

Alley Company Quarterly Nattering Nabobs and the Wall of Worry

April 15, 2011

The stock market continued to advance in the first quarter of 2011 despite natural disaster in Japan, unrest in the Middle East and North Africa, and lingering European sovereign debt concerns. Additionally, the “nattering nabobs of negativism” in the press continue to build a “wall of worry” for the market to climb. The resilience of the market in the face of these issues is a sign of the improved investor psychology that we highlighted in last quarter’s letter. Perhaps recent comments by Kansas City Fed President Thomas Hoenig capture these sentiments most succinctly:

“The financial crisis is over, and the U.S. economy is recovering. GDP growth in the United States averaged 3.0 percent from the third quarter of 2009 through the fourth quarter of 2010 ... While parts of Europe and the U.K. have grown less robustly, the fact remains that the U.S. and much of the world is experiencing sustained economic growth...[Fed] policy should acknowledge the improving economic trends and begin to withdraw some degree of accommodation.”

Tangible evidence of better investor confidence emerged in January and February with positive net cash flows into domestic equity funds. These positive flows follow cumulative *outflows* of \$335 billion over the past four years (2007-2010). During the same time period, bond funds had cumulative *inflows* of \$754 billion underscoring investor risk aversion. Two months do not make a trend, but analysis of the past four years shows that tremendous running room exists for a positive shift in sentiment toward equities by the average investor.

The underpinnings of the market are solid in our view. Valuation analysis continues to favor stocks over bonds and cash. Based on \$94.00 per share of expected earnings in 2011, the S&P 500 is currently trading at an “earnings yield” of 7.1%. The 10-year Treasury bond, by contrast, currently yields 3.4% and cash and their equivalents continue to yield next to nothing. The following table assesses some of the big-picture fundamental factors that have underpinned the market’s recovery and are evidence of the significant progress the economy has made over the past two years.

Strong Market Underpinnings

Corporate Earnings	Corporate America buckled down in the wake of the recession, cutting expenses and improving balance sheets; now it has produced solid growth in revenue; the result is strong profit margins to the benefit of shareholders <i>with record earnings expected in 2011</i>
Real GDP	The first quarter of 2011 is expected to be the 7th consecutive quarter of positive GDP growth
Conference Board Leading Economic Index (LEI)	The February increase of 0.8% followed a January increase of 0.1%; eight of the ten indicators rose for the recent period; LEI is supportive of positive economic growth for 2011
Unemployment Claims	The 4-week moving average of 390k is greatly improved from the 600k+ average during the recession
Corporate Bond Spreads	BBB corporate bond spreads peaked above 7% during the recession; at current levels of approximately 2%, corporate borrowing costs have dramatically improved
Institute of Supply Chain (ISM)	A reading of >50 is expansionary; the recent reading of 61.2 is at decade highs and suggests robust manufacturing trends
CPI	Despite higher commodity prices, broad inflation measures remain contained; the slack in capacity utilization and the labor market should help keep inflation in check

Despite these strong underpinnings, there are problems that need to be solved, particularly in the aftermath of the great recession and near failing of our financial system. One of the biggest issues for the economy and the markets is the U.S. debt and deficit, a problem that has now been exposed at every level (federal, state and municipal). This issue is among the most talked about in the world, which is a positive in that it has heightened the awareness of the need for corrective action. This problem is real and there is and will continue to be a cost to correct our budget woes, but at the same time making progress toward a credible plan is the key, and this is happening on at least three fronts: the Simpson-Bowles deficit reduction commission, the Gang of Six Senators, and Congressman Ryan's plan. Inaction is not an option, and thus it is our view that a long-term deficit reduction plan will materialize, which will be viewed favorably by the financial markets.

Two other areas of concern are housing and the labor market. Each have not recovered from the recession as significantly as perhaps some would like, but recall that housing in particular was a bubble that inevitably was going to end and a rapid recovery given the financial crisis that ensued is nonsensical. Our view is that housing will take more time to stabilize before a meaningful recovery is possible, but that the worst is over. The labor market, meanwhile, is showing signs of progress, with the unemployment rate having improved to 8.8% from its peak of 10.1% in October 2009 and unemployment claims having improved to 390,000 (4-week moving average) from 600,000+ during the recession. A positive trend appears to be firmly in place.

Monetary and fiscal stimuli have played important roles over the past two years and there is healthy debate (even within the Fed) about whether the economy will fall back when the accommodation retrenches. Every recession in modern times has been dealt with using fiscal and/or monetary stimulus to provide support until the economy can run on its own power. Frankly, this recession is no different, other than the fact that it was more complex with the added problem of an impaired financial system. Our belief is that Federal Reserve Chairman Bernanke has struck the right balance in beating deflation and making sure that the financial system has sufficiently healed, with the objective of regenerating the necessary “animal spirits” in the U.S. economy.

There has been a “sea change” in confidence across most sectors of the economy which is manifesting itself into positive fundamental reality. While there continues to be a tug of war between improving fundamentals and the fiscal problems that threaten to derail them, reasonable valuation and strong earnings continue to carry the day in the context of a hopefully improving fiscal picture.