992 and 1962.

The 1992 decline was more of a sideways pause, lasting 161 days. The 1962 correction was a slow crash, falling 27% over 196 calendar days. With the current market up nearly 70% (the average gain in relief rallies is 47%) in only 294 calendar days (the average relief rally lasts 402 days) this current rally has gone the farthest in the least amount of time.

The challenges for investors in the current recovery rally are trying to identify the pause, then ascertaining its depth. Technical analysis (since it has a basis in market psychology) can be useful in determining a trend reversal, particularly due to the psychological nature of the relief rally. Fundamental analysis (in Part 2) can help with the depth – how much of the rally is relief and how much is based on solid valuation.

The first and simplest technical indicator is market volume. On both the NYSE and the NASDAQ, volume has been trending lower since the last solid upward movement in early July through August. Volume trended noticeably lower from September into early December, coinciding with a mostly sideways market. Since mid-December, the markets have moved to new highs. However, volume has not picked up with it, making many traders question the validity of the new yearly highs.

No technical analysis is completely valid without confirmation – every technician looks for confirmation of any technical reading. We can use a Money Flow Index (MFI) calculation to get a deeper view of the volume indication. A money flow index calculates the average money flow (defined as average period price times volume) over a defined rolling number of periods (typically the previous 14 trading days or weeks) separating up days from down days. If average money flow on up days (meaning heavier volume) exceeds the average on down days, the index will move higher. The readings can go from 0 to 100, with any reading over 80 suggesting overbought conditions, while any reading under 20 suggests oversold conditions.

In addition to static readings, the MFI can also suggest divergences in the price of an underlying security or market index. In other words, if an index or stock is reaching new highs while an MFI is not, this suggests that the market highs are not solid and a reversal may be at hand. Again, confirmation of this situation is key. If the underlying index is moving upward, we would want to see a period of lower MFI highs and lower MFI lows, a clear pattern of downward divergence, before being reassured of significant increase in the probability of a reversal.



Another technical indicator is the Relative Strength Index (RSI). An RSI measures the average degree of price movement over a rolling average number of trading days (again the 14 previous periods). Attempting to measure price momentum, the RSI is a gauge of internal strength. Like the MFI, it is indexed from 1 to 100, with any reading over 70 indicating overbought and below 30 as oversold. The most popular use of an RSI is a “failure swing”, another measure of divergence. A “failure swing” is commonly defined as a situation when the underlying security or index reaches new highs but the RSI fails to surpass its previous high. If the RSI then turns down and falls past its recent trough, it has completed the “failure swing” and indicates a trend reversal.

Bollinger bands can also indicate trend reversals after periods of low volatility. The bands consist of upper and lower boundaries, each two standard deviations away from the 20-period moving average. Bollinger bands can be used in conjunction with other indicators, such as an RSI, to confirm trends or reversals. For example, if the price level is close to the upper bound for a period while an RSI diverges, it is an indication of a pending price reversal. The Bollinger bands point to relative price strength/weakness.

Using these technical indicators on the seven relief rallies after recessions, we can reasonably conclude that:

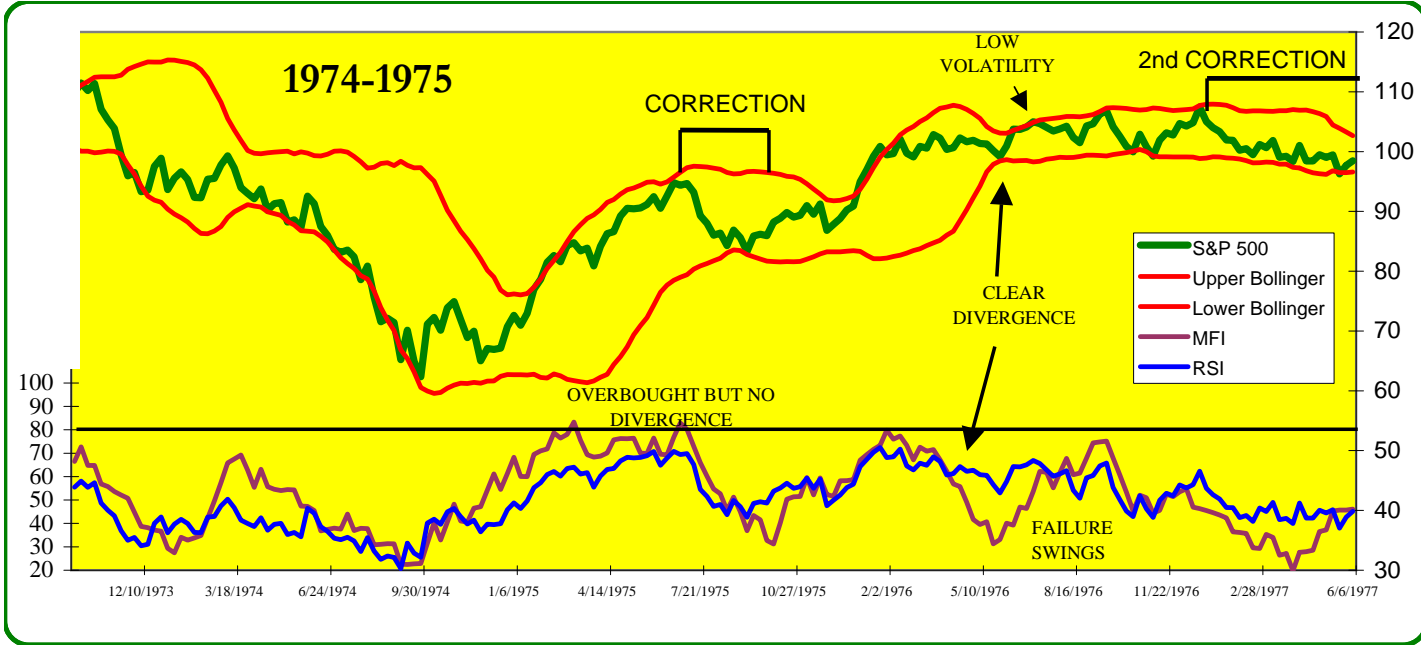
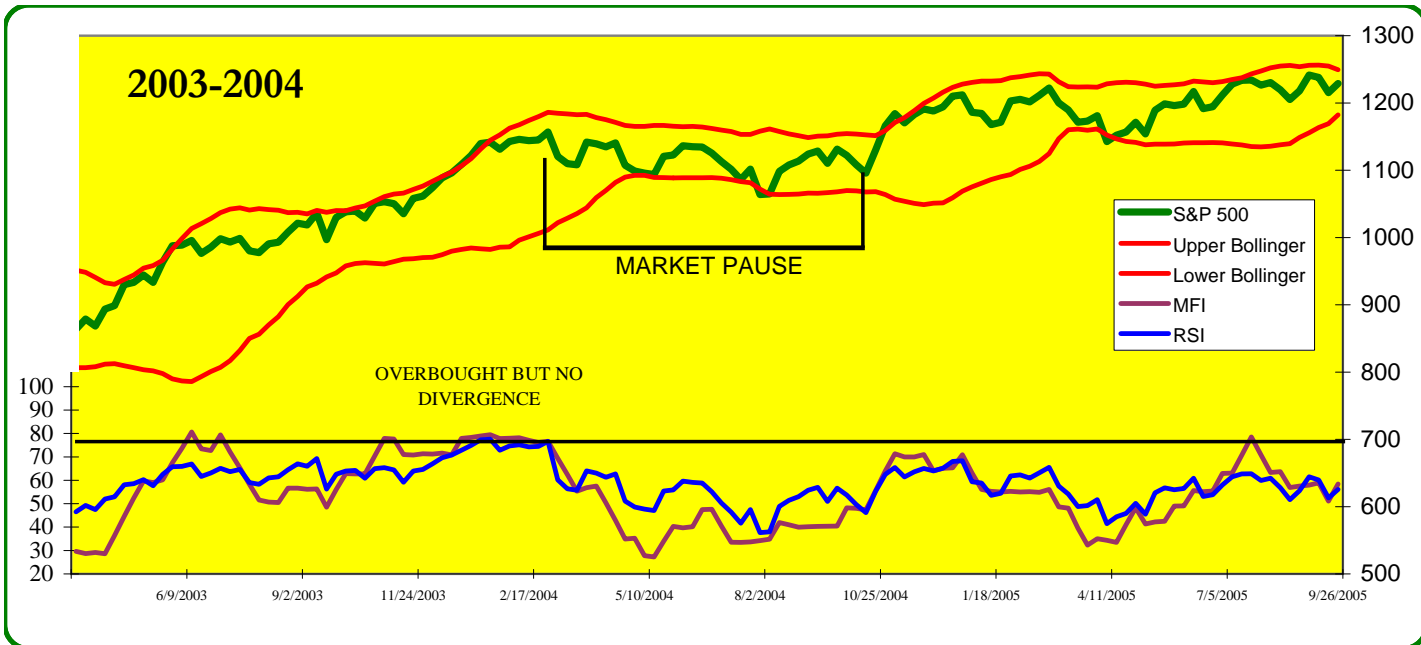
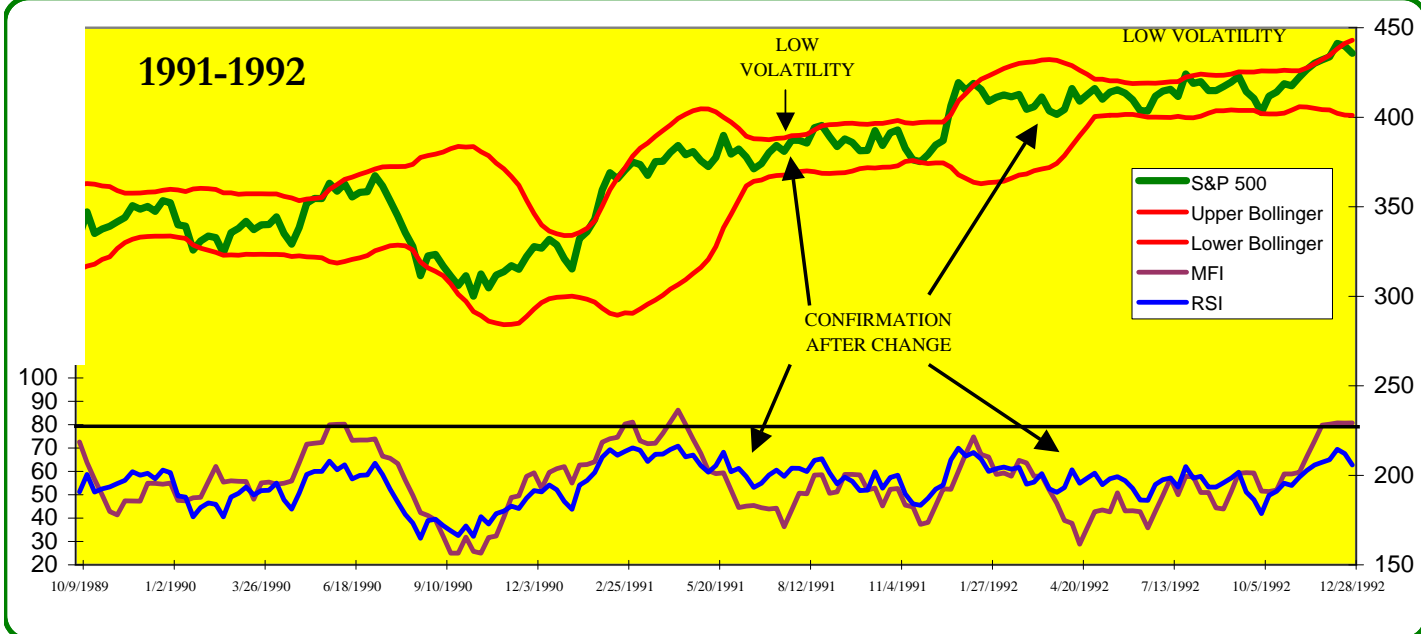
- For four of the rallies (58-59, 61-62, 70-71, 82-84) there were clear technical signals of a reversal: overbought indications in the months preceding the highs, clear divergences in both MFI’s and RSI’s, clear failure swings, and some Bollinger band tightening.
- The 91-92 indicators confirmed the pause the market undertook after the

move had been made. This was one of the outlier corrections, so the technical breakdown is not unsurprising.

- The 03-04 correction began before any solid technical indications. The indicators did, however, solidly confirm the negative direction of the market once the trend was underway.
- The 74-75 correction was also confirmed after the change in trend, most likely due the short, sharp nature of the contraction. The change in trend after the 1976 high (a second correction, not counted in our figures above) is clearly shown by each of the indicators.
- Also not part of our figures above, the 2007 market highs show clear indications of a pending reversal.

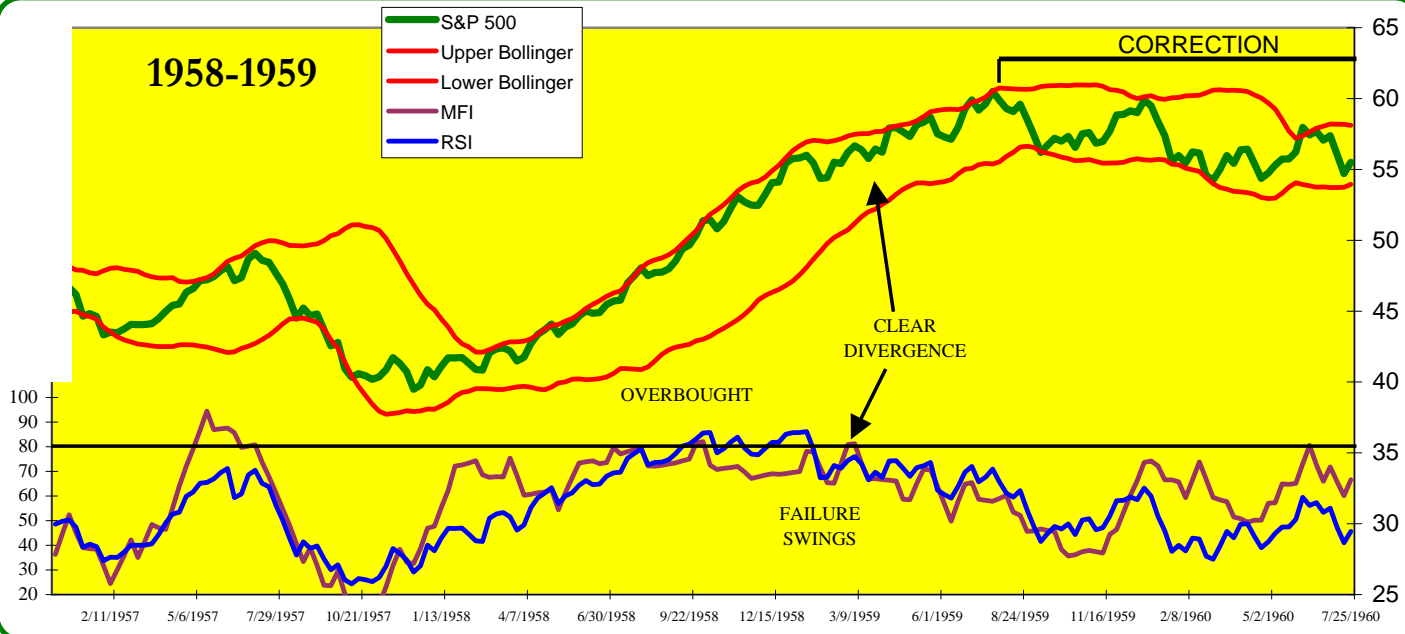
The indications for the current market have not established a clear technical pattern – yet. There are some suggestions of a pending reversal, but they have not yet been clearly confirmed. The MFI reached an overbought level in June 2009, matching the overbought signal of June 2007 and the relief rally pattern of overbought signals in the months preceding relief rally highs. While there is some suggestion of a divergence from both the RSI and MFI, it is not clearly established, particularly with a lack of failure swings. There is also an indication of reversal from a tightening of the Bollinger bands plus the market’s hugging of the upper band without confirmation from either the RSI or MFI.

From the data, we cannot reach any definitive conclusions of a pending market reversal. There are some initial suggestions that it may be in the works, but it is not, as yet, clearly defined.



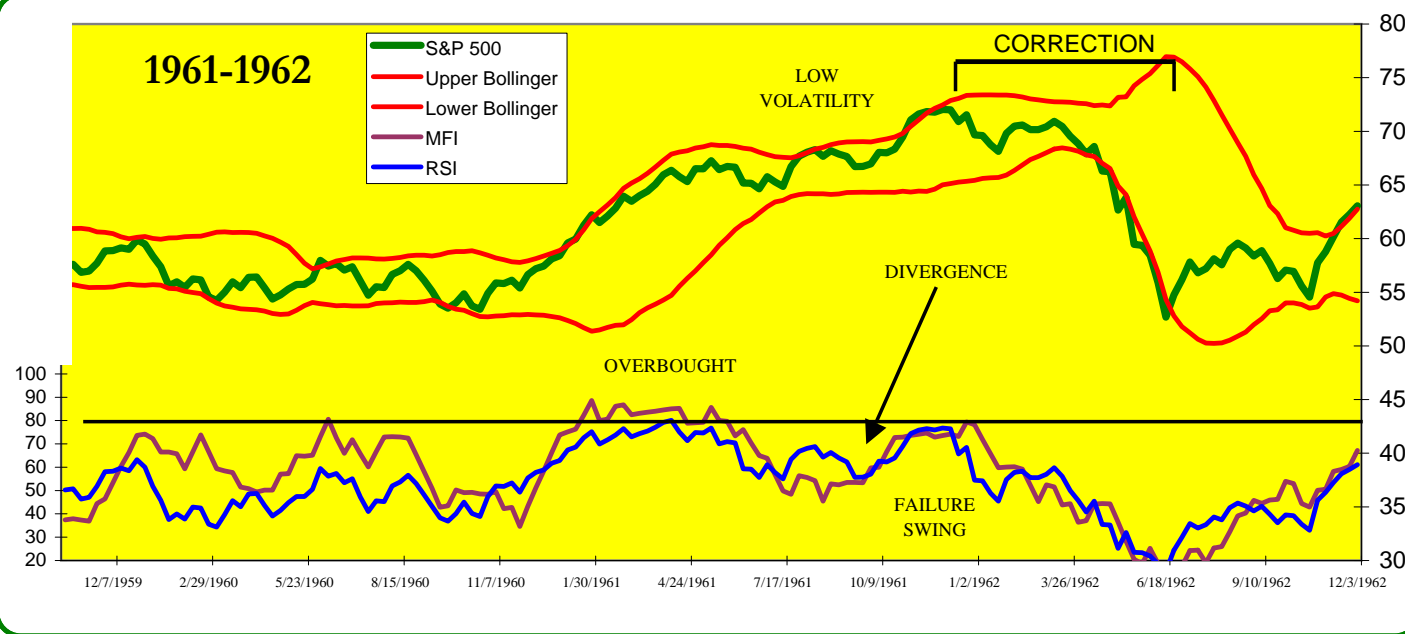
### 1958-1959

- S&P 500
- Upper Bollinger
- Lower Bollinger
- MFI
- RSI



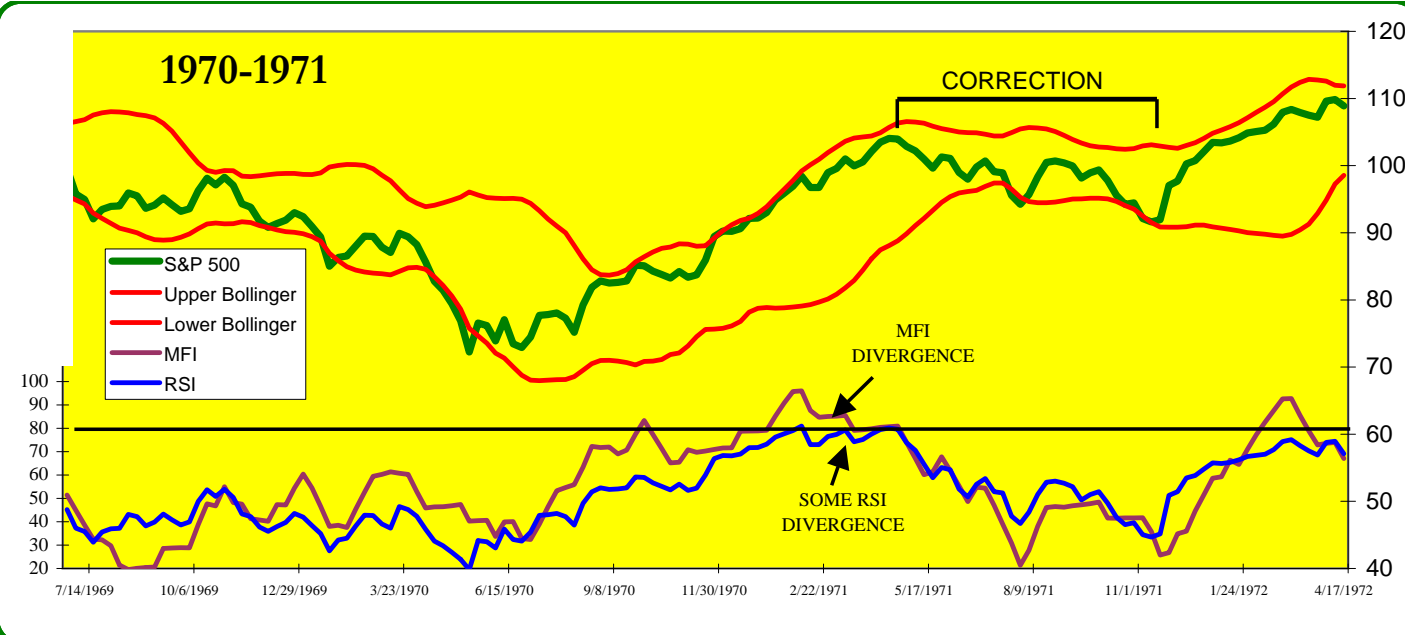
### 1961-1962

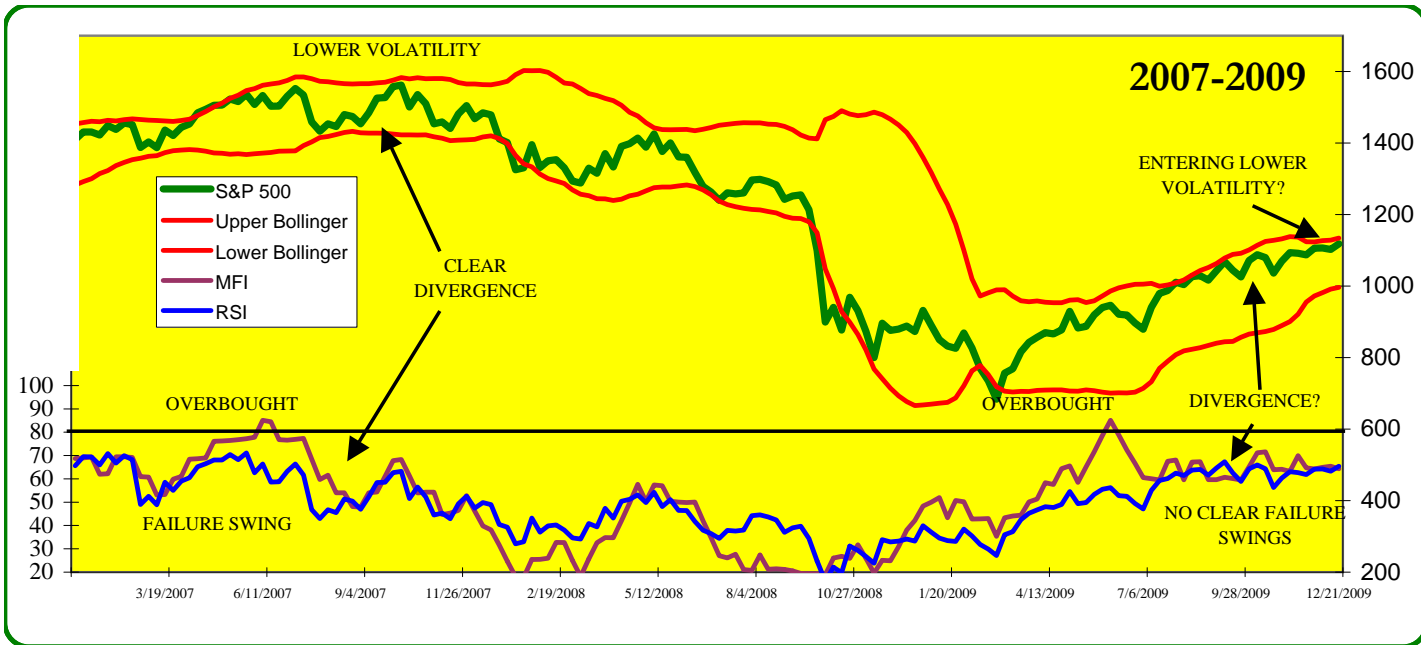
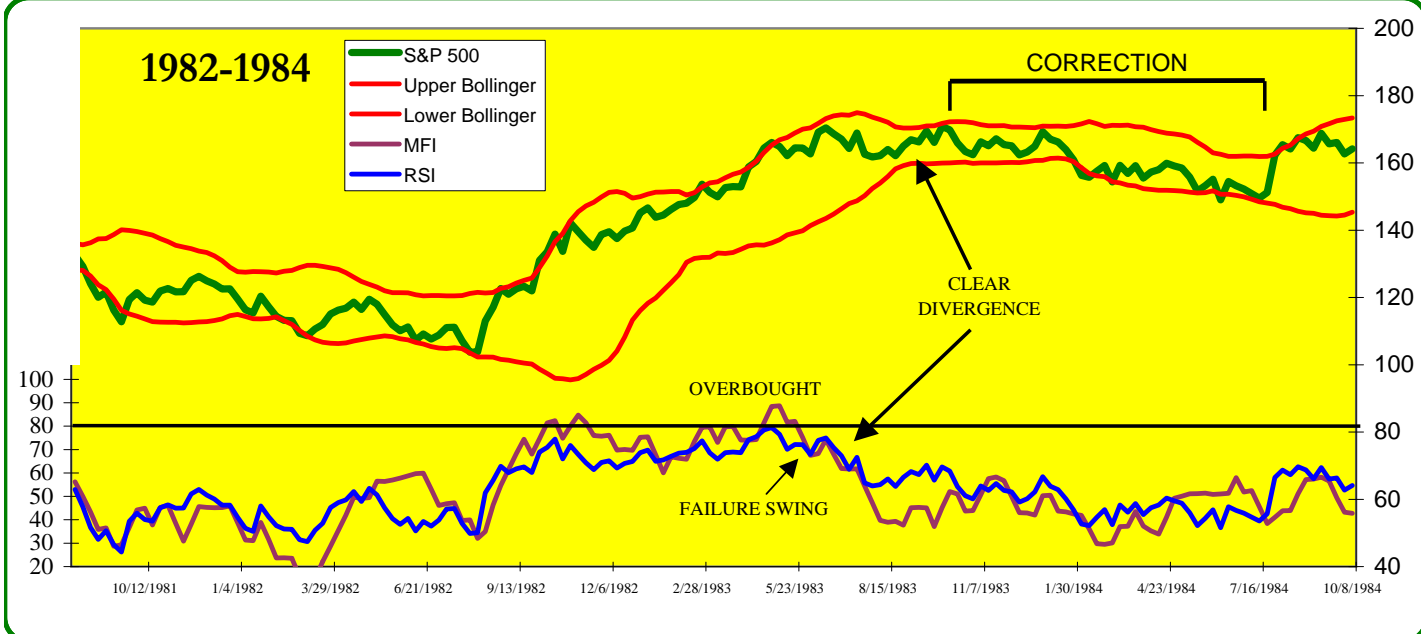
- S&P 500
- Upper Bollinger
- Lower Bollinger
- MFI
- RSI



### 1970-1971

- S&P 500
- Upper Bollinger
- Lower Bollinger
- MFI
- RSI







## Part 2 The Fundamental Tie-Breaker

There are many reasons to regularly review the fundamental outlook of the economy and markets, but with a potential reversal or correction in the future, the task becomes even more relevant. Without a clear technical signal, the fundamental analysis may be the only way to clearly confirm the initial indications from Part 1.

Beyond the value of predicting the actual trend change, there is a greater need to try to find the depth of any future pause/correction. After all, each relief rally ended as a function of investors' needs to confirm the strength and correctness of the rally off the bottom. Confirmation both as a technical indicator for the market's movements and confirmation fundamentally that the preceding recession is really over and the recovery is robust enough to sustain itself during the coming removal of stimulative actions.

At their core, the corrections in each relief rally are about taking enough time to fundamentally assess the economy and its relation to the

markets. Each pause is relatively lengthy exactly because it takes a lot of time to reach a confirmed consensus. That is, the correction will not be over until enough buyers are convinced that there will be enough buyers (nobody knows for sure until everybody knows for sure). That assurance cannot be assured until it is clearly and universally confirmed that each recovery is sustainable.

Inevitably, the same fundamental questions will arise in 2010. Is the recovery that is currently underway (everybody finally agrees a recovery is happening, it only took eight months for it to be near-universally accepted) sustainable? How will the answer to that question impact depth and breadth of any correction?

Before answering those questions for 2010, we will rework the relief rallies and corrections/pauses from the previous seven recessions from a fundamental standpoint. In order from smallest correction to largest:

1991-1992	Recovery Leg	Total Days	Beg	End	PE at Market HI	PE at Leg Begin	PE at Leg End	Trailing 5 Yrs
					before Recession			Average PE
Recovery Leg	39.77%	448	10/08/90	12/30/91	16.8	15.5	26.1	16.3
Correction Leg	-3.98%	280	12/30/91	10/05/92		26.1	23.2	16.9

### FUNDAMENTALS DURING CORRECTION

GDP	Solid 4% <sup>s</sup>
Earnings	Rising Faster Than Market
Unempl	7.3      7.6      Peaks in Q292
Int Rates (Fed Funds)	4.22      3.07      Falling
Int Rates (Bonds)	8.22      7.93      Falling
CPI	
Consumer (Bal Sht)	1364      1205      Flat Hard \$ Assets, +\$200bn Mortgages
Consumer (Deficit)	17.5      13.4
Household Debt as % of GDP	61.3%      61.5%



2003-2004	Recovery Leg	Total Days	Beg	End	PE at Market HI	PE at Leg Begin	PE at Leg End	Trailing 5 Yrs Average PE
					before Recession			
Recovery Leg	39.43%	392	02/03/03	03/01/04	29.4	28.0	21.7	31.9
Correction Leg	-7.96%	280	03/01/04	08/09/04		21.7	19.3	29.6

**FUNDAMENTALS DURING CORRECTION**

GDP	From 1.2% to 7.5% in Q304		
Earnings	Rising Faster Than Market		
Unempl	5.8	5.4	Falling Throughout Period
Int Rates (Fed Funds)	0.99	1.64	Beginning Upward Trend
Int Rates (Bonds)	5.28	5.37	
CPI			
Consumer (Bal Sht)	-1517	-1874	+\$200b in Deps, +\$500bn Mtgs, +\$100bn Cons Cred
Consumer (Deficit)	16.7	17.4	
Household Debt as % of GDP	84.9%	87.1%	

1958-1959	Recovery Leg	Total Days	Beg	End	PE at Market HI	PE at Leg Begin	PE at Leg End	Trailing 5 Yrs Average PE
					before Recession			
Recovery Leg	53.27%	588	12/16/57	07/27/59	9.3	11.9	17.2	12.0
Correction Leg	-11.73%	455	07/27/59	10/24/60		17.2	16.4	14.6

**FUNDAMENTALS DURING CORRECTION**

GDP	From 10.9% Q259 to 1960 Recession (Choppy GDP)		
Earnings	Falling Slightly Slower than Market		
Unempl	5.0	5.5	Rising Through Recession
Int Rates (Fed Funds)	3.46	2.64	Rising To the End of 1959, Falling Thru 1960
Int Rates (Bonds)			
CPI	0.69	1.23	
Consumer (Bal Sht)	167	173	+\$30b in Deps & UST, +\$15bn Mtgs, +\$8bn Cons Cred
Consumer (Deficit)	1.8	3.4	
Household Debt as % of GDP	36.4%	39.7%	



1970-1971	Recovery Leg	Total Days	Beg	End	PE at Market HI	PE at Leg Begin	PE at Leg End	Trailing 5 Yrs Average PE
					before Recession			
Recovery Leg	42.69%	294	06/29/70	04/19/71	18.0	13.2	19.2	16.6
Correction Leg	-11.96%	210	04/19/71	11/15/71		19.2	17.9	17.2

**FUNDAMENTALS DURING CORRECTION**

GDP	2.3%, 3.2%, 1.1%, Follows 11% Grwth in Q171		
Earnings	Rising		
Unempl	5.9	6.0	Falling After
Int Rates (Fed Funds)	4.96	4.05	Peaking above 5% in Q371
Int Rates (Bonds)	7.62	7.24	
CPI	4.38	3.27	
Consumer (Bal Sht)	339	348	+\$35b in Deps, +\$15bn Mtgs, +\$7bn Cons Cred
Consumer (Deficit)	2.4	3.3	Falling Savings Rate
Household Debt as % of GDP	42.3%	43.4%	

1974-1975	Recovery Leg	Total Days	Beg	End	PE at Market HI	PE at Leg Begin	PE at Leg End	Trailing 5 Yrs Average PE
					before Recession			
Recovery Leg	52.09%	266	09/30/74	06/23/75	18.4	7.0	12.0	15.5
Correction Leg	-12.14%	77	06/23/75	09/08/75		12.0	10.8	14.5

**FUNDAMENTALS DURING CORRECTION**

GDP	3%, 6.9% in Q2 & Q3 1975, Amidst Fast Recovery		
Earnings	Rising		
Unempl	8.8	8.4	Falling After
Int Rates (Fed Funds)	5.72	6.29	Peaking in Q475
Int Rates (Bonds)	8.75	8.94	
CPI	9.18	7.91	
Consumer (Bal Sht)	473.5	484.2	
Consumer (Deficit)	1.1	4.7	
Household Debt as % of GDP	43.3%	42.8%	



	Recovery Leg	Total Days	Beg	End	PE at Market HI	PE at Leg Begin	PE at Leg End	Trailing 5 Yrs
					before Recession			Average PE
1982-1984								
Recovery Leg	64.47%	420	08/09/82	10/03/83	9.2	8.9	11.8	8.1
Correction Leg	-12.75%	252	10/03/83	06/11/84		11.8	9.5	9.3

**FUNDAMENTALS DURING CORRECTION**

GDP	Above 8% in each Quarter		
Earnings	Rising Quickly		
Unempl	8.3	7.2	Falling Before and Bottoming
Int Rates (Fed Funds)	8.96	11.27	Peaking in Q284
Int Rates (Bonds)	12.56	13.71	
CPI	3.79	4.33	Peaking in Q284
Consumer (Bal Sht)	1061.2	1176.2	+\$170bn Deps, +\$70bn UST, +\$90bn Mtgs,
Consumer (Deficit)	14.6	12.6	+\$50bn Cons Cred
Household Debt as % of GDP	46.9%	46.5%	

	Recovery Leg	Total Days	Beg	End	PE at Market HI	PE at Leg Begin	PE at Leg End	Trailing 5 Yrs
					before Recession			Average PE
1961-1962								
Recovery Leg	34.88%	406	10/24/60	12/04/61	17.2	16.4	22.4	15.1
Correction Leg	-26.87%	196	12/04/61	06/18/62		22.4	15.8	17.5

**FUNDAMENTALS DURING CORRECTION**

GDP	8.4%, 7.4%, 4.4%		
Earnings	Rising, Slower		
Unempl	6.0	5.5	Falling Before and Bottoming
Int Rates (Fed Funds)	2.86	2.89	
Int Rates (Bonds)	4.38	4.29	
CPI	0.67	1.24	
Consumer (Bal Sht)	177.1	179.4	
Consumer (Deficit)	2.1	2.5	
Household Debt as % of GDP	41.3%	41.4%	

Notes *Int Rates (Bonds)* refers to composite AAA-rated corporate bonds  
*Consumer (Bal Sht)* is the nominal amount of total Household Deposits plus Credit Market Assets minus Financial Liabilities, in billions of current dollars  
*Consumer (Deficit)* is the total amount of Personal Consumption Expenditures above earned income minus taxes, expressed as a percent of Total Disposable Income



## Economic Basis

Five of the corrections occurred during extremely robust gains in GDP. Not surprisingly, from our August 2009 Special Report, those recoveries were all before 1990. The 1971 correction came after a recovery quarter that saw 11.6% growth. While GDP growth during the correction was an average of 2.2%, growth in the next two quarters was 7.3% and 9.8%. There were clear signs during the correction that the recovery, even though it had slowed, was robust enough to be sustainable.

The 1975 correction (the short pause) began in the quarter after the recession. GDP expanded from 3% to 6.9%. After the correction, GDP growth continued in the next quarters, registering 5.4% and 9.3%. Growth slowed in 1976 (from the 9.3% to 3%, then to 1.9%) creating the second recovery pause. This correction lasted 427 days, until early 1978, and saw the market drop nearly 19%, despite hefty growth during the period (average GDP was 6.9% in the first three quarters of the correction). The last two quarters registered zero growth and a minimal 1.3% gain (the end of 1977 saw a near-recession), but GDP grew 16.7% in the quarter after the end of the correction. On a fundamental basis, the problems leading to the near-recession kept the downward trend intact until 1978, when the huge expansion signaled an end to the intermediate economic issues.

The correction in 1983 occurred during the heart of a very robust recovery – average growth was 8.2% during the entire correction. While the economic fundamentals were more than solid, the correction was about other fundamental economic parameters (discussed below).

By the time the 1959 correction began, GDP growth had averaged 9.5% in the four previous quarters. The market inflection coincided with an economy that had already begun to contract into the 1960 double-dip recession. The end of

the correction coincided with the emergence of the economy from that recession – the market had turned positive the quarter before the worst of the recession (-5.1 in the fourth quarter of 1960) becoming the 1961 relief rally.

The correction after that relief rally in 1961 was the worst event. Fundamentally, growth was strong in the last three quarters of 1961 (averaging 7.5%) but the economy was slowing into the middle of 1962. At the end of the correction growth had slowed but it was becoming more evident that the economy was recovering enough to be sustainable. The depth of the downturn had more to do with fear over a third recession forming (the 1960 double-dip was caused in large part by aggressive monetary policy) from rising inflation. But, as we will discuss below, it was also due in large part to aggressive valuations.

In 1992, the long pause saw an average of 3.5% GDP growth for four consecutive quarters. Not as robust as the previous recoveries, but enough to convince investors (and monetary policy experts) that it was sustainable.

The final correction of 2004 occurred almost three years after the recession had ended. Growth had finally picked up to an average of 3.9% following an average of 1.7% in the six quarters after the 2001 recession.

In each case there was compelling fundamental evidence (with the exception of the 1959 correction/recession downturn) for ending each correction. In each of those six corrections, not only was GDP growth robust enough to warrant optimism, unemployment had fallen or had begun to fall by the end of the correction period. It was easily accepted that each economic event was over and that uninterrupted cyclical growth could and would resume unabated.



## Valuation Basis

Market valuations play an integral part of the correction equation, and seem to have a particular relationship with the extent of each downturn.

The small downturns of 1992 and 2004 were likely due to compelling fundamental factors, including rapidly rising earnings. At the end of the 1992 correction, the market PE was 23 times earnings. That far exceeded the preceding five year average of 16.9, but, despite a rapidly rising market, those mounting earnings brought market ratios down to an average of 19.5 from 1993 through 1997. Not particularly overvalued during a solid economic growth, low-inflation environment. Robust earnings growth provided a compelling justification for slightly above-average multiples.

Earnings multiples at the beginning of the 2004 correction were over 20 as well, but, again, earnings were rising much faster than the overall market. In fact, during the relief rally, the PE ratio actually fell from 28 to 21.7. By the end of the short correction the PE had fallen below 20 to 19.3. Compared to the previous 5-year's average of 29.6, valuations were not out of proportion.

The two smallest corrections saw earnings multiples over 20, but they were both during times of rapid earnings expansions. The four "average" corrections all saw PE's that were relatively close to their averages.

In 1959, the S&P traded at 17.2 times trailing earnings and finished the recession/correction at 16.4 times earnings. Both were slightly above the 14.6 average of the previous five years, but that average is skewed by single digit PE's mid-decade. PE ratios remained compressed after the immediate post-war recessions, as inflation remained unevenly high, averaging 3.5% from 1948 to 1951, with several spikes above 9%. It was not until the end of 1954 that earnings multiples finally broke above their long-term average of 11, and not until mid-1958, during the beginnings of the relief rally, that PE's stayed well above that average. A multiple of

16 was not decidedly overvalued, particularly after massive recovery growth during the period without excessive inflationary pressures.

It was the relief rally after the 1960 recession that led to overvaluation and, not coincidentally, the worst of the corrections in 1962. At the start of the correction in December 1961, the market earnings multiple was 22.4, well above the five-year average of 17.5. The problem was that the market, reflecting too much relief, had moved higher, rapidly outpacing earnings. Euphoria of surviving two consecutive recessions that included the worst quarterly non-war GDP decline since the early 1930's (-10.4% in Q1 1958) got the better of investors. That euphoria was derailed by both heady values and the possibility of a third recession. The oft-vigilant Fed had begun to raise interest rates by mid-1961 to again head off inflationary pressures that persisted throughout the 1950's (using a Philips Curve basis for monetary policy meant raising the cost of credit during rapid expansion). The prospect of another contraction was too much for those high valuations, resulting in a six-month crash that wiped out all the gains of the relief rally, pushing the market below where it had begun just nineteen months before.

Both the 1971 and 1984 corrections saw PE valuations fall to around their averages. The earnings multiple at the end of the 1971 contraction was 17.9 compared to a five year average of 17.2. Inflation had been falling for close to two years straight (and would continue for another two quarters) so those valuations were not out of line for such an environment (the average PE for the decade of the 1960's was 17.6). It was also within the orthodoxy of the period for investors to expect that trend to continue – the inflation problem was relatively new and the role of monetary factors was not widely understood.

After the problem of inflation had become imbedded following a decade of continuous uplift, earnings multiples had fallen to levels not seen since the early 1950's. The relief rally that began in 1982 with a PE of 8.9 ended with a PE

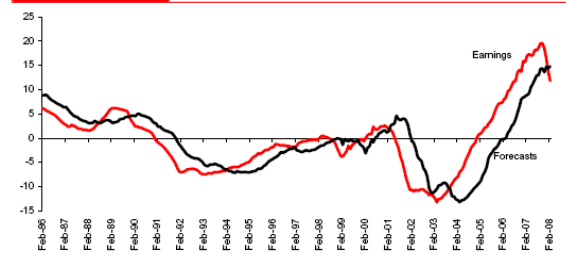


of only 11.8 (despite a 64% rise). The 1984 contraction brought the market multiple back down to 9.5, very close to the five-year average of 9.3. With a backdrop of rapidly falling inflation, solid GDP growth, and moderating interest rates, it is little wonder that the twenty-five year bull market began there (with a huge boost from a massive expansion in credit).

The last correction was the 1975 short event. Because of inflation after the oil shocks of the previous year, the market's PE of 10.8 was well short of the 14.5 average. On that basis valuations were compelling enough (even after a 52% rise above the recessionary low), with rapidly rising earnings and economic growth to keep the correction short, though somewhat sharp. That it was a 12% drop in two months fits the overall market climate of the time: rapid, outsized movements. Through the end of 1976, the S&P had gained almost 73% in 819 calendar days. The second correction saw a drop of 18.6% in 427 days due to accelerating inflation. It began with a market PE of 10.8 and ended with a multiple of 8.2 a year and a quarter later. So the second mid-70's correction was more about PE compression than economics since earnings were still moving higher relative to the market. The average multiple during the rest of the decade was 7.9 despite positive, real GDP growth and solid, if unspectacular, earnings growth. Inflation was, justifiably, the dominant market theme.

So where does the current relief rally stack up? The current PE on the S&P 500 is just below 88. That reading includes the huge financial writedowns from the fourth quarter of 2008 – the largest (by a lot) quarterly earnings loss in the history of the index. On an operating earnings basis, the market has a PE of 28. Those numbers are significantly higher than the multiples at the end of both the 1992 and 2003 rallies and well above the five-year average of 21. Considering that earnings growth is not likely to be anywhere near as robust as during those two periods, it cannot be likely that the coming correction will be an outlier (small event). Current estimates for 2010 earnings show little

Analysts lag reality (S&P500 earnings, deviations from trend, \$ per share)



Source: GQ Equity Research

growth, but robust growth is estimated for 2011. Based on current estimates (that have yet to factor in any significant charges) for 2010, the S&P 500 is trading at a multiple of 24.5 – still well above average.

If we accept current estimates for 2011, then the market begins to approach average valuations with a multiple of 18.2. However, that would mean no market growth for two entire years just to approach reasonable valuations.

What if those 2011 estimates are a little rosy? Analysts have a very bad track record in predicting earnings during direction changes – slow to adjust downward during contractions and slow to adjust higher during recoveries. Perhaps that is the one glimmer of hope, that analysts are being unduly cautious in their 2010 estimates. The reality is that analysts cannot predict earnings with any accuracy. Looking at the chart above, it is clear that analysts are more like accountants – they anchor their estimates to reality after the fact. Indeed, these future estimates are created from top down economic analysis using the same economic forecasts that did not foresee a recession as late as summer 2008. They are also in large part built on the assumptions created by Federal Reserve economists, the same experts that forecast a worst case of 8% unemployment in 2009 (it moved above 10%).

The probability of earnings achieving quick growth rests on revenue growth. For the September 2009 quarter, aggregate trailing twelve-month revenue for the companies in the S&P 500 is down **\$1.4 trillion** (15.5%) from the same period in 2008, and nearly **\$1.7 trillion** from the high in 2007. To rebound to those levels, consumers are going to have to return to pre-crisis spending patterns. However, households are in the worst shape they have ever



been (balance sheets show more net debt in nominal terms and as a percentage of GDP) have rising unemployment and persistent joblessness, persistent reductions in credit (there are 100 million fewer credit cards now than a just a year ago) and record reductions in asset income. There is simply no source for revenue growth amongst consumers. Businesses will not spend without a reasonable assurance of sustained consumer spending. Perhaps that is the theory behind “stimulus” spending, but bailing out state budgets and winterizing schools and abandoned buildings will not fill that spending gap – it can only preserve it (ignoring any negative effects from too much credit confiscation).

Without sustained revenue growth, the only way for companies to grow earnings is to further cut costs. This may be the only answer since revenue has not rebounded as analysts predicted (shockingly). The forecast for the third quarter 2009 called for an 11.9% year-over-year decline, but actual revenue was down over 14%. The longer the revenue drought continues, the more companies will decide to grow through cutting (again).

Assigning a reasonable valuation to the current market in these conditions is an ugly exercise. At a multiple of 17 times calendar **2010** earnings, **fair value for the S&P 500 would be 773.5! That valuation is 30% below current market levels. At 15 times earnings, the S&P should be 682.5, or nearly 39% below current values.**

In spite of the current level of universal optimism, it may be too much of a leap to expect investors to hold stocks and patiently wait for 2011 to come and go, justifying current market prices. That rationalization will get increasingly difficult if 1) inflation becomes a dominant factor that pressures already high valuations, and/or 2) the economy does not follow the most optimistic scenario.

The combined impact of inflation and higher interest rates on PE’s is well documented. We currently expect an acceleration in both for 2010 and 2011 (leading to another contraction). That 2011 multiple of 18.2 is an overreach if both inflation and interest rates move higher together.

### Valuation Comparisons

	<u>PE (ttm)</u>	<u>PE(2010)</u>
S&P Midcap 400	26.9	17.6
S&P Smallcap 600	38.8	18.9

The above estimates use operating earnings as their basis, not “as reported” earnings.

Using the current discount estimate for the difference between operating and as reported earnings on the S&P 500 of 15%, the 2010 PE becomes 20.8 for the Midcap 400, and 22.3 for the Smallcap 600.

Calendar 2010 estimates for the Midcap 400 and Smallcap 600 would require huge increases in earnings of 53% and 104%, respectively. In other words, the 2010 estimates return earnings to their 2007 calendar year highs.

In order to achieve those levels, earnings in the consumer discretionary, energy, information technology and materials sectors would have to surpass previous highs. For the Smallcap 600, information technology earnings are estimated to grow at a 229% rate in 2010 over 2009, and over 100% in the energy and consumer discretionary sectors. Growth estimates in the information technology and consumer discretionary sectors for the Midcap 400 are 79% and 33% respectively.

Again, these are all operating earnings estimates that take no account of potential charges. Without contesting the validity of the 2010 earnings, current index levels are still overvalued. Factoring economic concerns (operating earnings estimates are bottom up, meaning they take no or little account for economic conditions) and there is a very small probability of quickly rebounding to 2007 highs.

The 2010 as reported earnings estimates for the S&P 500 are 31% BELOW 2007 actual, as reported earnings. The 2011 estimates are still 8% below 2007 highs.

Using a more realistic, but still optimistic, scenario where earnings rebound to 85% of the 2007 highs, the Midcap 400 is overvalued by at least 16%, and the Smallcap 600 is overvalued by at least 19% (using a multiple of 17 for both).

Using our own estimates, we believe that both are overvalued by at least 25% based on 2010 earnings.



It was the interaction of both that led to the 1962 slow crash. That market had strong parallels to the current – a heavy recession not too far in the past, an overly optimistic relief rally, then a crash from undue valuations as rates and inflation raised the specter of more economic damage.

Out of all the corrections we studied, the 1962 market fits most with current expectations, with one extremely important exception. That correction occurred during a period of *robust* growth. Even the most optimistic investor would have a hard time making the case that the next year plus will see robust growth. The fact that such a large down trend occurred when economic fundamentals were actually on the side of the optimists does not bode well if the current market wakes up to the current predicament.

If the economic fundamentals worsen, as we expect, what will be the result? We are not far removed from one of the great panics of modern history. The Panic of 2008 will be studied and reviewed for generations. Investors that suffered massive losses in that panic will not

optimistically wait out another nasty downturn. Those that have returned to stocks (and a vast majority have) will not have the patience or the fortitude to sit on the sidelines during an above-average correction. Itchy fingers await the slightest tremor of trouble to pull the trigger, running for the exit as quickly as possible. The most common lesson for the unwise burned by panic once, is to panic faster the second time.

That is why the 1962 example remains relevant. Stung by two *mild* recessionary downturns, investors ran for the exits on the smallest chance of a third. What if those investors had been through the Panic of 2008? Confidence has not fully been restored (if it had, the Treasury market would not be as oversubscribed and money market funds so abundant). The real worry in this market is that something will shake investors from their euphoria and force them to realize that even the optimistic outlook is something to be feared. A return of a fearful market can transform an impending correction into something significantly more than average.



## Conclusions

All the average corrections were accompanied by positive fundamental properties and compelling valuations. The 1992 and 2004 corrections may have been slightly overvalued, but not when you factor in the potential bubble growth that was beginning to emerge. Both periods had a positive contribution from the consumer that cannot be matched today. Both markets also had a tremendous push from expansionary credit, something that, again, will not/cannot be duplicated in 2010. Absent those factors, there is no way to justify such high valuations.

It is difficult to say with clarity what will push the market off its current perch. In our last report, we believed that the accounting changes related to FAS 166 & 167 had the potential to be the catalyst. In mid-December, regulators agreed and adopted (partially) the phase-in that the banks universally argued for. The rash of TARP repayments in December were not really about CEO pay or government meddling. They were about converting preferred shares to common equity, safely raising capital ratios under the cover of an alleged government seal of approval for the banking system. This problem has not been solved; it has only been pushed down the road. Beginning July 1, 2010, banks will have to adopt the new rules, but will not have to raise additional capital until January 1, 2011 (which, despite the assurances of “experts”, is very much a possibility – see our estimates in our November 2009 Special Report).

The inflection catalyst could come from many different sources, which is exactly why we have become cautious investors. The unknown factors that could cause a decline far outnumber any reasons for the market to move higher. Whether it is another Dubai problem (which should not have been a surprise) to an implosion of one or more of the PIIGS (Portugal, Italy, Ireland, Greece, Spain). The Greek financial meltdown is almost a given, but the finances of any one of those countries could cause a market

event (absent any independent monetary power each is essentially powerless to correct imbalances like the “responsible” countries have – printing money; instead each may be forced to make painful choices that have so far eluded the US, UK and other bailout nations).

The market has somehow discounted any rumblings in Athens as a nonevent – the EU will simply bail them out. Even if that is the case, it places no importance on the method or source of that bailout. Similarly, the market seems to have discounted the potential downgrades of UK debt. Having survived a fiscal crisis once in the 1970’s, perhaps prospects of a revisit are no longer earth shattering. However, there is surely limited appetite for a US downgrade. That has been completely ignored, despite the fact that, for the first time in the ninety-seven year history of rating sovereign US debt (through two world wars, a Great Depression, Cold War and massive asset bubble bursts) Moody’s has added the United States’ sovereign debt to its negative watch list.

Perhaps a US downgrade is the most likely catalyst for the start of the correction. This has to be the first time in history that US bond auctions are now a regular and important news item for stock investors. The fact that such importance is placed on these auctions implies that many investors are nervous about them and may in fact be awaiting and expecting a failure.

The last time there was such a wide disconnect between economic reality and the markets was only a few short years ago – in autumn 2007. Despite rumblings of credit market freezes, bank troubles, and even a bank run, the market pushed to new highs. We are not predicting another financial meltdown (though it is sadly still a possibility) but these two periods have in common massive negative potential far exceeding positive possibilities.

So much of the negative possibilities are hiding in plain sight. Unemployment is a perfect



example. The cable news and financial press have spent a lot of time trumpeting the decline in continuing unemployment claims. Yet it is fairly common knowledge that Congress has yet again extended unemployment benefits. That disconnect is easily explained through bureaucracy – the Bureau of Labor Statistics simply counts people on emergency or extended benefits on a separate line. While the number of people on regular unemployment falls significantly (as their benefits expire) they simply roll on to the new category. So instead of the good news of continuing claims falling 303,000 to near 5 million on the week ended November 28, the bad news is really that continuing claims *plus* continuing emergency claims increased by 24,000 to 9.3 million. Worse yet, those combined numbers are actually *4.2 million* above last year's elevated level.

Investors are left to figure the real state of the jobs market. The economy cut jobs in November (albeit a small amount) and the unemployment rate fell as more people *left* the labor force. This was/is portrayed as progress/good news! These potential workers drop out of the labor force because they are so discouraged by the job market that they are no longer looking for work. Moreover, the number of these people is hitting an all time high (could it be correlated with the two-plus years of unemployment benefits?).

To see this disconnect in action, one only has to watch Steve Liesman, CNBC's Senior Economics Commentator, deny the existence of the 4.1 million people on emergency claims (the

link to the video is in the Endnotes below). Or watch various CNBC guests talk about how the S&P 500 is fairly valued at its *current* PE ratio of 15 times earnings. Yes, they claim that the *current* PE is 15 times earnings (not 88 as we detailed above). That 15 comes from the reported PE of the S&P Depository Receipts (SPY). On its latest fact sheet, State Street (the ETF managers and chief sales force) claims their ratio is "the closing price divided by the sum of the forecasted fiscal year earnings per share." No real idea on where the estimates come from, which is particularly troubling as there is a huge difference between earnings estimated by the ETF vs. the index. In this case, do we believe the keepers of the actual index or the sales force that wants investors to keep buying more of the ETF?

There are too many financial problems to ignore, such as a larger, more systemic Dubai-type shock. Even though it turned out to be a lot of nothing, the market still sold off heavily before that was apparent. In addition, there are ample geopolitical tribulations, particularly Iran, which can potentially cause a market reversal.

In compiling this list of possible market-turning catalysts, we have not been able to come up with a single, rational, positive catalyst that can move the market significantly higher. Blind hope is not rational. With so many unbalanced negative factors combining with current market valuations and fundamental constraints, caution is, in our view, the only rational strategy for 2010. At least until there is confirmation that euphoria is a legitimate investment approach.

## Endnotes

Actual earnings results and estimates, current and historical are provided by Standard & Poor's:  
[www2.standardandpoors.com/spf/xls/index/SP500EPSEST.XLS](http://www2.standardandpoors.com/spf/xls/index/SP500EPSEST.XLS)  
[www2.standardandpoors.com/spf/xls/index/iee400\\_gics.xls](http://www2.standardandpoors.com/spf/xls/index/iee400_gics.xls)  
[www2.standardandpoors.com/spf/xls/index/iee600\\_gics.xls](http://www2.standardandpoors.com/spf/xls/index/iee600_gics.xls)

CNBC, December 11, 2009, Steve Liesman vs. Rick Santelli:  
[www.distressedvolatility.com/2009/12/rick-santelli-steve-liesman-on.html](http://www.distressedvolatility.com/2009/12/rick-santelli-steve-liesman-on.html)

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