



# RESEARCH REPORT

September, 2009

## Market Overview & Strategy Comments: *How Solid Is This Rally?*

While the stock market is still down 35% from its all-time high (about 1500 on the S&P 500), it's also up about 50% from its 10-year low of less than 700 set in March. Historically speaking, a 50% market rally over such a brief few months is a fairly rare occurrence. We compare this to previous times.

<u>Key Statistics</u>	<u>Current</u>	<u>Change Since Previous Month</u>	<u>2009 Change</u>
Dow Jones Industrial Average *	9496.28	+3.5%	+8.2%
S&P 500 Index *	1020.62	+3.4%	+13.0%
S&P 500 Ave. P/E Ratio **	18.6x	+0.6x	+4.7x
NASDAQ *	2009.06	+1.5%	+27.4%
1 Year Treasury Bill Yield	0.43%	-5 bps	+6 bps
10 Year Treasury Bond Yield	3.40%	-12 bps	+115 bps
30 Year Treasury Bond Yield	4.18%	-13 bps	+149 bps
Municipal Notes - 1 Year Yield	0.65%	-5 bps	-50 bps
Municipal Bonds - 10 Year Yield	3.50%	-10 bps	-60 bps
Reuters/Jefferies CRB Futures	\$253.68	-1.5%	+10.5%
Gasoline NY RBOB (\$ per gal.)	\$1.99	-2.9%	+97.0%
Natural Gas (\$ per MMBtu)	\$2.98	-18.5%	-47.0%
Gold (\$ per troy oz.)	\$951.70	-0.2%	+7.7%

\* price only \*\* based on 2009 earnings estimates.

The Reuters/Jefferies CRB Futures Price Index is an arithmetic average of commodity futures prices with monthly rebalancing.

Gasoline NY RBOB price excludes local, state and federal taxes (the "wholesale price").

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Securities are identified for illustrative purposes only. This should not be construed as a recommendation to purchase or sell any securities.



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## **Market Overview & Strategy Comments:** *How Solid Is This Rally?*

While the stock market is still down 35% from its all-time high (about 1500 on the S&P 500), it's also up about 50% from its 10-year low of less than 700 set in March. Historically speaking, a 50% market rally over such a brief few months is a fairly rare occurrence; the previous four occasions were 1982, 1975, 1932 and 1930. And just like those four rallies, this one was preceded by a huge downturn in both the economy and stock prices.

Unfortunately, history offers little guidance on what might happen next -- no clear pattern emerges when we look at the market performance following each of these four rallies, although shortly after the rally some sort of consolidation phase tends to occur lasting at least several months. Not much of a surprise after such a strong run up.

*Returning to the present, we have a number of solid reasons why the market has rallied:*

- A steady stream of positive earnings surprises; roughly 75% of S&P 500 companies reported positive surprises this quarter, the most since records have been kept.
- Banking and credit market woes have abated due to the efforts of the Federal Reserve.
- Valuations in March simply became too low at just over 10x depressed earnings.
- Asia's economies are rebounding, led by China, sparking a global improvement in the key manufacturing sector.
- Stability in housing demand and prices has been a big relief to investors.
- Cost cutting and easy comparisons to performance at the start of the recession point to a profit surge later this year, which investors are anticipating by buying stocks now.
- Money market and short term bond yields have plunged to almost zero, making even the volatile stock market attractive for investors seeking income.

*But now that the rally seems to be entering the inevitable consolidation phase, where could the market go next?*

On one hand, some of the negative factors in place after 1975's surge look similar to what we see today, and that rally had no follow through. The similarities include:

- Strong commodity prices led by oil, which has doubled off its lows, could create some headwinds for the economy.
- The rising budget deficit, now expected to be almost \$10 trillion over the next ten years, and \$1.5 trillion in the current year, could potentially crowd out investment in this country.
- Consumers need to save more, not spend, and as savings rates rise spending will be less.
- 10% unemployment will keep spending growth to a slower pace as well.
- Excess production capacity will limit capital spending by businesses.



# RESEARCH REPORT

If these negative factors carry the day, they point to a longer consolidation phase for stocks as subdued domestic economic growth and rising deficits keep a lid on stock prices.

At the same time, there are also some of the same positives in place that we saw after the big 1982 rally which, after a few months' pause, kept going for the rest of the decade:

- Low valuations: Stocks are still trading at just 12x peak earnings, 14x estimated 2010 earnings and yielding significantly more than short-term treasuries or money markets.
- Decent profit prospects as highlighted by the better than expected 2<sup>nd</sup> quarter earnings. 2010 earnings could be up sharply as well versus depressed 2009 results especially given the fact the economy has stabilized.
- Strong fiscal stimulus in the form of government spending and tax credits.
- Low inflation despite upward pressure on some commodities.
- Supportive Fed policy with no sign it is likely to reverse course anytime soon.

While it seems a bit early to try to forecast too far ahead given what both the economy and markets have just been through, we do think that after the 50% rally since March, stocks are due for a pause. Investor optimism seems a bit high at the moment and many companies in the banking and heavy cyclical sectors seem ahead of themselves given their profit outlooks, which could cause them to falter as market leaders. Therefore, we think that a consolidation phase could actually be beneficial for the market as it gives time for new leadership to emerge.

*During this consolidation phase, we continue to focus on the following sectors as we believe they will likely play a key role in future market advances.*

- International stocks: Both international ETFs and ADRs offer exposure to the emerging Asian and Latin American economies which appear to be rebounding much faster than the rest of the world. *Schlumberger, Femsas, and the MSCI Emerging Markets ETF* are three examples of current holdings.
- Multinational U.S. companies such as *Heinz, MasterCard, Coca Cola and Colgate Palmolive* all have significant sales and profits derived from these same faster growing economies.
- Consumer staples and health care stocks (especially with health care reform under revision) both appear inexpensive and likely to shine relative to many other sectors in a slow growth economic environment. Their above average and growing dividend yields are also attractive if the market rally pauses.
- Stocks with growing yields: *Medtronic, Colgate Palmolive, and Johnson & Johnson*, among others, are still raising dividends despite the tough economy, providing a boost to the total return from stocks.
- Technology companies such as *Google, EMC Corp. and Cisco* offer companies key tools to raise productivity and profits during a period of limited capital spending budgets.

In summary, whether you want to look at the market as still down 35% from its high or up 50% from its low, we are due for some consolidation and potential change in leadership as investors look for evidence of the sustainability of both the economy and the rally. We remain comfortable that our portfolios are positioned appropriately to handle this consolidation and the environment beyond.

*Securities identified are for illustrative purposes only. This should not be construed as a recommendation to purchase or sell any securities. The securities mentioned may or may not be held in all client portfolios.*

## CORE HOLDINGS LIST FOR 2009

Source: FactSet, First Call, Value Line, Bloomberg & CAM Estimates.

			Recent	2009	2010	2009	2010	Est EPS	P/E to	Market		Div
September 1, 2009	<u>Company Name</u>	<u>Ticker</u>	<u>Close</u>	<u>EPS</u>	<u>EPS</u>	<u>P/E</u>	<u>P/E</u>	<u>Growth</u>	<u>Growth</u>	<u>Cap(\$mm)</u>	<u>ROE</u>	<u>Yield</u>
	<b>Standard &amp; Poors 500</b>	SPX	1,020.62	\$55.00	\$69.24	18.6x	14.7x	8%	1.8x	8,980,658	13%	2.5%
<b>Financials:</b>	Berkshire Hathaway Cl "B"	BRK/B	3,286.00	\$156.14	\$181.73	21.0x	18.1x	5%	-	48,745	4%	0.0%
	MasterCard	MA	202.63	\$10.97	\$12.84	18.5x	15.8x	16%	1.0x	22,225	10%	0.3%
<b>Consumer Staples:</b>	Coca Cola	KO	48.77	\$3.03	\$3.33	16.1x	14.6x	5%	3.1x	113,022	28%	3.4%
	Colgate Palmolive	CL	72.70	\$4.28	\$4.76	17.0x	15.3x	10%	1.5x	36,236	93%	2.4%
	Diageo Plc ADR	DEO	62.04	\$4.38	\$4.84	14.2x	12.8x	8%	1.7x	38,770	40%	3.7%
	Fomento Economico Mexico	FMX	36.38	\$1.92	\$2.51	18.9x	14.5x	23%	0.6x	7,862	8%	0.5%
	H.J. Heinz	HNZ	38.50	\$2.79	\$2.89	13.8x	13.3x	8%	1.8x	12,135	59%	4.4%
	Walgreen Co.	WAG	33.88	\$2.08	\$2.38	16.3x	14.2x	12%	1.1x	33,622	18%	1.6%
<b>Health Care:</b>	Becton Dickinson	BDX	69.62	\$5.00	\$5.26	13.9x	13.2x	12%	1.1x	16,666	24%	1.9%
	Johnson & Johnson	JNJ	60.44	\$4.52	\$4.89	13.4x	12.4x	7%	1.9x	166,561	30%	3.2%
	Medtronic, Inc.	MDT	38.30	\$3.08	\$3.36	12.4x	11.4x	10%	1.1x	42,505	18%	2.1%
	Novartis AG	NVS	46.47	\$3.91	\$4.37	11.9x	10.6x	8%	1.3x	122,570	16%	3.1%
	Zimmer Holdings	ZMH	47.35	\$3.87	\$4.28	12.2x	11.1x	10%	1.1x	10,147	15%	0.0%
<b>Consumer Discretionary:</b>	Staples, Inc	SPLS	21.61	\$1.14	\$1.34	19.0x	16.1x	15%	1.1x	15,610	14%	1.5%
	Target Corp.	TGT	47.00	\$3.00	\$3.34	15.7x	14.1x	13%	1.1x	35,337	15%	1.4%
	Toyota Motor Co. ADR	TM	85.19	NMF	\$2.03	NMF	41.9x	5%	8.4x	146,867	14%	2.3%
<b>Technology:</b>	Cisco Systems	CSCO	21.60	\$1.33	\$1.40	16.2x	15.4x	13%	1.2x	124,586	24%	0.0%
	EMC Corp.	EMC	15.90	\$0.83	\$1.05	19.2x	15.2x	12%	1.2x	32,151	11%	0.0%
	Fiserv, Inc.	FISV	48.25	\$3.67	\$4.09	13.1x	11.8x	12%	1.0x	7,449	14%	0.0%
	Google	GOOG	461.67	\$21.65	\$24.40	21.3x	18.9x	20%	0.9x	111,711	17%	0.0%
<b>Industrials:</b>	3M Co.	MMM	72.10	\$4.19	\$4.55	17.2x	15.9x	12%	1.4x	50,345	32%	2.8%
	ABB Ltd. ADR	ABB	19.17	\$1.10	\$0.98	17.4x	19.6x	2%	9.8x	44,528	28%	0.0%
	Danaher Corp.	DHR	60.71	\$3.36	\$3.59	18.1x	16.9x	11%	1.5x	19,411	14%	0.2%
	United Parcel Service	UPS	53.46	\$2.14	\$2.61	25.0x	20.5x	12%	1.7x	37,544	32%	3.4%
	United Technologies	UTX	59.36	\$4.08	\$4.44	14.6x	13.4x	11%	1.3x	55,874	25%	2.6%
<b>Energy:</b>	Apache Corp.	APA	84.95	\$4.87	\$8.55	17.4x	9.9x	10%	1.0x	28,522	4%	0.7%
	Petroleo Brasileiro S.A. ADR	PBRA	33.20	\$3.02	\$3.69	11.0x	9.0x	10%	0.9x	61,432	30%	1.1%
	Sasol LTD ADR	SSL	37.79	\$3.25	\$4.27	11.6x	8.9x	5%	1.8x	24,095	35%	3.4%
	Schlumberger, Ltd.	SLB	56.20	\$2.68	\$2.66	21.0x	21.1x	8%	2.6x	67,318	34%	1.5%
<b>Telecom Services:</b>	America Movil ADR	AMX	45.15	\$3.29	\$3.69	13.7x	12.2x	12%	1.0x	46,120	40%	1.0%
	China Mobile Hong Kong	CHL	49.22	\$4.15	\$4.24	11.9x	11.6x	15%	0.7x	197,470	28%	3.2%
<b>Transportation:</b>	Kansas City Southern	KSU	23.90	\$0.46	\$1.06	52.1x	22.5x	20%	1.1x	2,294	10%	0.0%
<b>Exchange Traded Funds:</b>	iShares MSCI EAFE Index	EFA	52.68	-	-	-	-	-	-	33,410	-	2.8%
	iShares MSCI Emerging Mkts	EEM	35.31	-	-	-	-	-	-	30,126	-	1.4%

0% weighting in utilities and materials.

The above is a list of common stocks currently held in clients' portfolios. Not all stocks are held in all portfolios for various reasons. Upon request we will furnish a list of all equity recommendations made within the past twelve months. This list includes the name of the security, date and nature of the recommendation, price at which the recommendation was acted upon, and the current market price of the security.

It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list.

Please contact Mickey Herst for a copy of the list.

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