



After the worst four-month stretch in the history of the stock market, October - January, the first quarter of 2009 finished with the best four-week stock market performance since 1933.

Could this latest market rally mean that we have seen the low water mark for stocks? The average stock market drop resulting from financial crises is 55% (inflation-adjusted), right where we were the first week of March.¹ That low put the bear market at 16 months, long even for severe bears.

So far we have seen the effects of mortgage defaults and residential real estate decline. There would seem to be more pain coming, born from the general recessionary effects of corporate real estate and consumer credit defaults; however, the monetary stimulus from several government programs will have a huge positive effect. The fiscal stimulus of tax cuts and increased government spending will also be factors, though less so than the monetary stimulus. For details of any of these massive monetary or fiscal government programs, please ask your investment advisor.

This quarter, the Economy Review shows several indicators which were at all-time lows finally turning north. We also examine specifically whether the stock market may be fairly valued today by analyzing one of the most fundamental value measures, price-to-earnings ratio (P/E ratio).

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Financial Markets Summary

The cliff dive of 4Q08 continued into 2009 for all asset classes through the first week of March. January, 2009, was the worst January in stock market history, and by March 9th the market undercut even its lows of November 22nd.²



Then began the best eight trading days since 1939 whereby the S&P 500 Index increased 17%.³ March, in fact, turned out to be the best month for the S&P 500 Index in six years. By the time 1Q09 ended, we were in an official bull rally, which is defined as a 20% increase in the major indexes.

Still, for 1Q09 the S&P 500 Index declined 11.0%, and the Dow fell 13.3% (including dividends). The banking, real estate and European sectors were hit especially hard, falling 29.6%, 33.4% and 17.9% respectively.⁴

Nevertheless, there were areas showing leadership in 1Q09. Technology stocks were actually positive as a group, while semiconductor stocks specifically rose 9.8%.⁴ The for-profit education sector, which Shaper & Granite uses extensively for its hedging characteristics, performed well. Career Education (CECO) gained 33.6%, ITT Education (ESI) gained 27.8%, and Corinthian Colleges (COCO) gained 18.8%.

The iBoxx Goldman Sachs Bond Index, which Sharper ♦ Granite uses as a bond benchmark, fell 5% in 1Q09 as economic pain weighed on corporations' credit worthiness across the board.

The average of all Sharper ♦ Granite client portfolios fell 6.0% (net of fees) for the first quarter. The risk level of the average of all Sharper ♦ Granite client portfolios was estimated to be approximately 39% less than that of the S&P 500 Index.⁵ Thus, while the average of all Sharper ♦ Granite client portfolios declined in 1Q09, it did beat the S&P 500 Index and Dow Jones Industrial Average significantly. ●

Are Stocks Cheap Today?

The most widely used measure we have for evaluating the fairness of stock prices is the ratio of the stock price to annual earnings. The sole reason a company's stock has value is that investors believe the company will earn enough future profits to pay the equity owners a dividend. If investors have confidence in a company's future earnings, and thus dividend power, they will be willing to pay more for that stock.



Is today's market offering unique buying opportunities for long-term investors? From 1871 – 2008 the P/E ratio for the general stock market has varied between a low of 6 and a high of 30, which it touched in 1999, and it has averaged 15.⁶ When the P/E ratio is well above 15, there will be at some point a downward correction in the price of stocks or a massive increase in earnings to revert the P/E ratio back toward its average of 15. When the P/E ratio is below 15, it implies a buyer's market for stocks, or that earnings must come down much farther.

At current levels the S&P 500 companies are trading at a P/E ratio of 10 times 2008 earnings⁷ and 13 times expected 2009 earnings.⁸ While this is less than the historical average, is it low enough?

If we look deeper at the P/E ratio and its relation to key economic variables, we find a strong correlation between inflation and P/E ratios—the lower the inflation rate, the higher the average P/E ratio, and vice versa. This makes sense when we consider that what we are paying for when we buy a stock is its future dividends. If inflation and interest rates are low, demand for stocks increases as the investment alternative, bonds, will be offering low yields (the case today).

Another reason for the relationship to inflation is that most of the dividend stream you are buying will be delivered well into the future. With low inflation, future cash flows are worth more since high inflation erodes future spending power. Thus, in a low inflation world investors will be willing to pay a higher price for assets that pay off in the future.

This textbook concept is fundamental to the valuation of all assets, but we also see this clearly in the historical data. When inflation is running under 2%, P/E ratios have historically ranged from 13 - 30, and have averaged 21.⁹ Thus, today's inflation level of 0% suggests that our current P/E ratio of 13 may indeed be low given the economic conditions.

Next, what about the accuracy of earnings estimates? Currently, analysts are projecting the gloomiest expected earnings growth forecast on record. The median estimated one-year earnings growth for the S&P 500 companies is now -15.4%.¹⁰ Expectations are about as negative as they can get, keeping the bar low.

Additionally, as the chart below shows, earnings have fallen to 6.2% of national income, well below their long-term average.¹¹ It also shows that profits, even at the 2007 peak, were only slightly above their long-term average. This suggests that there is much room for earnings improvement. Those who project stock prices based on last quarter's or this year's poor earnings underestimate the long-term value of corporate enterprises.

While the P/E ratio is a fundamental value indicator, note that it is not a useful timing device (in fact there are no useful proven timing devices). But then, the long-term investor is not interested in market timing.

Warren Buffet made several stock purchases at the end of last year. He stated that he was not sure whether the bottom had been reached, but that he did not care. Valuations were at a *generally* low level that we will see few times in our lives. The name of the game is to buy low and sell high at a later date. Sometimes investors forget about the importance of the first half of that maxim.

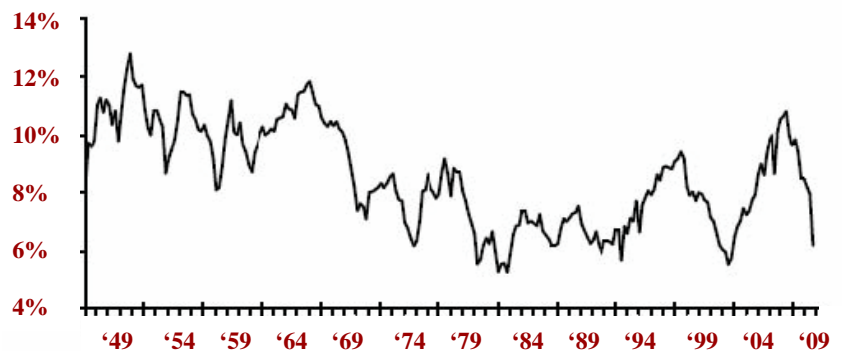
While no one knows when the exact bottom will form and the next bull market will begin, there is one class of investor who is unaffected and sleeps well. The long-term, steady investor does not need to perfectly time the bottom or even worry about market dips. She regularly invests through her IRA, 401(k), and employee stock-purchase programs. She dollar cost averages into the decline, buying assets at low prices over time, and selling them in future years at higher prices, either to support retirement or pay a child's college tuition.

She knows that by the time the investments will be needed to meet her future goals, the market will likely be higher. The stock market has yet to prove it can lose money or even be beaten by another major asset class over any 20-year or longer stretch of time based on data going back to 1802.⁶

Also, there is the danger of being out of the market when those few "whale" days surface. \$1 invested in stocks from 1996 to 2007, which includes the three-year, dot-com bear market, would have grown to \$16.85 (7% annual compounding return). By contrast, investors who missed the five best days in each of those years would be left with only 11 cents (-17% annual compounding return).¹² The average 12-month return of the S&P 500 Index after a bear market is 42%.⁷

Meanwhile, the short-term investor also rests easily, keeping his money safe, primarily in short, high-quality bonds, to meet the objective of buying a car or remodeling a home within the next couple of years. Only those with portfolios unmatched to their goals should be losing sleep today. Please do not hesitate to discuss with your investment manager the alignment of your life goals with your current portfolio. ♦

Profits as a Percentage of National Income



First Quarter 2009 Economy Review

The National Bureau of Economic Research (NBER) declared a recession to have begun in December, 2007, implying that the recession is now 16 months long.⁷ Economists are projecting at least one more recessionary quarter. In response to the recession, the government took monetary action in the form of lowering the Fed Funds rate target to 0 – 0.25% last quarter and held it there throughout 1Q09.

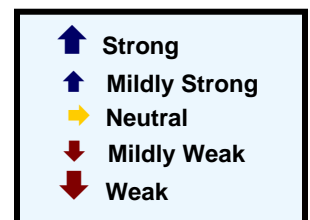


Our leading indicators below suggest for the first time that the economy may be bottoming. Indicators showing improvement include: interest rates, consumer sentiment, manufacturing, inflation, oil prices, and business spending. Remember that the stock market consistently leads the economy by 5 – 6 months. We believe the economy will likely see one more quarter of negative growth, with 1Q09 being severely negative followed by 2Q09 being nearly flat.

Leading Economic Indicator Summary

↑ Market Cycle: The second quarter of each year historically averages an annualized return of 10.9% with April tending to be the strongest month.⁶

Since September 18th, 2007, we have been in an environment of decreasing interest rates. The Federal Reserve has lowered the Fed Funds target rate to 0 – 0.25%, and the Fed will keep that target for several months to come. Interest rate direction is the most significant short-term influence on stock prices.⁶ Market returns from 1955 - 2006 averaged only 7.2% in the 12 months following rate increases compared to 18.5% following rate decreases.⁶ Once stock prices begin to improve, near-zero treasury yields will be unattractive to investors, providing even more demand for stocks.



→ Political Cycle: We are into the first year of President Barack Obama's term. Traditionally, the first year in the presidential cycle is the weakest; however, first-year Democratic presidents have fared better. Since World War II, the first year of the presidential cycle has seen the S&P 500 Index post an average gain of 8.5% overall and 15.7% under Democratic presidents.⁶ When the data is reviewed stretching back to 1888, first years are still the worst performers, returning 7.4% overall and 7.3% for Democratic presidents.⁶ However, the normal drivers of this phenomenon, post-election tough-medicine programs, will not be in play this time around.

↓ GDP Growth: Gross Domestic Product (GDP) is the official measure of the U.S. economy, tallying all goods and services produced in the United States. 4Q08 GDP fell 6.3%, following 3Q08 negative growth of 0.5%.¹³ Even worse news from the 4Q08 report is the unanticipated inventory build. The estimate for GDP in 2Q09 is for a 5.5% decline.¹¹ The good news from the GDP report was a higher-than-expected implied productivity. For the first three quarters of 2008, productivity growth averaged 2.5%, slightly higher than its long term average, a sign that private sector layoffs are boosting productivity.¹¹

↓ Employment: March was the 15th straight month of non-farm payroll decline, taking the unemployment rate up to 8.5%.¹¹ Employment in many cases is a lagging indicator for the general economy, which is why it normally does not appear in our Leading Economic Indicator Summary. When reviewing employment numbers, only weekly non-farm data should be observed to complete the economic picture, never the unemployment rate trend, which has political significance but is of little predictive value to economists.

↓ Home Price Trends: The Standard & Poor's/Case-Shiller Index is our preferred data for home price history. Through January the national index is down 19% from the previous year and 26% from the May 2006 national housing market peak.¹⁴ However, the index is signaling a slowing rate of price decline in some markets like Los Angeles, Cleveland and Denver. Meanwhile, most markets continue to see accelerating price declines, including Phoenix, Las Vegas, Charlotte, Portland, Seattle, Atlanta, Chicago and San Francisco.¹⁵ In the San Francisco and Los Angeles regions, where most of our clients reside, the 12-month declines as of January were 31% and 26% respectively, and the total price changes since the May 2006 peak were -42% and -38% respectively.¹⁵

The ratio of house prices to rents, an indicator of the true value of property, has yet to come down very far from its peak which was well above historical norms.¹⁶

- ↑ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, stabilized this quarter in some of the economy's most promising data. The March reading of 36.3 is still quite low, but it continued a three-month reverse in the index since its low point in December.¹⁷

Orders for durable goods, items expected to last more than three years, like computers, cars, and furniture, also rose in February over the previous month after six straight months of decline.¹⁸

- ↑ **Inflation Control:** News regarding near-term inflation continues to be good, as the GDP deflator fell in the fourth quarter by 0.1%, and the fourth quarter core PCE (Personal Consumption Expenditure) deflator rose only 0.6%, the lowest since the early 1960s.¹¹ Furthermore, the employment cost index for the fourth quarter came in at 0.5%.¹¹ This is a number that is watched closely by the Federal Reserve since it measures not only wages but also benefit costs. As the overall PCE deflator was -5.5% in 4Q08 when combined with the 2.2% annualized rise in employee compensation, this means that real employee compensation increased at nearly an 8% annualized real rate in 4Q08. Of course, more than 1.5 million lost their jobs in the fourth quarter, about 1.1% of the labor force, but those who retained their jobs received a good boost in real income.¹¹

Looking forward, the TIP-Treasury spread is 1.5% at 10 years and 1.7% at 30 years, indicating that the market is betting on only 1.5% inflation average over the next 10 years and 1.7% average over the next 30 years.¹¹ This is a remarkably low inflation projection given the amount of money that the government is pumping into the economy.

- ↑ **Oil Price Control:** Recessions have many self-correcting features. One helpful characteristic of this recession is that oil prices have fallen significantly due to decreased demand. Oil prices are a proxy for the global economy. After rising approximately six-fold since 2001, oil prices fell 19% this quarter, following 64% and 24% declines in 4Q08 and 3Q08 respectively.⁴

This decrease in oil prices amounts to a huge tax break for businesses and gasoline consumers. U.S. consumers are currently saving \$16 billion each month as compared to the first eight months of 2008.¹⁹

- ↓ **Consumer Spending:** The retail sales report showed core sales (less autos) up 0.7% in February.¹¹ This led many forecasters to predict a 1.0 - 1.5% increase in consumption for 1Q09. This would follow the two sharp 4% drops in 3Q08 and 4Q08 last year, the worst decline since World War II.¹¹ Goldman Sachs is forecasting a slight retail decline during all of 2009 totaling -0.5%.²⁰

The latest Conference Board reading inched up to 26.0 in March, up from 25.3 in February.²¹



- ↓ **Business Capital Spending:** New orders for goods, such as computers, rose by 3.4% in February, the first gain in seven months.²²

- ↑ **Investor Sentiment:** Three major sentiment indicators that we track surged from heavily bearish to bullish readings throughout March as the market surged 20%.²³ We would prefer to see these indicators remain bearish, suggesting that investors have not yet pushed their money in the market.

However, there is still plenty of potential as \$4 trillion in wealth is currently sitting idle in U.S. money market accounts earning an average yield of 0.33%.²⁴ This amounts to over 40% of the stock market's total value, an all-time high, and represents a huge pool of potential energy that someday will flow back into stocks, bonds, and other assets of various risk levels.²⁵

- ↓ **Corporate Earnings:** Year-over-year corporate profits of the S&P 500 companies fell from 24.7% in September, 2008, to 4.3% in January.²⁶

In each of the three past recessions – 1982, 1990, and 2001 – earnings fell 22% on average from peak to trough. Our plunge in this recession will be worse.²⁷ The fourth quarter of 2008 was the sixth consecutive down quarter for earnings, and 2008 the second straight down year.¹⁰ This will likely be the third-worst decline in the past 100 years, surpassed only by the massive earnings collapses during World War I and the Great Depression.¹⁰ Analysts are predicting a 35.5% decline in 1Q09 S&P 500 company earnings (-19.8% without financials).²⁸

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Insider Trading: Significant insider buying implies that executives have positive information about their respective companies' outlooks. This quarter, insider buying sank to the lowest levels seen in many years to a rate of \$10 million/day.²⁹ This implies that managers still lack confidence in their companies' future earnings.
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Merger and Acquisition Activity: The time to “liquidity event” (cashing out) for venture capitalist investments is lengthening. In 1998 venture firms invested \$14.1 billion in 1,930 information technology (IT) companies, and fifty of them went public, posting returns of \$2.7 billion. Last year venture funds sunk roughly the same amount of money into the same number of IT companies, and only two went public, returning a scant \$249 million.³⁰ ●

Notes and Acknowledgements:

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2. “February Blues after the Worst of Januarys”, *New York Times*, February 1, 2009
3. Merrill Lynch, March 23, 2009
4. Indexes used: Barclay's S&P Europe ETF (IEV), Vanguard's REIT Index ETF (VNQ), State Street's S&P Financials Index ETF (XLF), Barclay's Goldman Sachs Semiconductor Index ETF (IGW), Barclay's Goldman Sachs Oil Index ETF (OIL) based on spot oil prices
5. Global Investment Performance Standard's (GIPS) Original Dietz Method used to calculate returns. Arithmetic average used for return measurement. Performance is net of fees and may include assets tracked for clients that lie outside Sharper ♦ Granite direct management. Such assets total less than 4% of total assets. All client portfolios weighted equally in calculation of average client performance. S&P 500 Index returns include dividends. Past performance does not guarantee future results. Normalization to similar risk as S&P 500 uses weighted average beta of all client portfolio assets, then normalizes to beta = 1.0 (S&P 500 Index beta) using the Securities Market Line (SML). The SML is constructed as a line on the beta-return chart between two points, A and B: A is the point representing “risk free” at beta = 0, return = 3 month return of the 90-day Treasury Bill rate on the last day of the quarter as posted in the *Wall Street Journal*. B is the point representing the “market return” at beta = 1, return = 3 month total return (including dividends) of the S&P 500 Index. Beta (asset) = covariance (asset monthly price %Δ vs. S&P 500 Index monthly price change) / variance (asset monthly price %Δ) using Yahoo! Finance historical price data
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