FUNDAMENTALLY

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Three Faces Of Market Danger

AFTER one of the most volatile periods for stocks in decades, it's only natural for investors to wonder how risky the markets will be in 2010.

Unfortunately, that is impossible to predict with any certainty. But investors can at least look for the types of risks the market seems most likely to face. Those perceived dangers have shifted in recent years. In 2008, for example, there was the all-too-real risk of losing big money in the global credit crisis. Last year, after the crisis seemed to subside, investors who stayed on the sidelines risked missing out on the market's huge rebound.

Today, strategists say, investors face risks in three major categories:

EARNINGS RISK As the economy started to heal last year, investor expectations for corporate profits started to grow. That helped to drive up equity prices by 65 percent from March 9 to Dec. 31.

But after a rally of that magnitude, "people will start to get nervous about the ability of companies to actually meet those expectations," said Ben Inker, director of asset allocation at GMO, an asset management firm in Boston. That is partly because corporate profit forecasts have grown so lofty.

Wall Street analysts estimate that earnings for companies in the Standard & Poor's 500-stock index were up 193 percent in the fourth quarter of 2009, versus the period a year earlier, according to a survey by Thomson Financial. Moreover, they expect earnings for all of 2010 to be up more than 28 percent from 2009.

"While we are seeing profit improvement, we think the numbers that are getting baked in are excessive," Mr. Inker said.

Michele Gambera, chief economist at Ibbotson Associates, an investment consulting firm in Chicago, points out that "it's hard to have a stable improvement of corporate profits in an environment where companies are deleveraging."

It's also difficult to see profits soaring, he said, while the employment outlook is so weak. Not only does a struggling job market threaten consumer spending, it also exacerbates continuing problems in the financial system. "If people don't have jobs, they cannot pay off their debts," Mr. Gambera said.

VALUATION RISK When the market began to rally in March, stocks were roundly considered cheap. Back then, the price-to-earnings ratio for equities was a mere 13.3, based on 10-year averaged earnings, as calculated by Robert J. Shiller, the Yale economist.

But thanks to the recent surge in stock prices, the market P/E has jumped to a much frothier 20.8, versus the historical average of around 16.

"Current market valuations are high enough that they're more or less suggesting everything is going to be fine this year," said Robert D. Arnott, chairman of Research Affiliates, an investment management firm in Newport Beach, Calif. But if everything isn't — if the economy hits a speed bump, for instance, or if corporate profits come in lower than expected — investors may start to question the prices they are paying for risky assets, he said.

This is why James W. Paulsen, who works in Minneapolis as chief investment strategist for Wells Capital Management, says that this year, unlike 2008 and 2009, "it will be important for people to go back to assessing valuations again."

POLICY RISK Government economic policies are having a huge impact, but they can be tricky to predict. For instance, investors who were banking on imminent health care reform may need to rethink their strategy after the special Senate election last week in Massachusetts.

Health care is only one area that is up for grabs. This year, for example, the government and the Federal Reserve Board will face a big decision on whether to curtail the huge stimulus that has helped prop up the economy.

Mr. Arnott says he believes the Fed will be forced to raise short-term interest rates this year, possibly even before the recovery gains full traction.

The danger is that the markets may react badly to the end of the Fed's unusually loose monetary policy.

"It's not like the economy is out of the woods," said Duncan W. Richardson, chief equity investment officer at Eaton Vance, an asset manager in Boston. "The patient is still in the hospital."

INVESTORS must also keep in mind that the tax cuts enacted under President George W. Bush — which lowered the maximum rate on long-term capital gains taxes to 15 percent from 20 percent and the top dividend tax rate to 15 percent from 39.6 percent — are due to expire at year-end.

While it is unclear whether the Obama administration will extend those cuts, or at least extend them for the middle class, the uncertainty is bound to raise concerns on Wall Street.

Because of the "potentially big risks that may come out of Washington," Mr. Richardson said, "investors need to be more diversified than ever." □

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