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Market Insights

A periodic newsletter from Idaho Trust

The recent market volatility experienced in the stock market has grabbed the media's and investor's attention. Investors, busy mulling over the foreign and domestic economic uncertainty, the European debt crisis and the political brinkmanship from Washington, D.C. sent the stock market tumbling when the U.S.'s credit rating was downgraded. It was at this point that the stock market's volatility suddenly increased. In this month's Market Insight we discuss the recent market volatility in a historical context and some of the underlying fundamentals of the stock market.

Volatility

The stock market has historically experienced large swings after macroeconomic events such as the U.S.'s credit rating downgrade. History shows us many examples of this. The Russian sovereign default and subsequent Long-Term Capital Management bailout, the tech-stock bubble, the 9/11 terrorist attacks, the global financial crisis and the onset of the European debt crisis, just to name a few. All of these events provide examples of how markets have behaved after the emergence of significant macroeconomic events.

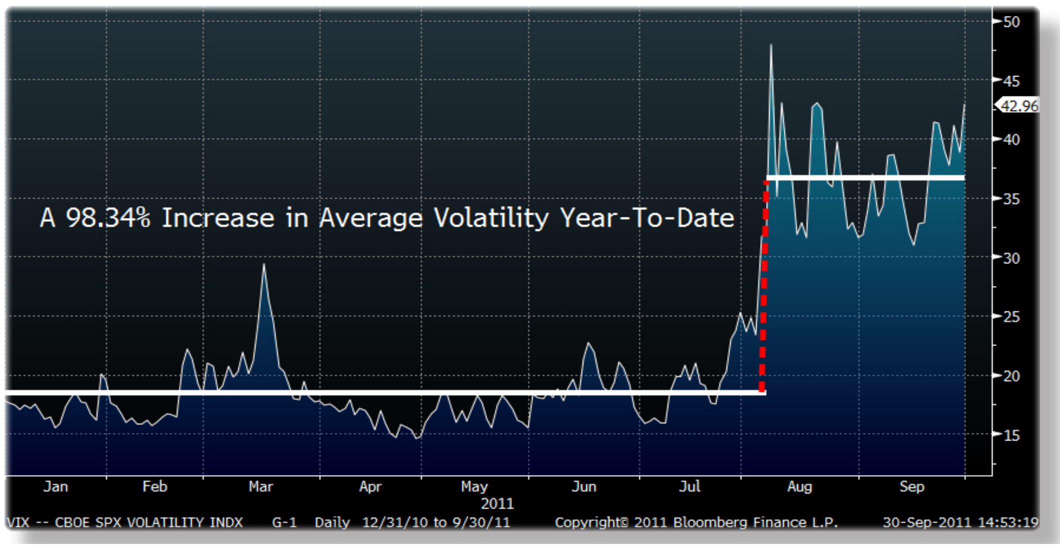
In 2011, leading up to the downgrade, volatility in the stock market was significantly lower than it was after the downgrade (see chart). This pronounced spike in volatility suggests that it was indeed the downgrade that triggered the increase in volatility and not one of the other macroeconomic events present in the market place.

Idaho Trust Bank offers holistic wealth management services featuring its LifeNeeds™ investing process. Idaho Trust's LifeNeeds™ investment process utilizes proven strategies and techniques delivered by a highly trained staff of wealth management professionals.

LifeNeeds™ wealth management accounts feature optimized asset allocations, robust security screening and Idaho Trust's unique TacticLogic™ investment process. All of which are tailored to our client's unique financial needs, insuring LifeNeeds'™ clients the best possible expected return according to their risk tolerances.

This chart shows the Chicago Board of Exchange's S&P 500 volatility index which has increased 34% since the August 5th announcement of the U.S.'s credit rating downgrade by Standard & Poor's. To put that increase into relative terms of magnitude, when investment bank Lehman Brothers collapsed, on September 15, 2008, the index increased as much as 155% before declining to a 26% increase by year-end. After the September 11th terrorist attacks in 2001, the index only increased by 37%.

Putting the current volatility in a historical context helps us understand that the level of volatility is more ordinary than out-of-the ordinary, given our current macroeconomic environment. History also teaches us that these periods of heightened volatility are temporary in nature.



Corporate Earnings

In a market that is full of worrisome news, corporate earnings remain a bright spot. Corporations are still turning a profit and growing earnings. In fact, the S&P 500 index's (SPX) member companies have reported a 16.25% annual earnings increase so far this quarter. Unfortunately, earnings growth has been much higher in previously reported quarters when the economy emerged from the recession. Although earnings growth remains positive; it has been declining for six quarters and is projected to continue downward.

Energy (i.e. oil and gas companies) and Material (i.e. metals companies) sectors have had the highest rates of earnings growth. While all sectors have generally experienced declining earnings growth rates, the non-cyclical defensive sectors such as Utilities, Health Care and Consumer Staples (i.e. household products) have seen their earnings growth decline at the slowest pace. The Telecommunications sector is the only sector in the SPX to report a negative annualized earnings growth rate.

Performers and Laggards

There are parts of the stock market that have performed much better than others. Growth companies, companies with above average earnings growth as measured by the S&P 500 Growth Index, have performed well this year.

Value companies, those priced attractively at current levels measured by S&P 500 Value Index, have not done as well as growth companies. Growth companies returned 0.61% versus -6.58% for value companies Year-to-Date (YTD). While investing in growth companies has been rewarded this year; value companies are trading at historically low levels and appear poised to perform well in the future, given their current valuations.

Large-cap stocks have fared better than their mid- and small-cap counterparts thus far in 2011. The SPX has returned -8.68% versus -13.02% and -13.79% for its mid- and small-cap stocks respectively YTD. This has changed from the first half of the year when the stock market had positive YTD returns which were led by mid- and small-cap stocks.

Due to investors' risk aversion which has been prevalent in the market this year, non-cyclical or defensive sectors have outperformed their cyclical peers. The Consumer Staples, Health Care and Utilities sectors of the SPX have returned an impressive 3.38%, 2.52% and 10.78% YTD respectively. While Financials, Industrials and Materials have returned -25.14%, -14.68% and -21.70%.

Current Valuations

Since the stock market's reversal and sell-off in the 2nd half of the year, stocks have looked more attractive. Of course, a stock being attractively priced or overpriced depends on how you are measuring it or what you compare it too.

The Price-to-earnings ratio (P/E) is a common measurement of a stock's relative attractiveness. It measures the price paid for the company's stock as compared to one share's worth of the company's earnings. For example, a P/E Ratio of 15 would mean that the stock's price is 15 times higher than one share's worth of corporate earnings.

An attractively priced stock offers high earnings-per-share for a low price. This year's corporate earning's growth has been positive, though not robust, and prices have declined which has lowered stock's P/E ratios to attractive levels. Currently the SPX is trading at 12.38 times earnings, which is well below its 20-year average P/E ratio of 20.38 times earnings. It is even below its 50 year average of 16.63 and the P/E ratio at the end of the second quarter of this year at 14.58 times earnings. So, even if earning's growth is slower than desired, prices have more than accommodated, providing attractive investment opportunities.

Conclusion

The first half of 2011 was a notably strong market for stocks. This all changed with the continuing bad news dominating the headlines. Investors this year have had a lot to worry about. The U.S. credit rating downgrade appears to have been the spark that has sent the market in to a period of high volatility.

S&P 500 Index

3 Month	-13.87%
Year-to-Date	-8.68%
1 Year	1.14%
3 Year	3.73%
5 Year	-5.76%

S&P 400 Index

3 Month	-19.88%
Year-to-Date	-13.02%
1 Year	-1.28%
3 Year	12.65%
5 Year	11.47%

S&P 600 Index

3 Month	-19.83%
Year-to-Date	-13.79%
1 Year	0.21%
3 Year	2.32%
5 Year	1.34%

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