

## U.S. Equity Monthly Newsletter July 2010

### *What's Holding Equities Back?*

We are now seven months into the year and equity markets, as measured by the S&P 500, are virtually unchanged since the start of the year. While this is a nice improvement since June 30<sup>th</sup>, it is disappointing to us relative to the fundamentals. By the fundamentals I mean earnings growth, valuation and other investment alternatives.

Earnings growth is great! The S&P 500 is expected to post 30%+ earnings growth this year. Your holdings at W.P. Stewart are expected to achieve growth in the high teens in 2010. We believe your earnings growth rate catches up, and surpasses, the more cyclical S&P 500 in 2011. So it does not look like earnings are the problem for your portfolio or the broader market.

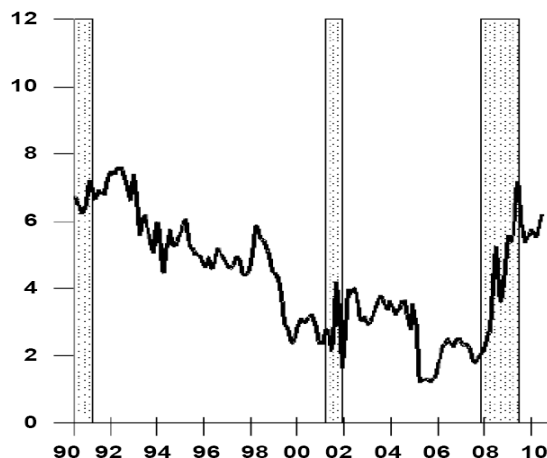
Let's look at valuation. The market is currently trading around 12 times expected 2011 earnings. Given the presumed faster growth of your holdings, your portfolio is trading around 14 times expected 2011 earnings. This is well below our historical average of 22 times over the past two decades. Importantly, your current multiple is only one point above the bear market low reached in March of 2009. We think the environment is significantly improved since then but you are paying close to the same multiple. In our view valuation is not the issue either.

Surely there must be juicy returns in other markets that are luring money away from equities. With cash yielding near zero percent, medium-term corporate notes near 3% yields and 30-year Treasury bonds near 4%, we are having a tough time seeing what is so exciting elsewhere. Yet money keeps flowing in that direction, defying the predictions of many.

So why is all this going on? Why have equity prices not improved this year in spite of good fundamentals? In our view, it all comes down to one word...confidence. We believe the U.S. economy and the equity markets are being restrained by a lack of confidence. I'd like to walk through some of the indicators we look at and more importantly, how this lack of confidence could change.

The economic retreat in 2008 and the resultant market pullback have deeply shaken the faith of companies and individuals creating a more cautious outlook for both groups. We appreciate this development and view this as a reason that the economic recovery has been sub-par. We see three developments that are indicative of this concern. The first is the consumer savings rate which was recently reported at 6.2%, the second highest point since the early 1990's and compared to a range of 1% to 4% over most of the past decade.

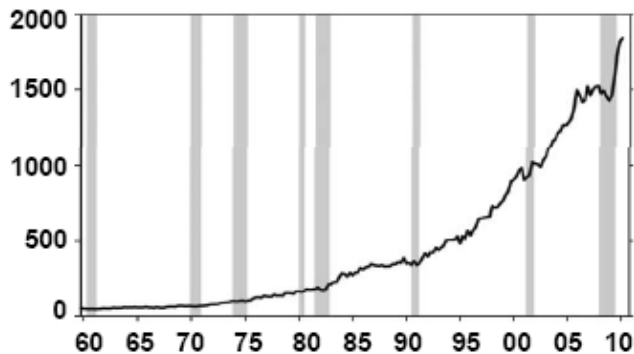
**Figure 1. U.S. Saving Rate—3 Month Average**



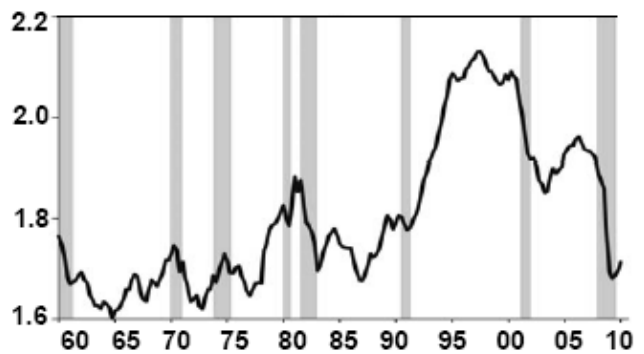
Source: ISI Group

The second is corporate balance sheets that have more cash than at any point in history. The third point is an outcome of these two factors; the velocity of money is back down to where it was in 1987 and is roughly 20% below its peak.

**Figure 2. U.S. Nonfinancial Corporate Liquid Assets (\$ Bn)**



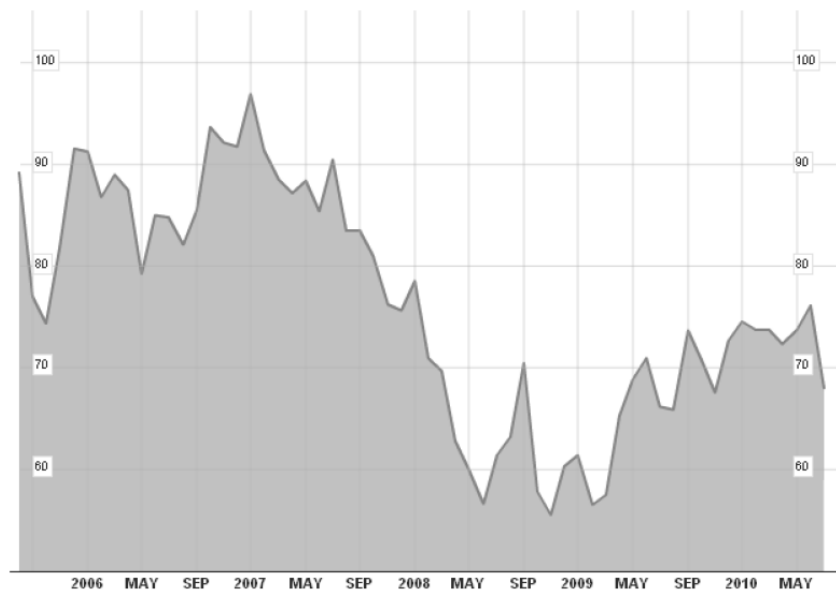
**Figure 3. U.S. Velocity of Money**



Source: ISI Group

The big picture seems to indicate that companies and individuals are afraid to spend and have therefore turned into savers and hoarders of cash. While this is not necessarily a bad thing, it is a depressant on the economy, especially when interest rates are so close to zero. Given that the economy has been improving for more than 12 months and the unemployment rate topped out six months ago, and is down 1% since then, this fear seems to be driven from the unknown. With financial and healthcare reform bills already passed (but the implications not well understood) and energy and tax bills still to come, companies and individuals are more wary of government involvement than ever before. To quote a small businessman we spoke with recently in Pittsburgh, “How can I invest or grow my business when I don’t know what healthcare costs or taxes are going to be? I am in wait and see mode.” Unfortunately, this seems to sum up the collective mindset of our nation right now. This is evident in July’s consumer confidence reading that fell sharply after generally climbing for the past 15 months.

**Figure 4. Consumer Confidence**



Source: Bloomberg

Good news in the form of clarity could be just around the corner. Like many investors, we believe that checks and balances in government are a good thing. The reality is that the three branches of government have been in the hands of one party for the past 18 months. The November elections could bring about power sharing in Washington which could be a positive development. Some conviction or evidence that Washington might lessen the current anti-business stance and possibly extend the current tax cuts for all earners might be a welcome change. We believe this could propel equity valuations higher, restart corporate spending and hiring and encourage individuals to spend responsibly rather than save cash out of fear. In our view, restoring confidence will go a long way toward ensuring that the economic recovery continues, or even accelerates.

We believe the best investment approach during a time of uncertainty like this is to find companies that can grow earnings through any environment. This has been a hallmark of what we do at W.P. Stewart but we have redoubled our efforts on this front. In July, we added to our investment in companies like Amphenol, Apple and Google as they are all growing earnings at a 20%+ clip and we believe can continue to grow at a robust pace in any foreseeable environment.

While we can't promise that sentiment will change soon, when faced with the fundamentals of strong earnings growth, attractive equity valuations and a spirit of innovation among your portfolio holdings, we like the prospects for making serious money in high quality growth stocks over the next five years.

We look forward to reporting on our progress over the remainder of the year and encourage you to contact us if you have any questions.

Kindest regards,



Jim Tierney  
Chief Investment Officer  
W.P. Stewart & Co., Ltd.