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MARKET CALLS

The Earnings Party Where Nobody Came

Friday, August 2, 2002
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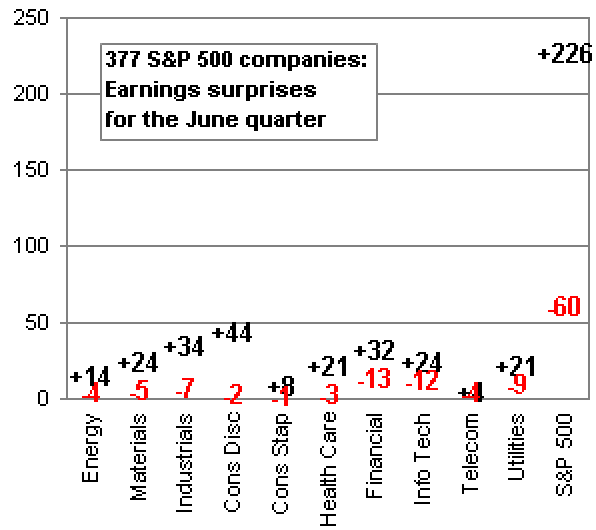
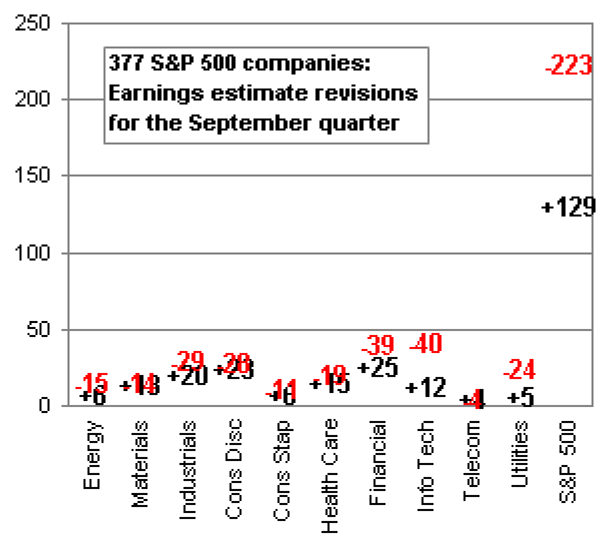
The strange dynamics of the past earnings season -- upside surprises, downside revisions, and an uptick for tech.



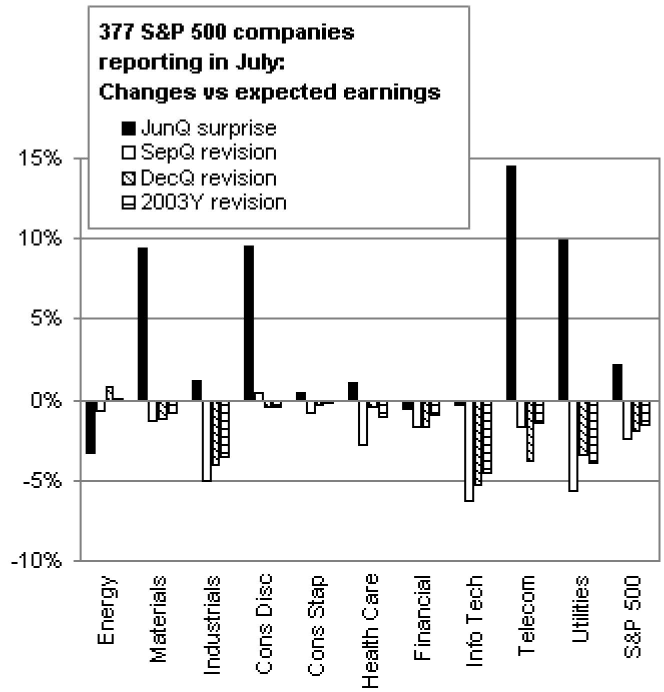


Samuel Johnson called remarriage "the triumph of hope over experience." But the earnings season that just ended may be the bear market opposite: the triumph of experience over hope. Despite an overwhelming majority of upside earnings surprises in July, analyst revisions were just as overwhelmingly negative. Students of market psychology may choose to interpret this as evidence of excessive pessimism, or even of capitulation. That may be, but it surely means that the analysts are using the cover of a decent quarter to bring their way-too-rosy estimates somewhat more into line with reality.

377 companies in the S&P 500 reported their June quarters last month. Of these, 226 reported earnings that beat the consensus of Wall Street analysts -- while only 60 missed. This happened in virtually every sector of the market, with the only exception being Telecommunications Services, where positive and negative surprises tied at 4 each.

The net dollar value of all the surprises -- the dollars unexpectedly earned in the upside surprises minus the dollars unexpectedly lost in the downside surprises -- was a gain of $1.9 billion, or 2.2% of the total earnings expected. The largest positive contributions came from the Consumer Discretionary sector (thanks to **Ford** and **General Motors**) and the Telecom sector (thanks to **AT&T** and **Nextel**). Three sectors -- Information Technology, Energy and Financials experienced a *negative* net dollar value of surprises. Because even though in those sectors a larger *number of stocks* surprised on the upside, a few big misses (such as **Advanced Micro Devices**) dominated the net dollars.

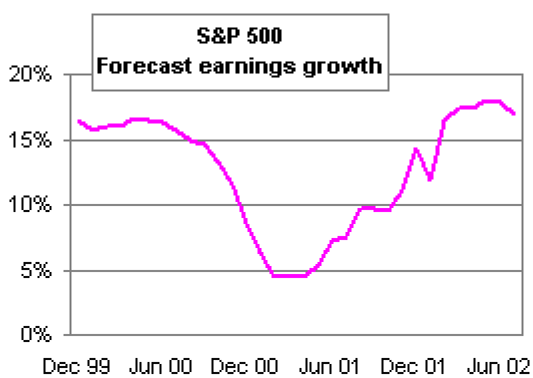
But for those same 377 companies, analyst revisions last month took back that $1.9 billion positive surprise, and then some. 223 companies got downward revisions for the coming September quarter, while only 129 got upward revisions. In perfect mirror symmetry with the upside surprises, this happened in virtually every sector of the market, with the only exception being Telecom, where upward and downward revisions tied at 4 each.



The net dollar value of all the revisions was a loss of $3.0 billion -- almost twice the gain from the June quarter's surprises -- or 2.4% of the total earnings expected. The largest downward revisions were in the Industrials sector (thanks to **Tyco** and the airlines stocks), but other large downward revisions were seen in Information Technology, Financials and Utilities. The one and only sector that had positive revisions, on average, was Consumer Discretionary.

The downward revisions in these 377 companies for the December quarter are just as dire. Overall, the net dollar value of all the revisions was $2.4 billion, or 1.9% of expected earnings for that quarter. Same for fiscal 2003: downward revisions totaled $9.0 billion, or 1.6% of what had been previously expected.

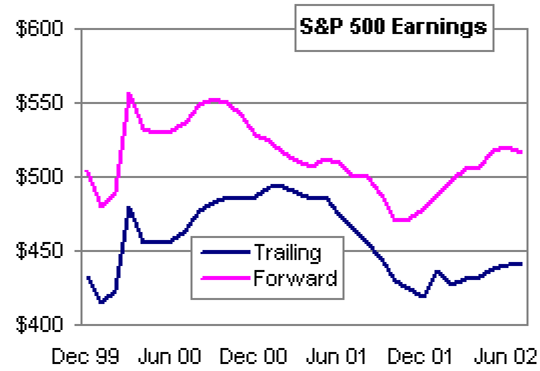
Why are the analysts so gloomy about the future -- when this past earnings season has been ostensibly so terrific? Well, who wouldn't blame them for being gloomy -- they've had to live through the same bear market as the rest of us, but on top of that they've had "Buy" ratings on just about everything all the way down, and the cops are crawling through their e-mail folders looking for evidence of fraud.

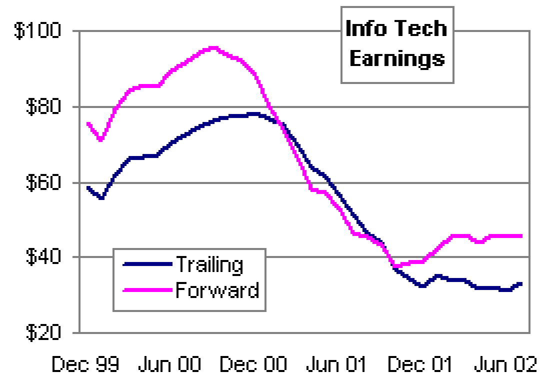


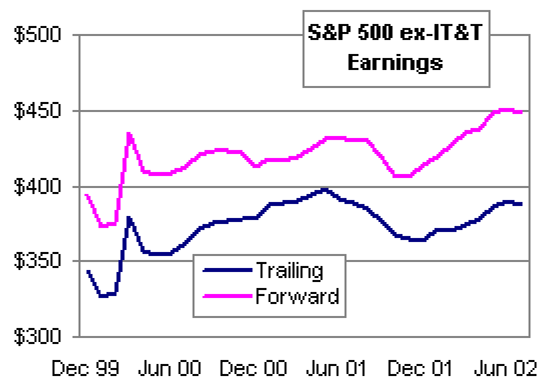
But in terms of the professional psychology of the typical Wall Street analyst, the reality is that a positive earnings season has provided an opportunity to bring estimates down a little bit from levels that had clearly been too optimistic. What better time to do it? Now the analysts can pose as prudent contrarians, and keep what's left of their dignity. But if this past earnings season had been a disaster, the same downgrades would make the analysts look like scared lemmings. One must keep up appearances in this business.

1-year forecast earnings growth for the S&P 500 has been running above 17% for the last 4 months, as fantasies of a "super-V" economic recovery have gripped Wall Street. Now we've just seen the first downtick in earnings growth expectations since January, as the reality of a more tepid and gradual recovery starts to set in.

The drop in growth expectations comes from the combination of *both* the downward revision in forward earnings estimates *and* another uptick in 12-month trailing actual earnings. Trailing earnings grew a mere 0.01% in July, but at least they grew -- extending their winning streak coming out of last February's notable dip. At the same time, forward estimates fell 0.8%. See the top chart at right.







That single basis point of trailing earnings growth that the S&P 500 managed to eke out last month was thanks to -- surprisingly -- the Information Technology sector. Tech's trailing 12-month earnings grew 7.5%, the first uptick at all since the single-month head-fake recovery last January. See the middle chart at right.

With so many tech companies guiding earnings forecasts lower, and none pointing to signs of a recovery, it's hard to attribute too much to this uptick in trailing earnings. It probably means nothing but that year-over-year comparables are *finally* starting to be somewhat flattering. But that was enough, in July, to cause technology stocks to strongly outperform the broad market on a risk-adjusted basis. For the month the S&P 500 fell 7.9%, while the NASDAQ 100 fell 8.5% -- normally we would expect to see the tech-heavy NASDAQ 100 down twice as much as the S&P 500.

Without Tech's positive contribution, trailing 12-month earnings for the S&P 500 would have been lower last month, for the first time since February -- even after taking out the negative contribution from the Telecom sector. See the lower chart at right, above.

The stall-out in trailing earnings recovery and the lowering of forward earnings for the S&P 500 puts a little pressure on our claim that the market is deeply undervalued. That said, it is so extremely undervalued that even radical cuts in forward earnings estimates would not substantially change our conclusions. Using our "yield gap" model -- which calculates the difference between the forward "earnings yield" of the S&P 500 and the yield of long-term Treasuries -- it would take a drop in earnings growth all the way from today's consensus forecast of 16.9% to *negative* 4.1% to bring the S&P 500 up to fair valuation based on long-term historical norms.

We continue to take the position we have taken all along -- recovery will be gradual and tepid (even the last of the great super-V superbulls must surely have given up by now). And we continue to take a cautiously optimistic stance on equities based on valuation -- with a Model Position long the S&P 500 at a 45% allocation, not entirely offset by another Model Position short the NASDAQ 100 and long long-term Treasuries. TM