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The "E" in the S&P's "V"

Tuesday, May 7, 2002

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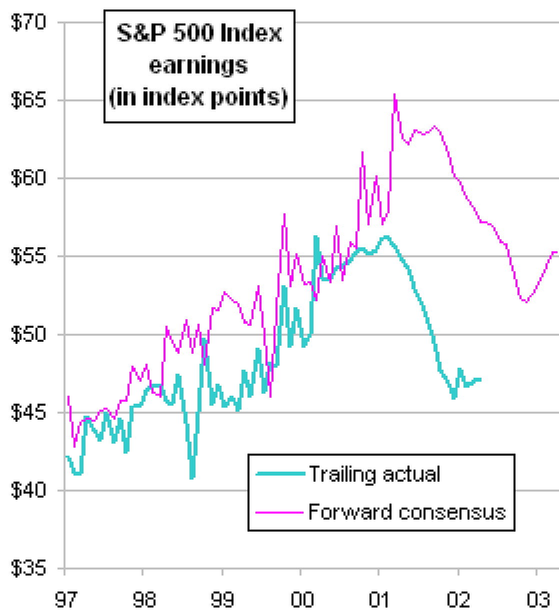
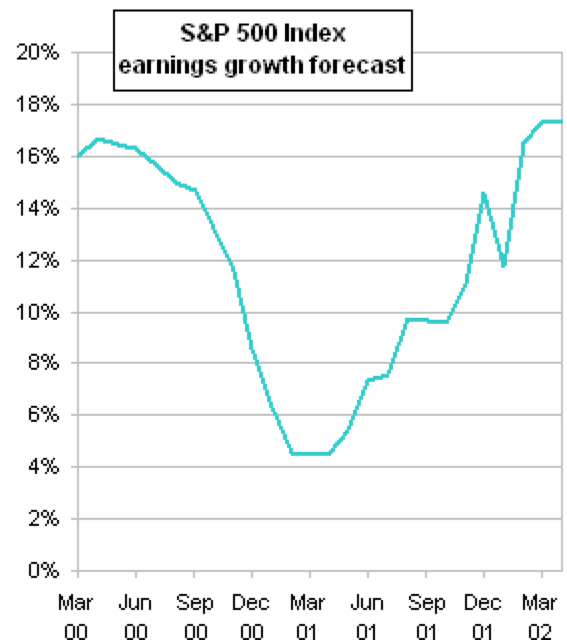


Our "yield gap" analysis -- which gave rise to our call last December to sell technology stocks and buy long-term bonds -- was based on the idea that stock prices had gotten far ahead of consensus analyst earnings estimates (see "Vay Out of Vack, Even for a 'V'" December 10, 2001). That was the right call for techstocks, because prices had advanced aggressively from the post-911 lows while, at the same time, consensus earnings estimates had crashed from the post-bubble highs.

For the S&P 500 the analysis is different. Stock prices are not especially out of whack with consensus earnings estimates. But consensus earnings estimates themselves may be significantly out of whack with reality.

Peak trailing 12-month earnings for the S&P 500 of $56.3 were achieved in March 2000, the same month that both the S&P 500 and the NASDAQ hit all-time highs at the top of the so-called bubble. This was a slight upside surprise, as the forward consensus a year earlier had only forecasted $52.1.



At the same time that trailing earnings were peaking, the forward consensus peaked too -- at $65.3. A year later, earnings had stalled out and begun their historic decline; consensus forward estimates started to come down, too.

Today the forward consensus is forecasting earnings of $55.3. That's a steep drop from the $65.3 peak forecast made in March, 2000. But that doesn't change the fact that this is a forecast of a return to peak earnings just one year from now. Put another way, the consensus is calling for nothing less than a "V"-shaped earnings recovery.

In terms of year-on-year percentage earnings growth, the consensus forecast is now more aggressive than it was at the top in March 2000,

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and more aggressive than it has been at any time since then. The consensus is calling for a 17.3% jump from today's actual trailing earnings of $47.1.

There may be nothing inherently implausible in forecasting a higher-than-normal earnings growth rate immediately following a sharp and unexpected earnings slump. But a return to peak earnings a year from now is, in our judgment, a bridge too far. While there are surely signs that the economy has stopped contracting, there is no justification to expect a level of economic expansion in the coming twelve months that would compare to the twelve months ended March, 2000.

One specific area of concern is that, this time, the S&P 500 will have to make it to peak earnings without tech. At the peak in March, 2000, 12.9% of the S&P 500's earnings came from the Information Technology sector. But for the most recent trailing 12 months, tech contributed only 7.7% of the S&P 500's earnings.

While it is true that the forward consensus has Information Technology earnings growing at a faster-than-market 36.3%, those earnings are coming off a severely diminished base. So tech is only forecasted to contribute 8.9% of S&P 500 earnings for the coming twelve months -- a 4% drop from the 12.9% it contributed in March, 2000. For tech to get back to a 12.9% contribution this year, it would have to turn in 96.5% earnings growth.

That's not going to happen. So that means that non-tech components of the S&P 500 will have to perform significantly *better* than they did in the twelve months ended March, 2000, to make up for tech's smaller contribution this year.

So now *both* the tech and the non-tech sectors of the stock market are facing real hurdles. For tech it's "P" -- prices are still too high. And for non-tech it's "E" -- prices have pulled back a bit, but the illusion of reasonable value is being propped up by unattainable earnings expectations. For both, we're a long, long way from "V."