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### **Northbrook Perspective August-8-2011**

- To analyze market conditions today, it is important to review economic and market conditions over the last few decades. The market environment today is not like the 1970s, when P/E ratios were low but inflation and interest rates were high. Investors today are worried about different problems: a weakening domestic economy, Europe's debt mess, political dysfunction in Washington and a massive and seemingly intractable federal budget deficit. Yet American corporations rarely have been in better shape, with generally robust profits and balance sheets flush with more than \$1 trillion in cash.
- Corporate profits remain robust. Around 80% of S&P 500 companies have reported quarterly results and the average positive surprise is 4%, double the average of the past 25 years. Moreover, aggregate corporate earnings and revenue are both up about 13% from the year-ago period, according to Yardeni Research. On top of that, corporate cash balances are at record levels and a growing number of companies are buying back shares and raising dividends. American corporations have shown that they can make a lot of money even if the economy isn't sprinting and Wall Street analysts believe they will continue to do so. In the last week of July, they raised earnings estimates for all 10 S&P 500 sectors.
- Private sector companies have higher cash flows, lower debt levels and higher cash balances than at any point over the last ten years. Public sector government, however, has the largest deficits and highest debt over the last ten years.
- The benchmark Standard & Poor's 500 index trades for little more than 12 times projected 2011 profits, one of the lowest price/earnings (P/E) ratios in a generation. The normal P/E range is 14 to 17. The Dow Jones Industrial Average has a similar P/E, about 11.6 times this year's estimated earnings. Its dividend yield of 2.62% exceeds the depressed 2.56% yield on the 10-year Treasury note, another rare occurrence.
- The S&P 500 Index is at 1200, which is 14.7 times reported trailing earnings of \$81. If the market earnings remain flat from here, the market could trade down to 12x earnings, or about 980, which could represent another 15% correction. This level would be unlikely because there is some earnings and margin growth which will increase the actual S & P 500 earnings above the trailing twelve months level of \$81.
- Wall Street still predicts that the Standard & Poor's 500 Index will rally in 2011, even after speculation the U.S. economy is heading for a recession that prompted the biggest plunge since the bull market began. Chief strategists at 13 banks from Barclays Plc (BARC) to UBS AG (UBSN) see the benchmark measure of American equity surging 17 percent through Dec. 31, the average estimate in a Bloomberg survey. Their projection that the index will reach 1,401 hasn't budged in four weeks.
- Strategists say earnings growth will fuel gains. S&P 500 profit will rise 18 percent in 2011 and 14 percent in 2012, according to the average per-share analyst estimates in a Bloomberg survey. More than 75 percent of corporations in the index have exceeded earnings estimates for the second quarter, with total income topping projections by 5.2 percent.
- Investors have been rattled by the swift pace of the sell-off, in which the S&P 500 fell more than 10% in 10 trading sessions. This marks only the fourth such decline in a bull market since the end of World War II. The other three 10% drops occurred in late 1974, October 1997 (during the Asian crisis) and August 1998 (after the collapse of the hedge fund Long-Term Capital Management). The good news is that the market rallied an average of 18% in the ensuing three months after each of those three setbacks, according to J.P. Morgan strategist Thomas Lee.
- Markets have a tendency to overreact in both positive and negative directions.
- The markets are currently pricing slower growth, European debt problems and a higher probability of a global recession into stock prices, however, Warren Buffett, a well respected investor does not believe that we will experience a double dip recession.
- In conclusion, we think that the S & P 500 could correct an additional 10 percent if earnings and expected earnings decline. This is unlikely given the consensus of Wall Street and reporting companies to date. World debt and deficits will likely keep global GDP lower and it will take longer to reduce the global debt and deficits.