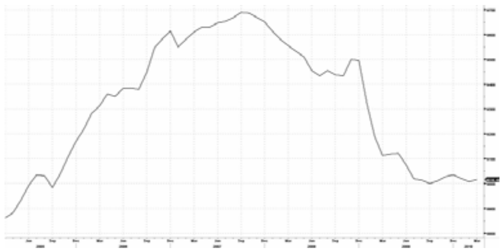
Monthly Report for May 2010

Fund manager's strategy report

Profit margins to return to record levels soon?

The National Bureau of Economic Research (NBER) is a private, US-based research organization that, among other activities, attempts to determine the beginning and end of recessions in the United States. The members of the National Bureau's Business Cycle Dating Committee have been largely in agreement that the last recession began in December 2007. Although the activity in the financial markets has been painting a completely different picture for the last several quarters, the NBER committee has yet to agree on if and when the recession can officially be declared over. The problem in making this determination is that the committee relies on several indicators that don't always point in the same direction.

Some of the most important indicators of economic performance include industrial production, retail sales and real median household income (excluding government transfer payments). While most indicators show that by the NBER's definition the recession is over, another important indicator, namely the job market, continues to generate concern. While employment -- and thus real median household income -- normally begins to rise again at the end of a recession, we have yet to observe signs of this development (see chart at right). With income levels already low primarily as a result of layoffs, the recovery seems to have had little effect on the job market thus far. This is evidenced by the unemployment rate, which at 9.7% is still twice as high as before the crisis – even given the fact that governments often whitewash jobless figures in an attempt to prove the effectiveness of their adopted measures. Before the crisis, the maximum unemployment benefit period for US workers was about six months. It has since been extended to about 18 months. However, those receiving unemployment benefits for more than six months are now statistically no longer considered unemployed, as in "normal times" they would be not be included in the statistic. By the same logic, however, one could argue away the entire global economic crisis, as it, too, is not typical of "normal times."



In any case, the NBER Business Cycle Dating Committee's reluctance to make an official declaration regarding the end of the recession is not completely unjustified. Meanwhile, things are looking quite different again on the stock market.

Stock market euphoria high

While some fundamental indicators continue to send mixed signals, the mood in the stock markets – despite the turmoil surrounding Greece – continues to be downright positive. The P/E ratio for the S&P 500 has risen from 12 in March 2009 to currently over 18 (right chart, green line). However, because a P/E ratio of 18 is not considered particularly favorable, analysts are tending increasingly toward basing their 'buy' recommendations on estimated P/Es alone. Because sell-side analysts tend to be somewhat optimistic (to some degree as a result of their job), P/E estimates for the coming twelve months are typically on the low end. The current estimated P/E ratio (red line on chart) is 14, meaning that currently reported profits for the last twelve months would need to rise by an average of 30% in the next twelve months. Interestingly, growth forecasts for sales revenue are more conservative than those for profits. Combining these two forecasts only makes sense if profit margins are expected to rise sharply. In other words, profit margins would need to reach the record highs of 2007, which, given the continued fragile state of the real economy, doesn't exactly appear realistic. As a result, along with increased profit expectations, the potential for disappointment has once again risen notably.

Long-term-oriented investors must not let themselves become infected by the current euphoria. The ARVEST Investment Committee has proven in the past that, in the long term, maintaining a critical distance from market sentiment pays off – in the truest sense of the phrase.

30.04.2010
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