

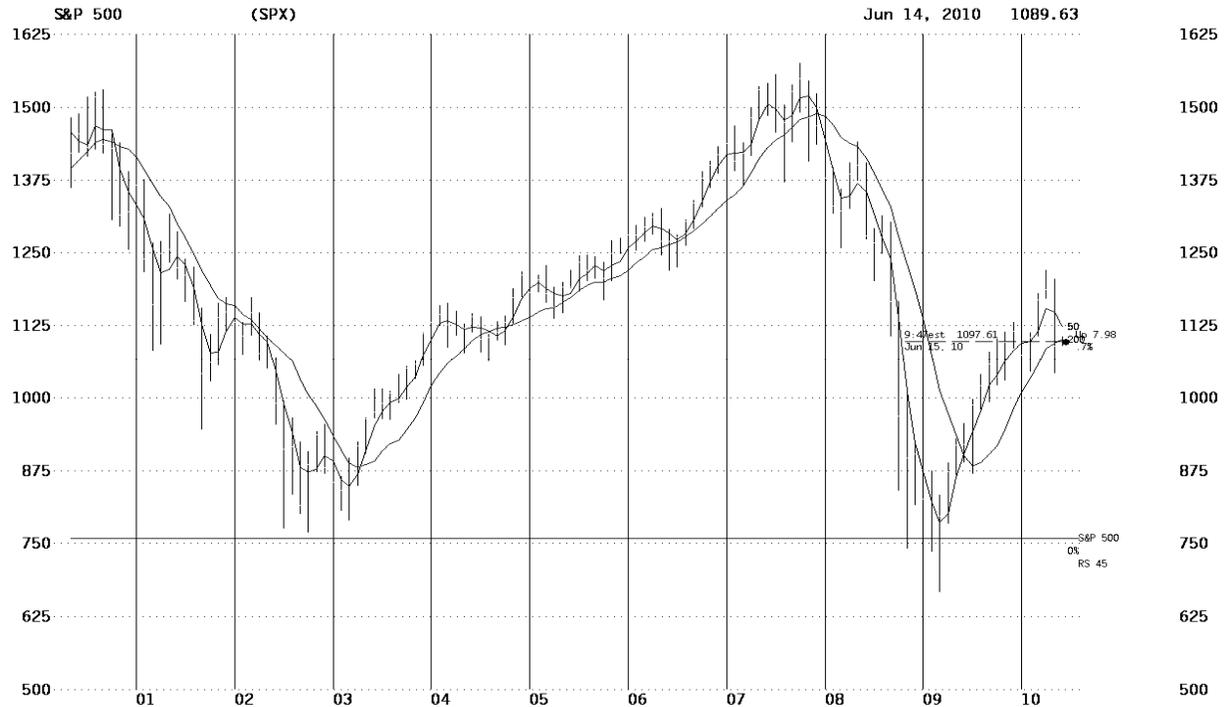


## U.S. Market Report

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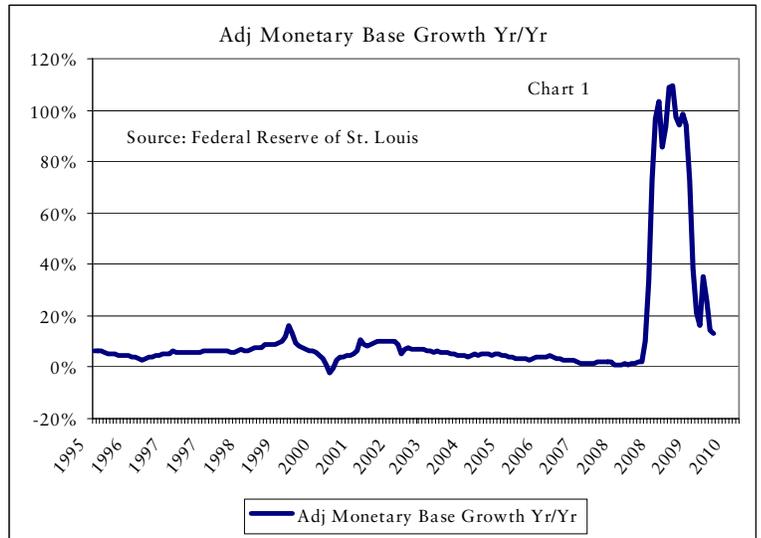


### REVIEW & OUTLOOK

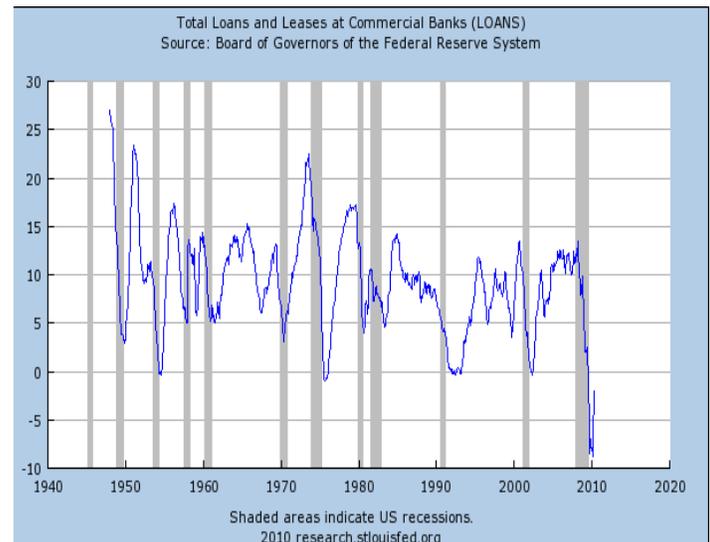
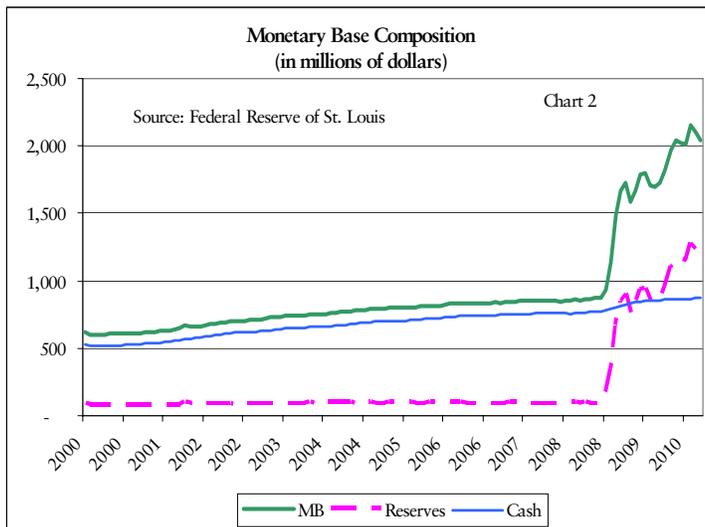
Since April 23<sup>rd</sup>, the U.S. has been experiencing what we view as a normal correction within the context of a Bull Market. We wouldn't be surprised to see prices bounce a great deal over the current summer, with some sharp rallies and equally sharp sell-offs. Nonetheless, we expect prices to be substantially higher one year from now. Equity portfolios should sharply outperform fixed income, cash or real estate over the next twelve months. Our bullishness is based on several factors: 1) the economy is coming out of a deep recession and corporate earnings still have plenty of room to grow; 2) the S&P 500 is nearly 30% undervalued based on our valuation model; 3) there is little inflationary pressure currently in the pipeline; 4) interest rates are expected to stay low through the end of the year; 5) measures like the CBOE Volatility Index, which measures the level of risk implicit in stock option prices, tells us that investors remain very nervous and are likely underinvested in equities—there is lots of sky above us. The best time to accumulate stocks is when valuations are attractive, business has begun to expand and people are fearful. From our perspective, we are there.

## ECONOMICS

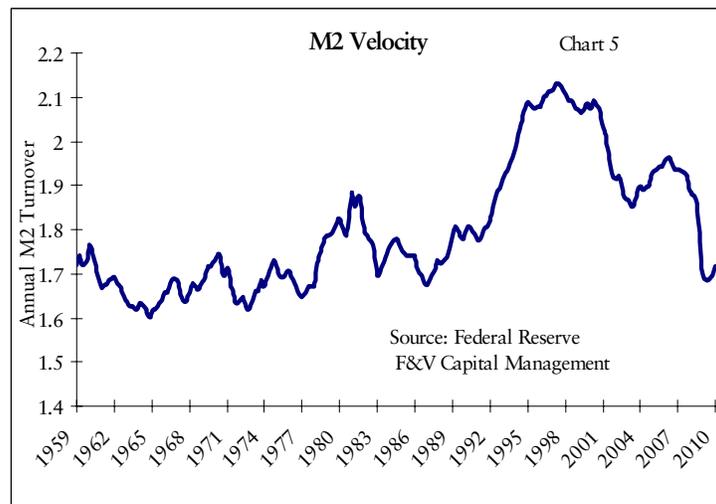
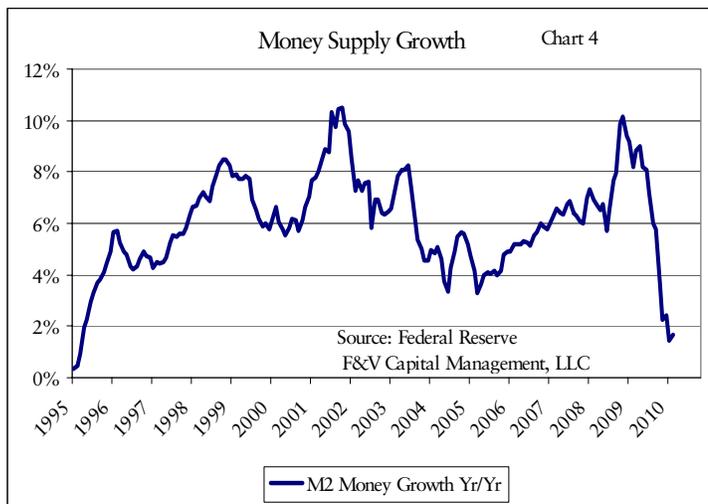
Widespread fears to the contrary, there is very little risk of inflation. We have heard from our clients and other contacts that many people, particularly in Germany, are concerned about rising inflation. Part of the concern stems from the ECB's plan to buy the sovereign debt of certain countries. And, in the U.S., the famous chart of growth in the U.S. Monetary Base is often cited (see chart 1). Indeed, there have been many market commentators in the U.S. that have pointed to the chart and voiced concerns about coming inflation. But for the next year or two, at a minimum, we do not see a material inflation risk and here's why:



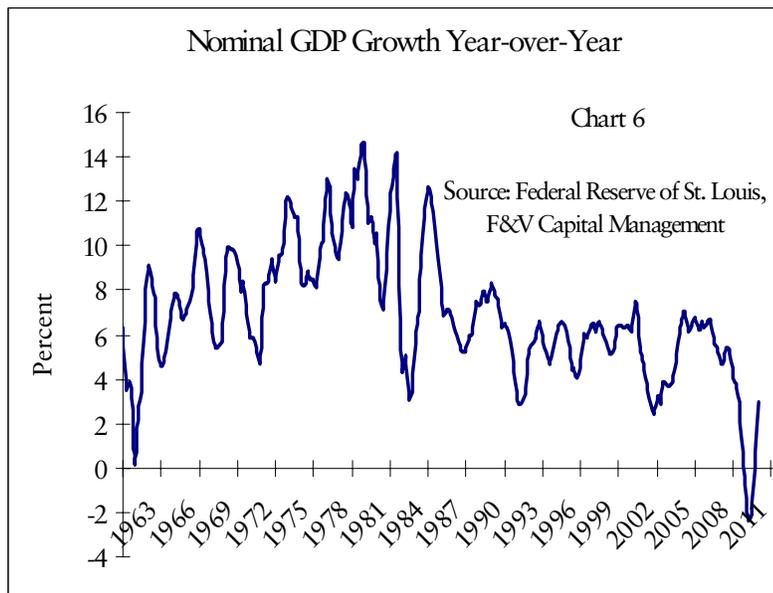
**The Monetary Base (MB) and the money supply are not the same thing.** The monetary base includes cash and coins, but not deposits by individuals or businesses at banks. The MB's biggest component is now bank reserves at the Fed (see Chart 2). While cash has had a steady, normal ascent, an explosion in bank reserves has sent the MB skyward. Two factors have been at play. First, since the financial crisis of 2008 began, banks have been reluctant to lend to themselves or anyone else. As a matter of preservation, the bank managers have raised lending standards and in some cases totally withdrawn from certain markets. This has led to an unusual decline in bank lending (see Chart 3). Year-over-year growth in loans and leases decreased nearly 10% during the recession, a rate of decline that has been unprecedented during the post-war period. Second, the Federal Reserve did exactly what it should do. It stepped in and acted as lender of last resort and provided the liquidity that was being demanded by banks, businesses and individuals throughout the economy. The Fed created liquidity by purchasing already existing debt securities that were lacking markets as well as by creating new lending vehicles for businesses. These two factors—a lack of bank lending combined with new liquidity generated by the Fed—resulted in banks accumulating much of the new liquidity in the form of reserves.

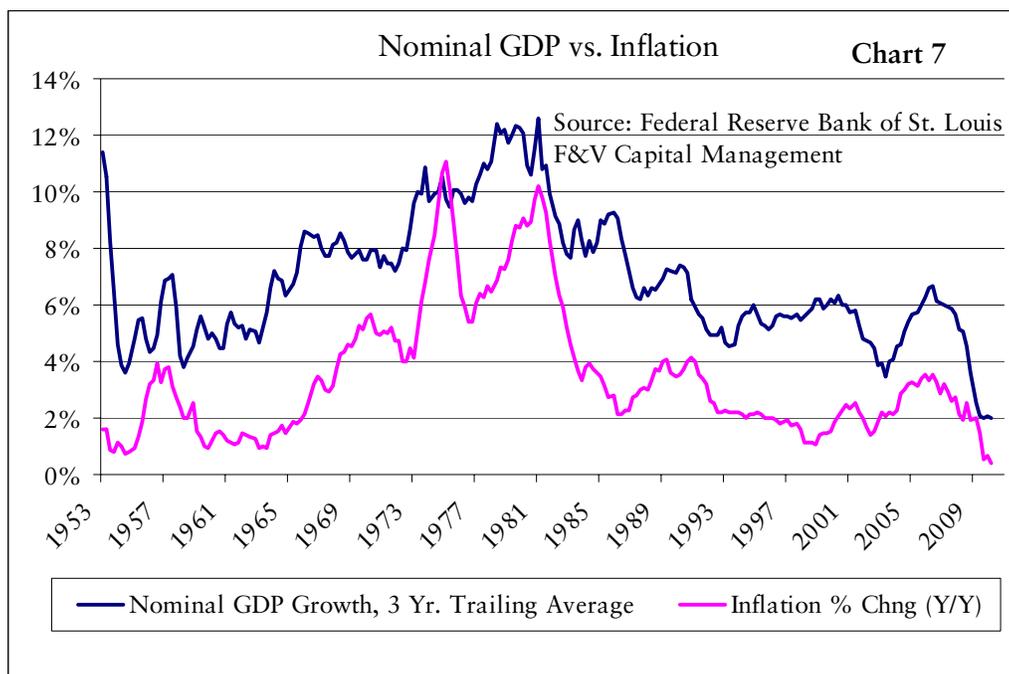


The Money Supply did grow at a decent speed in 2008 and 2009, but at nothing like the rate of growth in bank reserves. Furthermore, money was hoarded and spending declined. Whereas the year-to-year growth in the monetary base peaked at 109% in May 2009, the M2 money supply peaked at 10% in January 2009 and has since been declining (see Chart 4). More importantly, the velocity of money, which is the rate at which it turns over, has been declining for the past decade and fell at a very rapid pace during this past recession (see Chart 5). Money velocity is a function of people's willingness to hold money balances. If people fear inflation or wish to hold smaller money balances for other reasons, they will treat money like a hot potato and accelerate spending. Conversely, when people are increasingly risk adverse and wish greater money balances, spending decelerates as money is hoarded. This is what we have seen in this cycle: extreme growth in the monetary base (109% peak) has only resulted in moderate growth in the money supply (10% peak) which has still resulted in a decline (-2.4% trough) in nominal spending (see Chart 6).



Money is inflationary only if it is spent. With spending growth over the past few years so low, inflation is just not on the horizon. The government can print as much money as it wants but if we dump the cash in the sea or store it all under our beds it can't create inflation. Money must be spent to affect prices. Chart 7 shows the trailing three year growth rate of nominal spending (Nominal GDP). We use a three year trailing average because the price level is sticky, so to speak, and ordinarily responds to changes in spending growth only after a sustained period. As shown in the chart, spending growth over the past three years has fallen to an average of only 2% and more recently has been negative (the year-to-year rate can be seen in Chart 6). Aside from low inflation, the low level of spending also is consistent with the low long term interest rates.





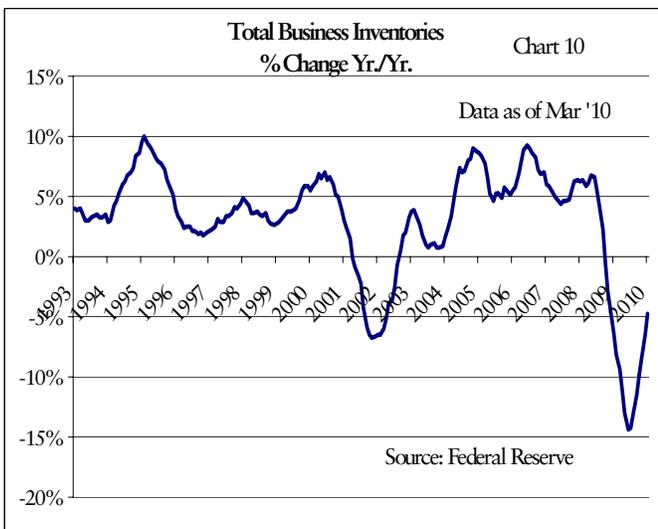
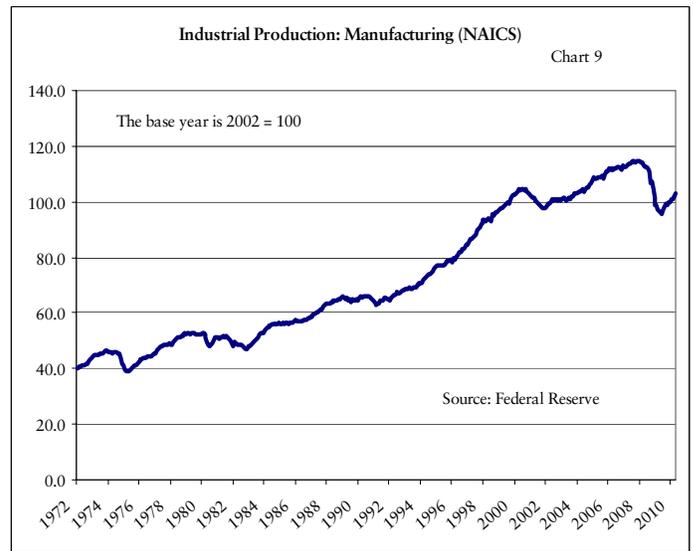
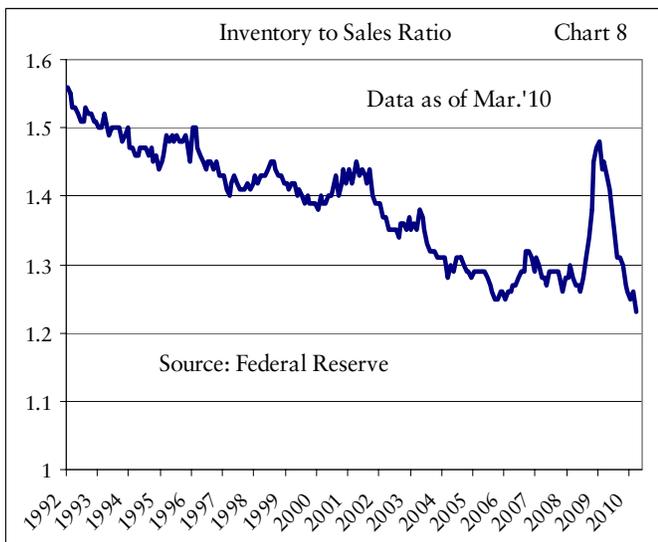
The U.S. economy is now experiencing moderate real growth in the 3.0% to 3.5% range (see Table 1). Over the long term, real growth in any nation is a function of factors like population growth, capital investment and the functional operations of institutions like the legal system, universities and government, which impacts growth via taxes, spending and the regulation of business. But, shorter-term, the business cycle is driven by monetary policy and the swings in the behavior of businesses with regard to production, inventory control and the hiring and firing of employees. Overbuilding in the US real estate sector led to a contraction in real estate prices, which quickly resulted in a contraction in spending. The first order effect has been that inventories quickly ballooned relative to the lower sales level (see Chart 8) Businesses reacted in the rational fashion by cutting production (Chart 9) and employment. This business cycle is now playing out in the typical fashion: the Fed reduced short term interest rates and added liquidity to the banking system in order to stimulate nominal spending, and industrial production is increasing as businesses move to rebuild inventories (Chart 10).

**Table 1: U.S. Growth and Inflation**

	Nominal GDP Growth	Real GDP Growth	Inflation
1990	5.8%	1.9%	3.9%
1991	3.3%	-0.2%	3.5%
1992	5.8%	3.4%	2.4%
1993	5.1%	2.9%	2.2%
1994	6.3%	4.1%	2.1%
1995	4.7%	2.5%	2.1%
1996	5.7%	3.7%	1.9%
1997	6.3%	4.5%	1.8%
1998	5.5%	4.4%	1.1%
1999	6.4%	4.8%	1.5%
2000	6.4%	4.1%	2.2%
2001	3.4%	1.1%	2.3%
2002	3.5%	1.8%	1.6%
2003	4.7%	2.5%	2.1%
2004	6.5%	3.6%	2.8%
2005	6.5%	3.1%	3.3%
2006	6.0%	2.7%	3.3%
2007	5.1%	2.1%	2.9%
2008	2.6%	0.4%	2.1%
2009	-1.3%	-2.4%	1.2%
2010e	4.1%	3.5%	0.6%
2011e	4.1%	3.1%	1.0%

Sources: the Federal Reserve; 2010 and 2011 real GDP estimates by JP Morgan; nominal GDP and inflation estimates by FVCM.

Inflation as measured by the GDP Deflator.



The biggest risks to U.S. growth come from government policies and from the international front. The Obama administration and Congress has been passing a blizzard of new rules and regulations which may very well be justified on some level, but also will carry some cost to the economy. Also, on January 1, 2011, the Bush tax cuts that took effect in 2003 will expire. At that time, the top marginal tax rate on ordinary income will rise to 39.6% from 36%, the tax on dividends will rise to 39.6% from 15%, the capital gains tax rate will rise to 20% from 15%, and other taxes such as the inheritance tax will rise. The argument is that tax rates must rise because of the enormous rise in government spending under Obama, but we think the net result will be a drag on growth. The other drag on growth is the weakness in the European economy. The U.S. real estate markets are likely to remain soft and prices depressed for several years. Because of the “wealth effect,” soft real estate values will likely depress consumer spending growth for several years and the U.S. economy will be increasingly dependent on exports. Coming out of the depths of this recession, improvement in the trade balance has been a contributor to U.S. growth, but a continuation of those trends is uncertain.

**Chances are that growth will continue into 2011 and beyond.** It is true that in places like Zimbabwe, Cuba and now Venezuela, that despotic governments can do such damage that an economy goes into a long term contraction and even ruin. However, amid the gloom that many people are now feeling, it's always best to keep in mind that in most places like Germany and the U.S. the natural order is that the economy expands with only occasional periods of decline. And when we look at the data, it seems to us that the U.S. economy has only begun to re-expand. As shown in Chart 11, new manufacturing orders are now solidly back to the high levels of the most recent expansion. With new orders staying strong, businesses will have to keep adding to production and rebuild inventories as well as meet growing final demand. Thus far, there has been a reluctance to significantly increase employment because of the costs involved, but other indicators like a lengthening of working hours suggest that employment gains have just begun. Indeed, as shown in Chart 12, the unemployment rate appears to have peaked as jobs have been added in recent months. As businesses are essentially forced to rehire workers in order to meet demand, economic growth will become what some describe as self-sustaining: Job growth leads to income growth which leads to spending growth which leads to production growth which leads to more job growth.



## THE US EQUITY MARKET

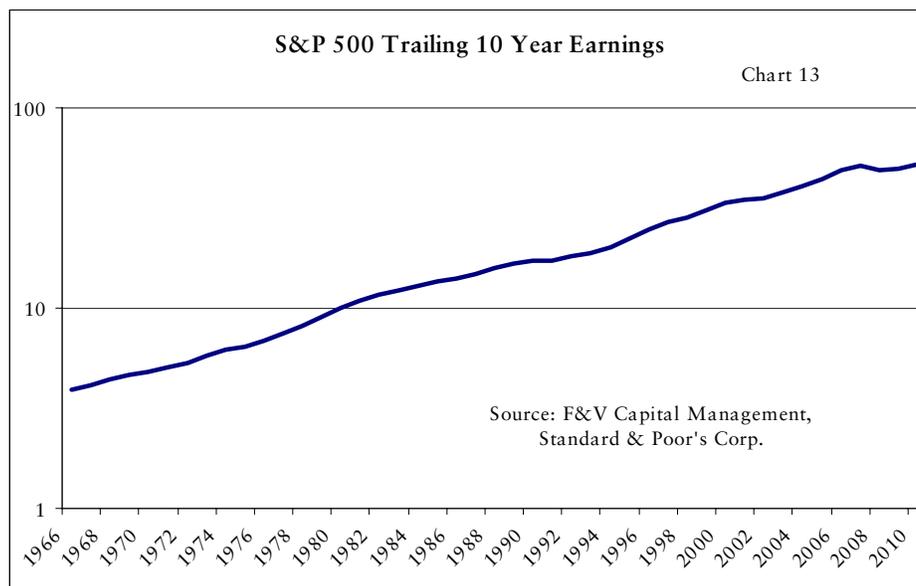
Earnings forecasts are still trying to keep up with the actual growth rate of earnings. Because corporate earnings were so deeply impacted by the recession (see Table 2 for details), expectations among analysts had become quite depressed. For nearly a year now, consensus earnings estimates have been rising. For example, the consensus estimate of 2010 operating earnings for the S&P 500 was 67.1 back in August 2009. That consensus has steadily risen and is now up to 80.3, versus our current estimate of 87.76. This rebound in expectations has been a primary driver of this first leg up in stock prices. Over the next twelve months, the market is likely to be fueled more by earnings growth itself, as opposed to increases in estimates (i.e., the first derivative, not the second). This shouldn't be a problem, however, as we expect operating earnings to rise 9% next year on top of the 35% gain this year we are forecasting. Revenues are anticipated to increase a relatively modest 6% in 2010 and 8% in 2011, but margins are still widening thanks to higher capacity utilization and rapid growth in labor productivity.

**Table 2: S&P 500 Revenues and Earnings**

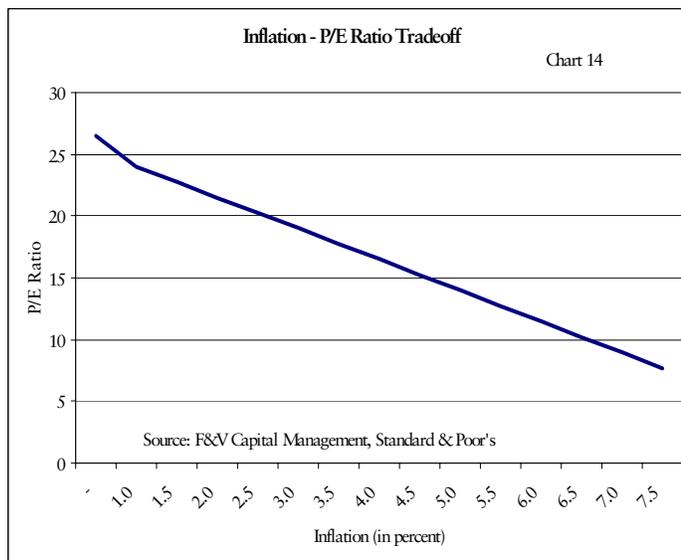
	Revenue	Operating Earnings	Special Charges	Net Earnings	Operating Margin	Net Margin
1987	373.84	19.31	1.81	17.50	5.2%	4.7%
1988	408.19	27.65	3.90	23.75	6.8%	5.8%
1989	461.15	24.46	1.59	22.87	5.3%	5.0%
1990	509.08	23.22	1.88	21.34	4.6%	4.2%
1991	512.57	19.03	3.06	15.97	3.7%	3.1%
1992	523.64	22.75	3.66	19.09	4.3%	3.6%
1993	527.22	26.54	4.65	21.89	5.0%	4.2%
1994	552.06	31.28	0.68	30.60	5.7%	5.5%
1995	598.41	37.71	3.75	33.96	6.3%	5.7%
1996	616.43	41.18	2.45	38.73	6.7%	6.3%
1997	640.40	45.08	5.36	39.72	7.0%	6.2%
1998	634.51	44.49	6.78	37.71	7.0%	5.9%
1999	663.21	50.88	2.71	48.17	7.7%	7.3%
2000	712.28	56.34	6.34	50.00	7.9%	7.0%
2001	732.41	45.17	20.48	24.69	6.2%	3.4%
2002	675.93	48.13	20.54	27.59	7.1%	4.1%
2003	695.36	55.55	6.81	48.74	8.0%	7.0%
2004	777.70	66.99	8.44	58.55	8.6%	7.5%
2005	871.58	76.29	6.36	69.93	8.8%	8.0%
2006	945.17	88.17	6.66	81.51	9.3%	8.6%
2007	1,013.57	86.23	20.05	66.18	8.5%	6.5%
2008	1,061.28	68.63	53.75	14.88	6.5%	1.4%
2009	943.00	65.26	11.29	53.97	6.9%	5.7%
2010(E)	999.58	87.76	7.39	80.37	8.8%	8.0%
2011(E)	1,079.55	96.00	8.05	87.95	8.9%	8.1%

Source: Standard & Poor's Corp. Thomson Baseline. F&V Capital Management, LLC

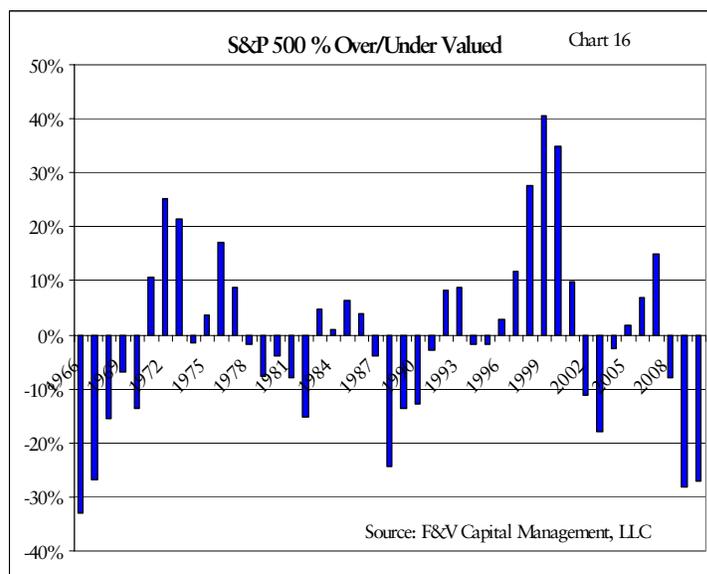
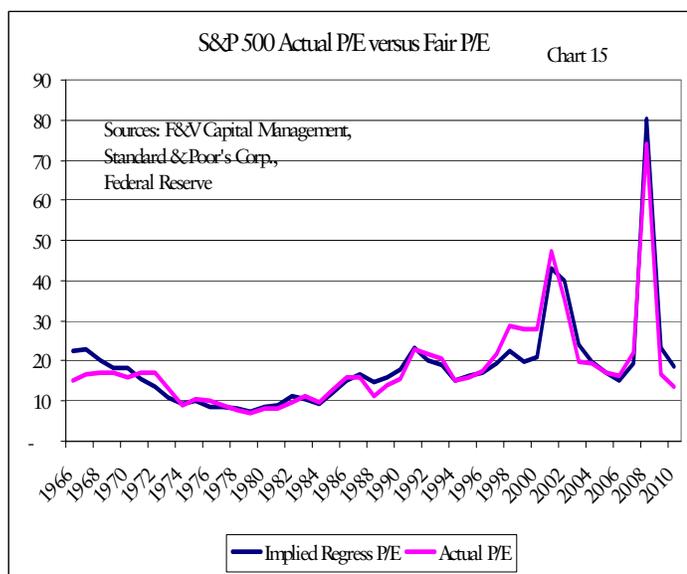
Earnings growth is an important factor in determining the best time to buy stock, but for valuation purposes it's best to smooth out the earnings cycle. During recessions, corporate earnings decline and, thus, P/E ratios tend to rise even though stock prices typically are falling. Conversely, at the peak of an economic recovery, earnings are high and P/E may appear fairly reasonable even though stock prices are rich. In order to use the S&P 500's P/E ratio as a measure of valuation in a way that eliminates this cyclical bias, we use the trailing 10 years of earnings, which is enough to smooth out most of the business cycle effects (see Chart 13).



**Inflation is a critical factor in determining a fair P/E ratio.** A 4% yield on a long term bond may be reasonable if inflation is only 1%, but it would be totally unreasonable if inflation was 5%. Investors need to be compensated for the loss of purchasing power that comes with inflation. For the same reason, P/E ratios are low during periods of higher inflation, and high during periods of low inflation. Chart 14 shows the tradeoff between inflation and P/E ratios for the S&P 500 as calculated by FVCM using a regression model and 60 years of data.



**From a valuation basis, stocks look cheap.** In order to calculate a fair P/E ratio for the S&P 500, we have found that the trailing six years of inflation works out to a good proxy for inflation expectations. In other words, whatever the inflation rate has been over the past six years works out to be a good measure of what people think inflation is going to be in the future. Right now that number is about 2.5% and, as we have previously reviewed, we think inflation is going lower still. This will be good for stock valuations. Our fair P/E model also incorporates the trailing ten years of earnings for the reasons described above, and the results are fairly impressive. Chart 15 shows the close relationship between our model and the actual P/E ratio of the S&P 500 since the mid-1960s. Chart number 16 shows the variance between the two lines, which is our measure of whether stocks are under or over valued given normalized earnings and inflation expectations. The S&P 500 by this measure is some 25% to 30% undervalued.



**The ideal conditions for equities are low inflation, an expanding economy and earnings, low interest rates and an expansionary monetary policy. Right now we have it all.** People are nervous, but this is almost always the case when the markets have gone through difficult times. It is also usually the best time to allocate capital to equities. Market volatility is unpredictable and totally normal. From our perspective, this recent decline in stock prices is an excellent opportunity to add to equity positions.

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