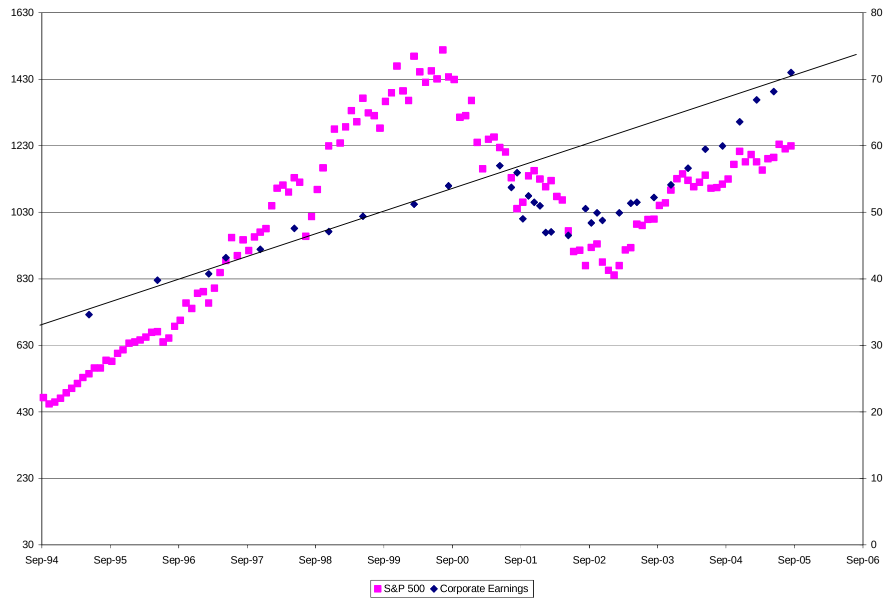
October 13, 2005

Note

RE: Oct05 Price v. Earnings Data

This is the actual Price (S&P 500, pink series, left y-axis) and Earnings (blue series, right y-axis) data used in yesterday's Note. There are interesting observations to draw from this raw data.



First, contrast the slope of Earnings over the past few years with the slope over the first half of this period. Clearly, the recent rate of earnings growth has been awfully strong (15%+ per annum), as earnings rebound from the dip a few years ago. This is the root of the Fed's inflationary concerns and something expected to slow ahead. Over the next year, corporate earnings growth is expected to be in the neighborhood of 9%, which is more inline with a normal, healthy rate of earnings growth. However, many investors are concerned by the fact that earnings growth is expected to slow, suggesting they're unaware it's just slowing to a more natural rate.

Second, the market is noted for being a reliable gauge of future economic activity, perhaps due to a self-fulfilling mechanism. Note how prices turned south about a year ahead of earnings. Also note how prices began moving higher ahead of the earnings recovery, though with less lead-time.

Finally, investors often fixate on the artificial, such as calendar quarters and/or years. YTD, stocks have done very little, creating the impression of a "bad" market. Over the full past year, however, stocks advanced about 10%, which is roughly an average annual return for stocks. Over the prior full year, stocks again advanced about 10%. That's not enough to excite investors and inflame their passions, and it's arguably less than it should have been per yesterday's Note, but it's a long way from a "bad" market.

Lowell