

Market Update: Uncertainty Remains High

Stocks look fairly valued but inflation is a real risk.

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It is hard to argue with the broad consensus that the stock market is about fairly valued at the current 900 to 950 level on the S&P 500. The current operating earnings estimate for the S&P 500 is a little over \$60/share. At this level, stock prices are approximately 15 times corporate earnings, which is not cheap given the current economic uncertainties but not expensive in light of the diminished risk of a depression.

A few positive signs

Credit spreads have corrected from their unprecedented levels, pushing bond issuance up considerably. New equity issuance has also improved, especially for credit worthy banks, which are seeing their balance sheets improve as a result. And, while we expect to continue seeing lower profile bankruptcies, the General Motors Corp. bankruptcy was a watershed event that is now behind us.

The two major risks

We currently face two significant economic risks: a reacceleration of economic weakness and inflation. Fresh economic weakness would create the fear that there is not much more the government can do. We believe this risk is low though and put its likelihood at about 10%. The more likely risk is that the economy strengthens but the Federal Reserve does not raise interest rates quickly enough, resulting in accelerating inflation. We think there is a 30% risk this will occur in about two years.

The most likely outcome

The most likely outcome is a weak recovery – annual gross domestic product (GDP) growth of no more than 2% – until United States consumers feel they are in a financial position to begin

spending again, as consumer spending accounts for 70% of the US economy. We believe that consumers will only begin to open their wallets for discretionary items once they have increased their savings rate to at least 8%, up from a current rate of 5% and recent rate of zero.

Why will Americans suddenly start saving? Because they have no choice. Most have been chastened by a rapid reduction in their net worth as almost all asset prices have fallen, exposing excess leverage and lack of savings from current income. The oldest baby boomers, meanwhile, are facing diminished retirement savings just as they approach retirement age. At the same time, they must also contend with uncertainty surrounding Social Security benefits, Medicare coverage and rising healthcare costs. As a result, we expect to see individuals refilling their retirement coffers the old fashioned way: by saving a percentage of each paycheck.

Foreign spending

Hopefully the Chinese will begin to do the opposite and reduce their current 40% savings rate. This would dramatically help offset the expected weak consumption growth in the US. All of which would help address the trade imbalance between the US and China – one of the major underlying causes of the financial crisis.

Continuing uncertainty

We are also hopeful that market volatility will continue to abate as the probability of the more extreme outcomes recedes. However, we will not lose sight of the fact that future uncertainty remains high because no one can predict the consequences of the unprecedented policy responses to the crisis. Additionally, it is too early to know what form the administration's recently unveiled regulatory proposal will ultimately take and whether it will be sufficient to restore investor confidence.

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