

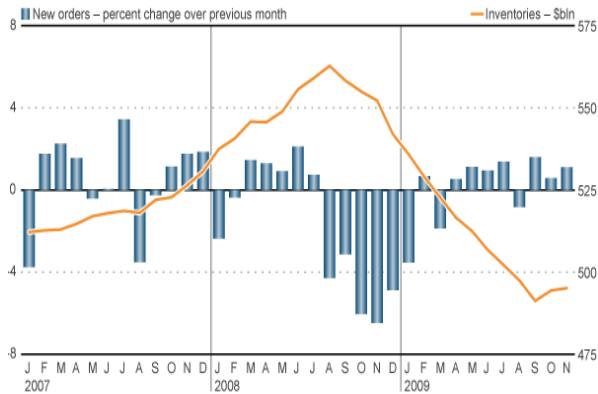
INSIDE DEBT

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Tuesday, January 5, 2010

CHART OF THE DAY

U.S. factory orders



New orders at U.S. factories rose 1.1 pct in November in their third straight increase and inventories grew for the second month in a row, showing recovery in manufacturing.

TODAY'S TOP NEWS

- U.S. pending home sales slump, factory orders up
- Fed's Hoenig-may need curtail some bank activities
- Kraft sweetens Cadbury bid; Buffett weighs in
- Fed may re-enter MBS market later in 2010 - Market News
- U.S. company default rate declines in December - S&P
- Pension boost seen giving \$180 bln to U.S. companies

ECON WATCH

FOR WEDNESDAY JANUARY 6

ET	Indicators	Unit	Reuters	Prior
03:43	IT Markit/ADACI Serv PMI	ind	-	49.8
03:48	FR Markit/CDAF Serv PMI	ind	59.3	60.9
03:53	DE Markit Serv PMI	ind	53.1	51.4
03:58	EZ Markit Serv PMI	ind	53.7	53.0
03:58	EZ Markit-comp PMI	ind	54.2	53.7
04:28	GB CIPS/Markit Serv PMI	ind	56.6	56.6
05:00	EZ Industrial new orders mm	%	-1.1	1.5
05:00	EZ Industrial new orders yy	%	-	-16.5
05:00	EZ Producer prices mm	%	0.2	0.2
05:00	EZ Producer prices yy	%	-4.5	-6.7
07:00	US Mortgage market index	ind	-	595.8
07:30	US Challenger layoffs	k	-	50.349
08:15	US ADP Nat Employment	k	-73	-169
10:00	US ISM N-Mfg PMI	ind	50.5	48.7
10:00	US ISM N-Mfg Bus Act	ind	50.5	49.6
	US FOMC minutes from meeting of Dec 15-16			
	GB BoE starts two day Monetary Policy Meeting			

MARKETS TODAY

TODAY'S TOP STORY: Pending sales of previously owned U.S. homes fell sharply in November, but a surge in orders received by factories offered assurance the economic recovery remained on track.

For more please click here

TREASURIES: U.S. Treasury prices rose as bargain hunting persisted in the wake of recent losses, while widely diverging data on factory orders and pending home sales lent the market little new direction.

- 10-yr treasury prices rose 16/32 yielding 3.76 pct from 3.82 pct on Monday. Last week, 10-yr yields rose as high as 3.918 pct, their highest since early June.
- 30-yr bond prices rose more than half a point to yield 4.6 pct from 4.65 pct. 5-yr notes rose 11/32 yielding 2.57 pct.
- One-month and three-month T-bills yields fell after pushing higher on Monday as the year-end demand for cash subsided.

FOREX: The dollar fell the most against the yen in nearly a month as weaker-than-expected U.S. housing data dampened expectations the U.S. Fed could hike rates sooner rather than later.

- Dollar fell 0.9 pct to 91.67 yen, on track for its biggest one-day percentage loss since early December.
- The euro fell 0.28 pct at \$1.4367, having climbed to around \$1.4483 earlier in the day to hit its strongest since Dec 17.
- The dollar index was up 0.12 pct to 77.618.
- Sterling fell 0.56 pct at \$1.5997.

CORPORATES: U.S. corporate bond yield spreads were generally steady on Tuesday as investors focused on the primary market and welcomed 2010's first wave of new debt sales.

- The CDX.IG-13 index tightened by 1 bps to 81 bps.
- Lloyds TSB Bank's launched \$5 bln in two-part debt sale.
- General Electric Capital launched a \$4 bln two-part debt sale while German state bank KfW sold a \$4 billion offer.
- Other major deals include a \$3 bln sale of 10-yr bonds by Barclays.

STOCKS: The benchmark S&P closed at a fresh 15-month closing high as data showing that factory orders rose for a third straight month in November offset a report that pointed to more weakness in the housing market.

- Dow fell 0.11 pct to 10,572.02, S&P was up 0.31 pct to 1,136.51 and Nasdaq gained 0.01 pct to 2,308.71.
- S&P automobiles index rose 5.74 pct, S&P financials index was up 1.7 pct and S&P energy index was up 0.79 pct.
- KBW banks index rose 2.24 pct.
- Dow's top performer was Kraft Foods, which gained 4.89 pct to \$28.77.

C & E: Oil rose for the ninth straight day as cold weather in the United States and Europe boosted demand for heating fuel.

- Crude oil was up 0.43 pct to \$81.86 per barrel, off an earlier high of \$81.99. Gold fell 0.17 pct to \$1,119.15 an ounce.
- The Reuters-Jefferies index was up 0.02 pct at 289.39, its highest close since Oct. 14, 2008.

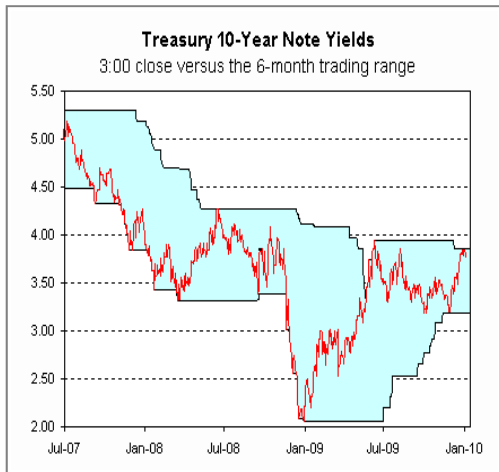
• For MARKET SNAPSHOT click here

• For NEXT UP click here

• For DEEP DIVE click here



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.045	0.015	0.046	-0.011
3-Mo Bill	0.065	0.055	0.066	-0.015
6-Mo Bill	0.160	0.150	0.162	-0.019
1-Year	0.375	0.350	0.381	-0.031
2-Year	99.969	100.000	1.017	0.121
3-Year	98.789	98.820	1.548	0.211
5-Year	100.313	100.359	2.558	0.391
7-Year	99.844	99.891	3.275	0.484
10-Year	96.875	96.938	3.757	0.563
30-Year	96.438	96.500	4.595	0.797

EQUITIES

	INDEX	CHANGE
DJIA	10549.65	-34.31
NASDAQ	2304.61	-3.81
S&P 500	1133.88	0.89

OIL

	PRICE	CHANGE
NYMEX	81.9	0.4
BRENT	80.5	0.6

EURODOLLAR FUTURES

	CLOSE	CHANGE
Jan-10	99.740	0.000
Mar-10	99.670	0.015
Jun-10	99.425	0.050
Sep-10	99.060	0.065

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.150	O/N	0.170
2-Week	0.180	2-Week	0.200
1-Month	0.180	1-Month	0.200
3-Month	0.210	3-Month	0.230
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.160	10:00 AM	0.100
2-Week	0.190	3:00 PM	0.097
1-Month	0.190		
3-Month	0.240		

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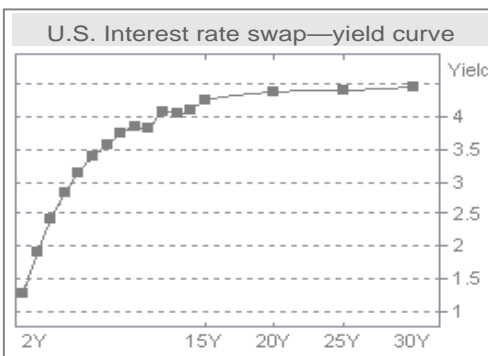
	SPREAD		RATE	
2-Year	26.25	30.25	1.27	1.29
3-Year	35.25	39.25	1.89	1.90
5-Year	26.00	30.00	2.81	2.81
7-Year	9.25	13.25	3.36	3.36
10-Year	7.50	11.50	3.82	3.81
30-Year	-17.00	-13.00	4.42	4.40

FUTURES

	PRICE	CHANGE
CBOT 5 yr	114.95	0.40
CBOT 10 yr	116.00	0.47
CBOT 30 yr	115.56	0.47

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.130	0.160	-	-
1-Month	0.230	0.320	0.129	0.139
3-Month	0.250	0.450	0.151	0.161
6-Month	0.350	0.650	0.200	0.210
12-Month	0.900	1.300	0.430	0.440



CURRENCIES

	BID	ASK
Euro	1.4368	1.4370
Sterling	1.5997	1.6002
JP Yen	91.70	91.72
Swiss Franc	1.0335	1.0338
Can Dollar	1.0387	1.0392
Mexico	12.8203	12.8264

FED FUNDS NYFRSM - 10AM

Open	0.1400	1m	0.2228
High	0.1600	3m	0.2594
Low	0.0800		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	12	11	1.14
3-Year	1.75	10/08/2012	3	0	1.61
5-Year	2.625	20/11/2014	17.5	16	2.74
7-Year	5.125	18/10/2016	16	13.5	3.44
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	37	36	4.97

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	8	7	1.1
3-Year	1.375	09/01/2013	27	25.5	1.83
5-Year	3	28/07/2014	3	0	2.61
7-Year	5.25	15/09/2016	16	0	3.48
10-Year	3.75	27/03/2019	17	16	3.93
30-Year	6.25	15/07/2032	36	0	5

Active MBS 15YR

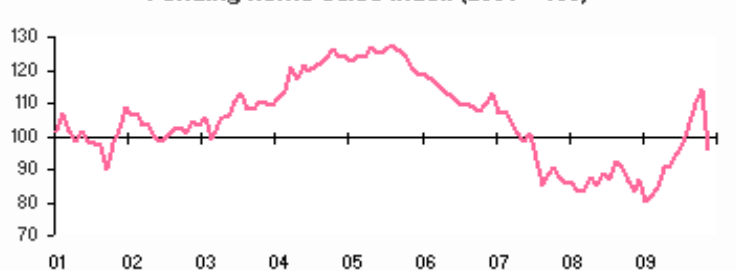
	CPN	BID	ASK	YIELD
FNMA	5.0	104.2900	104.3100	2.843
FHLMC	5.0	104.2800	104.3000	2.856

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.0100	105.0300	3.187
FHLMC	5.5	105.0200	105.0400	3.130
GNMA	5.5	105.0410	105.0610	3.741

Wrightson ICAPSM Chart of the Day

Pending Home Sales Index (2001 = 100)



TODAY'S TOP NEWS

U.S. pending home sales slump, factory orders up

Pending sales of previously owned U.S. homes fell sharply in November, but a surge in orders received by factories offered assurance the economic recovery remained on track.

The National Association of Realtors said its Pending Home Sales Index, based on contracts signed in November, dropped 16 percent from October to 96.0 after rising for nine straight months.

Analysts polled by Reuters forecast pending home sales falling 2 percent in November. The realtors group blamed the drop on the end of a rush to beat the original expiration of a popular tax credit and expected sales to resume an upward trend.

A separate report from the U.S. Commerce Department showed new orders at U.S. factories rose 1.1 percent in November, notching their third straight increase and beating market expectations for a 0.5 percent gain.

In a sign that the economic recovery that started in the third quarter of 2009 continues to gain momentum, inventories at U.S. factories rose 0.2 percent month over month in November, following a 0.6 percent increase in October, the Commerce Department data showed.

Kraft sweetens Cadbury bid; Buffett weighs in

Kraft sweetened its \$16.8 billion offer for Britain's Cadbury and a potential rival stood aside, but just hours later the U.S. food firm's influential top shareholder threatened to vote against the deal.

Switzerland's Nestle ruled itself out of any bid war as Kraft raised the proportion of cash in its hostile bid -- an attempt to sway shareholders in the British chocolate maker.

The plan appeared to give Kraft the upper hand, but then 9.4 percent shareholder Warren Buffett weighed in to warn he may vote against the deal, sending Cadbury shares lower and Kraft stock higher.

Buffett's Berkshire Hathaway Inc investment group said it had voted "no" to Kraft's proposal to issue up to 370 million new Kraft shares to help fund a Cadbury takeover, but may change its vote if it concludes that the offer does not destroy value for Kraft shareholders. The highly influential Buffett said Kraft's share issuance proposal gives it a "blank check" allowing the group to change its offer for Cadbury.

U.S. company default rate declines in December - S&P

S&P said the U.S. speculative-grade default rate decreased to 10.9 percent in December, the first monthly decline since October 2007.

During December, four defaults were recorded, bringing the year-to-date total to 189. All of the defaults in December were from the nonfinancial industry.

Last month's 10.9 percent rate, which is subject to revision, was down from 11.28 percent in November.

"Credit conditions in the U.S. remain challenging, but signs of improvement are beginning to emerge, such as improved lending conditions and a resurgence in new issuance," Diane Vazza, head of S&P's global fixed income research group, said.

S&P said it was the first monthly decline since October 2007, when the default rate hit a 25-year low of 0.99 percent. The highest U.S. default rate on record is 12.54 percent, set in July 1991.

S&P expects the speculative-grade default rate to continue declining to a mean forecast of 6.9 percent by September 2010. But if economic conditions are worse than expected, S&P sees the decline to only 9.9 percent.

Fed's Hoenig-may need curtail some bank activities

Some activities may need to be curtailed at large financial firms to prevent a recurrence of the financial crisis that resulted in a global recession, Kansas City Federal Reserve President Thomas Hoenig said.

"We do need to consider some activities that are in these largest institutions that probably should not be trading for their account, gambling ... That portion probably does need to be separated out," he said, speaking on a panel at the American Economics Association.

Commercial banking plays a crucial role in giving banks access to the payments system and functions as a key intermediary in the U.S. and global economies, he added.

The Kansas City Fed chief said some firms must be allowed to fail and called for federal regulators to have powers to wind down large systemic institutions on the brink of collapse.

Congress is considering wide-ranging financial reforms in the wake of the crisis, including monitoring risks to the broad financial system and giving authorities ways to shut down failing firms in an orderly way.

Fed may re-enter MBS market later in 2010 - Market News

The Federal Reserve is discussing re-entering the mortgage-backed securities market later this year if its buying power is needed to hold down interest rates, Market News said in a story citing Fed officials.

The \$5 trillion agency mortgage-backed securities market may weaken when last year's biggest buyer, the Federal Reserve, ends its \$1.25 trillion agency MBS purchasing program at the end of the first quarter of 2010.

Fed officials, however, "are prepared to contemplate changes if need be, depending on conditions in the economy, housing finance and in financial markets more broadly," Market News said.

The Fed's program has helped keep 30-year mortgage rates near record lows, attracting buyers to the housing market as it struggles to exit its worst slump in decades.

When the Fed stops buying at the end of the first quarter, rate in that market are widely expected to rise, pulling mortgage rates higher as well.

Pension boost seen giving \$180 bln to U.S. companies

The recovery in financial markets last year helped bring significant improvement to the financial health of U.S. pension funds, potentially adding \$180 billion to companies' balance sheets, a survey showed.

Mercer said U.S. pension funds were 85 percent funded at the end of December compared with 75 percent a year earlier.

But it also warned that such funds are becoming increasingly reliant on equity markets, and thus are vulnerable to volatility.

In total, Mercer found that U.S. pension funds run by S&P 1500 companies had a deficit of \$229 billion at the end of 2009 compared with their liabilities over 10 years.

"The improved funded status will add \$180 billion to the balance sheets of U.S. companies, which, over time will improve earnings and reduce the need for future cash contributions."

It said the funds had predominantly been investing in equities. Bond yields, however, are currently low given a general lack of inflation and low official rates. For investors with long-term liabilities, this means not only that they may not be getting enough return but also that they are threatened by any large-scale retreat from fixed income if central banks start raising interest rates.



TODAY'S TOP NEWS

Eurozone Dec inflation jumps, seen subdued in 2010

Euro zone inflation jumped in December as expected, data showed, mainly because of more expensive oil, but falling core inflation is likely to cap headline price rises in coming months, economists said.

Eurostat estimated that consumer prices in the euro zone rose 0.9 percent year-on-year in December after a 0.5 percent rise in November. But economists said the annual rise was consistent with a 0.3 percent month-on-month increase.

"It is likely that an adverse base effect on energy was virtually the only driver of the inflation acceleration -- we think energy added 0.4 percentage points to the yearly inflation rate," said Marco Valli, economist at Unicredit.

Economists said that large excess capacity in the economy and weak demand was likely to push down core inflation, which excludes the volatile energy and unprocessed food prices.

Further downward pressure on core inflation, which the ECB watches keenly in policy decisions, would come from growing unemployment, which will limit wage growth.

Canada Nov producer prices gain most since June '08

Rising oil and metals prices pushed up Canada's producer price index by 1.0 percent in November, twice as much as expected and the strongest showing since June 2008, according to Statistics Canada data.

The price climb followed two months of declines and surpassed the 0.5 percent increase forecast by analysts in a Reuters poll. Prices were down 2.8 percent from a year earlier, compared with a 6.4 percent drop in October year-on-year.

Petroleum and coal products jumped 4.9 percent in November and primary metals products gained 1.6 percent.

However, for the first time since March 2009, the rise in producer prices was not entirely dependent on energy prices. Excluding petroleum and coal, the index would still have risen 0.5 percent partly due to a depreciation of the Canadian dollar against the U.S. dollar in November. Raw materials prices also jumped more than expected with a 2.2 percent increase versus market expectations for a 1.2 percent gain.

German joblessness falls for sixth month running

German unemployment fell for the sixth consecutive month in December, buoying hopes the labor market has escaped the worse of the economic downturn.

The Federal Labor Office said seasonally adjusted unemployment fell by 3,000 on the month in December to 3.421 million, as statistical changes and a part-time work plan designed to prevent mass layoffs cushioned the labor market. The jobless rate held steady at 8.1 percent.

Economists polled by Reuters had forecast the jobless total would increase by 5,000 on the month and break the string of declines that has allowed Germany to defy the jobless trend elsewhere in Europe.

Separately, French consumer confidence fell unexpectedly in December, data showed, adding to concerns over the strength of demand in the euro zone's second-largest economy as unemployment mounts.

The monthly indicator of consumer confidence from national statistics office INSEE fell for the first time in four months in December to -31 from an unrevised -30 in November.

Analysts polled by Reuters had been expecting the confidence index to improve slightly over the month to -29.

UK construction contracts at slower pace in Dec

British construction activity contracted for a 22nd consecutive month in December but the pace of decline eased and firms were upbeat about the future, a survey showed.

The Chartered Institute of Purchasing and Supply/Markit construction PMI index rose to 47.1 in December from 47.0 in November and a series low of 28.6 hit in February.

Alan Clarke, UK economist at BNP Paribas noted the construction series was painting a more gloomy picture than the official data, which show the sector expanded in the third quarter.

A breakdown by sub-sector showed both commercial and civil engineering construction activity continued to decline in December, but residential construction expanded for a fourth month running and at its fastest rate since August 2007.

Incoming new business declined after rising in November. But construction companies were optimistic business would pick up over the coming year.

NEXT UP

POLL-U.S. distillate, crude inventories seen down

U.S. distillate stocks likely fell last week on cold weather demand, while crude inventories dipped as refinery activity rose, an expanded Reuters poll of analysts showed ahead of weekly inventory reports.

The poll showed distillate stocks, which include heating oil, fell for the fourth week in a row as temperatures plunged in much of the nation, increasing demand for winter heating fuel. In particular, freezing weather hit the U.S. Northeast, the biggest heating oil market in the world.

Distillate stockpiles fell 1.9 million barrels and gasoline stocks rose 500,000 barrels, on average, the poll of 13 analysts showed.

Gasoline inventories edged up as snow and slippery highway conditions limited road travel and as imports could have increased, some of the analysts said.

Refinery utilization was forecast up 0.3 percentage point at 80.6 percent of capacity. In the comparable week a year ago, refinery utilization rose 2.1 percentage points to 84.6 percent of capacity.

Dec ISM services index seen rising to 50.5

The U.S. services sector is forecast to have grown in December, according to a Reuters poll of economists.

The Institute for Supply Management's services index is estimated to have risen to 50.5 in December from an unexpected contraction of 48.7 in November, according to a median forecast culled from the Reuters poll. Estimates from the 53 economists polled ranged from a low of 48.3 to a high of 52.1.

The ISM non-manufacturing Business activity index is forecast to have risen to 50.5, according to a median forecast of 13 economists polled by Reuters. Estimates ranged from a low of 50 to a high of 54.7.



DEEP DIVE Commentary and Analysis

COLUMN-Bernanke's fearful asymmetry

By James Saft

Ben Bernanke may minimize the role of monetary policy in the housing debacle, but he minimizes two key factors; the effect low rates and the Fed's policy of cleaning up after but not popping bubbles had on risk-taking.

In what amounts to a defense of his own and Alan Greenspan's legacy, Bernanke maintains that low interest rates didn't cause the bubble, which he says required a regulatory rather than monetary solution.

"Borrowers chose, and were extended, mortgages that they could not be expected to service in the longer term. They were provided these loans on the expectation that accumulating home equity would soon allow refinancing into more sustainable mortgages," Bernanke said in Atlanta over the weekend.

And where, I wonder, did borrowers get the idea that these new-fangled mortgages were good for them and that double-digit house price increases would continue? Greenspan famously sang the praises of mortgage innovation and floating rates for house buyers, while both he and Bernanke missed the bubble and downplayed its potential impact almost all the way to the bottom.

Even more to the point was the Fed's asymmetrical response to bubbles: doing nothing to pop them on the way up, and dropping rates to ease the pain in their aftermath. So the Fed did after the dot-com crash and so it did again, in spades, after the housing bust.

The Fed under Greenspan, who seemed to believe that markets were not just efficient but somehow magical and whose direction of monetary policy during his term was largely consistent with that point of view, allowed the bubble to form. No amount of retro-fitting the Taylor rule on different variables will change that. Bernanke now acknowledges that he might be forced to use the blunt force of interest rates against future housing bubbles, but his speech seems designed to leave the reader with the impression that higher rates are a last worst choice.

So it seems that Greenspan's asymmetry has been made a bit more even by Bernanke, though given the experience of the last few years, that is still pretty scary. The incentives and attitudes, at least toward financial innovation, are still there and so is the belief that the Federal Reserve will be there to ease the pain if another bubble pops.

IT'S NOT "WHAT CAN I AFFORD?", IT'S "WHAT CAN I EARN?"

Bernanke makes the argument that the effect of lower rates pales in comparison with the impact of products that defer payments or allow borrowers to keep payments lower in exchange for taking more risk.

I think it's not hard to argue that the Federal Reserve, as an interest rate setting body, had a bigger impact on house prices during the brave new world period of heavy securitization than perhaps it had when Fannie, Freddie and their non government-backed competitors were smaller.

But it's important to understand that this impact had at least two important parts. The first Bernanke addresses; low interest rates as an enabler for house buyers who might not otherwise be able to reach for a given house. But the second is at least as important. Low interest rates almost certainly had a huge impact on the providers of capital, especially those providers of capital to the financial markets, as opposed to traditional bank financing of mortgages.

"What Bernanke seems to be overlooking in his exoneration of ultra-low rates was the impact they had on the world's bond managers," Barry Ritholz, CEO and director of equity research at research firm Fusion IQ in New York, wrote on his blog.

Those people, and I know because I was interviewing them throughout the period, were reaching for yield. They had badly thought out targets that had been put together during periods of higher inflation and they wanted to be able to meet them still despite a low overall rate structure.

That unmet need -- for an 8 percent return in a 3 percent world -- was met magically but only temporarily by structured finance. Is that the fault of low interest rates? Not strictly speaking, but it is in substantial part the fault of the Fed, which wrote cheap insurance for risk takers, praised their innovations and cleaned up after their messes.

Low rates in a world of asymmetrical monetary policy are all the more potent and all the more dangerous.

Still, better regulation is called for and without it higher rates in isolation would be dangerous and destructive. Based on Bernanke's latest speech, I am not guessing that we will get either effective regulation or preemptive interest rate rises.

The practical implication, for those of you interested in more than who is to blame, is more bubbles.

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

ANALYSIS-After 2009 junk rally, investors look to quality

By Chuck Mikolajczak and Leah Schnurr

Last year's breakneck rally in U.S. equities was fuelled by poor quality shares, but trade in 2010 is likely to be driven by select, high quality stocks.

The market will not be able to rely on the seduction of cheap prices this year. Selectivity is the buzzword now, and as the search for "quality" drives stock picks, many analysts say well capitalized, defensive companies will be a favored hunting ground.

"Investors have turned their focus toward consistent revenue growers that are churning out reliable earnings growth," said Joe Keating, chief investment officer, RBC Bank Investment Management in Birmingham, Alabama.

This process has already begun. Both the S&P MidCap 400 index and S&P SmallCap 600 index surged more than 80 percent from March lows, while the broad S&P 500 was up more than 60 percent, but the large-cap index outpaced their smaller brethren in the fourth quarter of 2009.

High quality names are traditionally thought of as shares of companies with larger market capitalization, low debt loads and a leadership position in their respective industries.

Even so, the selectivity mantra does not mean the sectors which saw the best performance during 2009's rally will decline in 2010. That's because quality can be somewhat of a foggy notion, as companies with steady earnings can continue to lag those with growth potential through bull markets.

In all but one previous bull market, low-priced stocks outperformed those with strong debt ratings, according to Jeff Rubin, market strategist at Birinyi Associates in Westport, Connecticut. "Basically, you want to dance with who brought you to the party," he said.

The best-performing sectors through bull markets are those associated with expansion -- materials, consumer discretionary stocks, and technology, according to Bespoke.

GOLDILOCKS STOCKS

In 2009 investors piled into beaten-up stocks that had been pounded in 2008. Many of these were shares that did not pay dividends, and many were also favored targets of short-sellers. But rise they did -- the 50 stocks with the lowest market cap in



DEEP DIVE Commentary and Analysis

the S&P 500 at the end of 2008 gained on average 113 percent in 2009, according to Bespoke Investment Group in Harrison, N.Y.

Though cheap stocks provided the fuel for the market's fiery run-up, the massive rally has not pushed stocks to expensive valuations.

Price-to-earnings ratios fell to bargain basement lows before March's rebound, trading at around 11 times earnings expectations, according to Alec Young, equity strategist at Standard & Poor's in New York.

Improved corporate outlooks have stocks at about 15 times forward earnings expectations for 2010, said Young, about in line with historical averages. He expects stock to stay in a range in 2010, trading between 16 and 16.5 times expectations.

"The valuations of some of the larger cap companies look pretty compelling," said Eric Marshall, director of research at Hodges Capital Management in Dallas, Texas.

Trailing 12-month valuations will look even more attractive when the fourth quarter of 2008 falls out of the calculation, as S&P 500 earnings were negative for that quarter.

The search for value will have investors trying to single out firms with the greatest profit potential after a year where investors were merely happy to hear that the outlook was not worsening.

Companies that have weathered the downturn best are ex-

pected by many to continue to show strong earnings growth through international exposure, an increased market share from competitive attrition and increased efficiency.

This favors large caps, but smaller companies in niche markets have more potential to benefit from the disappearance of rivals. In a December note, Citigroup investment strategist Tobias Levkovich named 10 companies with these attributes, among them Goldman Sachs, 3M and Procter & Gamble.

"The higher beta trade has been rewarding, but it is time to buy corporate leaders with strong cash flow and sustainable dividends," he wrote. "If slow growth is indeed the future trend, quality will matter."

S&P 500 companies are expected to show earnings growth of just over 37 percent in the first quarter, according to Thomson Reuters research. This is a handsome increase from the 23 percent growth analysts were expecting last April.

While the more conservative investment approach may appeal to those burned by the financial crisis, it doesn't necessarily spell the most returns. In 2009, S&P 500 companies that pay dividends had a 26.2 percent average gain for the year. Non-payers posted a hefty 65.3 percent gain.

"It may be flip, but any stock that's going up in our portfolio is high quality to us and to any investor," said Rubin.

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