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OBSERVATIONS ON THE MARKET

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Ever wonder why sometimes bad news is good news. Or why investors seem to change their emphasis on news events in a very short period of time. Many times bad news is interpreted as good news because the news was just not quite as bad as it could have been. We now seem to be in a cycle where some of the economic news is still bad, but the trend is definitely changing. The recent strong trends in corporate earnings announcements imply that other areas of the economy, such as employment, should also be on the mend soon.

The recent announcements regarding corporate earnings have been soundly beating expectations. The estimates for first quarter earnings are up 76% from the first quarter of 2009. Even with this dramatic improvement from last year, 82% of the companies that have reported so far this quarter have beaten expectations. They have also reported a 9% increase in sales, which suggests the trend should continue this year. Based on current S&P 500 earnings, the market is presently at a PE of 19. This is a little high compared to the last two decades, however, with earnings in a recovery mode, the higher growth rate leaves the current market's valuation less concerning. Since all indications suggest that expectations will be exceeded this quarter once all companies have reported, the market's valuation will continue to improve. Based on next year's estimates for earnings, the market is at 17 times earnings. One interesting point is that we may have a complete recovery in operating earnings by the end of next year. Virtually no one was predicting a recovery in corporate earnings in just three short years after what the economy went

through in the last two years. Unfortunately, it has come at the expense of unemployment.

The news regarding unemployment should start to improve soon. With revenue increasing, company new hires cannot be far behind. This is always one of the last parts of the economy to improve, but everything seems to be pointing to the fact that it is going to happen. This is probably the single most significant news item that will improve investor and consumer sentiment in the near term.

Few headlines get as much attention as our growing national debt. It has been somewhat surprising that the additional debt that has accumulated has not put more upward pressure on interest rates. According to RBS Securities, the government has actually over funded the current needs for the treasury. Since many of the bailout funds have been repaid, the treasury debt auctions later this year will probably decline by \$60 billion this year, and be as much as \$600 billion less in 2011. This makes for great short-term news headlines, but as Morgan Stanley states; "It's hard to get too excited because it's like drowning in 75 feet of water instead of 100 feet of water."

It is easy to feel somewhat relieved that the world economy is showing evidence that it has survived. We are now experiencing the sweet spot in the cycle where it all seems to be getting better. Confidence soars, and investors start to forget that there was a one-week period a short time ago when global finance stopped functioning. It is now important to realize that there will be a price to be paid at some point for such a steep V shaped recovery.