TrendMacrolytics

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Earnings Tell the Tale

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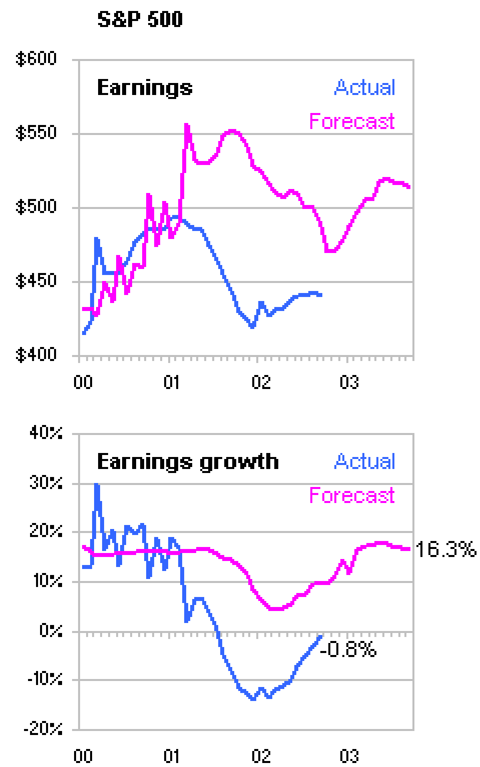
Our anemic "techless recovery" is perfectly reflected in corporate earnings.

Corporate profits data continues to support our macroeconomic view and our cautious optimism on equities outside the tech sector:

- The recovery is muddling through -- but it is slow and anemic
- There is no recovery in the technology sectors of the economy
- Aggressive growth expectations will be revised lower



S&P 500 earnings on a trailing 12-month basis were down 0.4% in September, a drop of $1.76 billion, bringing them to $441.0 billion -- just slightly lower than the $441.2 billion reported in June. This is first down-tick since what proved to be a "pause to refresh" last February, and it means we've just experienced a full quarter with flat-to-negative earnings.

Forecasted earnings have been coming down for the last quarter, and were lower by 0.8% in September. With forecasts coming down faster than actuals, that means that year-over-year growth expectations are coming down -- just as we've said for many months that they must in the absence of a "super-V" recovery scenario.

Today's 16.3% growth expectation -- derived by comparing actual trailing earnings to the consensus forecast -- still seems terribly aggressive in light of our forecast for anemic economy recovery. And all the more so against the backdrop of actual year-on-year earnings growth that is still slightly negative, despite what are getting to be downright embarrassingly easy year-ago comparables. But as the old saying goes, *it's not a stock market but a market of stocks*. At least it's a market of sectors -- the continuing abysmal performance of the Information Technology sector is masking what recovery the rest of the economy is managing to muster.

Actual earnings in the tech sector are simply showing no recovery at all. The best thing that can be said for them is that they are finally "stabilizing," which is perhaps a polite way of saying they are going down less rapidly. In September trailing 12-month earnings were down 5.1% month-

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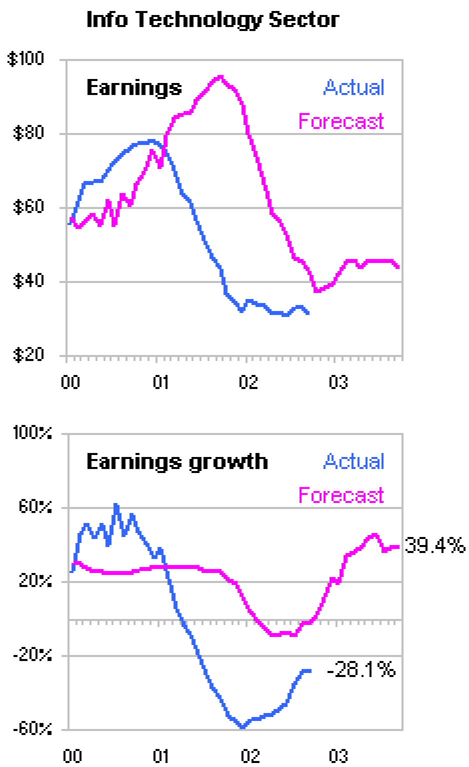
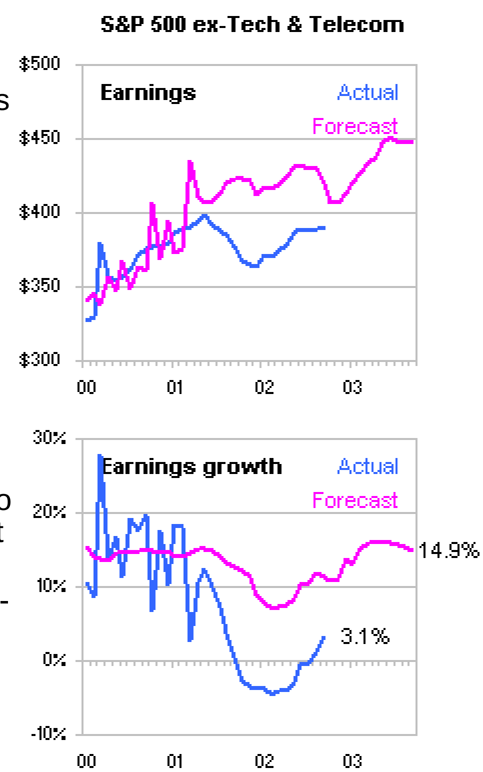


on-month, dropping $1.68 billion -- and thus explaining virtually the entire drop in S&P 500 earnings month-on-month.

Forecasted earnings only fell 4.3%, so month-on-month earnings growth expectations rose to 39.4%. This is down from May's peak of 44.3%, but still seems to reflect the triumph of hope over experience. Analysts seem to be doing the same thing they've done all the way down -- assume that the worse things get, the bigger the rebound has to be. This view is, at its heart, simply technical analysis as applied to earnings -- it's a theory of the inherent cyclicality of earnings, and it is being relied upon to the exclusion of facts to the contrary. The fact is that the Information Technology sector is on the verge of insolvency, with the exception of a handful of giant firms waiting to pick up whatever's left (see "Let's Play Survivor" September 24, 2002).



Viewed without the troubled Information Technology and Telecommunications Services sectors, the S&P 500 can be seen as making much more encouraging earnings progress. Actual trailing 12-months earnings were virtually unchanged month-on-month in September, with losses in tech and telecom made up by other sectors -- Consumer Discretionary, Consumer Staples, Materials and Healthcare turned in the best performance (this and other detailed information about sector performance and valuation is now available on our web site).

So the stealth non-tech recovery continues. We continue to find that most investors are unaware of the good news that actual trailing 12-month earnings for the S&P 500 ex-tech and telecom have now recovered to within 2.3% of their all-time peak level achieved in May 2001.

Year-on-year actual earnings growth is positive at 3.1%, moving up strongly in September for the fifth month in a row. At the same time, year-over-year earnings growth expectations continue to drift lower. At 14.9% it is still probably too high in light of our forecast for anemic recovery -- some, but not all, of the present deep undervaluation of equities will probably be resolved by a continuing decline in growth expectations (see "Q1 2000 Upside Down?" October 1, 2002). TM