

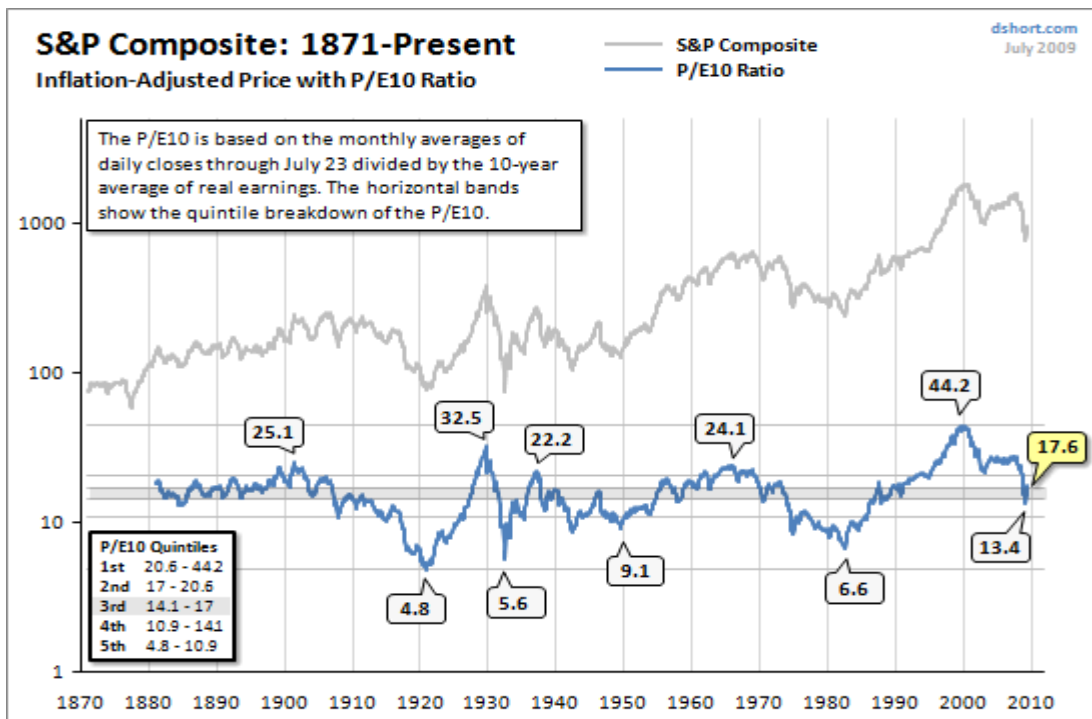
TECHNICAL OPINION

July 27, 2009

Stock Market Value: Current Assessment

1. Price/Earnings Multiple

A standard way to investigate market valuation is to study the historic Price-to-Earnings (P/E) ratio using reported earnings for the “trailing twelve months” (TTM). Proponents of this approach ignore forward estimates because they are often based on wishful thinking, erroneous assumptions, and analyst bias.



We use the P/E10 parameter to gauge the market's value. It is based on the monthly averages of the daily closes up to the present divided by the 10-year average of reported earnings. The horizontal bands shown on the chart represent the quintiles of the P/E10 in order to get a more precise view of how today's P/E10 relates to the past. Thus, each quintile represents 20% of the total. Ratios in the top 20% suggest a highly overvalued market, the bottom 20% a highly undervalued market.

Perspective

What can we learn from this analysis? Over the past several months, the decline from the all-time P/E10 high dramatically accelerated toward value territory, with the ratio dropping from the 1st to the upper 4th quintile in March. The price rebound since March has now put the index in the lower range of the 2nd quintile — on the expensive side.

A more cautionary observation is that every time the P/E₁₀ has fallen from the first to the fourth quintile, it has ultimately declined to the fifth quintile and bottomed in single digits.

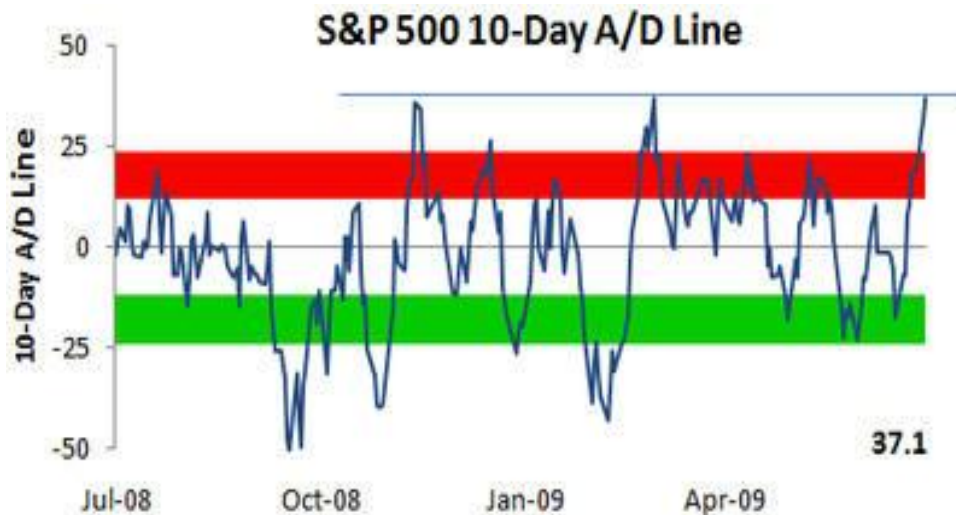
Based on the latest 10-year earnings average, to reach a P/E₁₀ in the high single digits would require an S&P 500 price decline below 600. Of course, a happier alternative would be for corporate earnings to make a strong and prolonged surge. When might the P/E₁₀ bottom? These secular declines have ranged in length from over nineteen years to as few as three. The current decline is now in its ninth year.

Courtesy: dshort.com

2. Advance/Decline Line

The 10-day advance/decline line is a widely followed breadth indicator that is used to measure both the health of a move as well as inflection points. It is calculated by finding the average daily number of advancers minus decliners over the last ten trading days.

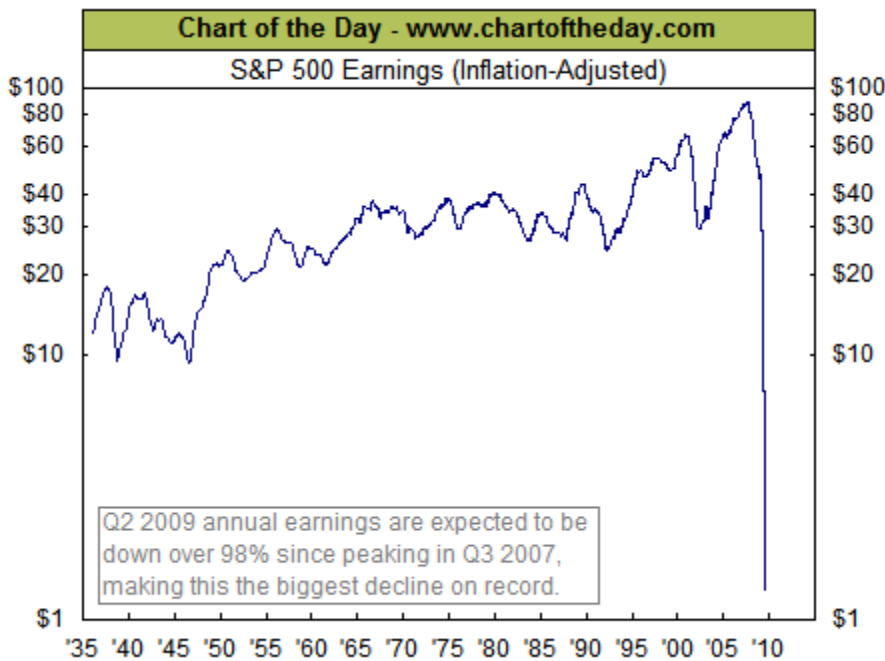
Below is a chart of the 10-day advance/decline line for the S&P 500. As shown, the recent rally has put the 10-day A/D line well into overbought territory, and at a level that has marked a peak during prior rallies in the past year. During the rally in early December and the initial rally off the March lows, the 10-day A/D topped out right where it is now. After 12 up days for the Nasdaq and an average gain of 13% for S&P 500 stocks since July 10th, it's time for a breather.



3. Chart of the Day

In recent earnings announcements, there have been a few companies reporting better than expected earnings and, as a result, the stock market rallied on the news. Some companies have reported better than expected earnings for Q2/2009, and others have struggled.

The chart shown below provides some perspective on the current earnings environment by focusing on 12-month, as reported S&P 500 earnings. The chart illustrates how earnings are expected (about 40% of S&P 500 companies have reported for Q2/2009) to have declined over 98% since peaking in Q3/2007, making this by far the largest decline on record (the data goes back to 1936). In fact, real earnings have dropped to a record low and, if current estimates hold, Q3/2009 will see the first 12-month period during which S&P 500 earnings are negative.



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