Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

October 2010

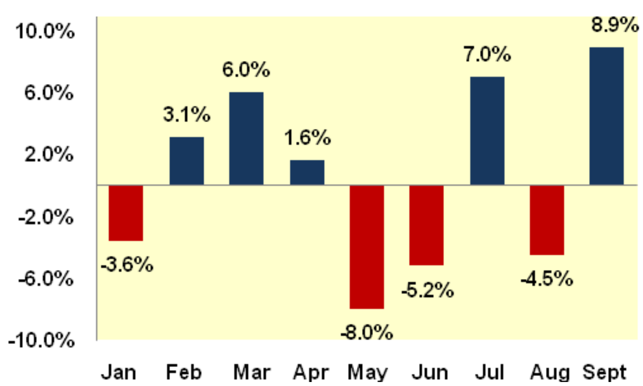
Anxious Investors Ignore Strong Corporate Earnings Rebound

> Most countries in all regions have gone through a prolonged phase
> as serial defaulters on debt owed to foreigners.
> *This Time is Different, Eight Centuries of Financial Folly*
> Carmen M. Reinhart & Kenneth S. Rogoff, 2009

> Those who cannot remember the past are condemned to repeat it.
> *The Life of Reason*, George Santayana, 1906

The U.S. stock market has been on a roller coaster ride in 2010. Rather than focusing on the strong recovery in U.S. corporate earnings this year, investors have retreated from U.S. equities, as the stock market has been buffeted by worrisome macroeconomic conditions and plagued by pessimistic investor psychology. To put this in perspective, the S&P 500 Index operating earnings are on track to rebound 33% from the $62 earned in recession-plagued 2009 to $83 in 2010. Yet the S&P 500 was actually down – 4.6% for the first eight months of 2010. Investor anxiety has caused the stock market to experience a remarkable level of volatility, as individual stocks have frequently moved in lockstep with macro forces (a high degree of market correlation) rather than with company fundamentals. This high degree of volatility was evidenced in May when the stock market dropped 8% – the worst May performance since 1940. Yet in September (historically the worst month for U.S. stocks over the past 85 years, losing an average of 1% during the month), the S&P 500 climbed 8.9%, turning in its best performance since 1939. The chart below chronicles the skittishness of investors, as they tried to make sense of the kaleidoscope of economic and political events around the world:

2010 S&P 500 Monthly Performance (total return)



Source: S&P 500

Investor Psychology

There are many underlying factors that contribute to the trajectory and behavior of the stock market, but most of these factors can be sorted into three general categories: corporate earnings; inflation, the direction and level of interest rates and liquidity; and investor psychology. Two of the legs of this three-legged stool are in reasonable shape. U.S. corporations are generally demonstrating robust and growing earnings, strong balance sheets (low debt and large amounts of cash on hand) and good international prospects. S&P 500 operating earnings are projected to increase 13% from $83 in 2010 to

$94 in 2011, thereby exceeding the previous high water mark of $90 achieved in 2007. The second leg of the stool has rarely been better with short-term interest rates near zero, inflation running at 1%+, and the economy and stock market awash in liquidity. It is the third leg of the stool – investor psychology – which is weak and wobbly and often seems near collapse. And, of course, it is investor psychology which is the hardest to measure and define. But here are the major themes which cause such negative investor psychology and flighty, volatile investor behavior.

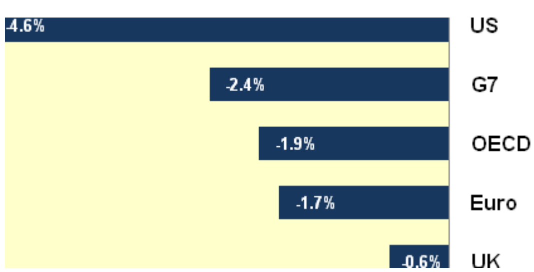
Secular Bear Market

U.S. investors are in the midst of a secular bear market. Currently, the S&P 500 is trading around 1165 – a price level it first reached in 1998. The last secular bear market in the U.S. lasted from 1966 to 1982, and many investors fear that the current one might last 16 years or more, given the problems facing the U.S. economy. In short, individual investors are decidedly negative on U.S. stocks and have withdrawn funds in 2010 from mutual funds investing in U.S. stocks. The flash crash in May shook retail investors and only accentuated the sense that the stock market is not being run for the individual investor.

Fiscal Stimulus is not Working

Investors know that the U.S. economy is in a mess. The enormous deficit spending – without parallel in the history of the U.S. except during World War II – has accomplished little. The U.S. fiscal deficit in 2009 was $1.4 trillion, and for the fiscal year which just ended on September 30, 2010, the OMB estimates the fiscal deficit was $1.3 trillion. What did this increase of $2.7 trillion in Federal debt achieve? A tepid economic recovery which appears to have run out of steam! After the strong 4th quarter 2009 GDP growth of 5.6%, U.S. economic growth began to decelerate with the 1st quarter 2010 growing only 3.7% and the 2nd quarter a disappointing 1.7%. Unemployment is stuck at 9.6% with approximately 15 million people out of work. What is the government's prescription to get us out of this mess? More fiscal stimulus in the coming year and the threat of across the board tax increases! The chart below compares the change in total employment from 2007 through the second quarter of 2010 in the U.S. with the U.K., the Euro-zone, the OECD and the G-7. When viewing these numbers, it is important to understand that the annual budget deficits in the U.S. as a percentage of GDP of 9-10% were much larger than in the Euro-zone (6%).

Change in Total Employment
2007 – Q2 2010



Source: OECD data based on all countries reporting as of Sept. 29, 2010

High Debt/GDP = Slow GDP Growth

The gross U.S. Federal debt of more than $13 trillion represents 93% of GDP, which was $14.6 trillion as of June 30, 2010. U.S. net government debt (gross debt less the amount owned by the Social Security system) will reach 70% of GDP by September, 2011. If current policies are maintained, net debt/GDP will reach 90% in 6-8 years. In general, large amounts of government debt have a negative effect on economic growth. Professors Carmen Reinhart and Kenneth Rogoff have done the most significant research on the effect of government debt on economic growth. They have concluded that when net government debt exceeds 90% of GDP, economic growth slows dramatically. The chart below shows the pernicious effect of high government debt levels on economic growth:

Select Advanced Economies 1790-2009
Real GDP Growth with Varying Levels of Government Debt

	Federal Government Debt/GDP			
	Below 30%	**30-60%**	**60-90%**	**Above 90%**
Average GDP Growth	3.7%	3.0%	3.4%	1.7%
Median GDP Growth	3.9%	3.1%	2.8%	1.9%
Number of Observations	866	654	445	352

Source: "Growth in a Time of Debt," Carmen Reinhart and Kenneth Rogoff; Charles Schwab

The problem facing the U.S. is that deficit spending is on steroids. Such spending will lower economic growth, which will result in chronically high unemployment. Many European countries have lived with this dilemma for decades. On the other hand, the U.S. has maintained a net debt/GDP level of 40% from the 1950s through 2008. It has also experienced average GDP growth of 3% for this same period. If U.S. GDP growth remains at the 2nd Quarter, 2010 level of 1.7%, the new entrants to the labor market cannot be absorbed, which will cause unemployment to remain mired at the 9-10% level.

Monetary Stimulus: Inflation or Deflation?

Another source of negative investor psychology is the Fed's current monetary policy. The Federal Reserve Bank has executed a program of enormous monetary stimulus, injecting massive liquidity into the markets, and reducing short-term interest rates to nearly zero. Will this stimulus ultimately cause skyrocketing inflation or is this monetary stimulus necessary to prevent deflation? The stimulus helps banks rebuild capital and aids consumers/homeowners in refinancing their mortgages and paying less on consumer debt. Yet, excessively low interest rates from 2001-2003 helped cause the housing boom. Asset bubbles in gold, commodities and U.S. Treasury bonds already seem to be building. Rather than worrying about the threat of inflation, decision makers seem to fear deflation even more. They point to the global marketplace which has enabled many millions of well-educated workers in emerging countries to compete with U.S. workers for jobs, resulting in job outsourcing and wage pressures for U.S. workers. The housing bust has also unleashed deflationary pressures, as household net worth has shrunk and many who wish to relocate for a new job cannot sell their houses. It is likely that it will take consumers some years to reduce the excessive leverage taken on over the past two decades. It is difficult to recall a period when investors needed to worry about the possibility of both inflation and deflation. This anomaly has clearly added to negative investor sentiment and market volatility.

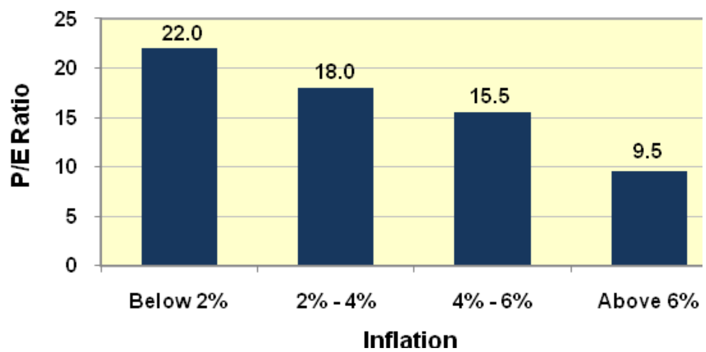
Taxes and Regulation

John Maynard Keynes is best known for his theories on how fiscal stimulus can counter economic contraction, but Keynes also understood well the part that "uncertainty" plays in preventing economies from performing at full potential. He wrote that economies perform really well only in moments of "excitement" or "animal spirits." Today, uncertainty rules the day. CEOs and small business owners alike are unwilling to commit capital to new projects and hire new employees without clarity about whether the Bush tax cuts will expire in 2011 and how the myriad new rules and regulations in the 2000+ page health reform legislation and 2319 page Dodd-Frank financial reform bill will affect their companies. Moreover, many banks are reluctant to lend while rebuilding their capital and many firms are unwilling to borrow in the face of such uncertainty. As Roger Lowenstein recently wrote in *The End of Wall Street*, "Credit can always be manufactured – not so the willingness to borrow, which rests on faith in the future." The stock market's 12% rise since August 31 may stem, in large part, from investors' betting that the chances for higher taxes and more regulation will diminish after the November elections.

U.S. Stock Market's Valuation Reflects Investor Fear

With the Dow Jones at 11,000, the P/E ratio for the Dow is 13.3 based on 2010 operating earnings. With inflation in the U.S. running at approximately 1%, the market's valuation of these companies appears quite modest, as the chart below shows. Historically, the inflation environment has had a significant influence on the valuations of stocks, with investors willing to pay more when inflation was low and less when inflation was high.

Average S&P 500 Price-to-Earnings Ratio in a Given Inflation Environment 1948-2010



Source: S&P 500, Bureau of Labor Statistics, Fidelity Investments

With inflation below 2% (as is the case now), the average P/E ratio during this 62-year period was 22.0 on trailing earnings. If the S&P 500 produces 2010 earnings of $75 (a conservative estimate), the resulting P/E on trailing earnings (with the S&P 500 at 1160) will be 15.5 – *fully 30% below the average valuation shown in the chart above.* Why the discount? Investors appear to have come to one of the following two conclusions: 1) the U.S. is in for a period of serious deflation (as in 1929-1933) with severe economic contraction, lower corporate earnings and lower stock prices (and the market is therefore correctly valued); or 2) the stock market is significantly undervalued but the U.S. is on an unsustainable financial path. This will usher in a new paradigm of low GDP growth, slower earnings growth and ultimately permanently lower valuations than in the past (and therefore the market is correctly valued). There is a third option: At Bradley, Foster & Sargent, Inc., we believe that the stock market is significantly undervalued (due to the real economic problems which the U.S. faces and to negative investor psychology), but we also believe that the U.S. will ultimately right the financial ship, finding practical ways to solve its problems (the coming election seems to have restored some investors' animal spirits already). With the free cash flow yield of many solid companies at 7-8% compared with the 2.4% yield of the U.S. Treasury note, many quality stocks represent real bargains. We believe that this third option is compelling, but we will remain vigilant and prepared to act if the evidence proves us wrong.