SCHAFER CULLEN

CAPITAL MANAGEMENT

James P. Cullen
President

The Recovery Phase Update

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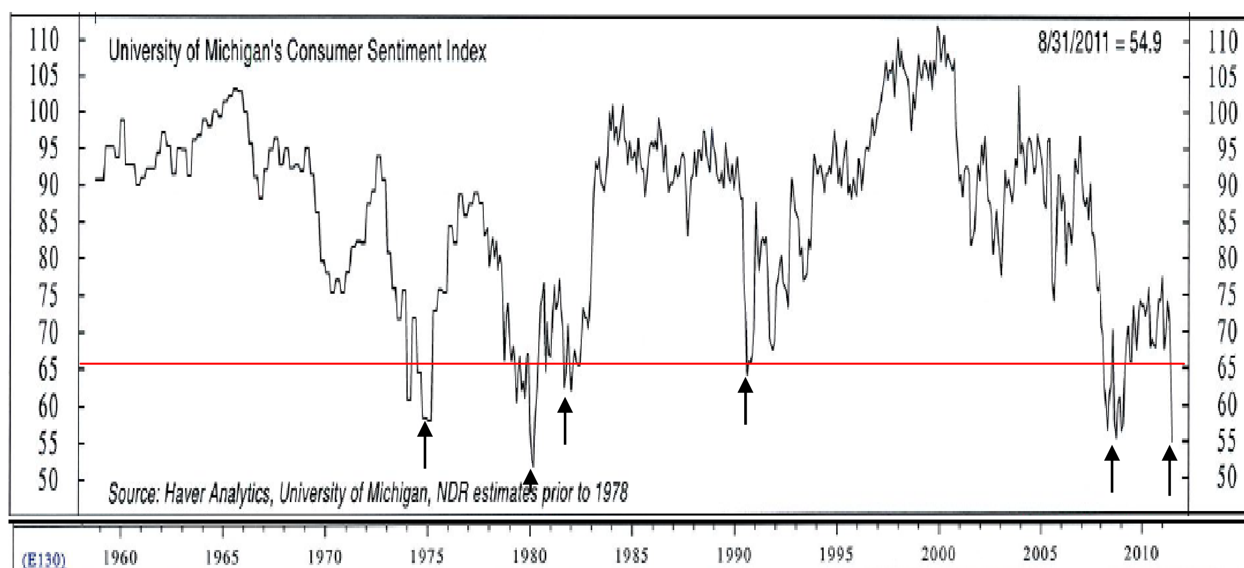
Not only has the recent headline news been bad, but dire long-term consequences associated with the headlines seem to hang in the air indefinitely -- Greece, Italy and the endless Euro saga, runaway U.S. government debt, the declining dollar, and a sluggish economy facing the threat of a double-dip recession. In addition, the extreme volatility produced by the high frequency trading gang has left investors frozen on the sidelines. **All the bad news and chaos is not unusual for a recovery period, something we'll talk about a bit later in this report.**

Meanwhile, earnings have been the strongest of any post-recession period in the last 50 years. **Also, while the news and markets can go from bad to worse, the negative sentiment can create opportunities**. Tracking the University of Michigan's Consumer Confidence Index is a good way to measure how bad the news is. Historically, when the confidence level drops below 65, it's a buying signal for the long-term investor. The chart below shows a recent reading of 55.7 -- the lowest level since 1980 -- while the table on the next page shows how the market has recovered roughly a year after all the earlier oversold periods.



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In a previous Market Letter, we first published the consumer confidence study during the 2008 recession when the headlines were at their most horrific. It is hard to believe that only a year later the market was up 35%.

Consumer Confidence Under 65%	S&P 500 a Year Later
Dec 1974	+ 34%
May 1980	+ 32%
Mar 1982	+ 38%
Oct 1990	+ 30%
Nov 2008	+ 35%
Aug 2011	?

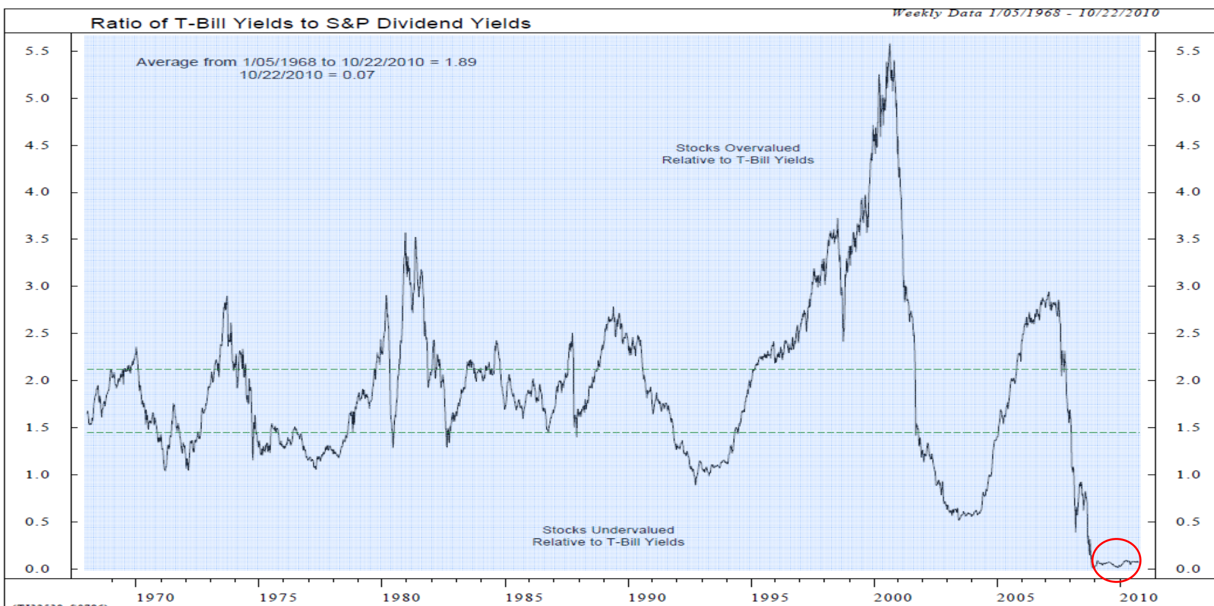
Source: S&P 500/SCCM, July 2011

The reason markets tend to climb dramatically after very negative periods is because a huge amount of cash builds up on the sidelines**.** **Then if there's any good news or even if the news becomes less bad, money can come stampeding back into stocks.**

Bonds Versus Stocks

While it is good to have history and sentiment on your side, it is even better when you also have favorable valuations. **Today with the market P/E at 11.5x earnings and the market dividend yield at 2.8%, stocks are at one of the most attractive levels relative to bonds in market history**.

The chart below shows that all the low points in the past 40 years (when bond yields were at or below dividend yields) were signals for long-term value investors to buy stocks. Today, equities are even more undervalued.



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Reviewing Post-Recession Recovery Periods

This table included in our earlier Market Letters shows the five-year performance of low P/E vs. high P/E stocks after every recession of the last fifty years.

Recession Period	5-yr Period Starting the Calendar Year After Recession End	Annualized Performance Low P/E Value	Annualized Performance High P/E Growth
1969-71	1972-76	+17.8%	+2.4%
1973-75	1976-80	+24.7%	+15.3%
1980-83	1984-88	+18.2%	+9.8%
1990-91	1992-96	+17.9%	+12.5%
2001-02	2003-07	+17.3%	+16.3%
2007-09	2010-14	-	-
Average		**+19.2%**	**+11.3%**

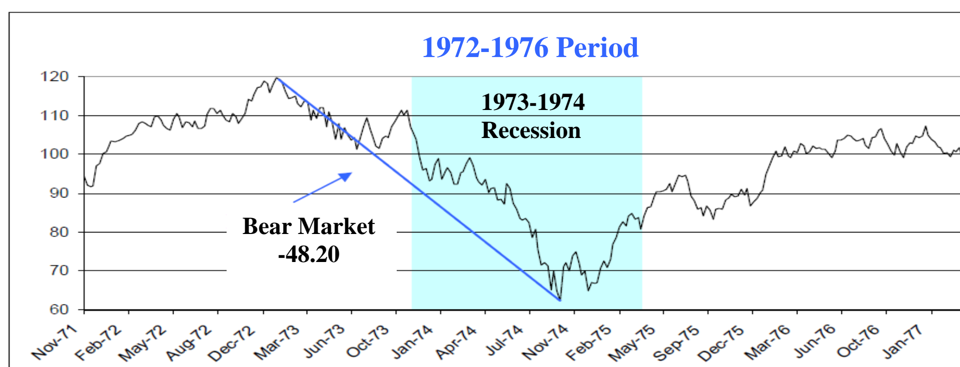
Source: S&P 500/SCCM, December 2010

The table makes clear that not only did value (low P/E) stocks do well in the recovery periods, but they did twice as well on average as the growth (high P/E) stocks.

Now let's look at what happened during each of the recovery periods adding the five-year period which includes the double-dip recession of 1980's.

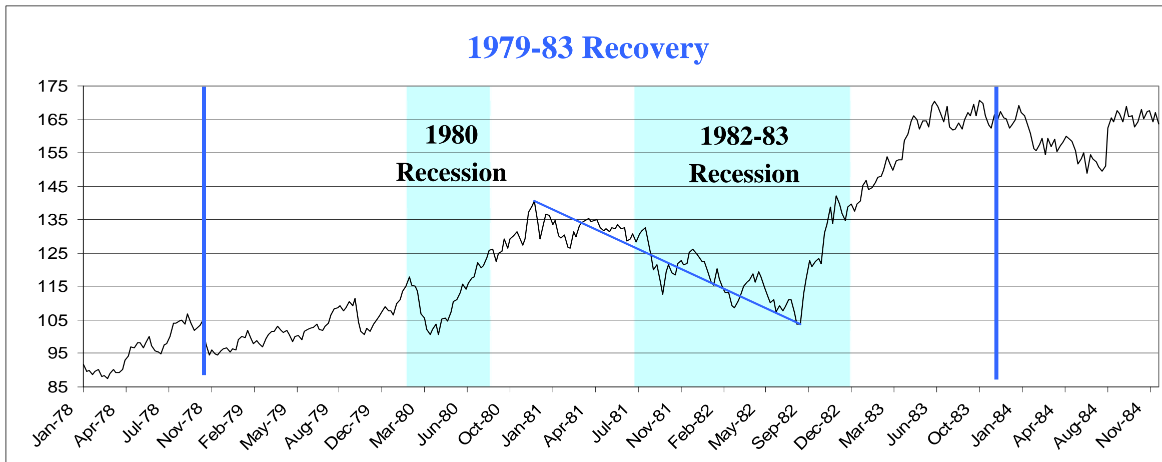
1972-76: It's hard to imagine a recovery period worse than this one, which included the worst stock market crash since the Great Depression. During the span, almost all the brokerage firms went out of business and the hot, popular stocks of the time, "The Nifty Fifty," collapsed. Even so, low P/E stocks were up +17.8% during the five-year stretch.

The chart below shows the S&P 500 from 1972 to 1976



Source: SCCM/July 2008

1976-80: Anybody worried about a double-dip recession can see how a market span of five years can digest even that dreaded phenomenon. At the end of this period, another recession, the one beginning in 1980, got under way. To see just how bad a double-dip recession could make things, we take an additional look at the five-year period 1979-1983 which includes the entirety of the double-dip recession. This performance (+24.5% annualized) was not much worse than the +24.7% for the 1976-80 recovery period. The chart below shows how the S&P played out over the double-dip period.



Source: SCCM/July 2008

1984-88: These years encompassed a time in which a record 275 US banks failed, four times more than the 75 banks that went under during the Great Depression. The period also featured one of the biggest single day market drops in history -- 22.6% on October 19, 1987.

1992-96: The five year span here produced less negative news flow than the other recovery periods. There was the second war with Iraq and the first World Trade Center bombing, but mostly what we saw during the time was a build-up of the technology boom and the rapid accumulation of consumer and government debt. **Even so, the annualized performance for the five years was +17.9%, not much different than the gains during more challenging recovery periods**.

2003-07: Memories are quite fresh about what happened to many of the tech and dot com companies prior to this period. This was the aftermath of the 80% drop in NASDAQ from January 2000 through 2003. **The market started rebounding in 2003, after the huge drop. This explains why the 2003-07 period was the best relative period for growth (+16.3% annualized) versus value (17.3% annualized).** Meanwhile, in 2008 these same tech stocks lead the market down, and for the entire ten year period from 2000 to 2010, NASDAQ remained down 50% from its highs.

Summary

When the headline news is bad, and consumer confidence is at such a low level, and valuations are as attractive as they are, the combination tends to create a unique buying opportunity for long-term investors.

Jim Cullen

Compound Annualized Returns for Rolling 5-Year Periods

Period	S&P 500 Bottom 20% by P/E	Period	S&P 500 Bottom 20% by P/E
1968-1972	**9.7%**	1987-1991	**10.5%**
1969-1973	**0.0%**	1988-1992	**15.4%**
1970-1974	**1.1%**	1989-1993	**14.5%**
1971-1975	**12.4%**	1990-1994	**10.1%**
1972-1976	**17.8%**	1991-1995	**23.2%**
1973-1977	**17.0%**	1992-1996	**17.9%**
1974-1978	**24.7%**	1993-1997	**22.0%**
1975-1979	**34.3%**	1994-1998	**17.8%**
1976-1980	**24.7%**	1995-1999	**18.2%**
1977-1981	**18.2%**	1996-2000	**13.9%**
1978-1982	**22.2%**	1997-2001	**13.3%**
1979-1983	**24.5%**	1998-2002	**4.7%**
1980-1984	**26.1%**	1999-2003	**12.1%**
1981-1985	**26.5%**	2000-2004	**16.0%**
1982-1986	**27.6%**	2001-2005	**15.4%**
1983-1987	**18.9%**	2002-2006	**16.0%**
1984-1988	**18.2%**	2003-2007	**17.3%**
1985-1989	**16.3%**	2004-2008	**-2.3%**
1986-1990	**6.1%**	2005-2009	**4.3%**
		2006-2010	**4.5%**

Source: S&P 500/SCCM, December 2010

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