

October 16, 2009

Adrian Cronje, Ph.D., CFA®, Chief Investment Strategist
Wilmington Trust Investment Management
Rex Macey, CFA®, CIMA, CFP®, Director of Investment Research
Wilmington Trust Investment Management

Earnings Good, Equity Valuations Reasonable

KEYPOINTS

- Earnings season is off to a good start.
- The climb of the Dow Jones Industrial Average to 10,000 is indicative of investors' confidence.
- Investment-grade corporate bond yields are low.

The lead headline in the October 15th edition of *The Wall Street Journal* — “Dow at 10000 as Crisis Ebbs” — says a lot, as does the subtitle — “A Rapid Recovery From Collapse, but Traders Voice Doubt About Bull’s Staying Power.” Confidence is returning, and investors are returning to risky assets. This doesn’t surprise us. About a month ago, we wrote that “our foot hovers over the brake.” At that time, we recognized the opportunity for further advances by maintaining our allocation to risky assets, favoring momentum and recovery. Our foot was over the brake in case earnings were disappointing and the recovery looked less certain.

About 10% of companies have reported their third-quarter earnings thus far, and the results are generally surprising to the upside, as happened last quarter. Many of the early reporters are resoundingly beating expectations, with the best reports coming from the cyclical sectors of consumer discretionary, financials, and technology. The weaker reports are coming from industrial, consumer staples, and health care companies. Of the companies that have reported, 81% have beaten their earnings estimates and 57% have surpassed their revenue estimates, an important development given firms’ recent heavy reliance on cost cutting to drive profits. In comparison, only 48% of companies beat their revenue estimates last quarter. According to First Call, bottoms-up S&P 500® Index earnings estimates — those derived from analysts’ predictions of earnings on a company by company basis — are \$60, \$75, and \$91 per share for 2009, 2010, and 2011, respectively. About \$20 of the growth is the result of moving from depressed/recessionary levels to normal levels. These values compare to peak fourth-quarters earnings of \$91 in June of 2007, and a trough of \$40 in June of 2009.

Equity valuations are reasonable

If U.S. stocks were valued at 15 times their expected 2011 earnings at the end of 2010, the S&P 500 Index would be at 1365 — about 25% higher than its current level. This assumes the bottom-up analysts are right, and the Index reflects the 2011 amount of \$91 per share. We’re not big fans of bottom-up forecasts, however, and we are not predicting a 25% rise in the S&P next year. Our point is that the market is reasonably priced. There is the possibility for significant gains from here. While there may be bumps along the way, we remain bullish on the long-term prospects for equities.

Arthur C. Pigou, an early 20th century professor of economics, elegantly expressed the notion that people grossly overreact in a crisis when he said, “The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant.” It’s our opinion that much of the recent strength in the market was a correction of the error of pessimism. Future returns will be tied to improvement in fundamental economic conditions rather than error correction.

Homeowners are more confident

Robert Shiller, the Yale professor of economics and finance who, along with Karl Case of Wellesley University conducts surveys of home buyers, recently wrote in the *New York Times* about an increase in optimism on housing prices. When homeowners were asked how much they expected the value of their property to change over the next 12 months, the average response was +2.3%, a dramatic change from the -0.4% expectation last year. The latest survey indicates that people think the slide in home prices is over, so there is no longer such a good reason to wait to buy. Like the rise in stock prices, this is another sign of returning confidence. We still wait eagerly for the return of the retail consumer.

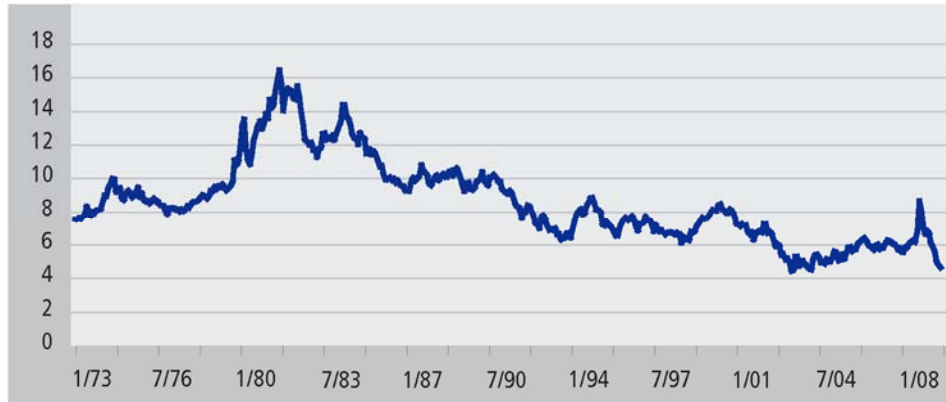
Nervousness about inflation is warranted

Investors are supposed to look forward and that’s what they are doing when it comes to inflation. On October 15, the U.S. Bureau of Labor Statistics released data on inflation. The Consumer Price Index fell -1.3% for the 12 months ended September 30. Excluding food and energy, prices rose 1.5%. Regardless, inflation has been mild to non-existent. The market for inflation-indexed U.S. Treasury Securities, also known as TIPS, offers evidence that investors are concerned about future inflation. As of October 15, the Barclays Capital U.S. Government Inflation-Linked Bond Index had gained 9.8% this year, while the Barclays Capital U.S. Aggregate Index had returned 5.5%. Homeowners don’t expect their houses to burn but they purchase insurance nonetheless. Risk management is ample justification. We recognize the threat of inflation and don’t have to expect that inflation will melt away the value of our savings to justify protecting against it. With something above \$10 trillion having been lent, spent, or pledged by monetary and fiscal authorities, with the near doubling of oil prices since their lows in February, and with the falling dollar, nervousness inflation is warranted.

Bond yields are low

Since we allocated money to investment-grade corporate bonds late last year, their yields have fallen dramatically. We believe most of the juice has been squeezed from this orange. The graph below illustrates the 400 basis point (4.00%) decline in the current yields of investment-grade bonds issued by industrial companies. Despite this movement, yield spreads against U.S. Treasuries remain wide by historical standards. For example, on average, investment-grade corporates are yielding 220 basis points more than Treasuries with similar durations (exposures to rising interest rates). The financial sector, which accounts for about 37% of the investment-grade market, has the largest spread relationship — about 286 basis points, on average. Having said all this, focusing on spreads over Treasuries misses important information. In absolute terms, bond yields are reaching some of the lowest levels in over three decades. The enormous amounts of liquidity pumped into the financial system have been particularly rewarding for corporate bonds. However, with the market reaching these low absolute levels, we have serious reservations about the reward-to-risk relationship.

All-in Yields are Near Record Lows
Investment-Grade Industrial Yield-to-Worst (%)



Monthly data from January 1973, through September 2009.

Source: *Barday's Capital*.

Investment Products: Not FDIC Insured / No Bank Guarantee / May Lose Value

Disclosure

The information in Market Notes has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed. The opinions, estimates, and projections constitute the judgment of Wilmington Trust and are subject to change without notice. This commentary is for information purposes only and is not intended as an offer or solicitation for the sale of any financial product or service or a recommendation or determination by Wilmington Trust that any investment strategy is suitable for a specific investor. Investors should seek financial advice regarding the suitability of any investment strategy based on the investor's objectives, financial situation, and particular needs. Diversification does not ensure a profit or guarantee against a loss. There is no assurance that any investment strategy will be successful.

Any investment products discussed in this commentary are not insured by the FDIC or any other governmental agency, are not deposits of or other obligations of or guaranteed by Wilmington Trust or any other bank or entity, and are subject to risks, including a possible loss of the principal amount invested. Some investment products may be available only to certain "qualified investors" — that is, investors who meet certain income and/or investable assets thresholds. Past performance is no guarantee of future results. Investing involves risk and you may incur a profit or a loss.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute. Third-party marks and brands are the property of their respective owners.