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Expectations and Realities for Earnings Season

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On January 30, **Morgan Stanley's hardware analyst Rebecca Runkle** published a major report on **IBM** called "End of an Era... Start of a New One." On that date she forecasted $4.75 per share earnings for 2002, and $5.60 for 2003. IBM was trading at 103.

After IBM issued its much-publicized earnings warning on Monday, she published another report lowering her numbers like every other Wall Street analyst. Now she's forecasting $3.95 per share for 2002 (down 17% from the prior estimate), and $4.45 for 2003 (down 21%). Yesterday IBM closed at 89 -- down 14% from its price at the time of Runkle's first report.

That means that on January 30 IBM was trading with a 2002 price/earnings ratio of 21.6, and now it's *risen* to 22.5. On January 30 the 2003 p/e was 18.4, and now it's *risen* to 20.0.

Today’s further decline in IBM’s stock price on SEC investigation concerns takes only a small fraction of the irony out of these crazy numbers. But is this the end of an era? Hardly.

When IBM's flim-flam man **CEO Lou Gerstner** stepped down in January, he was supposed to lock the doors and turn off the reality distortion field. Indeed, Monday's big warning has been touted as new **CEO Sam Palmisano's** attempt to "lower the bar." But it seems that nothing can stop techstock investors in their willingness to pay near-record multiples for growth -- or, more accurately, for the *expectation* of growth. No matter how brutally dismal the *reality* of no-growth may be, and no matter how many times CEOs say they see no turnaround -- "stabilization" at *best!* -- investors continue to tune their expectations to a growth boom that is always just around the corner.

One year ago when the markets were careening into their wrenching early-April lows, the best story that expectant techstock investors could come up with was some version of "we've never seen it this bad, so it just has to get better," or "it's always darkest before the dawn." Well, it got a lot darker. Back then the consensus forward earnings estimate for the S&P Information Technology sector was $66 billion, but only $33 billion was delivered.

That flimsy "it can't get worse" story filtered out all but the most faithful then, so buyers paid a forward p/e for the Information Technology sector of only 26.9 -- its lowest level since October 1998. It's never been lower since. So investors who bought then had valuations on their side, and they're just about even today despite the fact that earnings are massively lower now.

Investors *don't* have valuations on their side today. The Information Technology sector's p/e is now 35.1 -- down from the insane high of 50.0 last December, but still very beefy by any historical standards. So as earnings season unfolds, and there are more misses, more guide-downs, and more CEOs saying they see no signs of a turnaround, all techstock investors have to count on is the Gerstner reality distortion field.

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Yes, today's story is very seductive -- the V-recovery from the recession that never was. But we'll soon see how much reality that story can take. IBM's ability to expand its multiple in the face of reality may be remembered as the way this earnings season *began*, but the opposite may be remembered as the way this earnings season *ended.* And *that* end may indeed be the end of an era. TM