

Just Your Average Joe

Here we are, Halloween, one of my favourite times of the year. Ahhh, the tootsie rolls and the little munchkins dressed up as spooky ghosts and goblins is just the diversion most of us need right now. To top it off, the local Starbucks is giving free coffee to those who dress up for the big day. In this bear market we're not going to miss this chance. This year I've decided to go as Joe the Plumber, I'll be the guy with the low cut jeans and the media frenzy!! I give the other Joe credit for creating his fame; it's not easy being "an average Joe", there's lots of us around.

You may be wondering what Joe the Plumber has to do with this week's small cap update? Nothing really, we just needed something to tie in the Halloween theme with the letter. I guess we could write on the impact of the US Presidential election. It might be interesting to consider all the potential implications from the new leader. I think our feeling would likely be best described by what Leigh Pullen recently has coined the "Obama Bounce". The thought is if Mr. Obama is elected the markets may look at this with hope and relief resulting in a bounce in equities. We would argue though that the media frenzy and stock market analysis tied to the election generally fades quickly as this is a short term event. The economy is the long term event which the market will ultimately focus on. How the new President is able to address this issue will be the real story.

Speaking of the economy, this week we had the index of U.S. consumer confidence plunge in October. The majority of market participants described the drop as "unexpected". In addition, some stats on the housing market were very poor, but should that really surprise anybody? On this news the Dow Jones Industrial Average rose nearly 900 points! We should be clear, this wasn't the only major news on this day; there was a release that the commercial paper funding market was improving and speculation on further interest rate cuts. We got those cuts the next day.

The point is that the markets will at some point start to look through the current doom and gloom reports long before the problems are fixed and will focus on longer term value. It is at the worst points when markets have historically bottomed. The question though is when have we hit that worst point? We are always cautious to use the words "long term" and "market" in the same sentence as one of our biggest issues is the short sighted nature of the market in general.

This short-sightedness of the market brings us to the crux of our discussion, earnings. Looking back to our presentation material at the beginning of the year, we were very uncomfortable with the earnings projections

for the market. Today, they are starting to come down but from our perspective are still not realistic for the environment we are in. The market will become more and more gloomy now on corporate earnings, alas a good dose of reality is exactly what expectations need.

Take for example the release by Williams-Sonoma this week. For the fourth quarter, Williams-Sonoma lowered its earnings outlook to 10 cents - 30 cents per share from a prior forecast of 76 cents - 86 cents per share. For 2009 guidance dropped from \$1.03-\$1.15 to 25 cents - 47 cents per share. We listened in to the company call in late August when business was starting to fall off a cliff, in only a few months it has gotten significantly worse. The day before the announcement the stock was trading around \$10.50 with earnings for 2009 expected to be over \$1.00, providing investors an optimistic 10 times P/E multiple. The day of the announcement the shares fell to \$8.50 resulting in a P/E of closer to 20 times!! So for all the talk of the cheap multiple please remember its all based on future estimates, how many more significant cuts will we see like this? Lots. Reality has not set in on the earnings side for the market yet. The P/E of the market is not a science, figuring out earnings in this environment is more of an art than anything.

This sounds gloomy, where's the opportunity? The same individuals who pushed that stocks were cheap at the top of this market and couldn't see how a slowdown was possible will likely be the same ones to become so depressed they throw in the towel. They won't be able to see how things could get better the same way they couldn't see how they could get worse. The market will likely overshoot on the downside, assuming it already hasn't in many individual securities. This happened back in 2002 and is one of the precursors to better markets. Why? Because expectations are so low and despair so high that those little positive surprises start to take on significance. At that point you get companies with very low multiples and the potential of higher earnings growth, this is a powerful combination.

Yes many stocks look cheap, but short-term earnings are a big unknown. Analysts will continue to adjust their expectations lower. Investors focused on the upcoming three months rather than three years will continue to hit the panic button. Eventually, the market will not pay attention to these analysts' projections or the trailing economic data but rather the longer term economic value of the companies within the market. When will this happen? Don't ask me I'm just an average Joe, talk to the plumber. For those interested, Leigh Pullen will be interviewed on BNN at approximately 4:00-4:15 (EST) on Tuesday November 4th.