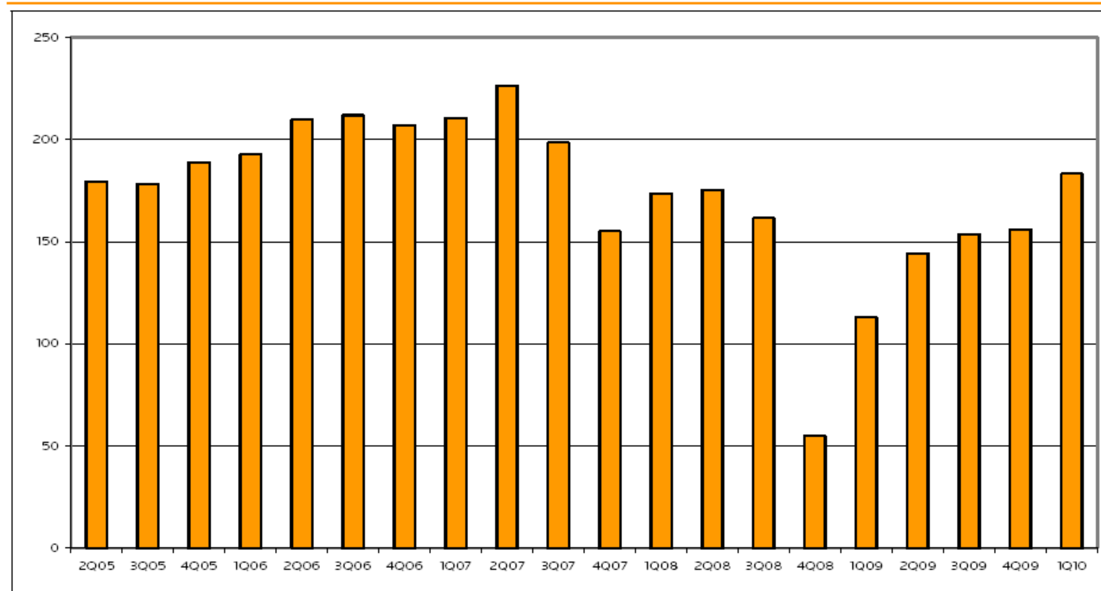
General Market Comment: **May 17, 2010**

The market, as I define as the NASDAQ here, is down 7% over that last 21 days. Are market lore, cycle theories, some market internal measures, fear of a spreading Eurozone crisis and general pessimism sufficient reasons to continue to "sell in May and go away" as the saying goes?

My read of the data says you may want to think twice before you dash for the exits.

My indicators continue to be consistent with early stages of a bull market that will increasingly be led by technology, i.e. our kinds of companies. This view is not inconsistent with a notion that the economy – while exhibiting robust year over year gains in all manner of macro economic measures – is still far from performing at its full potential. This fact bolsters the case for subdued inflation and interest rates – which are conditions that are supportive of rising earnings and stock prices.

The following chart from Thomson Reuters displays the earnings for the S&P 500 since 2005.



S&P 500 earnings have had terrific growth over the lows of 2008/2009. The year over year growth for Q1 earnings exceeds 50%. Earnings are the highest since Q3 2007. Growth is not just financials recovering from the panic lows. Earnings, excluding financials, have grown 39% over 2009. 9 of the 10 S&P 500 industry sectors have earnings growth. All of them have revenue growth. Earnings preannouncements for Q2 are pointing to even more upside.

77% of the S&P 500 companies have beaten estimates. Notice that 89% of the reporting tech companies have beaten estimates by an average of 12%. The aggregate % surprise of 15% is over 7X greater than the long term average of 2% since 1994. Margins are also expanding. Excluding financials, net income margins have improved 24% over 2009. They have improved 41% if financials are included.

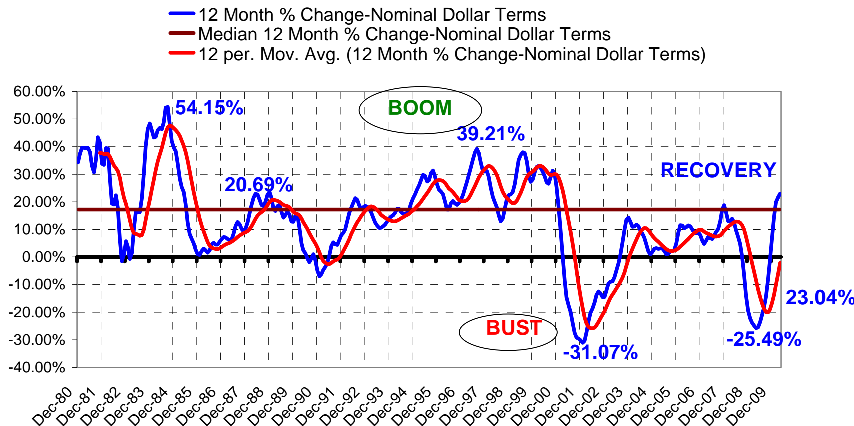
Q1 2010: EARNINGS SCORECARD

Exhibit 2A. S&P 500: Q1 2010 Earnings vs. Expectations

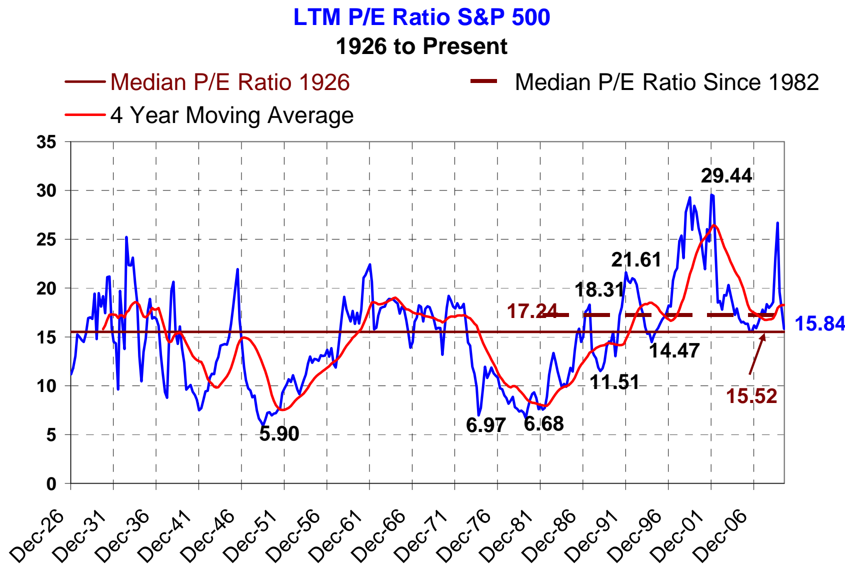
Sector	Above %	Match %	Below %	Surprise Factor %	Reported Total #	Index Total #
Technology	89%	3%	8%	12%	62	75
Consumer Discretionary	85%	8%	8%	18%	66	81
Industrials	80%	7%	13%	13%	55	57
Health Care	78%	8%	14%	9%	50	52
Utilities	78%	3%	19%	8%	36	36
Materials	77%	16%	6%	17%	31	31
Energy	77%	3%	21%	9%	39	39
Consumer Staples	76%	3%	21%	3%	34	41
Financials	61%	12%	27%	48%	77	79
Telecom Services	56%	22%	22%	0%	9	9
S&P 500	77%	7%	15%	15%	459	500

Source: Thomson ONE.

There is a reason why earnings are rising and particularly in tech . . . **we are in the midst of a major surge in broad tech related spending**. Earnings for Tech companies that have reported so far have grown 64% over 2009. Revenues for theses companies have grown 18%.

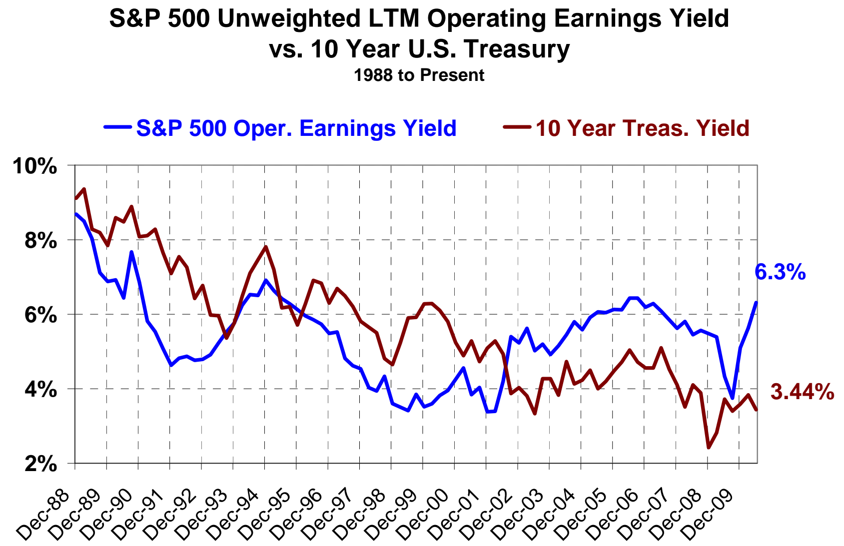


Have a look at the updated "Tech Pulse" chart to the left. Last year's recovery was arguably a reflexive rebound from unrealistic cuts in spending in response to the financial panic of 2008 and 2009. This year's extension of the surge is more indicative of a sustainable investment cycle. No wonder tech earnings are surging and margins are expanding.

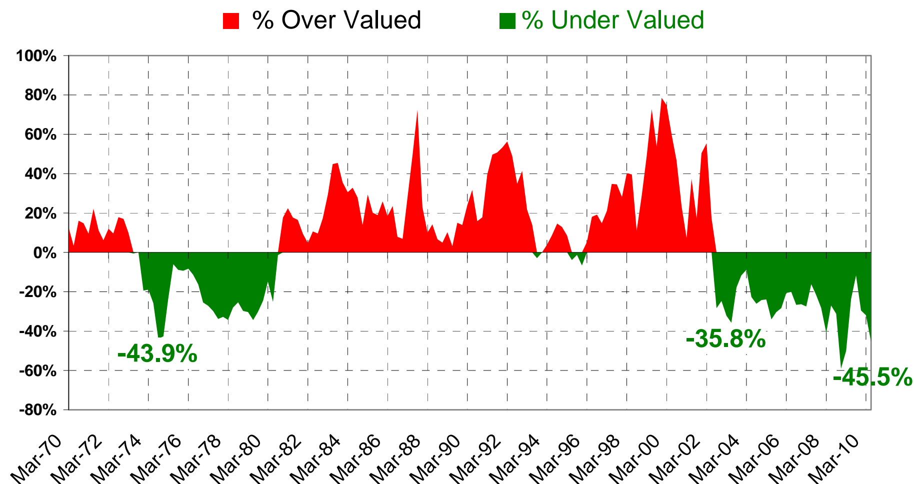


The combination of the recent price correction and rising earnings is producing a drop in the P/E ratio for the S&P 500. The ratio based on the current market price and earnings including the estimates for Q2 is approaching the median since 1926. The ratio based on the LTM earnings using Q1 earnings is 17.24 – equal to the median ratio since 1982. **It would be a stretch to call this market "expensive".** The market went up 5 consecutive quarters following the last time the P/E ratio tested the 1926 median in 2006. It went up 14 consecutive quarters following the test in 1994.

The spread between the earnings yield (*the reciprocal of the P/E ratio*) and the 10 Yr. Treasury rate has widened – an indicator that stocks are cheap relative to bonds. Sharp increases in the earnings yield such as in 1993, 2002 and 2009 have preceded bull markets.



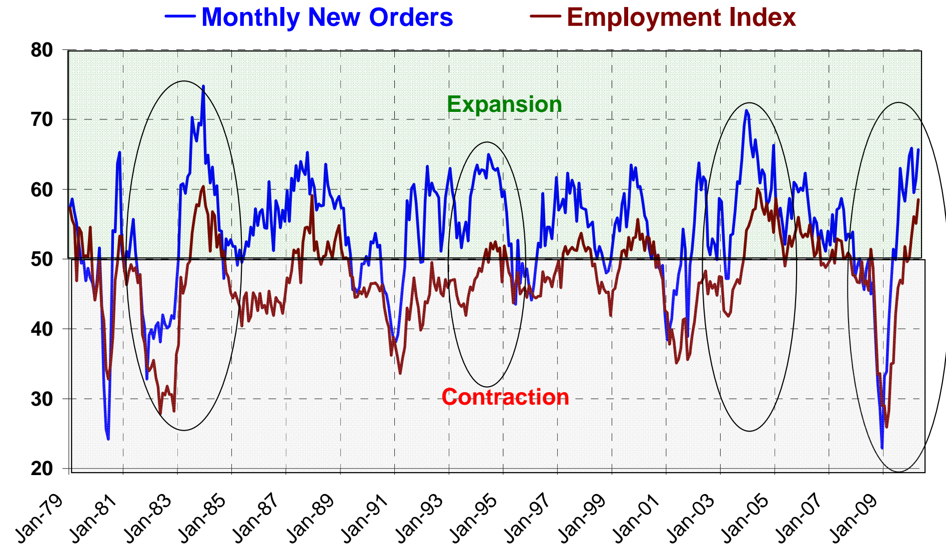
S&P 500 Percent Over / Under Valued
(Earnings Yield / 10 Yr Treas.)
1970 to Present



The greater the positive spread in the earnings yield vs. the 10 yr. Treasury rate, the more undervalued stocks are compared to bonds. This measure says the S&P 500 is 45.5% undervalued. An undervaluation of 40% or more has only happened 5 times since 1970. With exception of the panic of 2009, the market has been up 4 out of 5 times by an average of 33% 12 months later.

There are legitimate concerns about the Eurozone debt crisis. It is not clear to me that the restructuring of the PIIGS debts will either stop European economic growth or drag the rest of the world into a financial crisis. As the analysts at the Bank Credit Analyst noted – the crisis had reached the "riot point" and hence commanded forceful and coordinated policy responses such as we saw last week and are likely to see more of going forward. There is much about the crisis that I characterize as being resolvable "with a stroke of a pen". Don't get me wrong – there are fiscal consequences, but central bankers and governments have demonstrated a willingness to act decisively to stop financial panics as has been unfolding in Europe.

Have a look at the industrial production plotted on the left from last week as published by Scott Grannis. There is little doubt that the global economy is recovering – including the Eurozone. A weakening Euro will not particularly hurt – one can argue it will help European economies.



No need to be in denial – the economy is growing – whether or not Greece or another PIIG needs to get bailed out. We don't need to get too obsessed with the absolute level, only the slope of the curve. The equity markets will have an upward bias as along as new orders (*blue line on right*) and employment (*maroon line on right*) don't drop toward 50 on the ISM index.

So, what's the bottom line? . . . There are many brick masons ready and willing to add to the proverbial "wall of worry" that the stock market has to climb. There is undeniable historical evidence that the period from May through October is a weak period for stocks but that does not mean that they won't rise this year. Stocks rise when earnings outlooks are rising and interest rates are stable . . . kinda like now . . . The recent market correction is not alarming given the youth of the economic recovery, the persistence of easy of monetary conditions and the strength in earnings.

I stated in April I would not be too concerned if we had some pullback in prices. I remain of that conviction. I doubt we will see appreciable downside from current levels failing some exogenous shock to our collective psyche.

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Please refer to the latest Market Analysis report dated March 9, 2010 entitled "Spring Returns to the Serengeti" on our web site www.aberdeeninvestment.com for more data supporting our opinions on the economy and the market.

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Please do not hesitate to call if there are any questions.

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