Sent by e-mail Jan. 4, 2012 to Aberdeen friends and clients
"The Wildebeests head Into a New Year"

Aberdeen Investment Management, LLC

Wildebeest Tracks

By: Jeb B. Terry, Sr.

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2011 was no party- Looking forward to 2012

The following collection of recent blog posts offers a look back at

what was in 2011 and some prospects for optimism as we kick off 2012.

- The spread between the S&P 500 earnings yield and the 10 yr. Treasury remains near an unprecedented high - is mean reversion on the way and what does that imply? . . . - 01-02-2012 18:19:44 PM
- 10 Rules for investing in tough markets - Bob Farrell's wisdom still applies today - 01-02-2012 17:03:44 PM
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Wishing you all the best for a healthy, happy and prosperous new year,

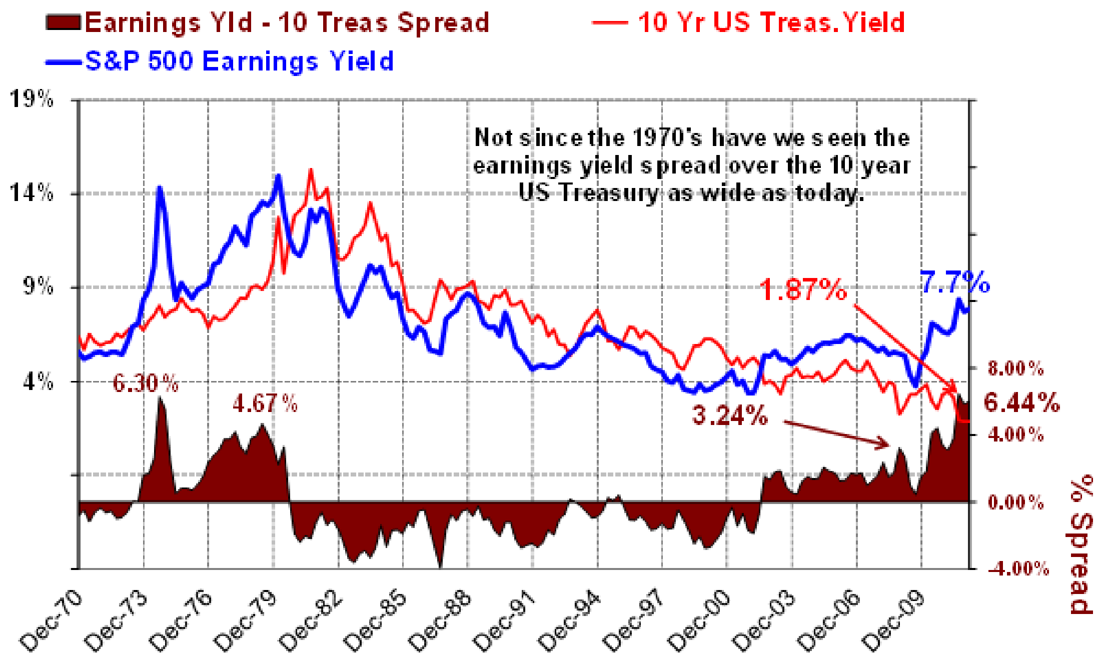
Jeb and Russell

The spread between the S&P 500 earnings yield and the 10 yr. Treasury remains near an unprecedented high - is

mean reversion on the way and what does that imply? . . .

01-02-2012 18:19:44 PM

The following note is a refresh of the chart I have presented in the past **here**, and the post I made in August **here**. The chart below displays the 10 year Treasury rate vs. the S&P 500 earnings yield and a histogram of the spread between the two. In modern market history there was only one time when the spread was as lopsided - Sept. 1974. The notion of "reversion to the mean" suggests that something has to give . . . Treasury rates will have to rise, earnings for the S&P 500 will have to fall or stock prices will have to rise - by a lot. In 1974 inflation was rising, the Yen devalued, Nixon resigned as President and we were in recession. Following the peak in the spread in Sept. '74, the S&P 500 gained 7.9% in Q4 and 21.6% in Q1 1975. The 10 yr. rate was stable and rose to 7.7% in Q1 1975. S&P 500 earnings actually declined sequentially in each of Q3 74, Q4 74 and Q1 75 so near term rising earnings was not a predicate for rising stock prices. The S&P 500 went on to rise over 30% in 1975 as the 10 year rate hovered in the 8% area. As I said in August . . . **Anyone who believes in reversion to the mean should be wildly bullish.** Returning the spread to where it was at Dec. 2010 would imply a gain on the S&P 500 of ~50%. Conversely it would imply a rate on the 10 yr. of ~4.5%. Each of those implications seem extreme. A "meet in the middle" can support a gain of 25% for the S&P 500 in 2012. *Jeb Terry, Sr. January 2, 2012*



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10 Rules for investing in tough markets - Bob Farrell's wisdom still applies today

01-02-2012 17:03:44 PM

Bob Farrell spent several decades as chief stock market analyst at Merrill Lynch & Co. He had a front-row

seat at the go-go markets of the late 1960s, mid-1980s and late 1990s, the brutal bear market of 1973-74, and October 1987 crash.

Farrell retired in 1992, but his famous "10 Market Rules to Remember" have lived on and are summarized below, courtesy of Jonathan Burton of MarketWatch [1]. The words of wisdom are timeless. They are especially appropriate as investors consider the outlook for 2012.

(Summary of a post by Prieur du Plessis On **August 19, 2011** http://www.investmentpostcards.com/2011/08/19/bob-farrell%e2%80%99s-10-rules-for-investing-in-tough-markets and edited by JBT)

1. Markets tend to return to the mean over time
By "return to the mean," Farrell reminds investors that when stocks go too far in one direction, they tend to come back to their long-term trend. Overly euphoric or pessimistic markets cloud people's estimation and judgment of what they can reasonably expect.

2. Excesses in one direction will lead to an opposite excess in the other direction
Markets in a bubble can seem ready to pop, yet they manage to stretch into unrecognizable shapes - and still find buyers. Think of Internet shares a decade ago or real estate before the housing crash. When the bubble bursts, watch out. The bubble today may be in U.S. Treasury bonds.
Conversely, markets in free-fall typically spring back as if tied to a bungee cord. Think about the sharp bounce U.S. stocks had in 2009 when the Standard & Poor's 500-stock index gained 47% in the 12 months following the low in March 2009.

3. There are no new eras - excesses are never permanent
This relates to rules No. 1 and No. 2. Many investors latch on to the latest hot sector, and soon a fever builds that "this time it's different." It never is, of course. When the sector cools, individual shareholders are usually the last to know and sell at lower prices.

4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways
This is Farrell's way of saying that a popular sector can stay hot for a long while, but will fall hard when a correction inevitably occurs.

5. The public buys the most at the top and the least at the bottom
The time to buy stocks is when others are fearful and sell when others are complacent. Accordingly, many market technicians use sentiment indicators to gauge investor pessimism or optimism, then recommend that investors do the opposite. Retail investors withdrew

6. Fear and greed are stronger than long-term resolve
Investors can be their own worst enemy, particularly when emotions take hold.
To counter fear and greed, practice self-control. In down markets, keep enough cash on hand so you're not tempted to sell at fire-sale prices and instead can buy on the cheap. In headier times, prune winners to the range you set for your portfolio's asset allocation and use the proceeds to buy laggards. This strategy will help you to be proactive instead of reactive.

7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names
There's strength in numbers, and broad, powerful market momentum is hard to stop, Farrell observes. Conversely, when money channels into a shallow stream, many attractive companies are overlooked as investors crowd one side of the boat.
That's what happened with the "Nifty 50" stocks of the early 1970s, when much of the market's gains came from the 50 biggest U.S. companies. As their price-to-earnings ratios climbed to unsustainable levels, these "one-decision" stocks eventually capsized.

8. Bear markets have three stages - sharp down, reflexive rebound and a drawn-out fundamental downtrend
The jury remains out on #8. We had the "sharp down" in 2008/2009, a "reflexive rebound" in 2009/2010. The question now is where are we in the "fundamental downtrend". Earnings and valuation multiples suggest we are possibly exiting the "downtrend". (JBT)

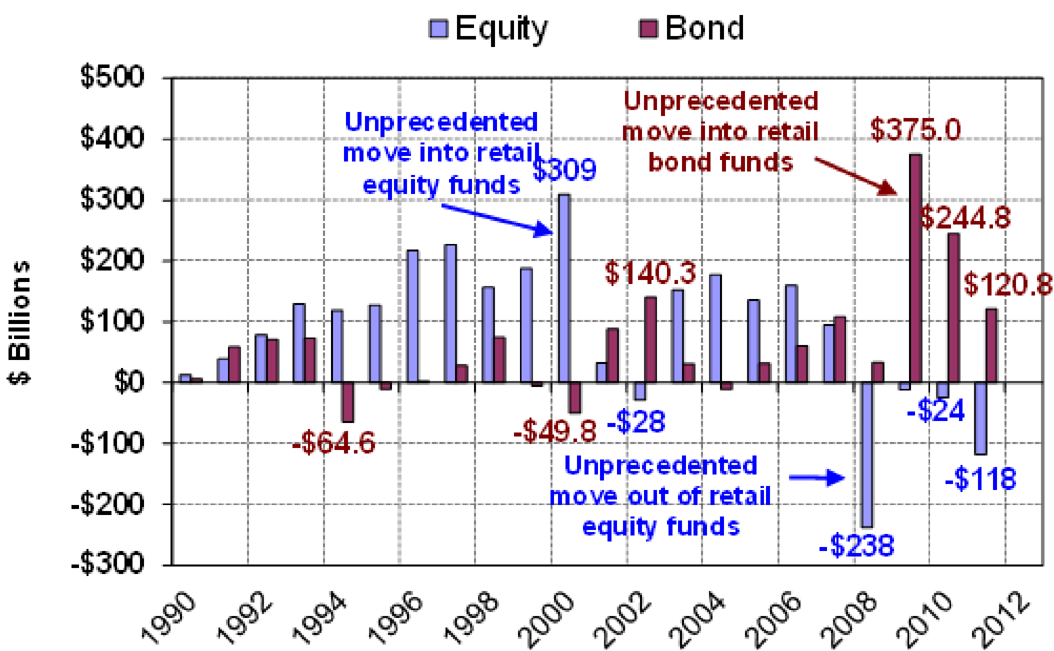
9. When all the experts and forecasts agree - something else is going to happen

Going against the herd as Farrell repeatedly suggests can be quite profitable, especially for patient buyers who can raise cash in frothy markets and reinvest it when sentiment is darkest.
10. Bull markets are more fun than bear markets
No kidding.
Source: Jonathan Burton, MarketWatch [2], August 17, 2011.

Retail investors continued to flee equity mutual funds for an unprecedented 4 years in a row . . .

01-02-2012 15:19:10 PM

Retail investor inflows and outflows from mutual funds are classic contrary indicators. Retail investors are the "wildebeests". 2011 saw the 2nd highest rate of equity fund withdrawals on record. It is no wonder that the equity markets had a tough year in 2011. The withdrawals had the greatest impact on smaller cap stocks as Aberdeen is only too painfully aware. The good news is when withdrawals reverse to net additions, overall equity prices can experience above average appreciation. The strong gains in 2009 were accomplished when rate of equity fund withdrawals slowed to just $11 bil. *Jeb Terry, Sr. January 2, 2012*



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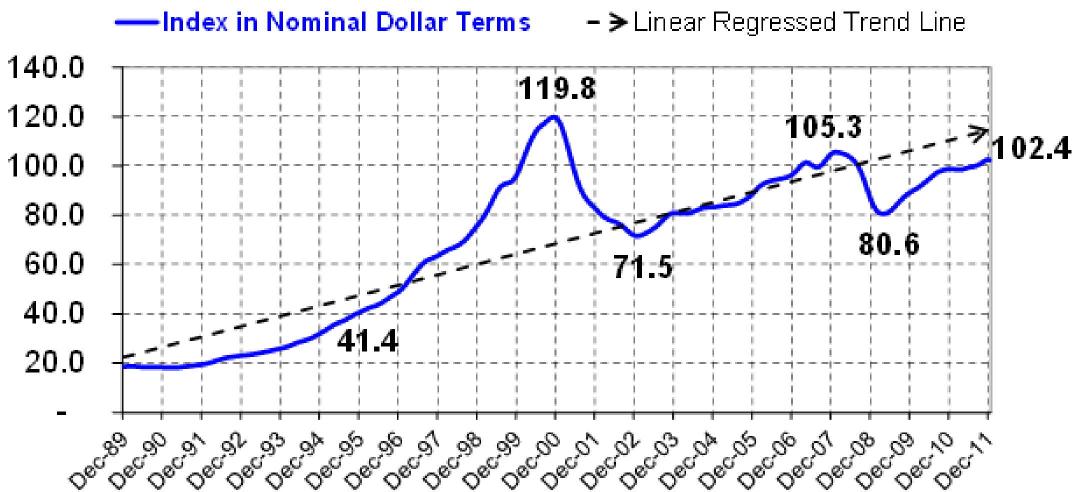
The Tech Pulse is rising, latest growth best since August 2010 . . .

01-02-2012 15:13:21 PM

The Tech Pulse prepared by the San Francisco Federal Reserve (here) continues to rise albeit at a slower rate than in 2010. The Tech Pulse has a 72% correlation (quarterly data) with the NASDAQ since 2003 and an 80% correlation since 2008. The data from 2003 shows that when the Tech Pulse has grown as much or more than the most recent quarter that the NASDAQ has been up 12 months later in 85% of the cases by an average of 11.6%. *Jeb Terry, Sr. January 2, 2012*

TECH PULSE INDEX
1990 to Present



Source: Fed Reserve Bank of SF

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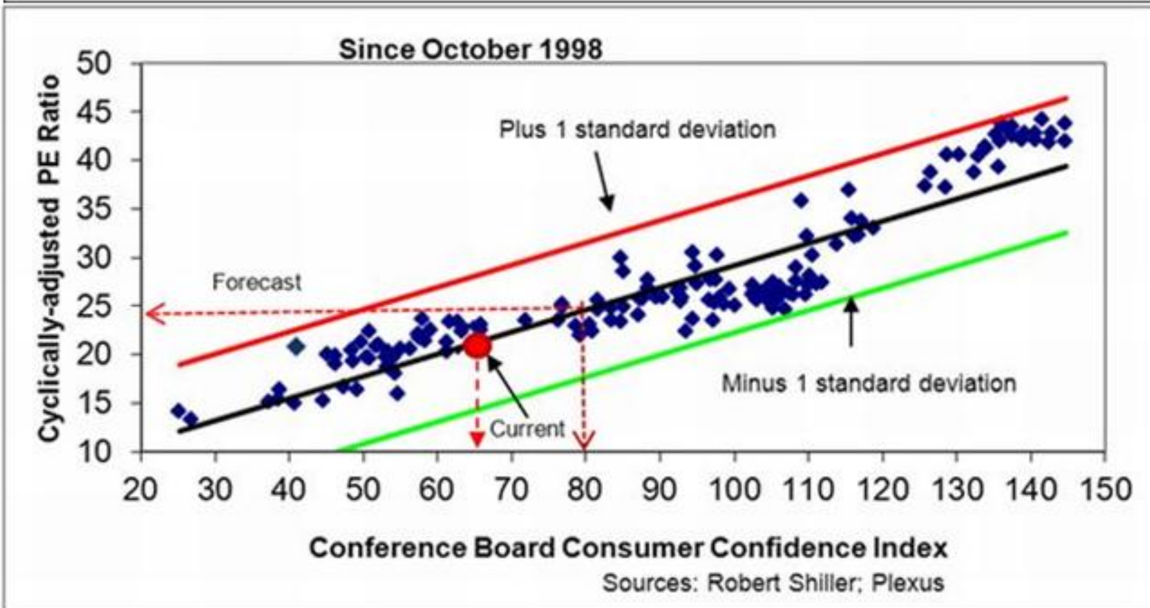
Improved consumer confidence could see U.S. stocks 20% higher in 2012 . . .

01-02-2012 15:11:47 PM

Amid the fear driven market activity there has been a remarkable improvement in consumer confidence. The degree of improvement somewhat mimics that seen coming out of the bottom in early 2009. Rising consumer confidence has been at least coincident with rising P/E multiples in the past. The analyst responsible for the following charts, Prieur Du Plessis (see his note here), suggests that consumer confidence should continue to rise in 2012 back to 2006/2007 levels in the area of 80. The historical relationship of confidence to the "Cyclically Adjusted P/E Ratio" (basically a 10 year smoothed P/E ratio) suggests that the P/E ratio would expand by as much as 25% in 2012. This translates to a gain in the S&P 500 of ~20%. *Jeb Terry, Sr. January 1, 2012*



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Leading indicators are still trending up going into 2012 . . .

01-01-2012 19:05:07 PM

Despite the ECRI's bearish call last month forecasting the U.S. will slip into a recession in 2012- the leading indicators including the Conference Board numbers are still pointing up. The following chart comes from Yardeni.com. *Jeb Terry, Sr. January 1, 2012*

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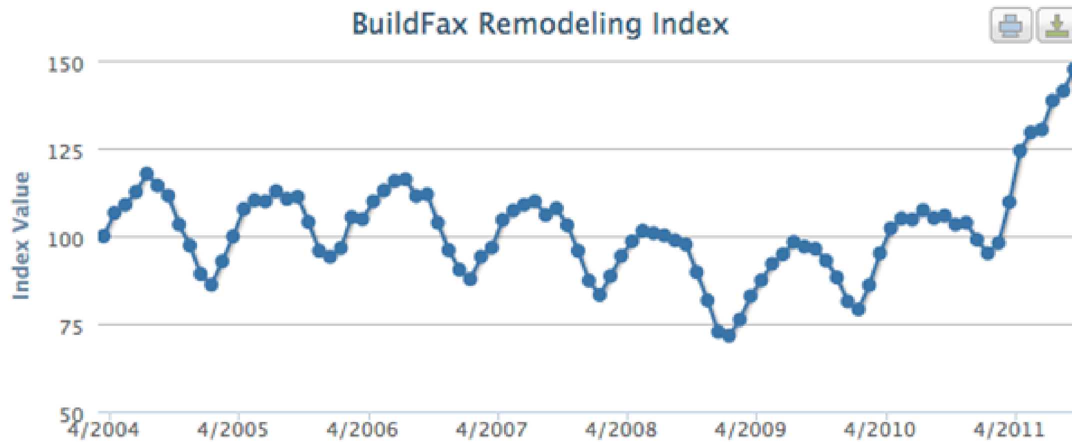
Home remodeling is booming . . .

12-28-2011 16:26:47 PM

A little commented on metric in recent weeks was a 30% year over year increase in housing starts. While that is impressive, home remodeling is up even more! **Home remodeling is up 40% year over year and is at a multi-year high**. To be sure while housing starts remain at a depressed level compared to pre-2008 crash levels, people are behaving rationally and investing in remodeling. It may be that families are using some of their cash hoard to invest in their current homes. The housing situation appears to be better than might be assumed from the headlines. *Jeb Terry, Sr. Dec 28, 2011*



Source: BuildFax Data Release: December 19, 2011 *The Residential BuildFax Remodeling Index rose 40% year-over-year in October-for the twenty-fourth straight month of year-over-year growth-to 147.6. Residential remodels in October were up month-over-month 6.2 points (4%) from the September value of 141.4, and up year-over-year 41.7 points from the October 2010 value of 105.8*.

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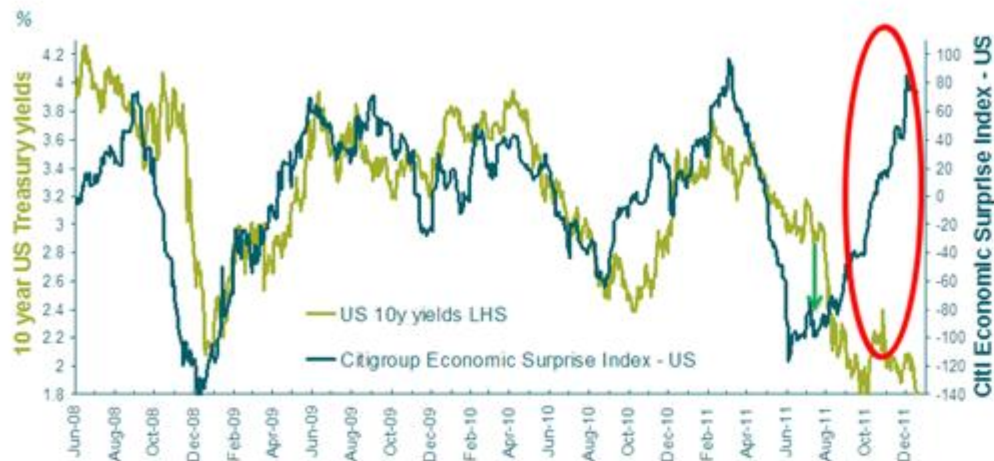
U.S. economic reports have increasingly exceeded estimates - this usually translates into stronger stocks and weaker bonds - but not now - what gives? . . .

12-27-2011 18:46:02 PM

Bond rates remain near all-time lows despite persistent strength of U.S. economic indicators beating estimates. Usually interest rates rise when the economy strengthens. The following chart, courtesy of www.bondvigilantes.com , shows the usually tight relationship between U.S. Treasury bond yields and an index of the degree by which U.S. economic metrics exceed their estimates. The fear of spreading Euro contagion has disrupted this relationship. Flight capital out of the Euro has bid down U.S. Treasury rates. The "bondvigilantes" point out that things in Europe will have to deteriorate even further in order for U.S. bonds to appreciate any more. If the Europeans achieve some stability, then we may see a flow out of treasuries and into equities, an upward move in interest rates and a strong rally in stock prices in th U.S. *Jeb Terry, Sr. Dec 27, 2011*



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2011 felt like a bear market and mostly it was - just ask the BRICS, the Europeans and small cap technology investors . . .

01-03-2012 22:38:45 PM

Now that 2011 is over the financial press is sifting through the data to see what can be learned from the 12 months just ended in order to forecast the 12 months ahead. You all probably have read that the Dow was up "6ish" percent, the S&P 500 was "flatish" and the NASDAQ was down ~2%. Those numbers fail to reveal the mayhem that was unleashed in Q3 on stocks all over the world and on those stocks that were outside of the realm of large cap, dividend paying U.S. stocks. The "risk off" trade hammered the emerging markets epitomized by the BRIC countries. The following chart from Ed Yardeni's blog does a good job showing how bad things got outside of the circus that was the Eurozone and U.S. political theatre in 2011.

Closer to home, there was real devastation in tech stocks - our area of focus. Masked by the impact of the mega cap tech names such as Apple and Microsoft was the fact that 77% of tech stocks having less than $500 million in market cap were down for the year (sample of over 500 companies). 44% of tech companies with more than $500 million in market cap also were down on the year. Approximately 60% of tech stocks remained under their 50 day moving average price at year end. No wonder over 90% of all equity mutual funds were showing losses for 2011 going into December. To make it worse - the wildebeests i.e. retail investors - yanked $118 billion out of those same equity funds in 2011 (see my note **here**) forcing the managers to sell at the lows - Dang!
So what does this mean? It means that 2011 had similar trauma - but not as severe -as in 2008. It means that the widespread panic that punished smaller equities and markets around the world was likely overdone. It means that several of Bob Farrell's "rules for investing in tough markets" (see my post **here**) can possibly come into play in 2012. Rules #2 and #4 come to mind.

#2 Excesses in one direction will lead to an opposite excess in the other direction,

#4 Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.

The conditions are ripe for a sharp rebound in growth oriented investments. The three most powerful words on Wall Street are "Better Than Expected". Economic and earnings reports in the coming days and weeks will need to be "better than expected" to trigger a better than average market rally in Q1. Expectations are anything but euphoric at the moment. *Jeb Terry, Sr. January 3, 2012*

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Sincerely,

Jeb Terry
Aberdeen Investment Management

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