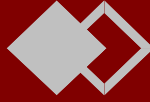

EARL M. FOSTER ASSOCIATES

INVESTMENT MANAGEMENT

MARKET UPDATE

AUGUST 14, 2009

Since its March 9th trough, the Standard & Poor's Index rallied sharply. Nevertheless, stocks are still 36% below their October 2007 peak. While sharp re-bounds from "bear" market lows are not unusual, the suddenness and the magnitude of the recent rise exceeded some of the most optimistic expectations. As a result, a debate has emerged as to whether stocks will continue their rapid ascent or retrace gains investors have enjoyed over the last five months.

Underlying economic conditions suggest that the bear market trough is behind us and any retracing of recent gains should be limited as the economic environment has changed significantly since March. The pace of the economic decline is moderating, and a recovery in the economy is gaining visibility. The last three readings from the Index of Leading Economic Indicators suggest improving economic activity lies ahead. Home prices and sales levels suggest that one of the worst hit sectors in this recession is in the process of bottoming; even if a recovery in this sector will need more time. Also, Federal stimulus funds continue to support economic activity. Furthermore, any pullback in stock prices should be cushioned by corporate profits whose decline may be less severe then some feared. Aggressive cost cutting by our corporations has protected, and in some cases improved margins, thereby mitigating the decline in shareholder earnings. Therefore, despite an economic recovery which may be modest, the stage is being set for a significant earnings rebound in 2010.

On this basis, investment strategy should balance the near-term risk of equities retracing some of recent gains with the longer-term return potential that will accompany a cyclical rebound in company earnings. Short-term, caution is appropriate as some retracing of recent price gains can be expected. It has happened during prior recoveries and there are no underlying fundamentals that suggest that this recovery should be an exception. Second, there is a seasonal phenomenon in which the months of August through October have been prone to stock market weakness. Third, the stock market is now selling close to 19 times this year's projected earnings. While this valuation may not be extreme on depressed earnings, stocks are no longer "compellingly" under-valued. Thus, a partial retracement of gains made over the last five months would not be out of the ordinary. At the same time, a return to the March lows would be inconsistent with the fundamental improvement in the economy.

Longer-term, stock prices could move significantly higher, supported by the cyclical recovery in earnings. For example, earnings for the Standard & Poor's Index could be as much as 50% higher than today's depressed level in three to four years (2012 – 2013). Should that occur, it would justify another 25% - 35% rise in prices. With a dividend yield of 2.5%, stock returns could be attractive. Therefore, any pull-back in stock prices over the next several months would further improve return prospects, and should be viewed as an opportunity for longer-term investment.