

# Walker & Associates

Walker & Associates Investment Advisors, Inc.

First Quarter 2009

**The broad economic environment remains highly stressed, and there is a great deal of uncertainty as to what the impact of the recently enacted government policies and programs will be.**

**Broadly speaking, the near-term imperative is to prevent a debt-deflation spiral from taking hold and that is the basis for policy actions. But longer-term these actions are likely to come at the cost of lower growth, higher inflation, and dollar weakness.**

**We consider four broad economic scenarios that we believe are reasonably possible in assessing valuations and potential returns for equities and other asset classes. We believe the likelihood of one of our more negative scenarios playing out is high enough to justify weighting those scenarios more heavily in our portfolio allocation decisions.**

**Short-term risk remains, and investors should consider now how they would react to another significant decline in the stock market.**

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## Quarterly Investment Commentary

Stocks saw their best one-month gain in March in more than six years, but while it was a welcome respite from the battering in January and February, the first quarter still ended with a double-digit loss for equities. The large-cap S&P 500 (based on Vanguard 500 Index Fund) surged by almost 9% in March, yet finished the first quarter with an 11% loss. REITs were beaten sharply lower as investors reacted negatively to deteriorating fundamentals and fears about debt rollovers, and after a weak rebound in March finished the quarter down 32.1%. High-yield bonds, on the other hand, had the best showing of any of the broad asset classes we track, with a gain of 5.3% for the opening quarter. Abroad, the results for developed-market equities were similar to what we saw at home. Vanguard Total International Stock Index Fund gained over 9% in March, but their 13% loss for the quarter was a bit worse than that of domestic equities. In contrast, emerging-market equities had a great March and finished the first quarter slightly in the black, based on Vanguard Emerging Markets Stock Index Fund. Turning to bonds, Vanguard Total Bond Market Index Fund was up 1.5% for the month, bringing their year-to-date results slightly into the black.

### Recap of the Current Economic Situation

The list of issues affecting today's investment landscape is dizzying; at the top is the dismal state of the global economy. The fundamental problem is that over the past several economic cycles U.S. households and financial services businesses took on increasing amounts of debt in order to fund consumption and investments. This trend was self-reinforcing as purchases with borrowed money drove up asset prices (such as homes and financial stocks) and profits, which supported even more borrowing. Ultimately this upward spiral was unsustainable, and its unwinding has created an adverse feedback loop of falling asset prices and lower spending and profits. As the economy deteriorates, contributing factors (such as rising unemployment, mortgage defaults, loan write-offs, reduced lending, and overall fear) all fuel one another.

In such a situation, most experts agree that the government needs to step in as a consumer and lender of last resort to try to stop or mitigate the effects of this adverse feedback loop. In effect, the public sector (the government) must take on more leverage and spend more in order to try to

plug the gap created by the deleveraging in the private sector. The \$800 billion fiscal stimulus package and the monetary and credit policy actions undertaken by the Federal Reserve and the Treasury to support the financial and credit markets are the result so far.

We agree that stopping a debt-deflation spiral from taking hold is very important, but there remains a lot of uncertainty as to how the government's efforts will play out. Generally speaking, we think that the policies and programs recently announced are likely to help move the economy towards recovery, but they may not alone solve the serious problems we are facing and we expect more government action in the months ahead. In our opinion, no matter what policies are introduced, the impact of consumer and financial system deleveraging will almost certainly be a significant drag on economic growth over the next several years, as saving and paying down debt replaces borrowing and spending. We also believe that there will likely be a price to pay down the road for the current policy actions in the form of a weaker U.S. dollar, higher inflation, higher interest rates and tax rates and, consequently, subpar economic growth and corporate profits, with lower-than-normal stock market valuations (P/E multiples).

### **Our Outlook for Equities**

The analytic framework for our equity return ranges—and the resulting asset allocation decisions—starts with four broad economic scenarios that we think have a reasonable likelihood of playing out over the next five years. We derive assumptions regarding earnings growth and valuations (P/E multiples) for the S&P 500 that we believe are consistent with each economic scenario. Our earnings and valuation assumptions are based on our analysis of stock market and economic history going back to the 1920s as well as a qualitative, forward-looking assessment that accounts for differences between this cycle and prior economic and market cycles.

#### **Each earnings growth path and P/E multiple implies an ending value for the S&P 500 five years hence.**

We can then calculate the approximate rate of return from capital appreciation and dividend yield for each of our scenarios. We can also test the sensitivity of the results to different growth and valuation assumptions. These scenarios and return expectations are not predictions. Rather, having calculated a range of potential five-year returns for equities (and other key asset classes as well), we use the results as key inputs in determining our tactical portfolio weightings.

#### **Our four broad economic scenarios are as follows:**

*Scenario 1: "Muddle Through"* - Economic recovery in late 2009/early 2010 but sub-par recovery for several years. Inflation gradually rises.

*Scenario 2: "Stagflation"* - Economic recovery in late 2009/early 2010 but sub-par recovery. Strong inflation (mid single digits) near the end of the five-year period.

*Scenario 3: "Severe Recession/Deflation"* - Extended/deep recession and potential deflation through 2010 due to severe deleveraging and negative wealth effects. Recession does end but recovery is anemic.

*Scenario 4: "Goldilocks"* - Government policies are effective and economy starts growing in the latter half of 2009. An average recovery with moderate inflation.

Over the past several months we have spent a great deal of research time analyzing historical earnings and stock market cycles going back to the turn of the century and thinking about how the current cycle might play out over the next several years. We have focused a lot of attention on our worst-case severe recession (Scenario 3). In the past, we have been comfortable assuming the economy will go through normal cyclical downturns (recessions) and recoveries. But starting with the events last September, we no longer think that is the most likely outcome given the deleveraging/negative spiral process we appear to be facing. (Although we don't think a normal recovery is the most likely outcome, we do not rule it out -- see Scenario 4). This has led

us to study the U.S. experience in the 1930s -- the last time our country went through a massive deleveraging process -- as well as more recent financial/banking crises in other countries.

We believe the growth path for corporate earnings over the next five years will likely fall somewhere between the worst post-recession recovery since World War II and the Great Depression (which saw the biggest drop in earnings in U.S. history). In our worst-case scenario we lean towards the latter. Note that we are not expecting the overall economy (GDP) or the unemployment rate to be anywhere near as bad as during the Depression. But we think the impact on corporate profits could be comparable. This is based on our judgment taking into account the extent of leverage in the system that must be unwound, balanced against the unprecedented fiscal and monetary actions the government is taking to prevent a repeat of the Great Depression. We believe the growth path for corporate earnings over the next five years will likely fall somewhere between.

### **Our Worst-Case Scenario**

In our worst-case scenario (Scenario 3), we assume a peak to trough decline in nominal S&P earnings of about 65%. This compares to a 75% decline during the Great Depression and is worse than any other earnings decline since then. We think the trough earnings will likely occur around the middle of this year. From the trough, we assume earnings rebound at the median rate of post-World War II earnings recoveries for the first two years and then assume they revert to the long-term trend rate of roughly 6% growth. We think these are conservative assumptions because we are not assuming the sharp recovery in earnings that typically happens after sharp earnings declines. Again, this reflects our concern about the high amount of leverage in the system and the potentially long-lasting effects of its unwinding. As we come out of the current contraction, consumers may be reluctant to take on debt, and bank lending (which will also likely be more-heavily regulated) could be cautious, contributing to a subdued earnings recovery.

The above assumptions give us an estimate of S&P 500 earnings of about \$51 five years out. To this earnings number we apply two valuation multiples. In one case we assume a P/E multiple of 16x. This is roughly the multiple we observed in the period after the earnings trough during the Great Depression. In the other case, we assume a lower multiple of 13x to account for the possibility that market psychology may be depressed if our worst-case economic scenario plays out. There are other macro risks as well, such as dollar depreciation and higher-than-expected inflation—both of which might compress valuation multiples. The market has experienced P/E multiples lower than 13x, but that has typically been during periods of high inflation (the 1970s), world war, or when earnings are growing very rapidly (e.g., after World War II) – none of which we expect five years from now in this scenario. So we feel that 13x is sufficiently pessimistic as an end-point multiple. But this does not mean the multiple couldn't drop below 13x at some point during the next five years.

Multiplying the P/E multiple and our earnings number gives us an estimated S&P price level five years from now. We then calculate the annualized price return and add the estimated dividend yield to derive our return expectation. From the quarter-end S&P level of around 800, five-year estimated returns in this scenario are not attractive (roughly -1% to +3%) though not a disaster. While we don't believe our most negative scenario is the most likely outcome, we believe it could occur and that it deserves to factor into our investment decisions. It is a key reason why we remain underweight to stocks despite their huge declines over the past 17 months.

### **Our Optimistic Scenario**

In our most optimistic Goldilocks scenario (Scenario 4), we assume that S&P earnings revert to their long-term earnings trend line five years from now. Prior to the events of last summer when the financial crisis began to intensify this was our baseline scenario. That is, we assumed the most likely outcome was that we would experience a normal recession/expansion cycle and so our best guess was that in five years time earn-

ings would be at or in the neighborhood of their very long-term earnings trend line (which reflects a 6% long-term average annual growth rate going back to the 1920s). However, given the deleveraging process as well as the potentially challenging longer-term consequences resulting from the current government intervention, we now view this scenario as less likely than our more negative scenarios, but still one that is reasonably possible and that therefore deserves to factor into our decision making.

This scenario generates an earnings number of around \$86 five years out. We apply an 18x P/E multiple, which is consistent with long-term historical average P/Es during periods of moderate inflation and normal economic growth. From the S&P around 800, this scenario suggests a stock market return of around 17% per year over the next five years. Such a return would be very attractive in both absolute terms and relative to the other asset classes we follow and is a key reason why we are not more underweight to equities than we currently are.

### **Our Other Scenarios**

Our other two scenarios generate potential returns that fall between Scenarios 3 and 4. We won't go into the details here, but qualitatively, both scenarios assume earnings growth better than in our worst-case scenario although still not as strong as in a normal cycle. The end-point earnings estimate for Scenario 1 is about 30% above our worst-case and for Scenario 2 it is about 25% higher. We picked our end-point P/E multiples in these scenarios based on a variety of analyses. We looked at the very long-term average P/E going back to the 1920s and eliminated the extreme outlier multiples during the tech bubble in the late 1990s. We analyzed the relationship between P/E ratios and inflation. We also factored in the potential for P/E contraction due to higher investor risk aversion as this market cycle plays out. Putting all of this together led to lower multiples (14x to 15x) than we used in our optimistic scenario. With the S&P currently around 800, these scenarios imply market returns in the 5% to 8% range—decent but certainly not compelling enough to warrant a tactical overweight to stocks.

### **Extending Our Time Horizon**

We want to emphasize that there will be a recovery in earnings at some point and we believe investors with a very long time horizon (greater than five years) should do at least okay owning equities at current prices and likely better than bonds. And as we extend our investment time horizon out towards 10 years, our expectations for equity returns move toward the more optimistic end of our range, in the upper-single-digit to lower-double-digit return range. This is because earnings and P/E multiples are more likely to normalize (revert to their long-term trend lines or averages) as time goes on and the global economy heals itself. But the path from here to there is likely to be bumpy and there will probably be some big dips along the way. When stocks do become sufficiently undervalued in the short term, we will look to opportunistically add to our equity exposure in order to generate higher long-term returns for our clients' portfolios. Moreover, we continue to hear from the majority of our equity managers that they are finding once-in-a-generation opportunities right now.

We remain strongly committed to focusing everything we do on rewarding you for your confidence.

Walker & Associates (4/9/2009)

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