



## A Rational Argument for a 15,000 Dow Jones in 2013

Valuations for US public stocks are influenced by many factors, but on the most basic level they are valued on their profits and the multiple of those profits (P/E ratios) people are willing to pay. For the past 210 years, profits on US public companies have grown at about 6% annually and at more than 8% annually over the last decade. Overall, price to earnings ratios average 14-16 times earnings but swing wildly on either side of that average. Given the long-term upward progress of earnings, regardless of the P/E ratios, stock prices climb over the long run and more often than not, reach new highs every year or two except during recessions.

Current earnings (trailing 12 months) are a known figure and future earnings are most often accurately forecasted for the companies in the S&P 500. Therefore, the main valuation variable is therefore the price multiple (P/E ratio), which is dependent, in our opinion, on three main factors:

1. Investor Sentiment - This key indicator is most influenced by what we call "headline risk," highlighted in the media. Sentiment, as measured by consumer confidence, roughly swings from 100 (normal) up to 120 (optimistic) and occasionally down to 50 for extreme pessimism. Investors' views are influenced by current news and the prospect of more of the same (good or bad) in the future. Over shorter periods of time this sentiment tends to be correct. However, when optimism gets too high, prices are at a greater risk to decline due to negative news than during less optimistic times (and vice versa). Over longer periods of time, investor sentiment swings back and forth across the 100 line, corresponding to normal business cycles.

Not surprisingly, P/E ratios are highest when investors are optimistic and lowest when they are pessimistic. For example, in 2000 investor sentiment and P/E ratios peaked along with the peak of the stock market, coinciding with high stock ownership by investors. The exact opposite occurred in 2009 as markets bottomed during extremely low (50) investor sentiment.

2. Inflation Expectations - Expectations of moderate inflation produce higher P/Es than expectations of either extremely high inflation or any deflation, which create negative environments for stocks. There is a high correlation factor between the CPI and P/E ratios over the years. That correlation also peaked in 2000 after inflation had fallen from 14% in the early 1980's down to an "ideal" 1-2% by 2000. Unfortunately, inflation could only move up or down from this sweet spot and thus has been a negative influence on stock prices ever since.

3. Politics and Government Policies - As we have seen lately, politics influence investors' opinions about the future business environment and have a direct correlation to valuations. Politics and policies have the

most positive influence on stock prices, like inflation, when they are in the center. Historically, neither of the extremes, liberal/protectionism or conservative/free markets, garnered as high of P/E ratios as when politics were well balanced and near the center.

Currently, S&P 500 operating earnings for 2010 are estimated to reach about the same \$88 per share level as their all time peak in 2006. However, stocks on average are still trading at an 18% discount to record price levels. 2011 earnings are now wildly estimated to be in the \$94-\$96 range, suggesting even greater discounts for 2011.

If these earnings estimates are close, then future stock prices can be forecasted by correctly estimating P/E ratios, currently at 18.3 of trailing and 13.7 of estimated 2011 earnings. Let's look at the influence of the three key P/E ratio factors:

Investor Sentiment - Presently, we are at about 70 on the 50-120 scale. As "Modern Portfolio Theory" suggests, this accurately reflects current headline news as we slowly recover from the recent financial crisis. This is still a very pessimistic reading, only historically reached during recessions. We expect that this important indicator will improve back to 100 in the years ahead as the economy improves. If we are wrong, there is limited downside risk from here. Overall, we see investor sentiment as a positive influence on P/E ratios in the years ahead.

Inflation Expectations - There are two current views of our inflation: 1) the CPI, as reported by our government, which is an imperfect internal measuring method; 2) Purchasing power for household and business needs in U.S. currency. Given the remarkable doubling of our money supply (like a stock split) and current deficits, we believe that inflation by any standard will be headed higher in the years ahead. Although we are not forecasting double-digit inflation, we still feel this will be a future negative factor.

Politics and Policies - As our newsletters written last year indicated, we believe that the election of Senator Brown of Massachusetts and the passage of Obamacare marked the furthest left that politics will reach this cycle. We have been creeping back towards center since and believe this will continue until 2012. After 2012, we might swing a little right of center, but we will take that risk. Overall, we believe this will positively influence stock valuation in the next few years.

Two of these three indicators are positive and are likely to produce a rising P/E environment to accompany the forecasted rising corporate earnings. Putting it all together, with more precision than described above, we believe that the current 13.75 P/E ratio on the S&P 500's 2011 earnings estimate will expand towards 15 and reward us with a 1425 price level by year end or, in other words, an up 13.3% year. For the Dow Jones Industrial Averages, a 13,300 would be a similar 2011 year-end target.

Given this target for 2011, a 15,000 Dow Jones level over the next two years of economic expansion is a reasonable goal of only another 12%. That could be achieved with only moderate corporate earnings growth and no increase in P/E ratios. Using 30-year market cycle charts and averages, a 25,000 Dow Jones level in 2020 can also be forecasted.

Yes, we have many things to continue to worry about – further housing problems, high national and household debt, China housing bust, weak dollar, etc. However, on balance, these issues are considerably smaller than 2010 issues of increasing foreclosures, protectionism, tax increases, run away national and state spending, and unbudging high unemployment. If you look beyond current headline “noise,” you can see a very visible positive economic environment emerging and returning to “normal” levels of fears, which will produce normal, non-recession stock valuations.

Given this U.S. economic outlook of improving politics and sentiment with a rising inflation, what stock strategies should be employed? Every investor’s suitability and goals differ and one should seek professional advice on their own. That said, we would suggest that a 2-4 year gain of 25-30% from the US Stock Market warrants holding stocks through the inevitable future dips and adding exposure (not panicking) on any significant drops. Further, the inflation risk can be substantially quelled by adding equity investments in resource producing emerging market countries. After a very dull past decade for US Stocks, a return to growth will be welcomed.