

THE EX ANTE FACTOR



AN INVERTED RISK/REWARD RATIO

Here we are just 3 days into 2008 and the damn S&P has already wiped out all of the price gains from last year which were very difficult to obtain in the first place. Consider the magnitude of the price swings in 2007:

On 12/29/06 the S&P 500 cash index (SPX) closed at 1418.13. From that level the market traded **up 3%** into a Feb high of 1461.57, **down 6.7%** into a Mar low of 1363.98, **up 14%** to new highs in July at 1555.90, **falling 12%** to an Aug low of 1370.60, **rallying 15%** to another new high in Oct at 1576.09 only to see it **fall 10.8%** into a Nov low of 1406.10, then **rising 8.4%** into a Dec high of 1523.57, giving most of it back, **falling 7.35%** into Friday's close at 1411.63.

That's quite a ride to only be back even after all that volatility, giving investors a gut wrenching inverted risk/reward. We think current market discounts are pointing to a similar risk/reward profile for 2008 and could be



very emotional for the buy and hold investor. For traders it will be equally as emotional so we stress the importance of staying nimble, taking what the market gives and giving what the market takes.

When analysts and pundits handicap the stock market's return for 2008 they concede slower earnings growth but cite multiple expansion as the catalyst that would drive optimistic +10% returns (when was the last time the S&P averaged 10%/year?). This was exactly the same logic used to forecast outsized returns in 2007. They argue the Fed will be lowering interest rates and it will drive higher P/E ratios. That translates into, don't buy stocks because of good

earnings prospects but rather because someone will be paying a higher price at a later date. This "greater fool" theory is highly flawed yet seems to be conventional wisdom on Wall Street and in the financial media.

It doesn't even make basic economic sense that the Fed can simply lower their target interest rate to generate higher price multiples. First of all, discounted cash flow models which are used to determine the present value of future earnings don't use the Fed funds rate as their cost of capital variable. Second, the market, not the Fed, sets the equity risk premium above risk free market rates. Due to the volatility and credit market turmoil, this risk premium has actually been rising as the Fed has tried to lower rates. Thus far the Fed has lowered the target rate 100bps and the S&P is essentially in the same spot it was when they began easing. Furthermore, it's striking that upon the market finally returning to the previous 2000 high that it would require substantially lower interest rates to maintain prices. Since the S&P tested the old highs and stalled, the 2YR yield has fallen 200bps in just 6 months. Surely traders aren't waiting on the Fed to actually lower the target rate another 100bps to catch up with the bond market before bidding up price multiples. If the Fed were able to boost P/Es we would be seeing the dynamic at work based on how the 2YR trades as it is leading the Fed's easing campaign. Thus far there is no evidence equity multiples are responding to the bond market's discount of lower interest rates and in fact it looks

like the opposite is occurring. This is the risk premium at work.

Our S&P 500 total return model is discounting an approximate 7.25% average annual return over the coming decade with the dividend providing roughly 2.0%. This return is consistent with the previous 10 years where your annualized return was roughly 7% with about 1.5% of that return coming from the dividend yield. Had you purchased a 10YR treasury in 1/98, you could have locked in a 5.50% annual return. Last year the S&P price returned 3.5% with a dividend reinvestment return adding about 2.0%. That total return barely beat comparable treasury yields and bank cds. Considering short term treasury yields are now around 3.0%, you can expect similar returns this year and like last week, you probably won't know whether you made money until the last day of the year. Despite the poor performance of this past year, historically over time the dividend yield provides much of the return in excess of risk-free treasuries or the risk premium. Unlike betting on Fed induced multiple expansion for earned risk premium, this assumption is logical.

Here's why:

In prior articles, we have pointed out the relationship between average annual nominal GDP and corresponding treasury yields. The bond market discounts growth within the maturity plus an inflation premium. Nominal GDP growth to a large extent represents the profits of all US corporations, therefore is highly correlated with average long run S&P earnings growth. Since the 10YR yield discounts average nominal GDP over the coming decade, it is also discounting the average annual earnings growth of the S&P 500 companies. Assuming no change in multiple, this is your return ex-dividend. Thus it can be said that over time, the 10YR yield or risk free rate and earnings yield on the S&P will be virtually the same and that the dividend is the risk premium earned over that risk free rate. Adding today's 1.90% yield to current 10YR yields gives you a paltry 5.75% return suggesting our model and current stock multiples to earnings may be optimistic given the bond market's growth discount. Nevertheless when compared with potential volatility the risk/reward is poor.



In addition to staring at below average earnings growth, this particular market environment creates an added dilemma for long term investors because most high dividend payers in the S&P 500 which include banks, utilities and telecom, also happen to operate highly leveraged balance sheets. With credit markets tightening, these companies may find it more difficult to raise debt capital and could result to lower or not raise dividend payments to conserve cash which could lower today's yield of 1.90%. With sub 4% treasury yields and falling, suggesting falling earnings, the total return looks measly to us considering the risk taken.

Bottom Line: We think 2008 will offer a buy and hold investors a similar inverted risk/reward profile as the market returned in 2007. We see best case, average returns with above average risk. Despite what many Wall Street analysts are forecasting in higher P/E multiples, we are looking for multiples to contract as volatility and risk premiums remain elevated throughout next year and beyond. That said, for the disciplined and nimble trader this environment could be ideal.

SCOREBOARD

Economic Indicator													
2007	Avg	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Nominal GDP (tril)				13,551.90			13,768.80			13,970.50			
Nominal GDP growth rate	4.83%			4.53%			4.67%			5.30%			
PCE deflator inflation	2.16%	2.10%	2.30%	2.50%	2.30%	2.40%	2.30%	2.10%	1.80%	1.90%	1.90%	2.20%	
ISM Manufacturing	52.19	49.30	52.30	50.90	54.70	55.00	56.00	53.80	52.90	52.00	50.90	50.80	47.70
ISM Services	56.03	59.00	54.30	52.40	56.00	59.70	60.70	55.80	55.80	54.80	55.80	54.10	53.90
Capacity Utilization	81.73	81.10	81.60	81.40	81.70	81.50	81.80	82.20	82.10	82.20	81.70		
Non-Farm Payrolls (k)	122.00	162.00	90.00	175.00	122.00	188.00	69.00	93.00	89.00	115.00	170.00	94.00	
Disposable Personal Income	10,174.46	9,934.70	10,013.30	10,095.50	10,088.20	10,134.70	10,177.90	10,238.20	10,275.40	10,296.00	10,310.00	10,355.20	
Personal Outlays	10,108.96	9,878.80	9,927.90	9,945.70	10,015.80	10,079.70	10,112.00	10,148.70	10,202.90	10,228.10	10,255.50	10,403.50	
Personal Savings	65.50	55.90	85.40	149.80	72.40	55.00	65.90	89.50	72.50	67.90	54.50	-48.30	
Consumer Credit (bil)	8.91	8.20	6.60	14.50	3.20	16.00	10.40	9.60	12.20	3.70	4.70		
DXY	80.44	84.60	83.57	82.93	81.45	82.30	81.92	80.77	80.79	77.72	76.50	76.17	76.60
Trade Balance (bill)	-58.58	-57.01	-57.88	-62.69	-58.64	-59.61	-59.43	-59.00	-57.59	-56.50	-57.40		
TIC Flows (bill)	49.22	85.90	95.50	32.70	94.60	116.00	53.10	94.30	-163.00	-14.70	97.80		
US 10YR Yield	4.57%	4.81%	4.57%	4.65%	4.62%	4.89%	5.03%	4.74%	4.53%	4.59%	4.48%	3.94%	4.02%
US 2YR Yield	4.26%	4.92%	4.65%	4.58%	4.60%	4.91%	4.86%	4.52%	4.14%	3.99%	3.94%	3.01%	3.05%
3M LIBOR	5.25%	5.36%	5.35%	5.35%	5.36%	5.36%	5.36%	5.36%	5.62%	5.23%	4.88%	5.13%	4.68%
2s/10s Spread	0.31%	-0.11%	-0.08%	0.07%	0.03%	-0.02%	0.16%	0.22%	0.40%	0.60%	0.54%	0.93%	0.97%
M2 nsa(m)	7249.56	7056.30	7066.60	7171.40	7258.60	7202.50	7248.20	7256.90	7319.80	7359.70	7374.60	7430.60	
M2 Growth Rate (annual)	5.58%	-0.99%	1.75%	17.80%	14.59%	-9.27%	7.61%	1.44%	10.40%	6.54%	2.43%	9.11%	
Marshallian K	0.527468			0.529180			0.526422			0.526803			
Implied Volatility (VIX)	17.71%	10.42%	15.42%	14.64%	14.22%	13.05%	16.23%	23.52%	23.38%	18.00%	18.25%	22.87%	22.50%

EQUITIES

INDEX	YTD RETURN
DJIA	7.25%
TRAN	1.43%
UTIL	17.60%
NYSE	7.28%
AMEX	18.00%
NDX	19.90%
COMP	10.75%
SPX	4.25%
RUT	(2.00%)
VALU	(3.30%)
WLSH	4.60%
STREET.COM	15.47%