Our Outlook for the Market

Five-star picks are more scarce since the market rally, but wide-moat opportunities can still be found.

By Bill Bergman, Senior Equity Analyst

We thought the market looked cheap back in March, but it looks closer to fairly valued today. We still see buying opportunities, especially among "wide moat" companies. And we've been raising our fair value estimates, on balance, in recent months. But the market rally since March has considerably closed the wide gap between price and fair value that prevailed during 2008 and into early 2009. "Consider buys" have grown increasingly scarce.

That's the basic message from our bottom-up research on over 2,000 individual companies. We estimate fair values for these firms using discounted cash flow methods, and we regularly track those fair values along with the underlying stock prices. You can do the same with our Market Valuation Graph. It shows the median price to fair value ratio for our whole research coverage. That tool also breaks the data out for NYSE vs. Nasdaq stocks as well as for the companies in our economic moat and uncertainty categories.

Digging into the overall totals by moat category and by sector provides some useful color on recent valuation developments. Among the 2,080 firms for which we reported fair value estimates at the end of the first quarter and the current quarter coming to a close, the number of fair value increases ran a bit ahead of the decreases (293 vs. 280). In turn, the median increase in fair value estimates was larger than the median decrease. The increases were relatively concentrated among firms we've determined to lack an economic moat. The relief in the market in recent months was also evident in this category, which saw the largest median percent increase in stock prices in our coverage universe. On balance, the widespread stock price increases outweighed positive net changes in our fair value estimates, and the market-cap-weighted average price/fair-value ratio rose from 0.65 in the first quarter to 0.88 currently, while the simple median price/fair-value ratio rose from 0.77 to 0.92.

We may be less bullish on the market generally, but at Morningstar, we believe that it's a market of stocks, not a stock market. We work hard to understand individual companies and their industries, and the premium on selectivity appears to have risen in recent months. While the market as a whole may look close to fairly valued right now, we still see opportunities, particularly among firms we've classified as carrying wide economic moats. The median price/fair-value ratio for our wide-moat category looks significantly more attractive than elsewhere in our coverage universe.

Wide economic moats are derived from fundamental competitive advantages that help shield the best companies from the worst things that recessions and inflation can throw at them. Amid persistent economic weakness and heightened inflation uncertainty, we have "consider buy" ratings right now on about one-third of the wide-moat companies, a considerably higher share of buy ratings than for our research coverage generally.

Price/Fair-Value Ratios by Moat Rating

	March 09	June 09
None	0.80	1.01
Narrow	0.74	0.87
Wide	0.68	0.79
Overall	0.77	0.92

Do wide economic moats matter for investment performance in the current economic environment? That's one of the reasons we try to identify them, and the proof appears to be in the pudding so far in the latest recession. Morningstar's Wide Moat Focus Index fell less than broader market averages from a 2007 peak into the March 2009 low, and it has since risen more than market averages. This is an equal-weighted index focused on some of our favorite wide-moat companies, and it has outperformed our wide-moat companies generally in recent months.

In turn, here's a look at price/fair value ratios for each of our equity analyst research groups, together with where they stood at the end of the first quarter. The narrowing P/FV gap occurred in each of these major groups, with the largest increases coming in banks and industrials. Fears about spreading failures and even nationalization in the banking sector eased in recent months, leading to a pretty widespread rally. But our banking team still sees significant value in the credit card companies like Capital One Financial COF, Discover DFS, and American Express AXP.

It's worth noting that the health-care sector has the lowest P/FV sector ratio and also saw the lowest increase in the P/FV ratio in the second quarter. We still think there is a lot of value to be had in that area. But wide-moat, 5-star stocks can be found in some of the relatively expensive sectors as well. Happy hunting!

See the following reports for our latest insights on the following sectors, plus industry-by-industry valuation data and our top picks in each group.

Banks
Bank stocks have staged a comeback—but aren't home free yet.

Basic Materials
Companies scramble to de-lever in a sour economy. China to the rescue?

Business & Financial Services
The business and financial services sector contains both stalwarts and the highly exposed.

Consumer
Can there be green shoots without consumer spending?

Energy
Energy firms take full advantage of market-driven opportunities in the second quarter.

Health Care
The health-care sector is in the waiting room.

Industrials
Operating conditions in the industrial sector are showing signs of mending.

Price/Fair-Value Ratios by Morningstar Analyst Research Group

	End of Q1	End of Q2
Banks	0.50	0.91
Basic Materials	0.64	0.95
Business & Financial Services	0.66	0.85
Consumer	0.67	0.85
Energy	0.69	0.95
Health Care	0.60	0.73
Industrials	0.55	0.87
Media & Telecom	0.64	0.83
Technology	0.64	0.90
Utilities	0.75	0.93

Media & Telecom

Media and telecom offer some pockets of stability, but few signs of an economic rebound.

Technology

We believe cloud computing will be a hugely disruptive trend for the entire enterprise IT market.

Utilities

Falling demand, rising interest rates, and inflation could crimp utilities.

Bill Bergman does not own shares in any of the securities mentioned above.