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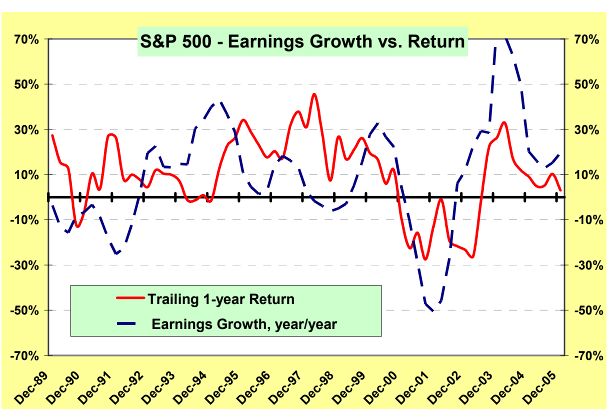
Investment Arrhythmia

A favorite expression on Wall Street is that (investment) history may not repeat itself, but it rhymes. It's a cute phrase, and one backed up by some appealing fundamental logic as well as reams of statistical analysis.

Our thoughts on this are pretty basic – sometimes yes, sometimes no. Consider the concept that stock market performance tracks more closely with corporate earnings growth than with anything else. If you look at those two data sets over very long time frames (say, 20+ years at a time), and compare the information in fairly large handfuls (say, rolling three-year chunks), the linkage is clear, direct and powerful. Given time, share price appreciation has always "rhymed" with earnings growth.

But, the devil is in the details. If you look at *one*-year earnings growth rates versus *one*-year stock market returns, the rhythm looks off. Per the following chart, since the late 1980's there have been many instances of "arrhythmia" when it comes to earnings and returns.



The relationship is clearly there, but it's been out of sync often since 1987, and by quite alot. Further, we are currently smack dab in a period when the earnings growth of companies has been "beating" much faster and stronger than the share price appreciation of those same companies. When might we expect the local stock market to start getting its groove back, so to speak?

Years of Back-To-Back P/E Contraction Since 1955

Years	*Total Return*	*Earnings Growth*	*P/E Contraction*	*3rd Year Return*
1965-1966	1%	+22%	(22%)	+24%
1973-1974	(37%)	+39%	(58%)	+37%
1976-1977	+15%	+39%	(23%)	+7%
1977-1978	(1%)	+25%	(29%)	+19%
1978-1979	+26%	+36%	(16%)	+32%
1987-1988	+23%	+51%	(24%)	+32%
1994-1995	+39%	+52%	(31%)	+23%
Average	***9%***	***+38%***	***(29%)***	***+25%***
2004-2005	+16%	+37%	(18%)	?

The folks at Legg Mason Capital Markets (whose U.S. large cap portfolios have beaten the S&P 500 for 15 straight years) have an opinion on this question - they think 2006 is the year. With the help of Morgan Stanley, they compiled the above table. In the past fifty years there have been only eight instances when corporate earnings grew in back-to-back years, while at the same time share price appreciation was so out of step that market P/E ratios contracted during each of those years. This happened in 2004-5. In each of the prior seven instances, the very next year was catch-up time. (see table)

We were initially struck by just how few times the combined pre-condition of back-to-back years with rising earnings and falling market P/E's has occurred. Given the uneven market dynamics reflected in our chart, we would have guessed this arrhythmia to have been a more frequent occurrence. Second, we were impressed by how the third year result was nearly the same in each case – very high returns. But, we figured this was because each of the preceding back-to-back years had something else in common - poor total returns. So, we researched and supplied the Total Return column. It turns out the initial two-year return sets have been all over the place. No real pattern at all.

Legg Mason makes a very interesting case. We've been concerned for some time that since equity investors have been discounting much of the last few years' dramatic growth in corporate earnings, they might subsequently punish share prices when earnings growth rates faltered. Since the market's P/E ratio has been "allowed" to decline in the face of rapidly rising earnings and flat long-term interest rates, we've worried it will decline even further when earnings growth finally stalls out. Legg sees things differently, observing that historical markets have a track record of rebuilding their P/E ratios, in a sort of snap-back effect, which could produce market returns well in excess of expectations if it happens in 2006.

This is potentially very powerful stuff. The Street is projecting 2006 net earnings of $79.30/share for the S&P 500 companies. With most precincts accounted for, actual earnings for 2005 appears to have been $71.50. So, about 11% earnings growth is forecasted for 2006. The sell-side might be too optimistic, but matters look to be miles away from a bad earnings year. On the price side of the ledger, the S&P index ended last year at 1248. It ended 2003 at 1112, when the year's earnings/share were just $48.74 (that's a trailing P/E ratio of 22). Even if earnings this year come in below current expectations, but still hit $77/share, that would provide further validation of the "continuing growth" story-line. Should the market P/E then rhyme with history, by snapping back to even just 19x, we could be looking at an S&P index level of 1463 or better by year-end. With dividends, that would be a +19% year.

Further, current equity market levels are not at all inconsistent with current, or even higher, bond market yields. Accordingly, we think the strategic key is whether the continuing earnings growth story-line gets validated, not whether interest rates go up or down 50-75 basis points. That's why we regularly check to see whether collective analyst estimates for 2006 and onward are being revised.

Conclusion

Perhaps certain aspects of investment history do repeat themselves. If so, we're left with the "uncomfortable" idea that 2006 might be a pretty good year for domestic stock market investors. If so, keeping your plan's equity exposures at current strategic target levels certainly seems warranted.

- RDS