

THE MARKET OBSERVER

JUNE 2010

After experiencing a 9% correction in late January into early February, stocks continued to grind higher with the S&P 500 reaching an interim high of 1,210 on 4/23/09, fueled by ongoing improvement in both economic and corporate fundamentals. The market initially withstood selling pressure following the government lawsuit against Goldman Sachs until ECB indecision over how to handle the Greek sovereign debt problem fueled fears that this crisis could spread into a global contagion. Volatility increased significantly during the beginning of May, with stocks initially giving back all of this year's gains before rallying 5.5% the week following the announcement of a \$1 Trillion EU, Euro Zone and IMF loan package to stem this crisis.

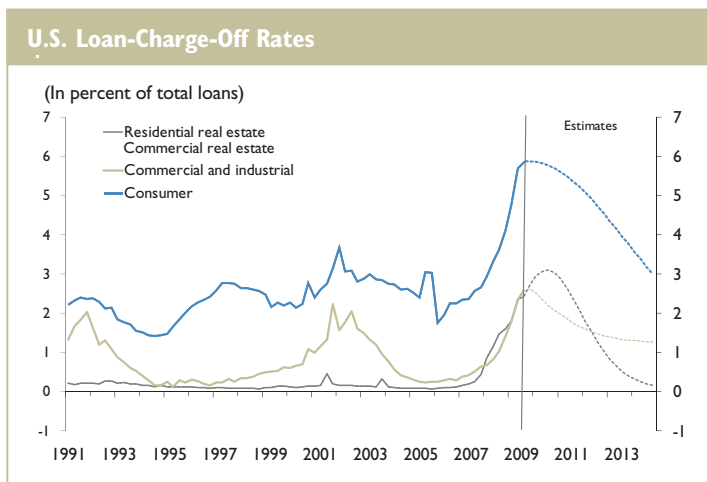
Volatility, along with continued skittishness subsequently persisted twice bringing stock prices back to their February lows.

A renewed focus on positive indicators both in Europe and the US saw prices rallying over 2% on June 15th to close at 1,115, roughly where it started the year. Stocks have advanced a net 64% from their March, 2009 lows and are now down a net 29% from their October 2007 highs. The market is now trading at levels last experienced in the month following the Lehman bankruptcy filing in September, 2008, which preceded the subsequent plunge below the 1,000 level in October 2008.

The overall decline between April 23rd and June 7th was approximately 14%. While such

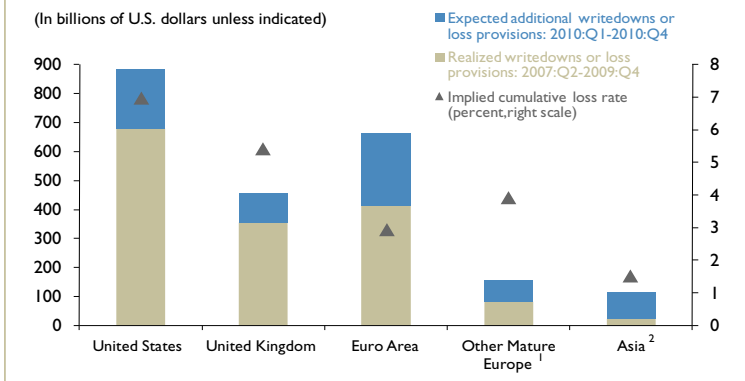
corrections are normal and often considered healthy, the experience of the past few months have brought to the forefront still lingering systemic fears that might lead to greater harm than simply the snuffing out of our cyclical recovery. These fears were confirmed by the most recent American Association

of Individual Investors (AII) poll showing individual investors sentiment at its worst level for the year. Interestingly sentiment reached its most recent bullish point on April 15th, roughly one week before the most recent peak in stock prices and subsequent correction. Reflecting on the investment experience of the past three years, it has certainly been difficult to follow through on what have been successful approaches in the past. One such approach has been to be a buyer during significant market draw-downs when others are selling. Contrarians who had the fortitude to be buyers in March 2009, obviously have been rewarded. Conversely, stocks seldom sell at levels that are considered "fairly" valued, spending much more time in what technicians call "over sold" or "over bought" extremes. Investors are rewarded when they align themselves with the momentum of the overall market and avoid the mistake (made by many over the past year) of exiting the markets prematurely. For investors who maintain a balance between liquid and income-producing reserves along with long dedicated equity as well as tactical strategies, the experience of the past three years has most



Sources: Federal Reserve; and IMF staff estimates.

Realized and Expected Writedowns or Loss Provisions for Banks by Region



Source: IMF staff estimates. ¹Includes Denmark, Iceland, Norway, Sweden, and Switzerland. ²Includes Australia, Hong Kong SAR, Japan, New Zealand, and Singapore.

probably reinforced their commitment to a disciplined plan.

It is a trait of human nature to become more risk tolerant when things are going well and less tolerant of risk during times of economic stress. The most important point to remember is that the cycles will recur. It is only a matter of time.

While most of us are focusing on longer-term fears concerning the structural soundness of the world economy and the time it will take to cleanse trillions of dollars of credit losses from the system, the ability of stock prices to find support at current levels appears to reflect the more immediate visibility of corporate earnings improvement.

A recent Merrill Lynch CIO outlook cited an interesting historical comparison of market valuation fundamentals between twelve years ago and today. In 1998, with the market approaching 1,200 for the first time, S&P 500 earnings were \$44. Current twelve month earnings are \$62 and calendar

earnings are expected to be \$80 this year. Cash flow and book value per share were \$72 and \$258 respectively in 1998 vs. \$144 and \$522 today. Consensus estimates see earnings surpassing the 2007 pre-crisis earnings peak of \$91 in 2011.

Perhaps the market is too optimistic in assuming that the current recovery will be sustainable enough to allow world and state governments, along with financial and real estate institutions to get their houses in order. Is the recent earnings improvement real, or is it as Dave Rosenberg of Gluskin Sheff in his *Lunch with Dave: Market Commentary* described as,

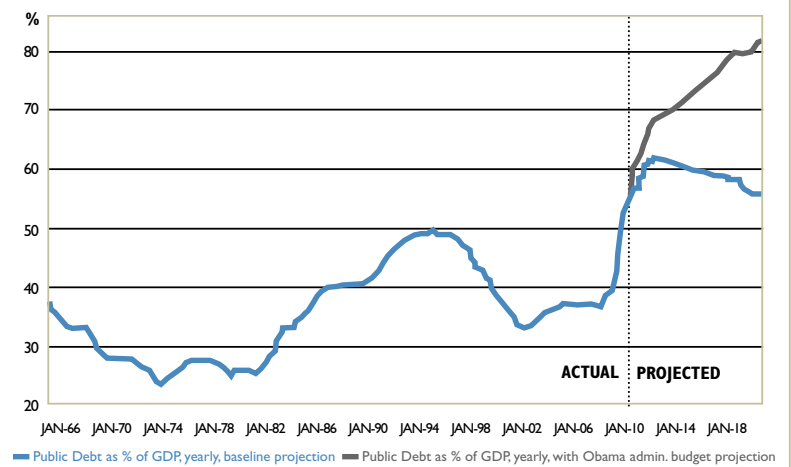
“a statistical mirage orchestrated by record amounts of monetary and fiscal stimulus that are simply unsustainable

and actually risk precipitating a very unstable financial and economic backdrop in coming years.”

Reviewing the charts on expected loan change offs and government deficits going forward provides a backdrop for the current fork in the road we have encountered. A sustained recovery may very well allow banks the time to clean up their portfolios using current earnings to gradually cover remaining writeoffs. It may also, one would hope, result in a projected government debt accumulation closer to baseline than projected.

Definitely food for thought as we move forward. At a minimum, a balanced approach would be to maintain core positions adding risk at this juncture only very selectively. The lesson once again being, not to get too caught up in recent market performance and to maintain a disciplined, ongoing understanding of your overall risk tolerance.

Government Debt is Not Sustainable



*Projected numbers under President Obama's proposed budget. Sources: FactSet and the Congressional Budget Office as of April 14, 2009



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