“Defying Gravity”
Can the Equity Markets Continue to Push Higher?
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When I was a junior in college at Georgetown University, my parents took me to my first Broadway show, *The Phantom of the Opera*, at the Kennedy Center. Ever since then, I have been a Broadway nut. Not to draw too many comparisons, but this stock market reminds me of one of the hits in the show *Wicked*, “Defying Gravity.”

The markets have doubled since the March 2009 lows. Even with this tremendous rebound, we believe the market can continue this robust upward trend and continue to defy gravity. With the S&P 500 at 1332, the market is again close to passing many strategists’ year end predictions. Goldman Sachs (Investment Strategy Group) has a year-end price target in their central case of between 1300 and 1375 for the S&P 500, Barclays Capital’s price target is 1420, and UBS’ price target is 1350.

First, let’s take a look at what has caused the market to continue its torrid pace.

1. The opportunity cost of staying out of stocks. Investors are not getting paid much to remain in cash or bonds. Good quality, large companies have lots of cash on their balance sheets and dividend yields are greater than some of these companies’ bond yields (AT&T, McDondald’s, Coca-Cola are examples).

2. Earnings have continued to be better than consensus. Over 75% of companies in the 4th quarter of 2010 reported earnings above consensus. Earnings are not excessive considering we are beginning to emerge from a very deep recession. A ratio that many professional investors review when deciding whether a stock or entire market is attractive is the price to earnings ratio (P/E ratio). The price to earnings ratio of a company is a valuation measure which compares a company’s current share price to its per-share earnings. While it’s important not to rely solely on this ratio, it is useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E. Generally, the lower the ratio, the more attractive a stock is. Since earnings have been good, the denominator is large and the price of stocks has gone up, but the ratio is not excessive. The revenue growth has been good enough for now, but questions remain whether the revenue growth should be growing faster than earnings; and how much of the growth in the top lines and bottom lines of corporations have been the result of the stimulus that has been created through the Federal Reserve’s actions. While input prices are increasing, which puts pressure on margins, with a soft labor market, companies are able to absorb these costs.

3. As mentioned above, price to earnings ratios are reasonable. Assuming $95 of earnings for the S&P 500 in 2011 the market is trading at a P/E ratio of 14. With an estimate of $102 for 2012, the projected P/E is 13 times earnings. Many large and mega-cap companies with growth prospects, high free cash flow yields and significant exposure to developing markets trade at 9-13 times earnings.

While the factors above will continue to cause the markets to increase, there are certain headwinds that we must pay attention to:

<u>Headwinds:</u>

1. Budget concerns. The deficit is expected to reach $1.6 trillion this year and while there needs to be a solid plan in place that comes out of the FED and Washington, extreme austerity would cut into growth prospects of the world. We don't feel that budget cuts will be a headwind in the year to come, but we are mindful of these cuts in the long-term. In addition, there has not been any job growth for some time. Many business leaders are pushing for a temporary reduction in the incremental rate on foreign earned profits, which would encourage companies to invest in the United States. American companies earn roughly one trillion dollars through their foreign operations – an amount larger than the original stimulus. Thus, this will be a very good start to creating job growth in this country if taxes on foreign earned profits would decline.

2. Situation in Middle East. The situation in the Middle East has impacted the markets, as markets do not like uncertainty. The situation has caused oil prices to skyrocket and financial markets to be more volatile. The recent events started in Egypt with Mubarak stepping down peacefully. Once the transition was in place, the markets steadied and reacted well. The unrest spread to Bahrain with fairly peaceful negotiations taking place. Bahrain is a small producer of oil in the GCC – Gulf Cooperation Council. The markets shrugged off the events in Bahrain. Demonstrations are not new to Bahrain, as the country is always able to settle or accommodate. Libya is at the other end of the spectrum. Moammar Gadhafi is vowing to put down any uprising, and as such, the markets are reacting poorly. Libya is a more important producer of oil, especially for Europe; and the oil is of a high quality, lighter and sweeter, and easier to turn into gasoline and other fuel. Oil production is actually less than 2%. If a complete or partial shutdown was to arise, other countries could easily replace lost capacity. There is plenty of oil in world storage and reserves to cover in the short term. The tipping point could be if the unrest continues to spread into other bigger GCC countries, like Saudi Arabia; but this seems less likely. In addition, other entrenched leaders in other Middle Eastern countries look good in comparison to Gadhafi and his response. The reaction to unrest should be less extreme and less impactful on the markets.

3. Higher oil prices which leads to higher gasoline prices. If the average gasoline prices hit 4.00 per gallon, it will be a major impediment to consumer spending. Due to the fact that there is not much wage growth, higher gasoline prices and higher interest rates are very combative to the consumer. Furthermore, diesel prices are very high which affects corporate business due to most transportation of goods occurs with vehicles that use diesel.

4. The Federal Reserve. While inflation is still low and will remain low for some time, inflationary expectations are not. The FED can start to raise rates despite actual inflation remaining low. Higher interest rates could have a major effect on small to medium size companies who need to access the debt capital markets to finance their operations. Furthermore, higher rates will lengthen the time it will take for the real estate markets and properties to stabilize. We must watch whether inflation expectations will change enough to matter to change the policy at the Federal Reserve.

5. Corporate Profits. Currently, the economic numbers suggest that it costs a company more to make something than it does for a customer to buy it (as measured by the Producers Price Index and the Consumer Price Index.) This is a major profit warning, as costs are accelerating faster than revenues. In a

fragile economy, it is difficult to push higher commodity and materials costs to the end consumer. Some companies have pricing power; others do not.

In addition to the above, the awful situation in Japan could have an impact on corporate numbers which might derail future growth plans for large multinationals.

6. Situation in other parts of the world. Europe continues to remain challenged, and we are hopeful that a resolution of a deal regarding the region's sovereign debt issues will be completed soon. Spain, Portugal and Greece continue to borrow most of their GDP and output. In contrast, states in the United States might borrow 2-3% of their respective municipalities' GDP. In addition to Europe, we are also watching what is occurring in Asia. Asia presents a problem to the extent that there is a slowdown. Asia has been the leading, driving force behind global growth.

While there are significant headwinds to the market, we remain constructively optimistic on the state of the equity markets for the next several years and recommend adding new money to the equity markets through actively managed long only managers. Furthermore, we are recommending that clients allocate a greater percentage of their capital in these times to the long biased long/short fundamental equity managers. These managers will provide more exposure to the equity markets than our market neutral long short managers. They hedge their portfolios by shorting stocks of the companies they do not like due to deteriorating fundamentals, excess leverage, management changes, or other events that would cause their stock price to fall. Overtime, these managers have done a much better job of protecting capital than traditional equity managers who are benchmark focused.

About Berman Capital Advisors

Berman Capital Advisors (BCA), an independent registered investment advisor based in Atlanta that specializes in wealth management for families and their foundations. Berman Capital Advisors currently manages close to 1.1BB in assets and was founded by former Goldman Sachs Senior Advisor Justin Berman in 2010.