

Market Monitor
December 2008

Extreme and Extraordinary

- **The extreme and extraordinary bear market performances argue for a correction or rally from the 30% decline in the last three months.**
- **S&P 500 earnings estimates have declined 20% in the last several months commensurate with the decline in stocks. However, for investors waiting for fundamental improvement before investing, there are not likely to be any positive developments soon.**
- **The EquityCompass investment rating has completed six years of published opinions that cover the good, bad, and ugly of stock market performances.**

At the end of 1999, when the NASDAQ had nearly doubled in price in a six-month period, many market observers recognized that conditions were frothy and due for a correction. However, contrary to the sense that stocks “should” correct, the NASDAQ proceeded to shoot straight up almost 25% before the inevitable occurred in late-March 2000. It was an extreme and extraordinary period of bullishness that had few historical parallels. We are reminded of this period in trying to rationalize the current equity market environment. The S&P 500 has lost 30% of its value in the last three months’ sell-off on the heels of a 17% market decline from its peak in October 2007. Assuming an unchanged December, the S&P 500 is on pace for one of its worst calendar years of performance on record. The 52% peak-to-trough decline is also the largest since S&P expanded the index to 500 stocks in 1957. These extreme and extraordinary performances are due for a “correction.” But as we are reminded, stocks will do what they are going to do and, in such volatile periods, are not bound to anyone’s notion of what they “should” do.

With a week of record gains, November performances were not as uniformly bad as in the prior month. Three sectors—Energy, Telecom Services, and Utilities—actually had positive gains for the month. There was also some discrimination developing with relative performance favoring stock attributes of higher quality, larger market-cap, and growth. But otherwise, the average stock declined 13.2% for the month after declining 23.2% in October, and 9.9% in September —extreme and extraordinary.

S&P 500 Earnings

The EquityCompass utilizes forward 12-month consensus earnings estimates as one of its valuation variables. This number is referred to as “bottom-up” and we use a service that “cleans” these estimates depending on how recently they have been updated and the accuracy of the provider in the past. Based on data at the end of November, the current forward 12-month consensus operating earnings estimate for the S&P 500 is \$81.10, which produces a P/E ratio of 11.0x. Forward estimates for the S&P 500 peaked in October 2007 at \$103.72 and steadily declined until September 2008, when it plunged from \$100 to the current level. There is little doubt that further declines are ahead. For perspective purposes, the largest decrement in earnings post-WWII occurred in 2001, when S&P 500 EPS declined 20% from the prior year. Before this period, the S&P 500’s largest earnings decline was 14% in 1974.

For investors seeking fundamental confirmation before initiating or adding to portfolio holdings, earnings growth can be a fairly reliable indicator. **Table 1** on page 3 shows the monthly estimates for the S&P 500 from 2002. From this data, we set a rule to fully invest when there have been two consecutive months of increases, and to sell whenever there have been two months of decreases.

All relevant disclosures appear on page 4 of this report.

These tactics would have produced the following trades.

- 1) Long on 6/28/02 at SPX 989 (beginning of data)
- 2) Sold on 10/31/02 at SPX 885
- 3) Bought on 5/30/03 at SPX 963
- 4) Sold on 12/31/07 at SPX 1468
- 5) Bought on 6/30/08 at SPX 1280
- 6) Sold on 8/29/08 at SPX 1282

The total return on this strategy has been 36.7% versus -9.6% for Buy & Hold, and is now on the sidelines waiting for earnings to improve for two consecutive months. This approach missed the bottom of the market in 2002, but invested in 2003, and stayed long until the end of 2007.

EquityCompass Investment Rating

The EquityCompass investment rating reached its sixth year anniversary this month. The period from 2002 to 2008 encompasses a market cycle that includes a bull rise of 100% along with the bear market that started in October 2007. The EquityCompass Buy/Neutral/Sell ratings are derived by four quantitative models that include relative valuation, price momentum, over-/underreaction, and quality. These models have separate insights and are organized in a way that provides five intervals ranked to their favorability of expected stock performance. The intervals are referred to as the EquityCompass Risk/Reward Rating and range from 100% in which all of the models are indicating favorability, to 0% which are the most unfavorable. The top and bottom two intervals are combined to produce an overall EquityCompass Buy/Neutral/Sell opinion. Performances for each of the risk/reward and opinion categories are shown in **Table 2**.

Table 2

EquityCompass Investment Rating Annualized Performances from Inception

(11/29/02 – 11/28/08)

EC Risk/ Reward Rating	Performance	EC Rating	Performance
100%	7.2%	Buy	6.7%
75%	5.3%		
50%	3.8%	Neutral	3.8%
25%	1.0%	Sell	-0.8%
0%	-2.6%		
Universe	3.5%	—	3.5%

All indices equally weighted, rebalanced monthly and include dividends

Source: EquityCompass Strategies

Table 1

S&P 500 Monthly Earnings Estimates with Signal Changes

Date	S&P 500 Index	Est. EPS (NTM EC Est.)	PE (NTM EC Est.)	MOM Change in EPS Est.	MOM Direction	2-Month Direction
6/28/02	989.82	\$57.50	17.2	--	--	--
7/31/02	911.62	\$56.60	16.1	-1.6%	Dn.	--
8/30/02	916.07	\$57.79	15.9	2.1%	Up	Dn. - Up
9/30/02	815.28	\$56.88	14.3	-1.6%	Dn.	Up - Dn.
10/31/02	885.76	\$56.28	15.7	-1.1%	Dn.	Dn. - Dn.
11/29/02	936.31	\$56.85	16.5	1.0%	Up	Dn. - Up
12/31/02	879.82	\$55.06	16.0	-3.1%	Dn.	Up - Dn.
1/31/03	855.70	\$53.10	16.1	-3.6%	Dn.	Dn. - Dn.
2/28/03	841.15	\$50.48	16.7	-4.9%	Dn.	Dn. - Dn.
3/31/03	848.18	\$49.71	17.1	-1.5%	Dn.	Dn. - Dn.
4/30/03	916.92	\$50.21	18.3	1.0%	Up	Dn. - Up
5/30/03	963.59	\$50.24	19.2	0.1%	Up	Up - Up
6/30/03	974.50	\$55.68	17.5	10.8%	Up	Up - Up
7/31/03	990.31	\$55.92	17.7	0.4%	Up	Up - Up
8/29/03	1008.01	\$58.19	17.3	4.0%	Up	Up - Up
9/30/03	995.97	\$58.67	17.0	0.8%	Up	Up - Up
10/31/03	1050.71	\$58.35	18.0	-0.5%	Dn.	Up - Dn.
11/28/03	1058.20	\$58.77	18.0	0.7%	Up	Dn. - Up
12/31/03	1111.92	\$58.85	18.9	0.1%	Up	Up - Up
1/30/04	1131.13	\$59.63	19.0	1.3%	Up	Up - Up
2/27/04	1144.94	\$62.00	18.5	4.0%	Up	Up - Up
3/31/04	1126.21	\$62.67	18.0	1.1%	Up	Up - Up
4/30/04	1107.30	\$64.11	17.3	2.3%	Up	Up - Up
5/28/04	1120.68	\$65.13	17.2	1.6%	Up	Up - Up
6/30/04	1140.84	\$65.58	17.4	0.7%	Up	Up - Up
7/30/04	1101.72	\$73.09	15.1	11.5%	Up	Up - Up
8/31/04	1104.24	\$71.88	15.4	-1.7%	Dn.	Up - Dn.
9/30/04	1114.58	\$73.23	15.2	1.9%	Up	Dn. - Up
10/29/04	1130.20	\$74.22	15.2	1.4%	Up	Up - Up
11/30/04	1173.82	\$75.85	15.5	2.2%	Up	Up - Up
12/31/04	1211.92	\$74.53	16.3	-1.7%	Dn.	Up - Dn.
1/31/05	1181.27	\$75.24	15.7	1.0%	Up	Dn. - Up
2/28/05	1203.60	\$76.01	15.8	1.0%	Up	Up - Up
3/31/05	1180.59	\$77.69	15.2	2.2%	Up	Up - Up
4/29/05	1156.85	\$78.41	14.8	0.9%	Up	Up - Up
5/31/05	1191.50	\$79.60	15.0	1.5%	Up	Up - Up
6/30/05	1191.33	\$80.16	14.9	0.7%	Up	Up - Up
7/29/05	1234.18	\$81.66	15.1	1.9%	Up	Up - Up
8/31/05	1220.33	\$82.76	14.7	1.3%	Up	Up - Up
9/30/05	1228.81	\$84.74	14.5	2.4%	Up	Up - Up
10/31/05	1207.01	\$85.53	14.1	0.9%	Up	Up - Up
11/30/05	1249.48	\$85.73	14.6	0.2%	Up	Up - Up
12/30/05	1248.29	\$86.75	14.4	1.2%	Up	Up - Up
1/31/06	1280.08	\$86.94	14.7	0.2%	Up	Up - Up
2/28/06	1280.66	\$87.89	14.6	1.1%	Up	Up - Up
3/31/06	1294.83	\$88.57	14.6	0.8%	Up	Up - Up
4/28/06	1310.61	\$90.37	14.5	2.0%	Up	Up - Up
5/31/06	1270.09	\$92.00	13.8	1.8%	Up	Up - Up
6/30/06	1270.20	\$91.26	13.9	-0.8%	Dn.	Up - Dn.
7/31/06	1276.66	\$93.04	13.7	2.0%	Up	Dn. - Up
8/31/06	1303.82	\$93.49	13.9	0.5%	Up	Up - Up
9/29/06	1335.85	\$93.94	14.2	0.5%	Up	Up - Up
10/31/06	1377.94	\$94.86	14.5	1.0%	Up	Up - Up
11/30/06	1400.63	\$93.98	14.9	-0.9%	Dn.	Up - Dn.
12/29/06	1418.30	\$95.34	14.9	1.4%	Up	Dn. - Up
1/31/07	1438.24	\$94.99	15.1	-0.4%	Dn.	Up - Dn.
2/28/07	1406.82	\$95.60	14.7	0.6%	Up	Dn. - Up
3/30/07	1420.86	\$95.40	14.9	-0.2%	Dn.	Up - Dn.
4/30/07	1482.37	\$97.76	15.2	2.5%	Up	Dn. - Up
5/31/07	1530.62	\$99.09	15.4	1.4%	Up	Up - Up
6/29/07	1503.35	\$100.69	14.9	1.6%	Up	Up - Up
7/31/07	1455.27	\$99.69	14.6	-1.0%	Dn.	Up - Dn.
8/31/07	1473.99	\$102.27	14.4	2.6%	Up	Dn. - Up
9/28/07	1526.75	\$103.73	14.7	1.4%	Up	Up - Up
10/31/07	1549.38	\$104.56	14.8	0.8%	Up	Up - Up
11/30/07	1481.14	\$103.23	14.3	-1.3%	Dn.	Up - Dn.
12/31/07	1468.36	\$102.76	14.3	-0.5%	Dn.	Dn. - Dn.
1/31/08	1378.55	\$99.87	13.8	-2.8%	Dn.	Dn. - Dn.
2/29/08	1330.63	\$100.58	13.2	0.7%	Up	Dn. - Up
3/31/08	1322.70	\$99.34	13.3	-1.2%	Dn.	Up - Dn.
4/30/08	1385.59	\$99.16	14.0	-0.2%	Dn.	Dn. - Dn.
5/30/08	1400.38	\$100.30	14.0	1.1%	Up	Dn. - Up
6/30/08	1280.00	\$101.43	12.6	1.1%	Up	Up - Up
7/31/08	1267.38	\$100.24	12.6	-1.2%	Dn.	Up - Dn.
8/29/08	1282.83	\$100.14	12.8	-0.1%	Dn.	Dn. - Dn.
9/30/08	1166.36	\$97.36	12.0	-2.8%	Dn.	Dn. - Dn.
10/31/08	968.75	\$87.60	11.1	-10.0%	Dn.	Dn. - Dn.
11/28/08	896.24	\$81.10	11.1	-7.4%	Dn.	Dn. - Dn.

Source: EquityCompass Strategies



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