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MARKET CALLS

Normal Valuation: Where Do We Go from Here?

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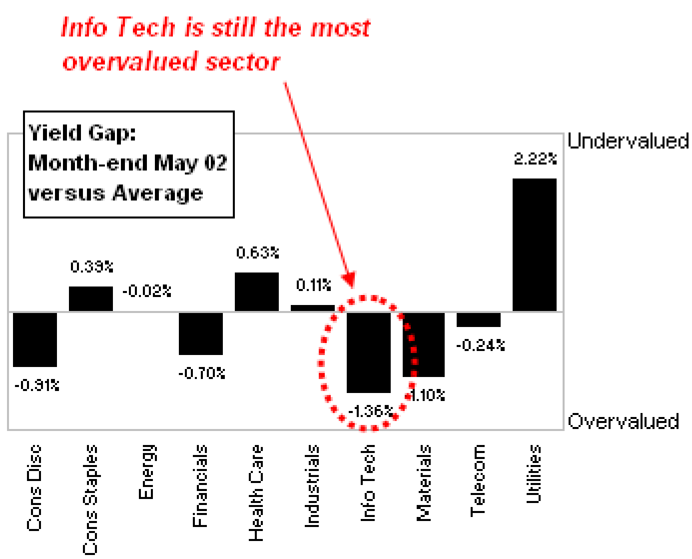
The overall market is normally valued for the first time in 5-1/2 years and earnings recovery is at hand -- what are the risks?

By our "yield gap" equity market valuation model -- which calculates the difference between consensus earnings-yield forecasts and long-term bond yields, and compares that to its own long-term norm -- the S&P 500 is now precisely at fair value (see "Return to Normalcy?" June 4 2002, for details about our valuation model). It's the first time the S&P has been normally valued for 5-1/2 years, other than for a brief two-month period in September and October 1998. And it took a lot to get here -- the S&P 500 has had to experience *both* a year-to-date *drop in price* of 10.5%, *and* a simultaneous year-to-date *improvement in earnings forecasts* of 7.9%.

So from a state of normal valuation -- where do we go from here? For the markets to move higher, one or both of two things is going to have to happen -- valuations will have to expand as sentiment improves, and/or earnings forecasts will have to be raised as economic recovery takes hold. Let's take a look at how these two factors -- sentiment and earnings forecasts -- intertwine.

While there's ample anecdotal reason to think that sentiment has plenty of room to improve from here -- there are no shortage of worries about such things as accounting scandals, terrorist attacks, and nuclear war between India and Pakistan -- the very fact that the market is normally valued suggests that sentiment is neither irrationally exuberant nor irrationally bleak at this point. Perhaps even after two years of a bear market, many investors still judge sentiment against the glory days of 1998 and 1999 as though that were the true mean to which we will inevitably revert -- a case of "been up so high, this feels like down to me." But the reality is that today's normal valuation is actually quite rich by long-term historical standards -- and is almost precisely the same level of valuation that obtained in December 1996 when **Alan Greenspan** first warned of irrational exuberance (see "The New High Plateau: The Valuation Conundrum" May 10, 2002).



The sense that sentiment is bleak today may also stem from the strong divergence in valuation between various sectors of the market -- a divergence belied by today's *overall* normal

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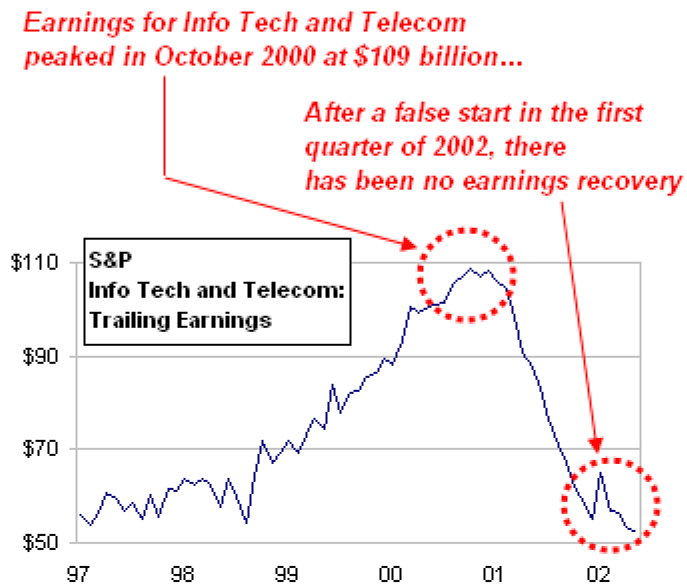
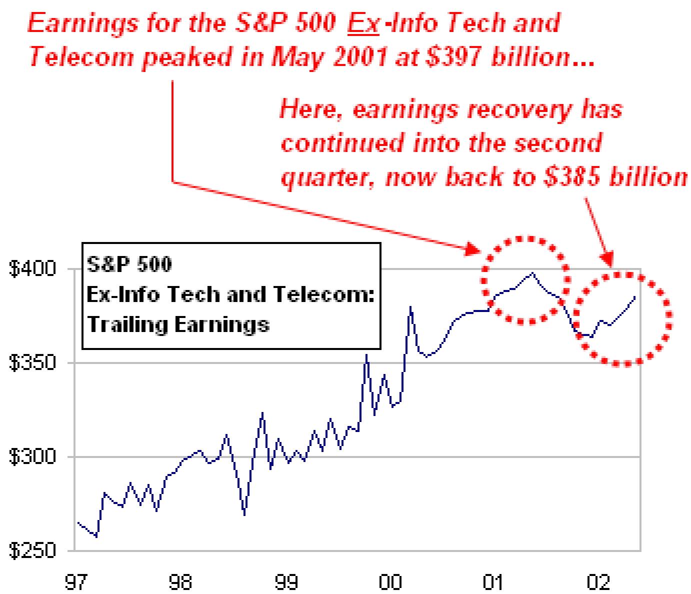
valuation. Information Technology continues to be the most overvalued sector -- suggesting that this is sector is the most intense focus for any hope and greed remaining from the glory days. Yet it is precisely this sector where earnings recovery has so far been the most elusive. The deep irony in techstocks between wish and reality -- coupled with the heavy media attention continually paid to this popular sector -- perhaps creates a sense of negativity out of proportion to the true level of market-wide sentiment.



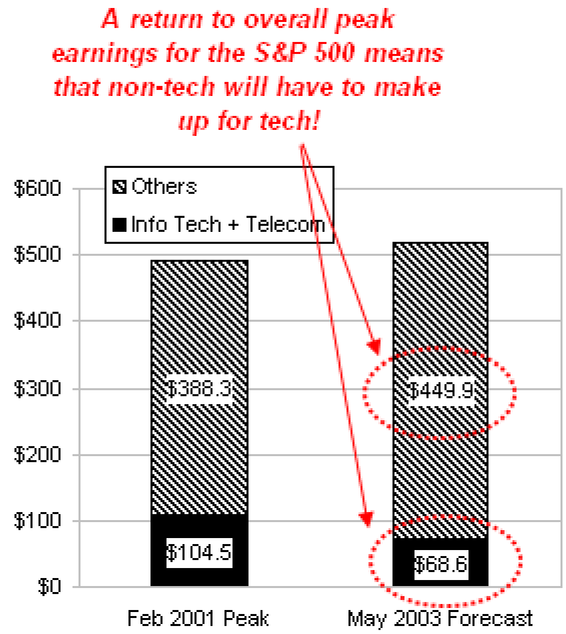


Across the Information Technology and Telecom sectors taken together --these sectors are surely linked in investor sentiment -- there has been no net earnings recovery at all. Trailing earnings peaked at $109 billion in October 2000, and subsequently rolled over into a cascade that wasn't interrupted until a strong spike early in the first quarter. But that proved to be a false start, as trailing 12-month earnings made new lows at month-end May at $52 billion. Erroneous extrapolation of that first-quarter spike into a sustainable earnings recovery is what led to **Intel's** notorious downward guidance revision last week -- and it could well be that this will be a pattern repeated across other technology and telecom companies as the coming earnings season gets underway (see "Intel: No News is Big News" June 7 2002).

At the same time, S&P 500 trailing 12-month earnings *outside* the Information Technology and Telecom sectors have been recovering quite smartly. They peaked in May 2001 at $397 billion. After that they entered into a slide both gentler and shorter-lived than tech and telecom's cascade. And now their first-quarter recovery continues to extend itself, making new recovery highs at month-end May of $385 billion. It would only take 3% growth from here to get back to peak earnings -- and based on nothing more than the long-term average earnings growth-rate for the S&P 500, that could happen in a matter of months.

Earnings recovery in the basic sectors of the economy is entirely consistent with our macro view that long-awaited relief from **the Fed's** disastrous deflationary stance is at hand -- evidenced by the rise in the gold price and the pullback in the forex value of the US dollar (see "Going for the Gold" June 4 2002). And retarded recovery in the more risk-sensitive sectors such as high technology is consistent with our view that those sectors most damaged by deflationary policies will take the longest to recover.

That's the good news. Now here are some of the risks. To live up to the consensus earnings forecasts for one year out -- the forecasts we use in our model that tells us that the overall market is fairly valued now -- will take considerably more than 3% growth. Specifically, the consensus forecast is for the S&P 500 -- including tech and telecom -- to set a new all-time record for the 12-months ended May 2003: that's $517 billion, or a jump of 18% over today's $438 billion, more than twice the long-term historical average earnings growth rate. And as the chart at right shows, that $517 billion earnings goal will have to be achieved with a lot less help from the Information Technology and Telecom sectors than it got from them in February 2001 when overall peak earnings of $493 billion were achieved. With this ambitious growth agenda baked into prices, any shortfall would result in lower prices -- unless valuations were to expand to make up the difference. If the overall market is presumed to stay fairly valued, then gains would only come from upside earnings surprises or forecast revisions.



S&P 500 earnings composition: Peak versus Forecast

Moreover, even achieving a return to peak earnings for the overall S&P 500 doesn't guarantee that prices will return to *their* peaks. For one thing, when the overall S&P 500 made its peak earnings in February 2001 at $493 billion, valuations were considerably richer. Whereas today the S&P 500 is normally valued, in February 2001 it was 12% overvalued according to our model.

Finally, remember that a return to peak earnings doesn't mean a return to peak earnings *per share* -- and it is earnings *per share* that drive share prices. Thanks to dilution from options issuance and other stock sales, the number of shares over which earnings must be spread has steadily increased. Vivid evidence of this can be seen in the fact that while peak earnings of $493 billion were achieved in February 2001, the peak in earnings per share was achieved almost a full year earlier in March 2000. At that time total earnings were only $480 billion -- that $13 billion difference is all dilution, pure and simple. And for all the post-**Enron** attention to options issuance and other accounting matters, we are aware of no evidence to suggest that dilution is getting any less.

So -- where do we go from here? We go forward, cautiously. We recognize that a return to normal valuation and a nascent earnings recovery outside of tech and telecom has made the overall equity market *not* entirely *un*attractive. But it is still something less than fully attractive. Investors can expect no winds at their backs from valuations -- stocks are just normally valued here, not cheap. And earnings expectations remain ambitious and fragile. It's too early to pop any champagne corks -- but why not keep a bottle on ice, just in case. Overall, things do look better than they have in a long while. TM