January 2010

AmegyBank
Investment Management

Markets Commentary

"Bull markets are born on pessimism…

… grow on skepticism, mature on optimism and die on euphoria."
-John Templeton

That is one of our favorite quotes about capital markets and certainly prescient for the year of 2009.

The year 2009 was one of the "narrowest" years in sector performance since 1982, meaning that only 3 of 10 S&P 500 sectors outperformed the index (Technology, Basic Materials and Consumer Discretionary). Tilting portfolios to the right sectors and themes was very important.

Emerging Markets and Mid Cap securities led in overall performance, so 2009 also showed that diversified portfolios do indeed work; even though that assumption was widely challenged less than one year ago after the Financial Crisis. We also learned that the media "strategy of the day" to buy only value stocks and bonds after the crisis was terrible advice, since growth stocks dramatically outperformed value stocks and equities dramatically outperformed fixed income.

After a period of unprecedented volatility and historic events, capital markets have now become more normalized, so the factors of investor psychology, liquidity and valuations should once again be most relevant for producing an outlook.

Economic growth may be stronger than expected in 2010

There are several reasons we believe that economic growth may be stronger than expected in 2010.

Yield Curve says so - The best economist in the world is still the yield curve and it continues to point towards strong economic growth, just as it did last year when many of us discounted it. As the release of Q4 GDP numbers approaches, we expect to see stronger than expected economic growth. As recently as six months ago, the notion of 5-6% GDP growth was unimaginable, but that may actually come to fruition.

"Kitchen Sink" political year – Politicians want to get elected. With elections in the Fall, we expect to see extraordinary measures taken to make the economy, housing, and employment situations as positive as possible. This is what we call a "kitchen sink" type of year. Some of these measures will be broadcast and some will be done quietly. Here is an example of a quiet measure from our friends at Ed Yardeni Research: on Christmas Eve 2009, the Treasury quietly lifted the credit limit on Fannie Mae and Freddie Mac, which allows them to borrow as much as they want. This was probably done to allow them to buy as many mortgages as possible and protect against continued housing weakness in 2010 as the Fed steps away and talks about their "exit strategy". This is an example of a quiet, extraordinary measure taken during a political year. We expect to see many more "kitchen sink" type of actions before the elections this year in November.

Productivity – Output is being boosted by productivity, which was extremely high in Q3 at 8% and expected to be at a high level again for Q409 and 2010.

Employment – The recovery in employment is happening faster than most expectations. To this point in the cycle, it is following the trajectory of a 1981 type severe downturn and strong upturn. The absolute levels are still low, but the leading indicators such as temporary workers are starting to turn upward.

Equities still look attractive, just not as attractive as last year

The good news is that the bad news was not nearly as bad as what was feared. There are many reasons to continue to be positive on equities this year even after the large rally they have experienced.

Investor positioning – Most investors are positioned too defensively as there continues to be a large amount of cash on the sidelines that will eventually need to be invested in something other than the miniscule yields of money markets. One of the most remarkable statistics was released in November 2009 and it reported where mutual fund flows had gone through November of 2009. Over 90% of all fund flows tracked went into fixed income, while only 10% went into equities. Of the equity percentage, there was a net outflow of money leaving domestic equity funds through November of 2009 (the remainder went into international equity). So, during a year that the S&P 500 Index was up 26%, there was a net outflow of money out of domestic mutual funds.

Dividend yields – As we highlighted last year, yields on equities are higher than yields on Treasury Bills for the first time in 50 years. The yields on equities will continue to look tempting compared to what investors are getting in short term fixed income or money markets.

Valuations – Valuations are very reasonable on many different measures. One valuation measure that is making a comeback from the 1960s is called "The Rule of 20". The "Rule of 20" simply states that the forward multiple of the S&P 500 Index should be 20 – (10 year Treasury yield). So, today it would state that fair value would be 20 – 3.5 = 16.5 or the S&P 500 Index should be trading at 16.5 times its forward earnings estimates. Since it is only trading at 14 times its forward earnings, this valuation measure would say that it is undervalued. "The Rule of 20" and other measures like Earnings Yields are good at adjusting for the inflation environment. Just as high inflation should cause lower multiples on earnings, lower inflation should support higher multiples on earnings.

Age – If this is the start of a new bull market (and we believe it is), they don't usually end after nine months. Historically, bull markets last for years.

Fixed income may be a difficult environment to navigate the next few years

After completing the greatest bull market ever in fixed income from 1981 to the present, the environment going forward looks very different. We have witnessed interest rates decline from 18% in the early 1980's to virtually 0% today. This has resulted in a tremendous tailwind for fixed income performance (as interest rates go down, bond prices go up leading to appreciation) and this has been coupled with higher absolute coupon rates.

Very different environment - Today we have the prospects of increasing interest rates at some point in the future from zero; as well as low coupon rates to act as a buffer for performance. Not since the late 1940's – early 1950's has the environment been similar and the results for fixed income were not good. Fixed income produced negative real rates of return (didn't keep up with inflation) and actually declined in absolute performance for the decade of the 1950's.

Will history repeat? - We expect the historical returns of fixed income, many of which were part of that massive bull market since 1981, to look very different than what the media was recommending after the Financial Crisis (sell stocks, buy bonds forever). During the 1950's, there was a very large divergence of relative returns between equities and fixed income. Keep in mind that we witnessed U.S. Treasuries up 1-2% in 2009 while the S&P 500 Index was up 26% for equities which is a large relative difference. Our opinion is that fixed income is going to be a more difficult environment to navigate through than what current sentiment is reflecting.

Best regards,

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Sources: Bloomberg, CNN, Financial Times, GaveKal Research, Don Hays, and Ed Yardeni

Disclosure Notes

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It is not possible to invest directly in an index.
Small-company stocks may be more volatile than stocks of larger, more established companies and sector investments tend to exhibit higher volatility than broadly diversified investments.
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