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Strategy Update

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STOCKS

The recent rally in stocks from the March lows of more than 50 percent has left many (including myself) wondering how we can justify current valuations. Whether we use operating or as-reported earnings (see data below), valuations are very rich. With this said, there have been plenty of times when valuations became extended, and stayed that way for long periods; sometimes years. However, since we are sitting at year-highs as of today's close, I thought I would run the numbers and see what the current valuation picture looks like.

For the S&P 500, closing just above 1,044 today, the operating price/earnings (P/E) multiple for the trailing twelve months is about 26X. This is not exceedingly high, although the normal range for the S&P 500 is between 10X and 20X with a long-term average of 15X.

More alarming is the P/E based on as-reported earnings, which include write-offs. The reality is that, although technically write-offs are non-cash accounting items, we all know the very real dollars—trillions of dollars—being lost by companies across the board. While the timing of these losses can work to the advantage of companies, and certainly the decision as to when to take the write-offs impacts as-reported earnings and by extension P/E ratios, the fact remains that we cannot completely ignore write-offs.

The current P/E ratio for the S&P 500, based on as-reported, trailing twelve month's earnings, is about 130X. Even more concerning is the fact that the bulk of the write-offs affecting the P/E ratio came in December (-\$23.25 a share). I do not think we have seen the end of write-offs, so I would expect to see additional, substantial write-offs coming in the next few quarters; most likely a lot in Q4. We will be replacing 4Q08 of course, so we will drop the negative impact of the write-offs from that

quarter, once we get through Q4 earnings this year. But, if more write-offs come, the valuation situation may not improve, or may not improve by enough to matter.

Looking ahead, if we use operating earnings estimates for the next four quarters (from S&P), operating earnings are expected to be about \$64 for the S&P 500, which gives us a forward P/E estimate of 16.3X. This is fairly reasonable, is within the historical range, and is only slightly above the long-term average. Standard & Poor's does not currently have their estimates up for as-reported earnings (they are under review), but I will bet that they are going to look similar to the trailing four quarters, with only a slight improvement.

While I question the health and sustainability of the current rally in stocks (and commodities – see below), I will acknowledge that the stock market has a powerful driver working in its favor—cash. There are still very large, multi-trillion-dollar, cash balances available. And, every day that the market runs higher, this pushes more investors off the fence and back into stocks. This doesn't mean they are making wise investment decisions, but it is certainly a big contributor to the rally, and it could very well continue for some time.

We are entering what has been historically the worst period each year for stock market performance—between the end of summer and the end of October. The crash of 1929, the crash of 1987, September 11, 2001, and last year's implosion of the financial markets, punctuated by Lehman's failure, have all occurred during this time period (only to name a few of the big ones). I had thought that summer would be weak, with volumes lower and less economic data, etc, but those cash balances continued to drive stock prices higher, and we ended-up having a great summer... probably one of the best ever.

My current allocation still favors stocks, although I am primarily in cash, with a few short positions (technology, financials, gold, and treasuries). I am obviously defensive at the moment, and cannot justify paying-up for stocks at their current valuations. Also, I feel the bond market is even more unattractive (see below).

What I am looking for is some kind of meaningful correction to not only test the technical support levels on the S&P 500, which are at about 950 and then 875 below that, but also to shake-out all of the weaker players that are just riding the wave of momentum. These weak players cause the frothiness we are seeing currently, and will be the first to run for cover, if we get any kind of jolt on the downside.

If and when we get this correction, my plan is to begin to build positions in those companies that I feel not only offer the strongest growth potential over the coming three to five years, but also that have clean balance sheets, (so they can weather the short-term weakness in the economy), those that have dominant market share, strong, stable, and proven management teams, and have demonstrated an ability to

make good decisions in hard times. This includes buying competitors or businesses that are complimentary to theirs when they can get a great deal.

I will likely start with 25 percent of the stock portion of portfolios, when I feel the timing and valuations warrant re-entering the stock market. If we have a correction, and a test of the technical support levels for the S&P 500, I will want to see stability develop after the test, to be comfortable that the market will not have another leg down, falling to a lower support level. I would feel comfortable putting some cash to work at the 875 level (roughly), but would still hold the remaining cash, at least temporarily, to see if we have continued selling.

A lot will depend on external economic factors occurring around the time of the correction, and this will certainly influence my sense of urgency. It has been painful to watch the stock market continue to rally and not participate, but I believe we will have better opportunities to buy the companies worth owning at better prices.

Also keep in mind that there have been varying levels of performance among the sectors represented in the market. Some stocks have done very well from the lows, but made the bulk of their runs in the first month or two following the March lows, while others were late to the party. This will certainly factor-in to their individual reactions to a correction, should we have one, and into my interest in owning them.

The sectors I will focus upon will be the same ones that I have been recommending since late last year, and are the same ones that have led the current rally—technology, financials, consumer discretionary, and industrials. These are the higher-growth sectors, that should outperform as the economy improves.

Within these sectors, I will target the top companies in each; the largest, most well-diversified in terms of geographic sales spread and product/service offerings. These will be the companies that weather the storm best, should we see a very slow recovery or possibly a double-dip recession, (which I wrote about in my column recently).

I will deploy the remaining cash I am holding, either shortly following the initial 25 percent investment, if the market holds/turns back up, or I will look for a lower entry point, in the event that the correction continues, dragging the markets down to lower support levels. *I will provide more guidance on this as we get into the correction (if it comes), and as I have more actionable information.*

COMMODITIES

As mentioned above, I am short gold, and believe that commodities, like stocks, are due for a correction. I feel, on a percentage basis, the correction in commodities will be of a larger magnitude than that of stocks, given the massive run-ups we have seen of late. Gold just topped \$1,000 per ounce, even though it pulled-back slightly from

that level today, and oil has been pushing \$75 a barrel (again). There are several meaningful factors driving commodity prices, not the least of which is that it is the only other market (besides stocks) that is working right now.

More specifically, a combination of inflation fears, optimism over a global economic recover that will drive demand for commodity-related goods (and commodities themselves), especially from developing countries like China and India, and speculators working the momentum trade, all have contributed to this recent rally in commodities.

I do not see the global (or U.S.) economy recovering at the pace necessary to justify the current valuations for commodities either. And so, at least in the short-run, I would expect a sizable correction in commodities too. Further, I feel that demand for oil will remain weaker, given all of the fuel-efficient vehicles that saturated the market over the last year or so. Many people replaced their SUV's with a Prius, or some other high-mileage car, and also most of us have changed our driving habits, combining trips, and just not driving as much. So, even if the economy turns, and turns well, I do not anticipate that demand for gasoline, and therefore oil, will return to pre-recession levels, for a long while. Demand for fuel in other, developing countries, like China and India, will not be enough to offset the drop in demand here in the U.S., at least not in the next few years. So, my overall view of commodities is bearish at present.

BONDS

I am also bearish on the bond market, for a variety of reasons. First, if you believe that inflation will be any kind of factor, then you must believe that bond yields, especially on the longer-end of the curve, must go substantially higher. We are still at rates we haven't seen since the 1960's, so the idea that we can add all of this debt, run trillion-dollar-plus budget deficits, run continuous trade deficits, fund a \$1 trillion health care overhaul/expansion, and devalue the dollar huge by printing money to stimulate the economy, *and* keep rates at 40-year lows, is unrealistic to say the least. Rates will go higher, and I feel also that the spread between the short-end and long-end will widen as well.

By extension, this means that bond prices across the board will fall, and that prices for longer-maturity bonds will fall by a higher percentage than shorter-maturities. The take-away is that we do not want to own long-maturity bonds of any type right now, and if you own some that you have held, you should look to lock-in these high prices.

Within the bond market, I like corporates and municipals with maturities of five years or less, and preferably three years or less. We are not getting paid much of a time premium to lock our money up for each additional year, so it makes little sense

to tie up money in long maturities. Within the corporate bond sector, there are many attractively-priced bonds within this maturity range, especially because corporations are still finding it next to impossible to raise new money in the bond market. This lack of available liquidity is still causing anxiety, and by extension, higher yields/lower prices.

As with stocks, I am focused on the largest companies in the same four sectors, with clean balance sheets and adequate cash on hand to make their interest payments. As yield begin to rise, there will be opportunities, as bonds with shorter maturities mature, to reinvest at increasing rates, and to lengthen maturities. The combination of rising rates and longer maturities will accelerate the increase in overall portfolio yields and income.

For munis, we must be very careful to only buy bonds that are either state G.O.'s (general obligations), or if buying a specific revenue bond, etc, we must understand the economics of the town from which those revenues will be generated. We will likely see many cities and counties go under before this economic storm passes, and the last thing we want to do is to get stuck in a bond that goes to zero, trying to chase a little extra yield and tax advantage.

Real Estate

Any of you who have been reading my commentaries and research pieces know that I was predicting the collapse of the real estate market and real estate prices as far back as the summer of 2004 (visit the research section of the MPAM website (www.mpam.bz) to see this research). Now that this has happened, the question is, when will we see a bottom, and more importantly, a recovery?

The simple answer is that we are not there yet, and I would expect to see prices continue to fall for at least several more quarters before we have a meaningful bottom start to form. More depressing is the fact that I do not see prices or activity rebounding for at least a year or two (or more) after we see a significant bottom form, which could, in and of itself, take a year or longer.

With this said, I think we have seen the bulk of the percentage declines in prices that we will have to endure, so the remaining declines, although they will come over a relatively longer period of time, will not be as sizable. I would expect another 10 percent or so in price declines here locally, before we see them bottom. For more expensive properties, this still represents a large dollar drop. (Sorry.)

From an investment standpoint, the timeline detailed above, coupled with the lack of availability of financing, will make real estate a dead-end investment for years to come. There will simply not be a price driver, as there was during our latest bubble period, because the speculators are out of business. Without them, prices would never

have gone as high (not even close), and I do not expect to see prices return to the recent highs for many, many years, and in some lesser surrounding markets, like Lompoc, Santa Maria, Ventura, etc, maybe never. There will be some deals to be had in the foreclosure market, but by and large, a high level of expertise, and rehab skills will be needed to take advantage of these opportunities. In general, I feel that stocks and bonds offer a much more attractive, long-term opportunity as compared with real estate.

SUMMARY

Patience and cash are king right now, and I would not be in a big hurry to jump into stocks or to add positions to existing portfolios at current valuations. While stocks can trade at extended valuations for long periods, eventually, they do come back to their fundamentals, and that is what I am waiting for. Remain patient, but have your cash ready, along with your game plan, and know exactly what you will buy and how much, and you will have the best chance to take full advantage, if we have the correction I expect. Even if I am wrong, I do not feel that stocks will trade above where they are today, by a significant amount, and stay there, erasing any chance we have to buy in, should we want to do so.

I could go on, but I think for now I have written enough (and I am tired). I plan to update my strategy reports about every other week, or whenever things change enough that I feel you need to know what I am thinking and doing. I hope this information is helpful. While I could always provide more detail, in the interest of your eyesight and patience, I think six pages is enough. Please feel free to email me or call me (craig@mpam.bz; 805-898-1400) if you would like to discuss this strategy Update (or anything else).