TrendMacrolytics

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Thursday, March 6, 2003

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Warren Buffett's perplexity reflects the market's paradoxical combination of growth and value plays.

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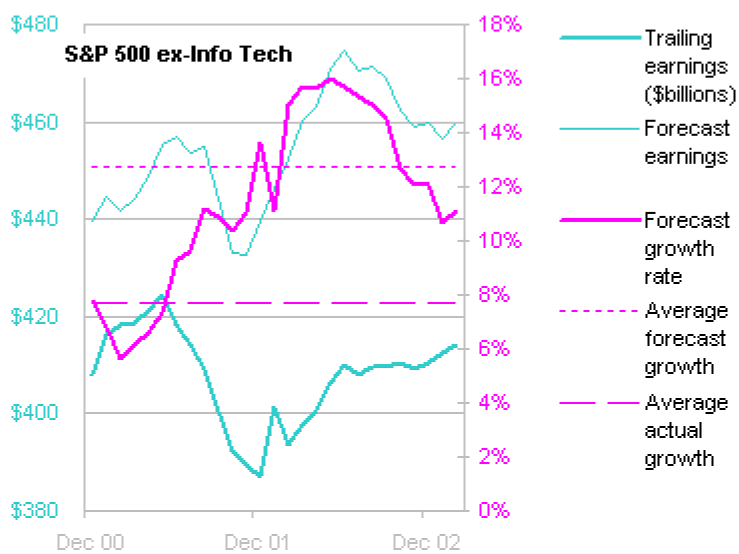
Warren Buffett has leaked portions of his upcoming annual letter to shareholders of **Berkshire Hathaway**, and the headlines are that he is terrified of derivatives, thinks his value stocks aren't undervalued, and likes junk bonds. We agree with him on one point for sure -- we like junk bonds, too (see "Bond Blowback" March 4, 2003). But we see no particular reason to fear derivatives now any more than all the other times that various critics have warned about them. As to stocks, we continue to see the overall market as meaningfully undervalued thanks to the primarily political uncertainties associated with a prospective invasion of **Iraq** (see "Going for Broke?" February 28, 2003).

That said, it's not difficult to understand why Buffett is gloomy on stocks. Just when the economic environment is the most uncertain, and all the musty textbooks he learned the business from would tell him that his brand-name stocks should be ports in a storm, it's the supposedly riskiest sectors -- the ones Buffett admits he doesn't know how to value -- that are doing the best. For example, Buffett's crown jewel **Coca-Cola** is down 14.0% year-to-date, while **Cisco** is up 3.1%. More broadly, while the overall S&P 500 has fallen 5.7% year-to-date, the Information Technology sector as fallen only 1.2%.

The chart at right helps us understand why -- it is complex, but rewards careful study. The heavy blue line shows trailing 12-month earnings for the S&P 500 minus the Information Technology sector, starting from December 2000. The light blue line shows the consensus earnings forecast for one year in the future. The heavy pink line is the consensus expected earnings growth rate inferred by comparing forecast earnings to trailing earnings. The two dashed pink lines show the long term average earnings growth rate, forecast and actual, from 1985 to present.



Now what can we learn from this chart? First, the fact that the average *forecast* growth rate of 12.8% is higher than the average *actual* growth rate of 7.7% reveals that analysts have been systematically too optimistic over the last

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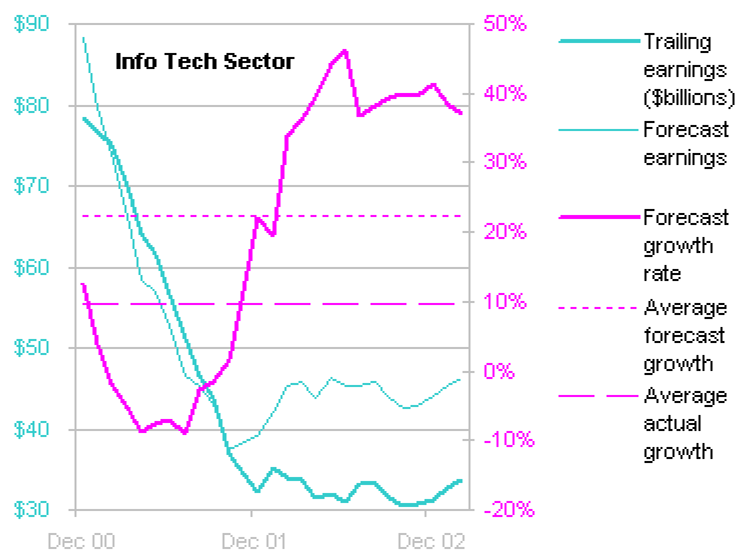
two decades. At the same time, the *actual* growth rate of 7.7% for this period is, itself, significantly higher than the approximately 5% to 6% actual growth rate that has obtained for the last half century.

Second, as actual earnings peaked in May 2001 at $424.4 billion, the forecast growth rate fell briefly below its long-term average. After that it rose steadily while actual earnings cratered, as analysts built rebound effects and easy year-on-year comparables into their growth forecasts. Now, with actual post-recession earnings having recovered to $414.0 billion -- only 2.4% below the all-time peak -- the forecast growth rate has edged down over the last year. But more than a year past the December 2001 trough in actual earnings at $387.1 billion, the forecast growth rate -- at 11.1% -- is still well above the actual average growth rate of 7.7%.

So that leaves the question: in our sadder-but-wiser post-bubble world, with a big dose of post-trough earnings recovery already under our belt, does anyone really think that the S&P 500 ex-Information Technology -- which is dominated by mature global companies like Coca-Cola -- can grow earnings for very long at anything like 11.1%? So if this forecast represents something like the best case, then under the weight of geopolitical uncertainties these stocks have to look like a bad bet -- all risk, no reward. And this is exactly where Warren Buffett's equity portfolio lives.

But that analysis is silent on the subject of *value* -- value being a function of market prices in relation to these unpleasant realities. Despite the absence of an earnings growth story, and in the presence of abundant geopolitical risks, our "yield gap" model suggests that at today's prices the S&P 500 ex-Information Technology is very deeply undervalued. In terms of price, these stocks would have to rally by 49.5% to be restored simply to their post-1985 valuation average. To run the valuation model in reverse, today's prices imply that earnings will *not* grow at 11.1%, nor at 7.7%, nor even at the post-war average of 5% to 6% -- rather, today's prices imply a *negative* growth rate of 25.7%. Unless you think it's going to get *that* bad, then stocks must be seen as cheap -- at least to some extent.



Now let's subject the Information Technology sector to the same scrutiny. As earnings fell dramatically from their December 2000 peak at $78.4 billion, the consensus earnings growth rate forecast fell dramatically, too, troughing at negative 8.8% in April 2001. Over the following year growth rates were revised wildly higher in too-early anticipation of an earnings trough that eluded the tech sector until just last October, at $30.4 billion (an horrendous drop of 61% from the peak).

Forecast growth rates for the Information Technology sector have been trailing down from their high of 46.3% in June 2002. But for the last eight months they have remained consistently about where they are now, at 37.0% -- far above the average forecast of 22.5% and the average actual of 9.7%. Yes, here too, over time the consensus has been too optimistic. But now, with this sector's earnings having troughed 10 months later than the rest of the economy, today's 37.0% growth consensus reflects a powerful "late bloomer" syndrome: much of the bounce-back effects and easy comparables still remain ahead.

Compared to the S&P 500 ex-IT, one could argue that with earnings forecasts so high, Information Technology has nowhere to go but down. But I don't see it that way -- I would say that *at least tech has a growth story it can tell*. I would go so far as to argue that from this position still so near the actual earnings trough, the Information Technology sector represents a heads-I-win, tails-I-win proposition. If war uncertainties are resolved soon and successfully, and **President Bush** is able to parlay that into enactment of his pro-growth tax-cut proposals, this most growth-sensitive sector stands to collect an outsized share of the upside. If war uncertainties drag on and tax policy stasis remains in effect, then at this point the sector has little to lose.

But what about *value*? While our model shows the Information Technology sector to be undervalued -- and over the last decade that's been a rare event! -- its recent strong relative performance has left if far less undervalued than the rest of the S&P 500. Our model suggests that technology stock prices would have to rise 14.7% to be restored to long-term valuation averages. Expressed in terms of implied growth rates, today's prices reflect expected earnings growth of 19.4% -- approximately the long-term average forecast -- rather than today's forecast of 37.0%.

The stock market, then is offering investors a perplexing choice. Technology stocks have a great earnings growth story, but they're not much of a value play. The rest of the market is a great value play, but doesn't have much of an earnings growth story. No wonder Buffett is putting his money in junk bonds. TM