

HAYDEN HARPER

“FOCUS ON THE BIG PICTURE”

BY: GREGG ADZEMA

We here at Hayden Harper thought it would be very helpful to our clients to begin providing a monthly commentary on our current investment philosophy and outlook. As the company’s Chief Investment Officer, I’ll do the actual writing; but, rest assured all investment decisions are vetted by our full Investment Committee before implementation. I chair that committee, but I am just one voice among several very smart, very experienced members.

Let me start by saying we will try to keep these letters brief and to the point. The last thing you need is one more long-winded, opinionated commentary on the direction of the stock market. In fact, we believe most of us are now inundated with too much market data and commentary, and as a result struggle seeing the “forest for the trees”.

In that spirit, let’s take a step back from the daily noise and honestly assess the current economic landscape. We believe it is reasonably clear that the recession is over, having ended sometime last summer or fall. Some readers would probably disagree with this assessment, and we don’t want to spend a lot of space defending it, but it is hard to argue with back-to-back quarters of positive GDP growth in the second half of 2009, and a forecast for positive GDP growth for all of 2010.

So assuming the economy is recovering, what is important to know is where we are in the recovery and how long it will last. Why is this important? It is important because economic cycles are incredibly powerful and long lasting – once they get going they overwhelm almost all other considerations and with very few exceptions, they play out over years, not months. That being said, we believe we are in the very early stages of this economic recovery. For those who like baseball analogies, we are in the second or third inning.

However, despite this belief, our outlook doesn’t begin and end with the economic cycle. We also consider valuation, liquidity and sentiment. Let me tackle these one at a time.

First, to determine valuation we typically start with a price/earnings multiple. For the S&P 500, the current forward four-quarter multiple is 13.7x as of April 19, 2010. This is based on an S&P value of 1,194 and a forward four-quarter earnings estimate of \$87.36. This earnings number has been steadily increasing and is up 10% since April 1, 2010. To put this current multiple in perspective, the average multiple over the last couple of decades is about 15.0x. So on this basis, stocks are currently not expensive.

Second, liquidity has been, and remains, very favorable. The Federal Reserve has reduced short term borrowing rates and has pumped an incredible amount of money into the economy over the past two years. Will it end soon? It has already started to end a bit - but the Fed Chairman, Ben Bernanke, continues to consistently commit to keeping liquidity very high for an extended period of time, and in front of the November elections. We can't imagine he won't have complete Democratic support.

Finally, we also track investor psychology. There are many ways to do this, but one good overarching measure with years of history is the weekly Investors Intelligence survey. The idea here is that if everyone who is surveyed is bullish, there is no one left to buy stocks. It is a contrarian indicator. This measure is currently indicating a bullish sentiment, but not extremely so.

In general, this year-long rally has been met with skepticism. How many times have we all heard that "Wall Street is way ahead of Main Street" and does not reflect the true economic pain still being felt by the average family? This is doubt and skepticism. Once people stop saying and writing this is when from a psychological perspective, we should begin to worry.

We know this is a very cursory treatment of these important topics, and we will flesh them out more in coming letters, but the gist is that we are only at the beginning of a recovery in the economic cycle combined with below average valuations, high liquidity and a generally skeptical public. I believe this is a recipe for continued stock market gains. We most certainly will have periodic bumps in the road as we encounter unforeseen bad news (i.e. Goldman Sachs fraud), deal with federal and local government deficit and debt struggles, or as we get temporarily over-exuberant every now and then, but the bigger trend is up and will remain so until some of these large pillars begin to crumble.

This rationale also carries over to emerging market equities, where growth is even faster than in the U.S. and balance sheets are much stronger. As a result, we are overweight select emerging markets. We will cover our rationale on this topic in next month's letter. Until then, have a terrific spring!