



# Weekly Market Commentary



December 21, 2009

## The Decade Ahead

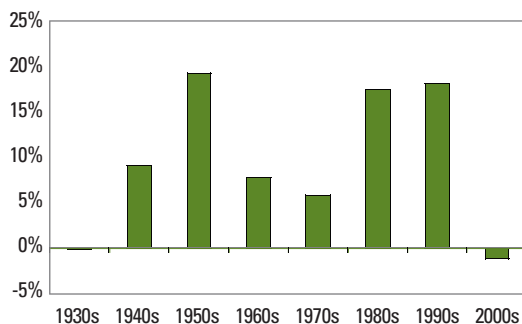
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#### Highlights

- In contrast to the widespread optimism and strong growth expectations at the start of the 2000s, the 2010s are starting with investors feeling pessimistic and pricing in weak growth.
- Specifically, next year we forecast: economic growth in the 3-4% range with growth slowing in the second half, stocks are likely to post gains early in the year that are later cut in half to end the year up only single-digits, and the bond market is likely to post flat-to-mid single digit gains as higher rates and wider spreads pressure returns.
- Over the full history of the S&P 500, the index has produced an annualized total return of 8.1%. We believe that stocks may post an average annual total return similar to this long-term average during the 2010s, supported by earnings growth in the mid-single digits and a dividend yield of 2–3%.

#### 1 The 2000s Were Worst Decade for the S&P 500 *S&P 500 Annualized Total Return (including dividends) by Decade*



Source: LPL Financial, FactSet

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Investors are ending the year bidding a fond good-bye to 2009 and good riddance to the decade of the 2000s. After the stock market's steady rise in the 1980s and 1990s, the volatility and losses of the 2000s made for an unpleasant experience for many investors.

Just how bad was the past decade? The 2000s were the worst decade in history for the S&P 500. In the 2000s, the S&P 500 total return (including dividends) is down about 11%, or an annualized loss of -1% for the decade. That is worse than the -0.1% annualized loss during the Great Depression decade of the 1930s.

What is the reason for the terrible performance this past decade? One of the main reasons is that investors were simply too optimistic at the start of the decade, pricing in powerful economic and profit growth expectations that pushed stock market valuations to record highs as the decade of the 2000s began.

Why are valuations so important? A change in the value investors place on earnings and dividends magnifies the changes in these components of return. We can measure this by looking at the price-to-earnings (P/E) ratio, the most common and useful measure of valuation. On average over the past 30 years, when the stock market, measured by the S&P 500, has risen or fallen by more than 10% the expansion or contraction in the P/E ratio has accounted for two-thirds of the market's performance.

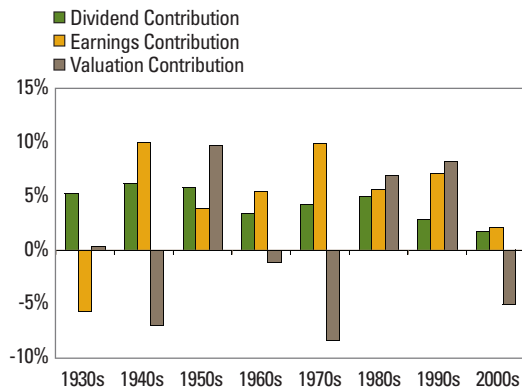
Although market cycles do not fall neatly into decades, sometimes it can be useful to look at market history by decade. Stocks rose every decade from the 1940s through the 1990s. While earnings and dividends have demonstrated a relatively stable growth trend across the decades, valuations have varied widely. Valuations acted as a drag on returns in '40s, '60s, '70s, and '00s, and boosted returns in the '50s, '80s and '90s. The net impact of changes in valuation over the very long term has been close to zero, but for extended periods the changes can be quite meaningful. In fact, during the 1980s and 1990s we witnessed valuation expansion make up nearly half of the total return on the S&P 500 index, as the P/E rose from the single digits to near 30. It is important to note that in the 2000s, the decline from the record high valuation at the start of the decade accounted for the entire decline since both earnings and dividends rose over the full decade. During the decade stock prices are down 25%, but earnings are up 23% and dividends have provided a return of 15%.

In contrast to the widespread optimism and strong growth expectations at the start of the 2000s, the 2010s are starting with investors feeling



## 2 S&P 500 Annualized Total Return Components by Decade

*Percentage Contribution to Annualized Total Return for Decade*



Source: LPL Financial, FactSet

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pessimistic and pricing in weak growth. This is evidenced by weak consumer confidence surveys and high cash balances. Even Wall Street analysts doubt the strength and durability of the market's recovery, as consensus expectations remain far from optimistic.

- Economists expect only about 2% growth next year—well below average for a year that follows a recession. History suggests the rebound from a recession as deep as the one we recently experienced would typically be 6–9%.
- Analysts are looking for only a typical post-recession 25% profit rebound for S&P 500 companies despite the far deeper than normal trough in profits during the recession. By year-end 2010 the forecast rebound would take S&P 500 earnings only back to \$76, where they were in 2005, which is about 20% below the trailing four-quarter earnings peak that took place back in mid-2007. We believe this is reasonable, though possibly conservative, given the mix of drivers in 2010.

Most importantly, the valuation of the S&P 500 is currently at a forward P/E of about 14–15. This slightly below average valuation seems out of place early in the recovery when profits are just starting to rebound. This slightly below-average valuation suggests investors have little confidence in companies sustaining EPS growth or that they expect high inflation to erode the value of that growth.

Although we do not see a return to a 1990s-type of environment of powerful gains and a return to soaring optimism, we disagree with the rampant pessimism on the market outlook for the 2010s. As the decade gets underway in 2010, we expect modest gains. Specifically, next year we forecast:

- Economic growth in the 3-4% range with growth slowing in the second half.
- Stocks, as measured by the S&P 500, are likely to post gains early in the year that are later cut in half to end the year up only single-digits, closing the year around 1200 on the S&P 500.
- We expect the bond market, as measured by Barclays Aggregate Bond Index, to post flat-to-mid single digit gains as higher rates and wider spreads pressure returns.

The global policy actions that allowed the healing to take place are going away, or may even reverse, and that could create a renewed slowdown, or in the worst case, a small contraction in the economy as 2010 goes on.

There will be many unique market-moving factors in the 2010s that we will explore as the decade goes on such as the impact of: a globally synchronized economic cycle, the rise of the middle class in the emerging world, an aging of the population in the developed world, the end of the long decline in interest rates, unsustainable federal budget deficits in the U.S., and the changing roles of government and business coupled with changing regulation in key industries such as energy, health care and finance, among many others.



Hollywood presents a very bleak outlook for the 2010s—from the film *2012* (currently in theaters about cataclysmic events occurring at the end of the 5,125-year-long Mayan Long Count calendar) to films of prior years set in the 2010s such as *Blade Runner*, *The Running Man*, and *Escape from New York*. We disagree. Over the longer term, we expect returns to be below the average of the 1980s and 1990s, but not negative returns like those experienced in the 2000s. Over the history of the S&P 500, going all the way back to the 1920s, the index has produced an annualized total return of 8.1%. We believe that stocks may post an average annual total return similar to this long-term average during the 2010s, supported by earnings growth in the mid-single digits and a dividend yield of 2–3%.

For greater insight into our 2010 Outlook please take a look at our just published *Outlook 2010*.

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#### IMPORTANT DISCLOSURES

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Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

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