



THE ADVOCATE GROUP

A Bridge to Financial Clarity

Weekly Commentary November 3, 2008

The Markets

Thank goodness, October is over.

Market historians were busy last month rewriting the record books on what seemed like a daily basis. Unfortunately, many of the new records were the type that we'd prefer to have remained unbroken. Here are a few of the new entries:

- October was the most volatile month in the S&P 500 index since November 1929, as measured by moves of at least 1% higher or lower, according to MarketWatch.
- As of October 28, this bear market represented the fourth largest decline in the S&P 500 index (on a closing basis) without a 20% rally. The only three other periods where we had deeper declines without an intervening 20% rally were in 1931, 1938, and 1974, according to Bespoke Investment Group.
- On a positive note, the Dow Jones Industrial Average rose 946 points, or 11.3%, last week. Barron's said it was the Dow's biggest one-week point gain on record and its largest percentage rise in 34 years. However, the end of the month heroics couldn't overcome the early in the month carnage as the Dow still lost 14.1% for the month, according to Barron's.
- Crude oil prices dropped more than 32% in October, the largest one-month drop on record, according to CNBC. That's good news for those of us who drive because the fall in oil prices has led to a dramatic drop in gas prices.
- The Conference Board Consumer Confidence Index™, fell to an all-time low of 38 (1985 = 100) in October, according to data from the Conference Board as reported by MarketWatch. This does not bode well for upcoming holiday sales.
- Gold futures prices dropped 18% in October, which was the largest one-month decline since February 1983, according to data from the Comex division of the New York Mercantile Exchange, as reported by MarketWatch.

They say records are meant to be broken. Well, we broke our fair share in October. Let's hope the next broken record is a positive one such as, "The fastest return to an all-time high after experiencing a 40% decline in the S&P 500 index." All in favor, say "Aye."

Returns through 10/31/08	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrial Average	11.3	-29.7	-31.4	-3.7	-1.0	0.7
NASDAQ Composite	10.9	-35.1	-38.8	-6.7	-2.3	-0.5
Standard & Poor's 500	10.5	-34.0	-35.8	-7.1	-1.6	-1.4

Sources: Yahoo! Finance, Barron's. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. Three-, Five-, and 10-year returns are annualized. Assumes dividends are not reinvested.

HOW DO YOU DETERMINE IF THE STOCK MARKET is overvalued, fairly valued, or undervalued? On the surface, you might think that with the S&P 500 index down 35% over the past year, the market should be undervalued. Whether it is or not, we won't know until we look back in hindsight. However, it's helpful to look at history and see if we can place the current market in context. With the caveat that past performance is no guarantee of future results, here are some thoughts:

- Market analysts use many different measures to value the market. Some measures are quantitative in nature, while others are rather arcane, such as Kondratieff Waves and astrological cycles. We'll just stick with the quantitative for now. One common measure is to compare the price of an index to the earnings of the underlying companies in the index. For example, if the price of the S&P 500 index is 1,000 and the underlying 500 companies in the index earned a total of \$50 per share over the previous 12 months, then the index would be trading at a price-earnings ratio (P/E ratio) of 20 (1,000/50). By comparing the P/E ratio of today's market to historical P/E ratios, we can see how this market compares to previous markets. Generally speaking, high P/E ratios are associated with high market valuations, while low P/E ratios are associated with low market valuations. Other factors may affect whether a given P/E ratio represents a high or low market valuation, but for our purposes, the above description is sufficient.
- As of last week, the S&P 500 index had a P/E ratio of 21 based on its trailing 12 months earnings, according to data from Birinyi Associates as reported by Barron's. That's above the index's 60-year average P/E ratio of 17.8. So, this means the market is overvalued, right? Not necessarily.
- The stock market tends to look to the future and if it expects earnings to rise next year, then that would increase the "E" in the P/E ratio and, all other things being equal, would lower the P/E ratio as future earnings come to fruition. For example, a recent Barron's survey of five Wall Street market strategists indicated they expect the S&P 500 companies to earn approximately \$70 per share in 2009. If we apply the historical average multiple of 17.8 to the \$70 earnings number, we end up with a projected S&P 500 index of 1,246 at some point in the future. That's an increase of nearly 29% from last week's closing S&P 500 value of 968. So, that would suggest the market may be undervalued, right? Again, not necessarily.
- Merrill Lynch's top down estimate for 2009 S&P 500 earnings is only \$60, according to Barron's. If we apply the historical average multiple of 17.8 to Merrill's number, then we end up with a projected S&P 500 index of 1068, which is still about 10% higher than last week's close. So, we're still potentially undervalued in today's market, right? Well, you're seeing a pattern here, so the answer is... not necessarily.

In the three examples above, we held the P/E constant at the historical average of 17.8. The bad news is, in some past economic recessions, the P/E ratio of the S&P 500 fell dramatically below the historical average. In fact, in 1975 and in 1980, the P/E ratio on the S&P 500 sank to around 7, according to Barron's. You probably know where this is heading so, take a deep breath... if we apply a P/E of 7 to the \$60 earnings estimate, that would leave us with the S&P 500 index at 420 at some point in the future. Based on last week's closing price of 968, that means we could be in for a further decline of 56%. Ouch!

Now, before you get too worried, we think the likelihood of the S&P 500 dropping to 420 is extremely remote. We're only showing it to you for educational purposes. And, to be fair, we should show you the other extreme, too. According to the St. Louis Federal Reserve Bank, during the bubble year of 1999, the P/E ratio on the S&P 500 hit 36. If we apply a 36 multiple to Merrill's \$60 earnings estimate, we get an S&P 500 index of 2,160. That's a 123% increase from last week's closing value.

Have we confused you yet? Here's the bottom line. Whether you think the market is over, under, or fairly valued depends on many factors, two of which include future expected earnings and the multiple investors put on those earnings. Depending on where you stand, today's market could be grossly overvalued, fairly valued, or grossly undervalued. There's data to support pretty much any view you want. The constant tug of war among investors who think we're overvalued, fairly valued, or undervalued may be one reason why we're seeing so much volatility in the markets.

Weekly Focus – Think About It

“To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude, even while offering the greatest reward.”

--Sir John Templeton

Best regards,

The Advocate Group

P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.

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