

## Weekly Commentary December 12, 2011

### The Markets

What's more important to the U.S. stock market, economic growth or the value of the U.S. dollar?

On the surface, economic growth would seem to be the logical answer since as the economy grows, earnings should grow, too. But, digging a little deeper, the answer is not so clear cut.

What muddles the answer is that large U.S. multinational companies generate about 47 percent of their revenue from outside the U.S., according to Standard and Poor's. When that revenue is translated back into U.S. dollars, the revenue could vary significantly depending on whether the dollar is strong, weak, or neutral.

For example, if the dollar is strong, then foreign revenue translates into *fewer* dollars which *reduces* a U.S. company's reported revenue. Lower revenue could lead to lower profits and possibly lower stock prices. The reverse is also true. If the dollar is weak, then foreign revenue translates into *more* dollars which *increases* a U.S. company's reported revenue and could lead to higher profits.

We're talking about the value of the dollar today because of the uncertainty surrounding numerous world currencies. The euro, in particular, is on the radar because it might soar or plunge depending on how Europe cleans up its sovereign debt problem. And, with Europe accounting for 22 percent of our total exports so far this year, any major change in the value of the euro could significantly affect U.S. corporate revenue and profits, according to the Commerce Department.

That's why Christopher Wood, strategist for CLSA Asia-Pacific Markets says, "The key variable for the U.S. stock market is not the U.S. economy, but the U.S. dollar."

In a globally based economy, the value of the dollar matters. It's one more variable that could affect stock prices and bears monitoring.

Data as of 12/9/11	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Standard & Poor's 500 (Domestic Stocks)	0.9%	-0.2%	1.2%	12.2%	-2.3%	1.0%
DJ Global ex US (Foreign Stocks)	-1.4	-15.5	-13.0	11.3	-4.5	4.6
10-year Treasury Note (Yield Only)	2.1	N/A	3.2	2.7	4.5	5.1
Gold (per ounce)	-2.2	21.2	22.8	30.6	22.2	20.1
DJ-UBS Commodity Index	-2.3	-12.0	-7.1	9.5	-3.3	5.0
DJ Equity All REIT TR Index	1.5	3.4	7.9	23.9	-2.5	9.8

Notes: S&P 500, DJ Global ex US, Gold, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods.

Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association.

Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable.

**IT'S NOT JUST HOW MUCH A COMPANY EARNS**, but how much of an earnings multiple investors put on those earnings that helps determine stock prices. To illustrate this, let's assume it's your lucky day and you have the ability to inherit one of the following five companies. Based on the data given in the following chart, which of the five companies would you choose to inherit?

<b>Company</b>	<b>2010 Annual Revenue</b>	<b>2010 Operating Profit</b>
Ford (car company)	\$128,954,000,000	6,658,000,000
DuPont (chemicals)	32,733,000,000	3,711,000,000
Honeywell (manufacturer)	33,370,000,000	3,134,000,000
eBay (e-commerce)	9,156,000,000	2,054,000,000
VMware (software)	2,857,000,000	428,000,000

Source: Morningstar

Just looking at the numbers, you might think Ford would be the obvious choice. Its revenue was nearly four times the next closest company and its operating profit last year was nearly 80 percent higher than the next closest company.

Interestingly, the stock market can tell us how it thinks these five companies stack up against one another. It turns out that as of last week, the market value of these five companies (stock price times shares outstanding) was between \$40.5 billion and \$41.9 billion. In other words, the stock market valued these companies at basically the same price.

That may seem strange since the financial metrics of these five companies differs significantly. How can Ford, with \$129 billion in annual revenue and \$6.7 billion in operating profit be worth about the same as VMware, a company with just \$2.9 billion in annual revenue and an operating profit of only \$0.4 billion?

This highlights the point that in the long run, earnings do drive stock prices; however, the value that investors place on those earnings can vary significantly from one company to the next at any point in time. So, what causes investors to value a small company like VMware at about the same market value as the much larger Ford? Ah, that's the million-dollar question which keeps investment analysts gainfully employed!

We mention these five stocks not as a buy or sell recommendation, but simply to point out that numerous factors affect the valuation of stock prices. It's not as simple as saying those with the most profits win.

## **Weekly Focus – Shuffling Cards**

Playing cards is about as American as baseball, hot dogs, and apple pie. So here's a trivia question for you. How many times must you shuffle a deck of 52 playing cards in order to ensure it is truly scrambled?

Mathematicians have studied this problem and determined that even after six shuffles you can still find patches of non-random sequences. It's the seventh shuffle that does the trick. At seven shuffles you reach a tipping point and the deck turns into chaos, according to the book *Magical Mathematics* by Persi Diaconis and Ron Graham as reported in *The Wall Street Journal*. So, if you

are concerned that one of your table mates is a skilled cheat, make sure you shuffle at least seven times!

- \* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
- \* The DJ Global ex US is an unmanaged group of non-U.S. securities designed to reflect the performance of the global equity securities that have readily available prices.
- \* Gold represents the London afternoon gold price fix as reported by the London Bullion Market Association.
- \* The DJ Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998.
- \* The 10-year Treasury Note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury Note as a benchmark for the long-term bond market.
- \* The DJ Equity All REIT TR Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust (REIT) industry as calculated by Dow Jones.
- \* The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.
- \* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.
- \* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.
- \* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
- \* Consult your financial professional before making any investment decision.
- \* You cannot invest directly in an index.
- \* Past performance does not guarantee future results.

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