

*Aberdeen Investment Management, Inc.*

## **Thoughts on Market Performance at Midterm Elections and in Q4 2010**

*The Wildebeests are preparing to fight for herd dominance in November*



**Jeb B. Terry, President  
Aberdeen Investment Management, Inc.**

**As of September 2, 2010**

[jbtsr@aberdeeninvestment.com](mailto:jbtsr@aberdeeninvestment.com)   [www.aberdeeninvestment.com](http://www.aberdeeninvestment.com)

Caution: It's a risky world we live in. My opinions are based on information believed to be reliable but hey, I could be wrong. Our purpose is to add information and analysis that results in a fuller thought process and better investment decisions. Risk and reward in investing go hand in hand. Every investor should understand their expectations, limits and tolerance for risk.

***ABERDEEN***

---

***ABERDEEN INVESTMENT MANAGEMENT***

## Thoughts on Market Performance at Midterm Elections and in Q4

---

### **Facts to Consider:**

- **Polls and prediction markets point to a significant Republican victory** in the November midterm elections that will likely change the control in the House of Representatives to the Republicans and may do the same in the Senate.
- **Gridlock in Washington is good for the stock market.** When different parties control the White House and the Congress, there has been dramatically improved stock market performance.
- **The Q2 earnings season exhibited continuing above average earnings** growth that significantly beat expectations.
- **Corporate profits**, including public and private companies, **continue to exhibit the strongest recovery in modern history.** Corporate profits are set to mark a new all time high in Q3 this year resulting in a full recovery in only 7 quarters.
- **Corporate cash flows and after tax margins have already set a new record high in Q2.**
- **Investment in technology remains the best in 10 years.**
- **Market valuation is compelling . . .** The S&P 500 P/E ratio is the lowest in 20 years.
- **Investor sentiment measures are at levels consistent with market lows.**
- **Companies have cash and are starting to spend it** on acquisitions and stock buybacks
- **Q4 is a predominantly up quarter.** Q4 has shown a gain for the S&P 500 in 80% of the cases since 1980 and risen sequentially over Q3 by an average of 7.4%.
- **The stock market is predominantly up in mid-term election years.** Q4 has seen an increase in the S&P 500 87.5% of the time in midterm election years in the post WWII modern political era.

**Conclusion:** Conditions for stocks are improving. The flight from equities has been excessive. The “surprise” potential is for upside events. Earnings growth is likely to continue to be stronger than macro economic concerns would suggest.

**BUY MORE GROWTH STOCKS – SELL BONDS**

## **Increasing Probability of Significant Republican Gains in Congress**

The prediction marketplace, Intrade, ([www.intrade.com](http://www.intrade.com)), has shown a dramatic increase in the odds for a Republican victory in November. It is appropriate to seriously consider the consequences of a change in control in the House of Representatives and a material weakening of Democratic control of the Senate. The extent of the change in the voting mix in Congress as currently predicted would be sufficient to block any major Democratic legislative initiative from being passed. That said, it is not likely to be sufficient to push through a complete repeal of healthcare reform in the near term.

Here is the chart of the Intrade prediction market for the proposition: “The Republicans to control the House of Representatives after 2010 Congressional Elections”

**Closing prices chart**



*Aberdeen Investment Management, Inc.*

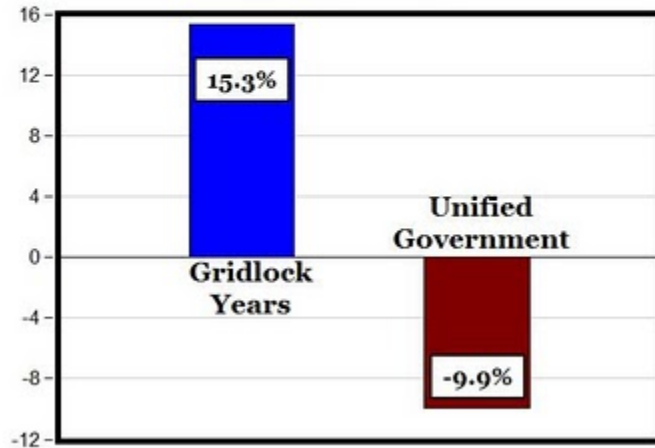
The generic congressional poll shows Republicans favored over Democrats by 45% to 39% per the Rasmussen poll of likely voters. This poll has consistently placed the Republicans ahead every week for over a year. A similar Gallup poll has the Republicans leading by a historic high 51% to 41%.

So . . . what happens if the prediction market is accurate and the Republicans gain control in Congress?

**History says that the ensuing gridlock in Washington would be good for the stock market.** It has at least been coincidental with, if not contributory to, strong equity market performance. The following chart and comment come courtesy of the Carpe Diem blog of Mark Perry and an article by Eric Singer of the Congressional Effect Fund.

### Gridlock is Great for Stock Market Returns

**Real Returns for the S&P500  
Gridlock Years vs. Unified Gov't.  
1973 to 2010**



“Since 1973, using the price of gold as a deflator (instead of the Consumer Price Index, which has suffered from style drift over the years) real, inflation-adjusted returns for the S&P 500 were a fabulous 15.3 percent gain in “gridlock” years, and a horrible 9.9 percent loss in years with unified government. That’s a 25 percent difference.

The reason for this difference is simple: Unified governments spend far more, and more quickly, and expand regulation much more than split governments do. Programs sail through, the dollar is jeopardized, and investors seek real assets like gold to counteract the political risks of an activist government.”

*Per Eric Singer of the Congressional Effect Fund*

## Earnings growth remains supportive of the case for a rising market

Whether or not change in Washington will foretell a stronger market, it is logical that a precursor to improved equity prices would be improved earnings.

The commentary from the most recent report on Q2 earnings from Thomson Reuters follows below. **The message is straightforward. Earnings growth is above average and P/E ratios are below average.** When 75% of S&P 500 companies beat earnings compared to the historical average of only 62% beating estimates, one should assume we are still in the early phase of a period of rising earnings.

- ▶ Of the 490 companies in the S&P 500 that have reported earnings to date for Q2 2010, 75% have reported earnings above analyst expectations.
- ▶ The blended earnings growth rate for the S&P 500 for Q2 2010 is 38%. The Materials, Energy, and Information Technology sectors are reporting the highest growth rates for the quarter.
- ▶ The forward four-quarter (Q310 – Q211) P/E ratio for the S&P 500 is 12.7.

**Exhibit 2A. S&P 500: Q2 2010 Earnings vs. Expectations**

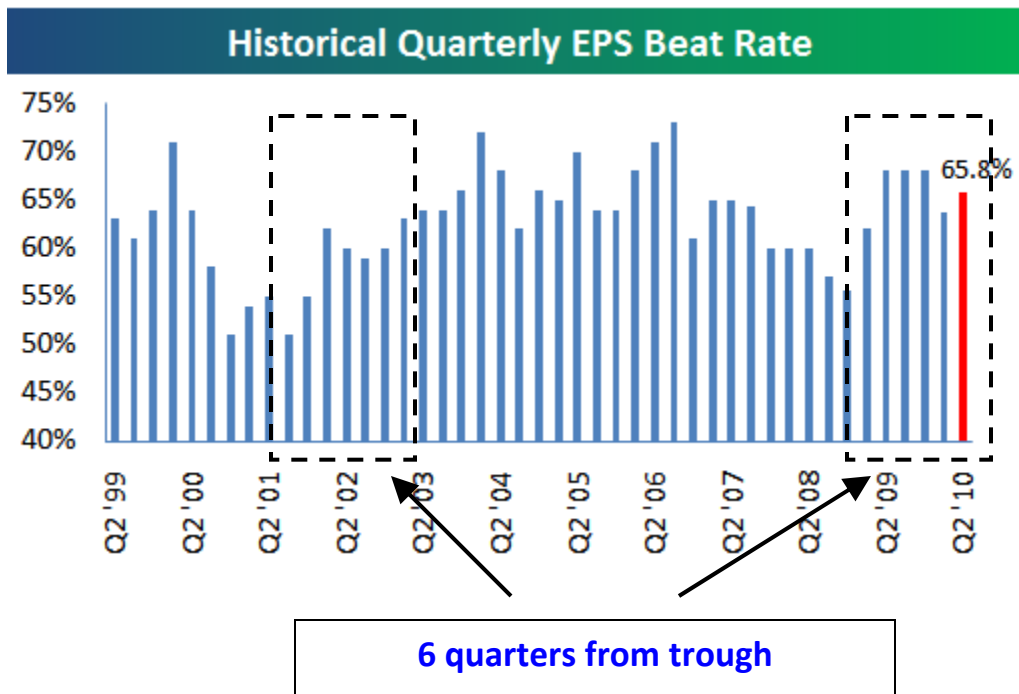
Sector	Above %	Match %	Below %	Surprise Factor %	Reported Total #	Index Total #
Health Care	82%	14%	4%	9%	51	51
Industrials	82%	5%	13%	7%	55	56
Telecom Services	78%	0%	22%	5%	9	9
Technology	77%	13%	9%	9%	75	76
Financials	76%	9%	15%	20%	78	80
Consumer Discretionary	72%	15%	13%	13%	79	81
Energy	72%	3%	26%	9%	39	39
Utilities	71%	0%	29%	7%	35	35
Materials	69%	3%	28%	5%	32	32
Consumer Staples	62%	16%	22%	2%	37	41
<b>S&amp;P 500</b>	<b>75%</b>	<b>10%</b>	<b>16%</b>	<b>10%</b>	<b>490</b>	<b>500</b>

Source: Thomson ONE.

*Aberdeen Investment Management, Inc.*

Through August 27, 490 companies in the S&P 500 Index have reported earnings for Q2 2010. Of these 490 companies, 75% reported earnings above analyst expectations, 10% reported earnings in line with analyst expectations and 16% reported earnings below analyst expectations. In a typical quarter (since 1994), 62% of companies beat estimates, 18% match and 20% miss estimates. Over the past four quarters, 76% of companies beat the estimates, 8% matched and 17% missed estimates.

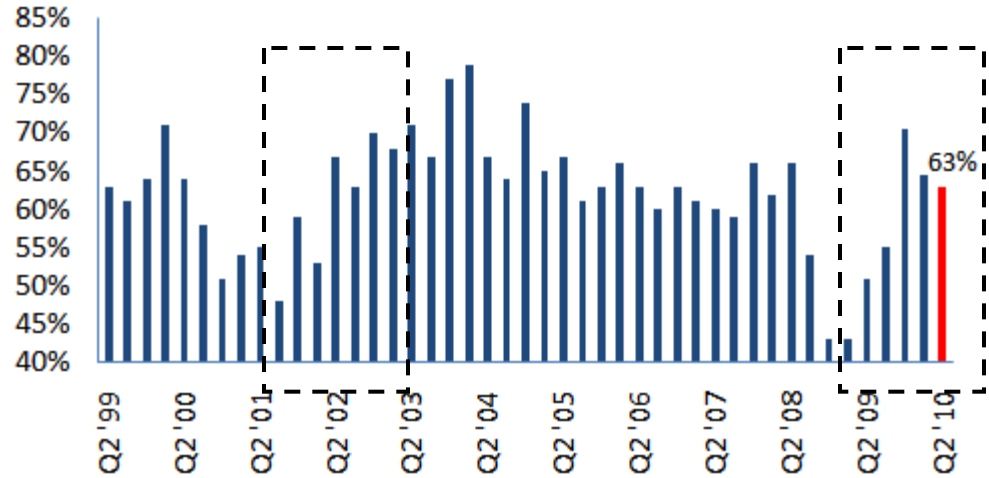
In the aggregate, companies are reporting earnings that are 10% above the estimates, which is above the 2% long-term (since 1994) average surprise factor but below the 12% surprise factor recorded over the past four quarters.



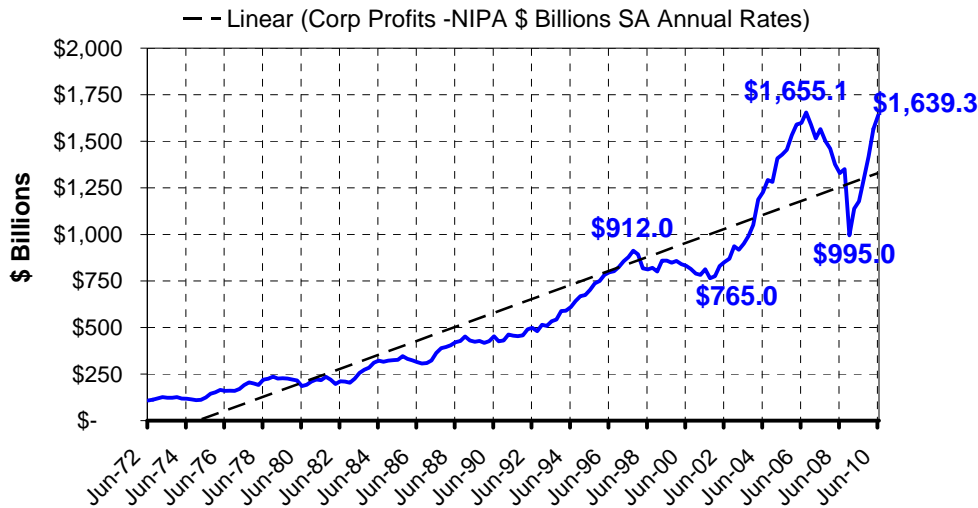
The chart on the right from Bespoke Investment Group displays the historical earnings beat rate for a larger sample size of public companies including the S&P 500. While it is a fact the beat rate did contract in Q2, **the beat rate remains above average and is consistent with continued earnings strength** – such as in 2003 and 2004. It would be a stretch to say that the tenor of the Street analysts is too optimistic and complacent. Therefore, I suspect companies should be able to extend the current high level of the beat rate into 2011.

**Historical Quarterly Revenue Beat Rate**

**Bespoke's illustration of the beat rate in revenue is also consistent with continuing growth.** It remains too early to conclude that revenue growth will begin to come in below estimates.



**Corporate Profits on the Mend  
1972 to Present**  
(Seasonally Adj. Annual rates per NIPA)



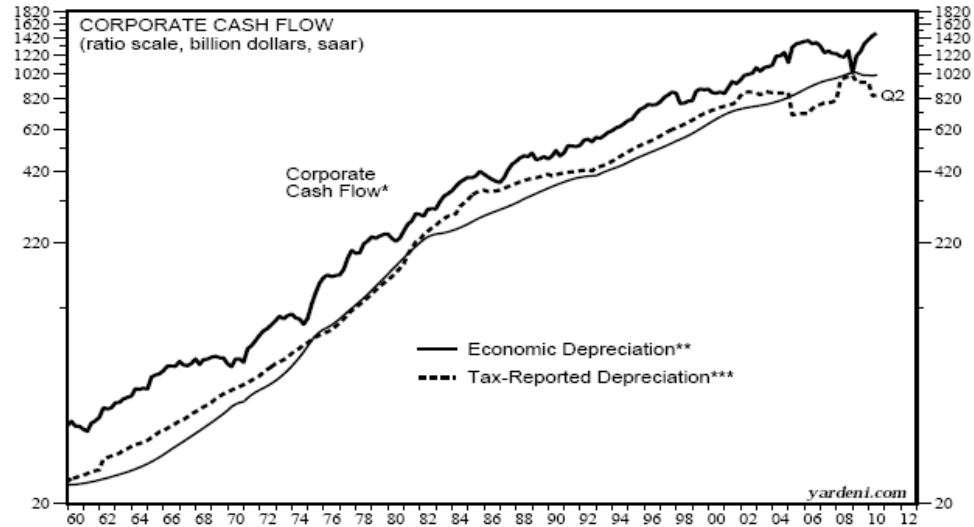
Source: Bureau of Eco Analysis. National Income and Product Accounts.

When we look at aggregate corporate profits as compiled from tax returns and reported by the BEA we can easily see the remarkable rate of recovery in earnings since 2008. **Total corporate profits are on track to set a new record high in the current quarter.** The growth is consistent with the results of my survey of managers of our portfolio companies.

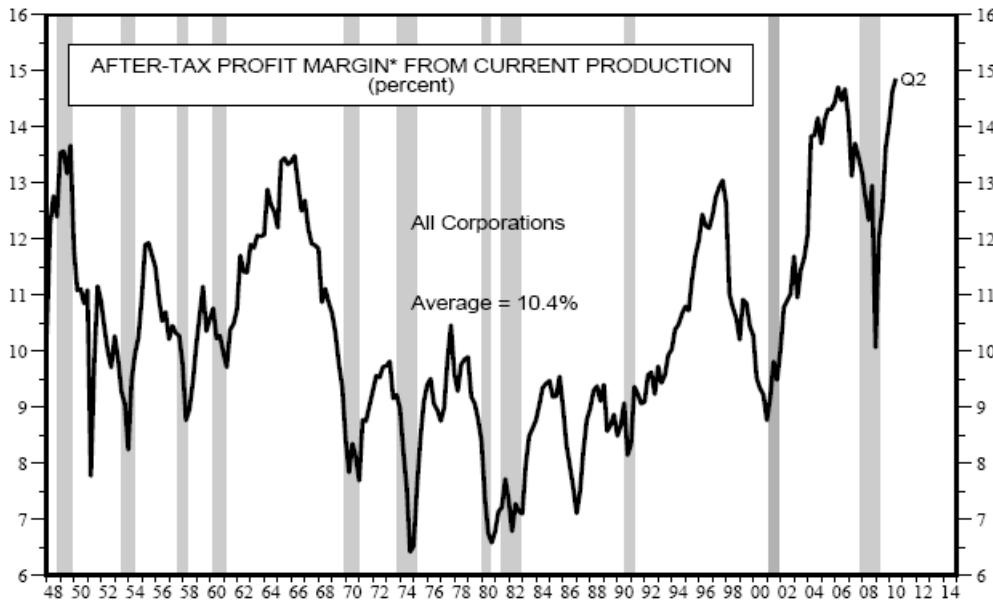
Corporate cash flow has already made a new high according to the BEA numbers and presented by Yardeni Research in the chart on the right and in the following comments.

**Cash Flow**

- **Total corporate cash flow increased 2.4% during Q2, the seventh gain in eight quarters. Cash flow is up 24.4% since mid-2008 to a new record high.**



\* After-tax retained earnings plus tax-reported depreciation.  
 \*\* Corporate capital consumption allowances.  
 \*\*\* Corporate capital consumption allowances with capital consumption adjustment.  
 Source: US Department of Commerce, Bureau of Economic Analysis.



\* Includes Inventory Valuation Adjustment and Capital Consumption Adjustment. These two adjustments restate the historical-cost basis used in profits tax accounting for inventory withdrawals and depreciation to current-cost measures in GDP. Source: Bureau of Economic Analysis.

After tax margins are also at a new high. We are experiencing the steepest recovery in modern history.

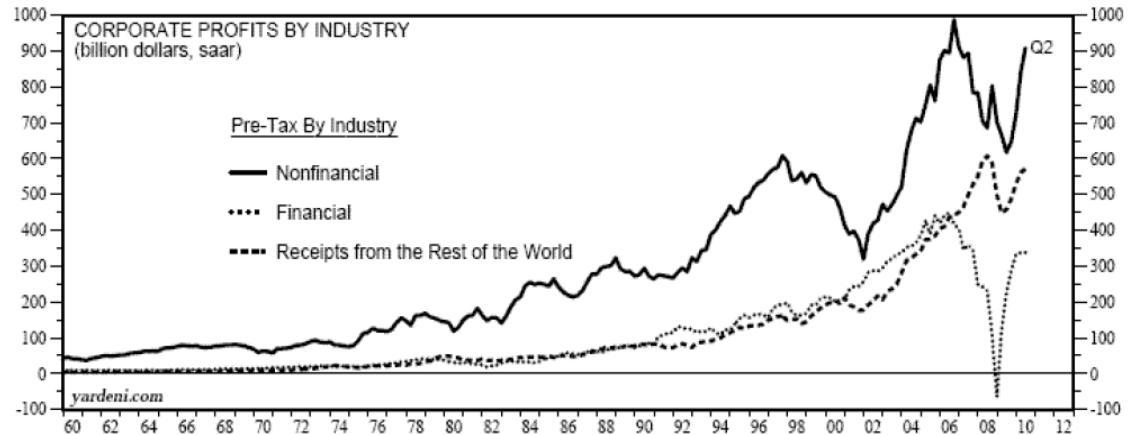
**After-Tax Profit Margin**

- **The after-tax corporate profit margin climbed for the sixth straight quarter to a record high of 14.9% during Q2 from 10.1% during Q4-2008, which was near a six-year low.**



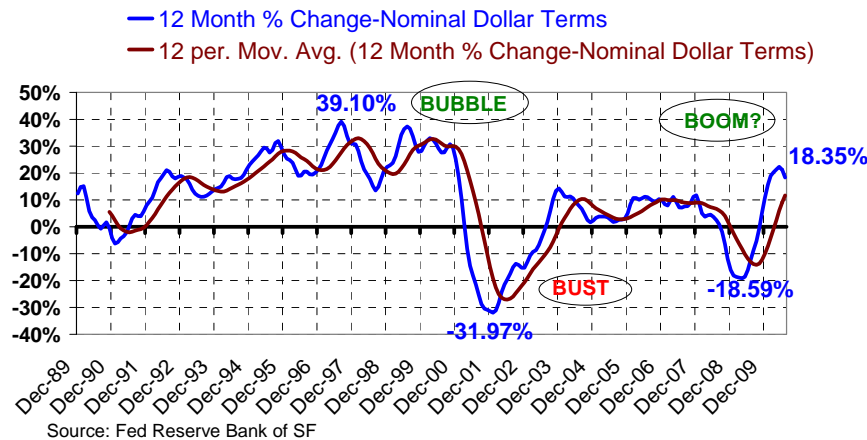
Some pundits have tried to torture the data to claim that too much of the earnings recovery has been attributable to government assisted earnings recovery in financial institutions. That is just not so.

There is an important line in the chart to the right for “receipts from the Rest of the World”. Perma bears tend to pay too little attention to the role of earnings generated by foreign operations of U.S. companies. Those earnings count the same as U.S. earnings and they are growing rapidly.



While the financial press is unimpressed with the growth in corporate America, we remain focused on the growth in technology, where our portfolio is exclusively concentrated, which continues to be strong. Technology investment and operating results are the best in a decade.

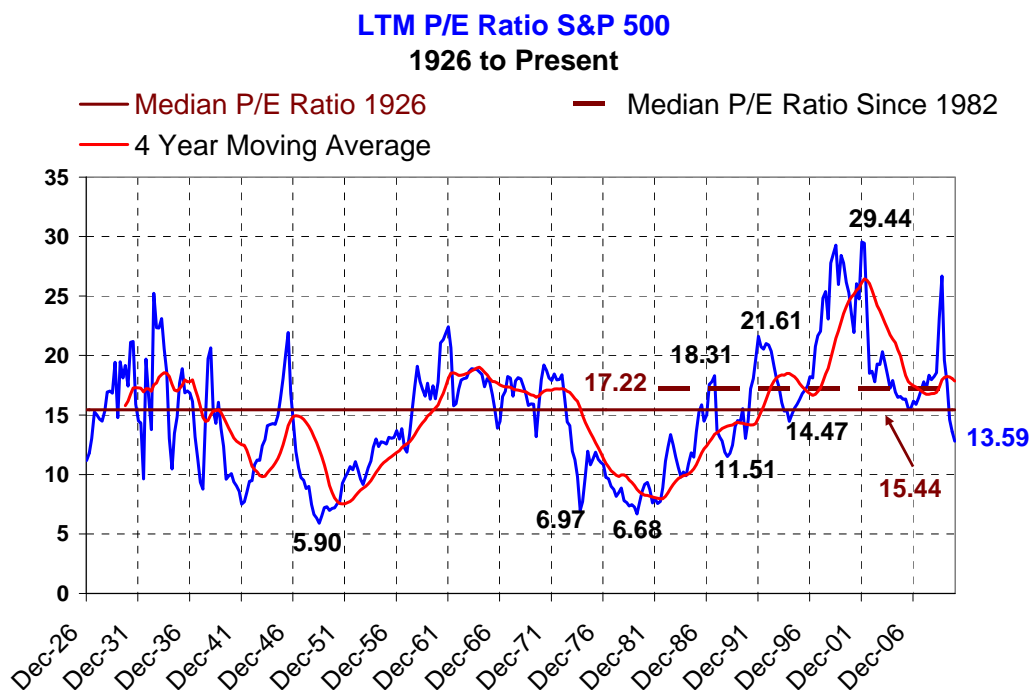
**TECH PULSE INDEX**  
1990 to Present  
12 Month % Change



## The market valuation is compelling

The chart below has an irrefutable message to me. It tells me the P/E ratio for the S&P 500 is the lowest in 20 years, is lower than the median ratio since 1926 and is far lower than the median ratio since 1982.

It is not enough to just notice that the P/E ratio is “low”. One should also look at the ratio in light of the rate of growth in earnings. **The PEG ratio today at approximately 0.14 (P/E ratio/ (LTM earnings growth x 100)) is the lowest in 60 years.**

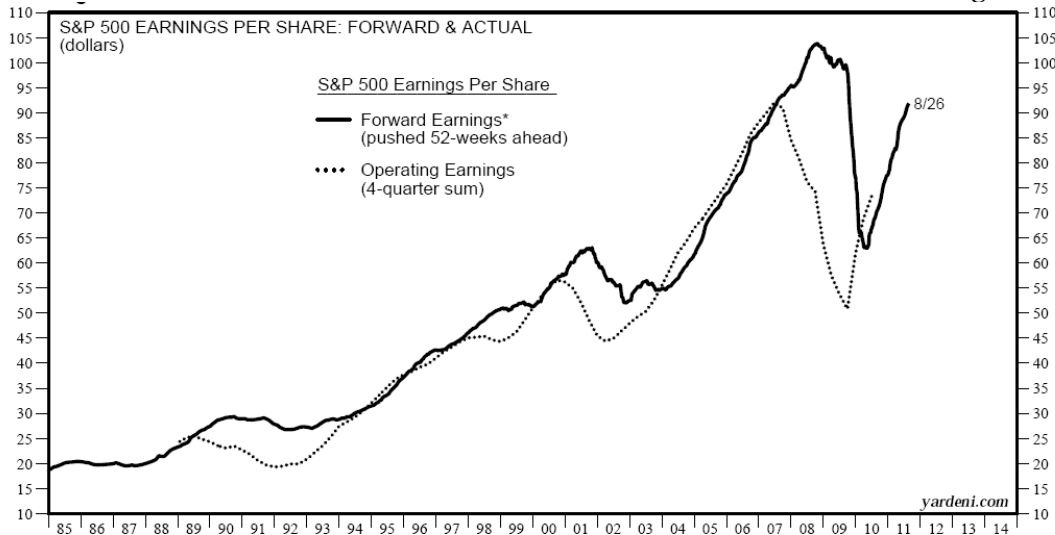


While the P/E ratio is apparently low – the PEG ratio is dramatically lower. The S&P 500 would have to rise by over 200% to above 3,200 for the PEG ratio to equal the median PEG ratio since 1970. It would have to rise by over 100% to equal the median PEG ratio since 1928. Conversely, earnings would have to collapse by over 50% sequentially in Q3 and or Q4 in order for the current market value to be supported by the median PEG ratio from 1928.

**The point – The market price today discounts an extremely negative outlook for earnings which seems unlikely to occur. Earnings growth will have to drop by ~70% in 2011 to justify today’s price level.**

There are pundits that claim that estimated earnings are always wrong and can’t be relied on for market outlooks. While forward earnings estimates have missed major downturns, they have been good indicators of sustained growth.

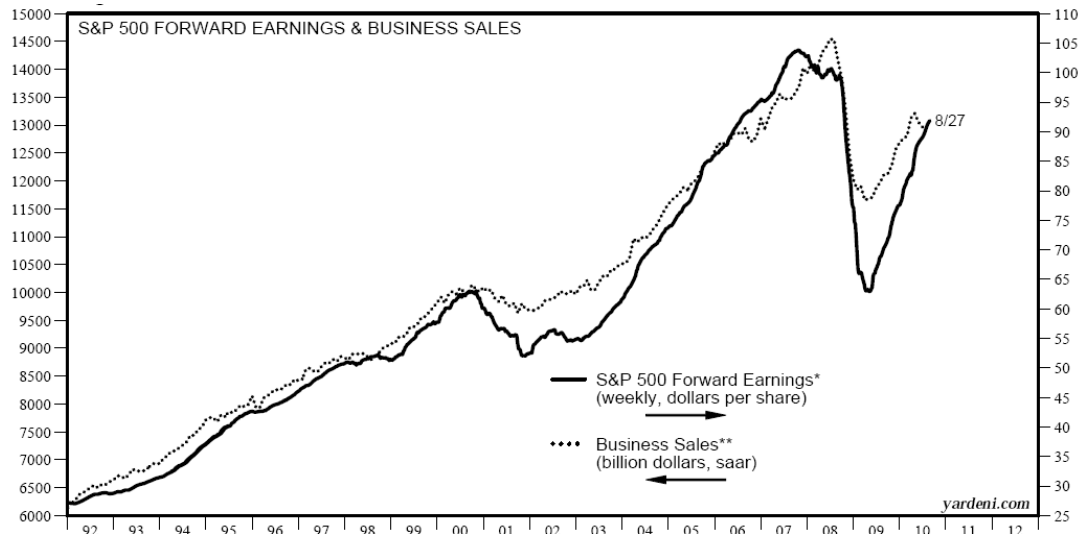
*Aberdeen Investment Management, Inc.*



\* 52-week forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current and next year's consensus earnings estimates. Monthly through April 1994; weekly thereafter. Actual 4Q sum from S&P until Q4-1993, from Thomson Financial thereafter. Source: Thomson Financial and Standard & Poor's.

The chart to the left shifts forward earnings by 52 weeks. One can see that except for the recessionary shocks of 90-92, 2000-2003 and in 2007-2009 that the forward earnings have been a good predictor of the longer term earnings growth. The predictive quality of forward earnings estimates is greatest in the early periods of recovery once operating earnings have clearly bottomed and shown at least a year's worth of improvement . . . kind like now – eh?

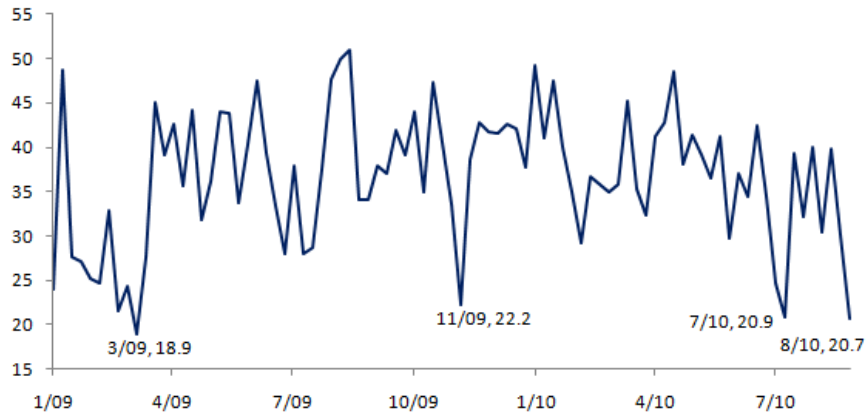
You can find many analysts claiming that the earnings recovery has been accomplished without revenue growth and therefore is unsustainable. This conclusion seems off base as can be seen in the chart from Yardeni Research to the right. Business sales are rising. Rising earnings are both a result of and a sustaining driver of rising sales.



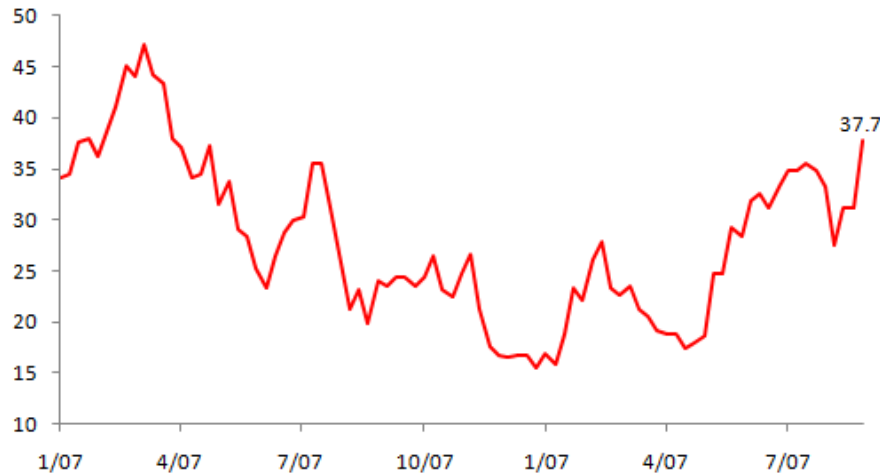
\* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994; weekly thereafter. Time-weighted average of current and next year's consensus earnings estimates.  
 \*\* Manufacturing and trade sales. Source: Thomson Financial and US Department of Commerce, Bureau of the Census.

## **Bearish Investor sentiment consistent with market lows**

**AII Bullish Sentiment: 2009 - 2010**



**Investors Intelligence Bearish Sentiment (%): 2009 - 2010**

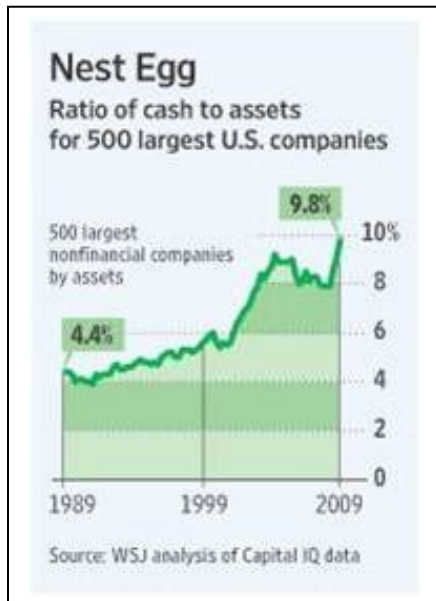


These two charts clearly show the “wildebeests” are scared. Bullish sentiment is flirting with the low of March 2009. Conversely, bearish sentiment is the highest since March 2009.

The message is clear – if it is advisable to take an opposite position to the broad sentiment measures then that position would be bullish today.

## **Companies have cash and are starting to spend it – August saw record high level of M&A activity**

- “Cash is king, and Big Tech companies have it pouring out their ears. The eight biggest companies in the industry are sitting on a collective stash of more than \$194 billion. **With cash earning next to nothing nowadays, investors want companies to put their cash to good use. The result: A tech M&A frenzy that industry analysts think is just getting started.** Analysts say the buyout boom is fueled by companies' reluctance to gamble on hiring and internally developing new product lines. But it also doesn't hurt that the cost of capital is extremely cheap right now, and a lot of potential takeover targets are attractively priced. The economic downturn has hammered many stocks, allowing buyers to offer generous premiums on valuations that are much lower than they would have been a few years ago.” *Banked billions spark tech takeover shopping spree – CNN Money August 24, 2010*
- "Companies are flush with cash," said Robert Profusek, global head of the mergers and acquisitions practice at the law firm Jones Day. "You've got to put it to use." **Acquisition activity in the fourth quarter of this year "is going to be phenomenally active,"** he predicted. *WSJ August 30, 2010*

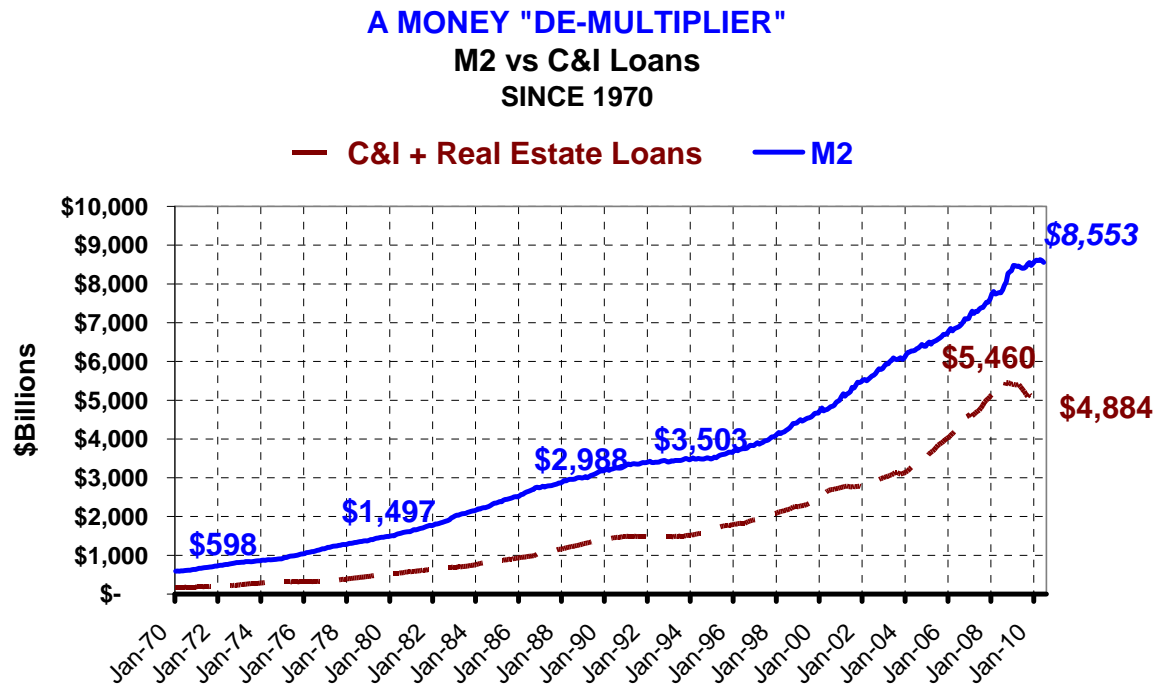


“According to the Federal Reserve, nonfinancial companies held \$1.8 trillion in cash and other short-term assets at the end of March — up 26% from a year ago, the largest increase since the Fed began keeping records in 1952. Cash now accounts for 7% of company assets, the highest level in nearly 50 years.”

“Cash as a percentage of sales was 13%, the highest level in more than 10 years. Meanwhile, the CFO Midcap 1500 (companies with annual sales of \$100 million to \$1 billion) collectively held \$111 billion in cash, up 15% from 2008. At the same time, year-end current liabilities fell 8% for the CFO Midcap 1500 and 9% for the S&P 500.” *CFO Magazine 7-15-10*

The M&A boom may be a benefit to the banks who need to restart commercial and industrial (“C&I”) lending to preserve spreads and fund future deposit interest rates. Bank financing of mergers and acquisitions is attractive business for the large money center banks. Bank earnings have recovered strongly over the last 18 months. The FDIC just reported that bank earnings were the best in almost 3 years in spite of continued elevated loan loss provisioning.

**Improving corporate earnings and balance sheets, rising M&A activity, strengthening bank balance sheets and the need to drive bank earnings with loan growth all suggest 2011 could see growth in C&I loans and therefore monetary velocity for the first time since 2008.** This turn of events could finally put in balance the famous monetarist equation of the economy  $MV=PQ$  where M=money supply, V=money velocity, P=price levels and Q=physical volume of all goods and services produced.



Source: Federal Reserve,

## Q4 . . . “It’s the most wonderful time of the year”

I have summarized the performance of the S&P 500 in the 4<sup>th</sup> quarter since 1945 and since 1980 in the following table. There have only been two occasions when Q4 was sequentially down following a prior year down quarter – 1978 and 2008. There was only one time when Q4 was sequentially down for three years in a row, which is what 2010 would be if the market were to drop, and that was in 1979. 1979 was very different than today. Earnings growth was negative in the 1979 Q3 and importantly, Fed Funds rates were being aggressively increased and inflation was over 13%. In addition, the earnings growth was materially slowing on a year over year basis as the economy was finishing a 5<sup>th</sup> year of recovery coming out of the 1974 recession.

Given 1) the still youthfulness of the current economic recovery, 2) the very high likelihood of continued rising earnings in Q3, 3) continued extremely accommodating monetary policy and 4) the seasonal tendencies of the market, **I am comfortable saying that there is almost a zero percent chance that Q4 2010 experiences a sequential or year over year price decline.**

	Q4 S&P 500 Sequential Price Moves			Following Q3 Earnings Growth		Following Q3 Earnings Decline	
	Total	When Price Move Positive	When Price Move Negative	Q4 Perf Following Q3 Earnings Rise	Positive Q4 Perf Following Q3 Earnings Rise	Q4 Perf Following Q3 Earnings Decline	Positive Q4 Perf Following Q3 Earnings Decline
<b>Since 1945</b>							
Count	68	53	15	21	17	44	34
% of total		77.9%	22.1%	32%	81%	68%	77%
Average	3.4%	6.4%	-6.9%	4.1%	6.6%	3.6%	6.4%
Max	20.9%	20.9%	-0.2%	16.0%	16.0%	20.9%	20.9%
Min	-23.2%	0.7%	-23.2%	-23.2%	0.7%	-22.5%	0.7%
<b>Since 1980</b>							
Count	30	24	6	14	11	16	13
% of total		80.0%	20.0%	47%	79%	53%	81%
Average	3.9%	7.4%	-9.8%	3.4%	6.5%	4.4%	8.1%
Max	20.9%	20.9%	-0.7%	16.0%	16.0%	20.9%	20.9%
Min	-23.2%	0.7%	-23.2%	-23.2%	0.7%	-22.5%	1.2%

In addition to the factors listed above in favor of a strong Q4 we can consider what has happened in past mid-term election years. **The occurrence of mid-term elections increase the odds that Q4 will have positive sequential and year over year appreciation.**

**Mid-term election years have been good for the stock market. There have only been two down Q4's in a mid-term election year going back to 1946.**

The last down quarter was in 1994 when there was a major change in control of Congress as the Republicans took over during the Clinton administration. It should be noted that a) Q3 1994 had a gain of 4+% in the S&P 500 and that b) following the change in control, the market went on to rise for 14 consecutive quarters.

It should also be noted that Fed Funds rates were being raised in 1994 and the market was overvalued relative to interest rates and the earnings yield – **we have the opposite conditions today.**

Mid Term Election Year			
	Q4 moves		
	Total	Positive	Negative
2010	?	?	
2006	6.1%	6.1%	
2002	5.5%	5.5%	
1998	20.9%	20.9%	
1994	-0.7%		-0.7%
1990	7.9%	7.9%	
1986	4.7%	4.7%	
1982	16.8%	16.8%	
1978	-6.3%		-6.3%
1974	7.9%	7.9%	
1970	9.4%	9.4%	
1966	4.9%	4.9%	
1962	12.1%	12.1%	
1958	10.3%	10.3%	
1954	4.1%	4.1%	
1950	4.9%	4.9%	
1946	2.3%	2.3%	
<b>Since 1946</b>	Count	16	14
	% of count		87.5%
	<b>Average</b>	<b>6.9%</b>	<b>8.4%</b>
	<b>Median</b>	<b>5.8%</b>	<b>7.0%</b>
	<b>Max</b>	<b>20.9%</b>	<b>20.9%</b>
	<b>Min</b>	<b>-6.3%</b>	<b>2.3%</b>
<b>Since 1970</b>	Count	10	8
	% of count		80.0%
	<b>Average</b>	<b>7.2%</b>	<b>9.9%</b>
	<b>Median</b>	<b>7.0%</b>	<b>7.9%</b>
	<b>Max</b>	<b>20.9%</b>	<b>20.9%</b>
	<b>Min</b>	<b>-6.3%</b>	<b>4.7%</b>