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## Stocks rally on Geithner pick as Treasury secretary

### Investors successfully test 2002-03 bear-market lows; could this mark a bottom?

November 26, 2008

Stocks staged a powerful final-hour, sigh-of-relief rally of nearly 8% Friday afternoon, as investors universally applauded President-elect Barack Obama's selection of Timothy Geithner, president of the Federal Reserve Bank of New York, to be his Treasury secretary.

The combination of the Geithner pick, a weekend bailout of Citigroup, and speculation regarding a proposed \$700 billion fiscal stimulus plan, spurred investors to tack another 8% onto the rally Monday for good measure, marking the best two-day period for stocks since the aftermath of the Black Monday crash in October 1987.

The S&P 500 had plunged by more than 26% between Barack Obama's historic election on November 4 and last Friday afternoon, as investors were uncertain as to the direction of economic policy under the new administration and the identity of the people who would orchestrate and execute it. So much for expectations of a post-election rally.

As a result, the equity markets over the past three weeks succumbed to mutual-fund and hedge-fund redemptions, year-end tax-loss selling, margin calls and selling strategies to avoid mutual-fund capital-gain distributions.

### Smoothing the way

But we share the market's enthusiasm for Geithner's candidacy, as his nomination promises a relatively smooth transitional bridge of continuity amidst a sea of uncertainty, in this critical change from the outgoing Bush administration to the incoming Obama administration.

As president of the New York Fed for the past five years, Geithner has been intimately involved with the decisions surrounding Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac, American International Group, Detroit's Big Three, the Troubled Asset Relief Program (TARP), and the other financial crises that have been important daily discussion topics thus far this year, so there will be no wasted time or effort on his part to get up to speed on what's already transpired — he'll literally be able to hit the ground running.

Equally as important, Geithner enjoys a close working relationship with current Treasury Secretary Henry Paulson, President Bush and Federal Reserve Chairman Ben Bernanke, and he is a former protege to previous Treasury Secretaries Bob Rubin and Larry Summers, both of whom are now high-level economic advisors within the new Obama administration.

### Familiarity breeds relief

A veteran of both the International Monetary Fund and the Clinton Treasury Department before he began his tenure as president of the New York Fed, Geithner has a well-earned reputation as both a pragmatist and a diplomat, is very familiar with Wall Street and commands the respect of members from both parties in both houses of Congress.

Investors are hopeful, we believe, that Geithner's presence will help to prevent an economic policy vacuum from forming in Washington over the next two months, regarding possible government inaction in battling the ongoing financial crisis. We've previously discussed the market's disappointment with Paulson's reticence to request approval from Congress to receive and spend the second \$350 billion TARP funding.

To that end, the government on Tuesday announced two new credit market programs totaling \$800 billion, in an aggressive attempt to ease the availability and cost of credit for conventional mortgages and consumer and small-business loans. These announcements helped spark the S&P 500's first three-day rally since September. It's last four-day rally was May 27-30, 2008.

### Fed to the rescue

First, the Fed established the Term Asset-Backed Securities Loan Facility (TALF), which will use \$200 billion to finance the purchase of



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new and recently issued AAA-rated asset-backed securities, backed by car loans, credit-card receivables, student loans and Small Business Administration (SBA) small-business loans. Paulson contributed \$20 billion from TARP to fund this program, which the Fed will leverage by 10 to one.

Second, the Fed also announced that it will purchase \$600 billion in agency debt, with \$100 billion in government-sponsored enterprise (GSE) paper, such as Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Board, and \$500 billion in GSE-guaranteed mortgage-backed securities. These actions are intended to lower funding costs for the GSEs, while also attempting to lower mortgage rates, all of which may help to stabilize the deeply troubled housing market.

### **Bottom or not?**

Aside from these positive macro-economic policy developments, however, the \$64,000 question for investors is whether or not we've seen a bottom in the stock market?

Over the past 13 months, the S&P 500 has plunged by about 53%. According to our friends in the economics department at Goldman Sachs, that's the third-worst bear market in U.S. stock market history, trailing only the 86% decline from 1929 to 1932 and the 60% drop from 1937 into 1942.

It's been our long-standing view that the current S&P 500 bear market would not end until it successfully tested the 2002-2003 bear market bottom at 768.63, which occurred on October 10, 2002. We believe this technical test happened last Thursday and Friday, when the S&P 500 dropped to an intra-day low of 741.02 before bouncing sharply higher.

### **Valuation key**

In our view, valuation tells an important story. At last week's share-price trough, the dividend yield on the S&P 500 had soared to 4.00%, which compares with last Thursday's 10-year Treasury yield of only 2.99%. According to our equity strategy friends at Morgan Stanley, it's been more than 50 years since the S&P 500's dividend yield was 100 basis points higher than the benchmark Treasury yield.

Moreover, the price/earnings ratios for the S&P 500 at last Friday's low point stood at 8.5 and 8.0 times estimated consensus earnings of \$87.00 and \$93.00 per share for calendar 2008 and 2009, respectively. That translates into earnings yields (calculated as the inverse of the P/E ratio) of 11.8% and 12.5%. But, with the 10-year Treasury note at an all-time low yield of just below 3.00%, that equates to a very extreme valuation imbalance for stocks of about 75%.

Now, there's virtually no chance that such lofty estimates for earnings or dividends will be achieved over the next year, given the depth of the current economic recession. For that reason, we've been working internally here at Federated with a conservative \$60.00 earnings estimate for 2009.

But investors appear to be pricing in a much more draconian cut to perhaps \$35.00 to \$40.00 per share, which we believe is simply too pessimistic, given the massive amounts of global fiscal and monetary policy stimulus in the pipeline.

For that reason, as we look forward to the Thanksgiving holiday weekend, we continue to believe that we may have put a bottom in for stocks last week.

### **The sun will come out — eventually**

Yes, the economic news is dreadful, as it should be as we're staring into the abyss of a recession that we believe started five quarters ago. But the economic news should get progressively less dreadful as we proceed through the first half of 2009, as the fiscal and monetary policy stimulus begins to kick the economy back into gear.

Importantly, the new Obama administration takes office on January 20, and we are impressed by the centric economic dream team he is assembling to steward the economy back onto a growth path through a combination of tax cuts and government spending.

We believe that businesses, consumers and investors will begin to gain confidence over the course of 2009 that the world is not coming to an end and that the recession will eventually end. At that point, we'd like to think that we'll look back to the fourth quarter of calendar 2008, as the bottom of the bear market and the start of the next up cycle for stocks.

And that will be a change in which we'd all like to believe. Happy Thanksgiving, everyone.

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Views are as of November 26, 2008 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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