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CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT

ARE EARNINGS RUNNING OUT OF GAS?

September 2005

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Are Earnings Running Out of Gas?

"Be fearful when others are greedy and greedy only when others are fearful." – Warren Buffett

We keep hearing that this bull market is earnings driven, and that continued strength in corporate profits will keep equities levitating for some time to come. However, since the start of the year, we have warned that profit growth, while clearly supporting equity prices, was likely at or close to a cyclical peak, and probably presaged a period of sub-par growth or even contraction. A number of recent developments appear to support this conclusion. To begin with, real earnings growth has slowed sharply since the end of 2003, and appears in danger of going negative (Table A). Further, while the energy sector accounted for 22.2% of S&P 500 earnings growth last year, and will likely total at least one-third of total growth in 2005, more than half of 2006 growth is expected to come from the financial, information technology (IT), and consumer discretionary sectors, with energy accounting for a mere 5% (Table B). (Analysts are in the midst of updating 2006 estimates to incorporate the effects of Hurricane Katrina; these revisions are discussed below.) Finally, corporate profit margins appear high relative to historical levels. Nevertheless, the consensus right now expects earnings to grow at double-digit rates next year, with margins actually widening a bit. We believe there is a real danger these projections do not come to pass.

Over the two years ended in June, the S&P 500 posted cumulative real earnings growth of 67.3%, more than one standard deviation above its average two-year growth since 1900 (9.4%). As we pointed out at the start of the year, two-year growth at least one standard deviation above average (50.9%) has been followed, on average, by two-year real growth of -3.4%. Thus, it is not all that surprising this growth has slowed sharply in recent months. Indeed, year-over-year quarterly earnings growth peaked in fourth quarter of 2003 at 73.4% and has slowed every quarter since, most recently posting a 6.3% gain in the second quarter of 2005, after rising 12.5% in first quarter of 2005, 16.3% in fourth quarter of 2004, and 46% in third quarter of 2004. Still, the consensus estimate for 2006 earnings growth is a robust 10.4%. (This figure is as of the end of August, and does not incorporate recent revisions. As such, it likely *understates* expected growth. Morgan Stanley, for example, boosted its 2006 S&P 500 earnings estimate by 6.5% on September 16.)

Our view remains the same: the recent spike in profits appears to have been driven largely by temporary factors, rather than underlying strength in the economy. Specifically, the wave of liquidity that continues to slosh around the globe has clearly benefited financial firms, which have posted record profits thanks to large gains in highly volatile businesses such as proprietary trading and issuance of low-quality credit products.[1] This liquidity has also fed through into economic activity, which in turn has contributed to the rise in energy costs, and therefore energy company profits. Indeed, these two sectors are expected to account for more than half of the growth in S&P 500 profits this year. However, while both sectors have done well of late, it is difficult to envision a scenario under which energy *and* financial firms post strong profits for an extended period of time, as the conditions that benefit one are likely to eventually hurt the other. (Energy company profits may also come under pressure from politicians eager to assuage voters they are "doing something" about high gas prices.) A period of sustained high energy costs, for example, would likely result in rising inflation, and would almost certainly cause the Fed to continue hiking policy rates, thus

[1] Please see our March 2005 U.S. Market Comment: *Earnings Growth: Don't Bank on It.*

depressing earnings at financial companies. While the financial sector has held up quite well during the Fed's current rate hike campaign, much of this can be attributed to a surge in profits from mortgage lending and related activities, which depend more on long rates than on policy rates set by the Fed. In short, over the past few years financial firms have benefited from the wide spreads made available when the Fed slashed short-term rates in 2001, and more recently from the housing boom/bubble that has been aided by low long-term rates. The good times, however, may be drawing to a close. Spreads have been compressing for quite some time, and the housing boom has shown preliminary signs of cooling, although it is still too early to have conviction that house prices have peaked.

The other two sectors expected to make significant contributions to earnings growth in 2006, meanwhile—IT and consumer discretionary—also have significant hurdles to overcome. The IT sector, for example, contains a number of what can only be considered cyclical growth companies selling at very high multiples. (The sector's overall price-earnings [P/E] is 27.3.) Considering how fast earnings have grown over the past few years, and the fact that tech sector margins are close to all-time highs, it seems possible investors are assigning very high multiples to what will turn out to be peak earnings. As Morgan Stanley's Byron Wien recently remarked: "The bubble has burst, but modest multiples that reflect the industry's cyclical growth status have not returned." Further, the requirement that companies expense stock options in 2006 is likely to hit IT company earnings, although it is certainly possible investors will choose to "look through" such charges as noncash and thus irrelevant.

Consumer discretionary firms, meanwhile, must contend with mounting signs of a slowing economy and cooling housing market. As Northern Trust's Paul Kasriel recently pointed out,[2] many economic stats were already softening *before* hurricane Katrina, including retail sales, private construction spending, and the ISM composite manufacturing index. While it is true that consumers have held up extremely well over the past few years, this resilience is entirely due to the persistent decline in the saving rate, coupled with capital gains (in the late 1990s) and home equity extraction (since the tech bubble burst). In 2004, for example, U.S. consumers borrowed $820 billion through mortgages, but bought only $540 billion worth of homes. The difference, $280 billion, was used for general consumption and represented 2.4% of GDP. More broadly, Bridgewater Associates estimates annual household spending today is about $1 trillion higher than it would be if not for the long-term decline in the saving rate. With the equity market treading water, and home prices potentially leveling out (if not falling), it is difficult to see where consumers will find additional resources for discretionary purchases. Still, betting against the U.S. consumer (and more recently, the housing market) has long been a losing proposition.

The current high profit margins enjoyed by U.S. firms are another area of concern. Excepting a brief period in 1978, margins, which tend to be mean reverting, are at their highest levels since the mid-1960s (Table C). Further, the recent trend of rising margins looks long in the tooth. Since 1947, there have been only three previous periods of rising margins that lasted 13 quarters or longer, with the longest being 20 quarters; the current trend, which began at the start of 2002, has already lasted 13 quarters. While the average rise in margins during the previous periods was 434 basis points (bps), meanwhile, margins have soared 918 bps during the current period. There are, of course, reasons to believe margins *should* be trending higher

[2] "Hurricane Katrina—A Supply Shock Interacts with Pre-existing Demand Restraint," September 6, 2005.

today, most notably the spread of globalization that has resulted in untold millions of low-wage workers joining the global workforce. Analysts, for their part, expect the trend to continue. Current estimates call for margins to widen in every nonfinancial economic sector in 2006, with projected gains ranging from 20 bps to 60 bps.

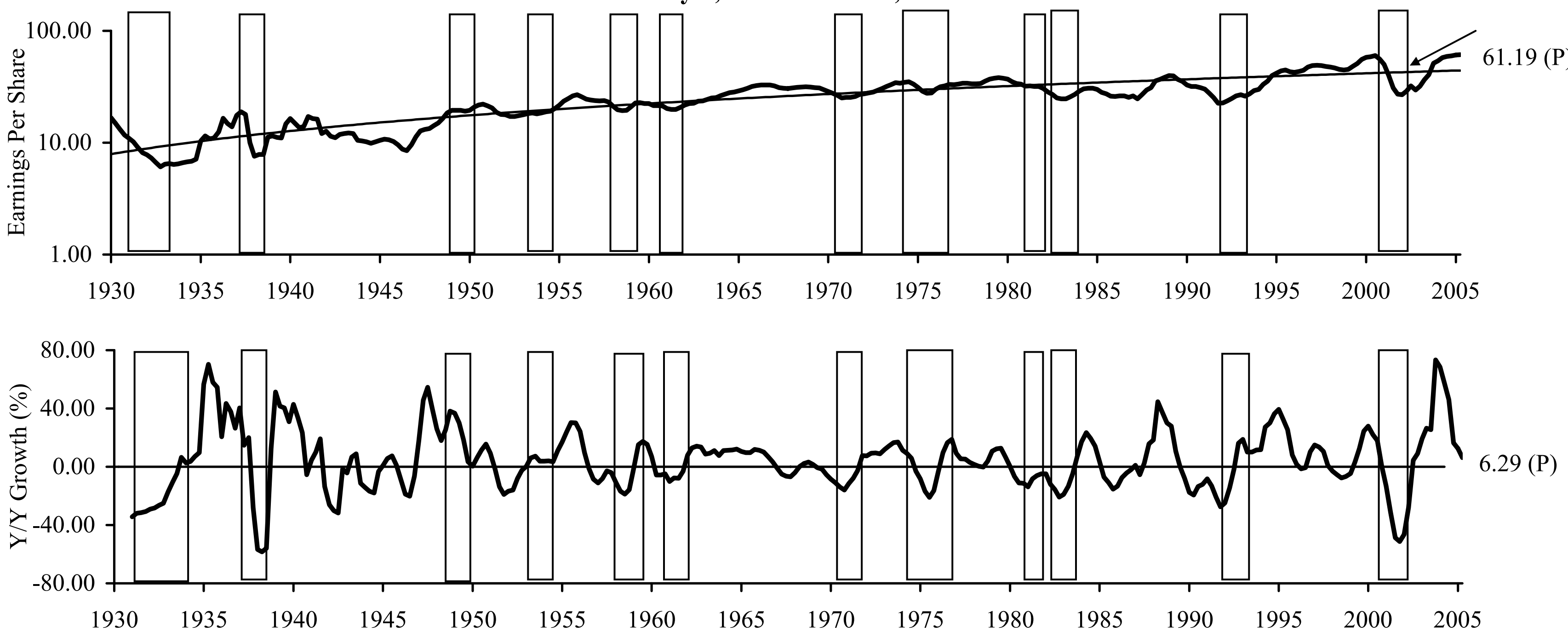
Indeed, analysts' optimism has been quite apparent in their ambivalent, if not downright positive, reaction to Hurricane Katrina. Morgan Stanley's Henry McVey, for example, recently raised his 2005 and 2006 earnings estimates for the S&P 500 as a whole, solely on the basis of rising energy costs. In short, McVey argues that rising energy prices will sharply boost earnings for energy companies, with little to no impact on earnings in other sectors. He is hardly alone. In August, analysts raised their 2005 estimates of energy sector profits by $4.4 billion; the net change for all other sectors was a decline of only $80 million.

In sum, we believe the risks to U.S. corporate profits are underappreciated. Historically high profit margins, coupled with a slowing economy, high and rising energy costs, and the uncertain aftermath of Hurricanes Katrina and Rita, strike us as a recipe for slower earnings growth. Analysts, however, continue to ramp up estimates not only for future earnings (Table D), but for profit margins, as well. Finally, P/E multiples of U.S. equities remain relatively high, and appear to be pricing in an extended period of strongly rising earnings and low inflation. Put simply, investors at the moment appear more greedy than fearful.

Table A

S&P 500 REAL REPORTED EARNINGS PER SHARE

January 1, 1930 - June 30, 2005



	Compound Average Growth Rate	Maximum Peak to Trough	Maximum Trough to Peak	Longest Sustained Rise Y/Y	Longest Sustained Fall Y/Y	Average Recession Growth Y/Y	Average Peak to Trough	Average Trough to Peak	3Q00 Peak to 1Q02 Trough	1Q02 Trough to 2Q05 Current Level
Percent Change (%)	8.14	-63.52	210.64	599.15	-80.42	-9.67	-37.88	91.84	-55.32	127.74
Periods	1930 -2005	1Q30 - 4Q32	4Q32 - 2Q37	1Q62 - 4Q66	2Q80 - 3Q83	(n = 12)	15.30 qtrs	12.67 qtrs	6.00 qtrs	13.00 qtrs

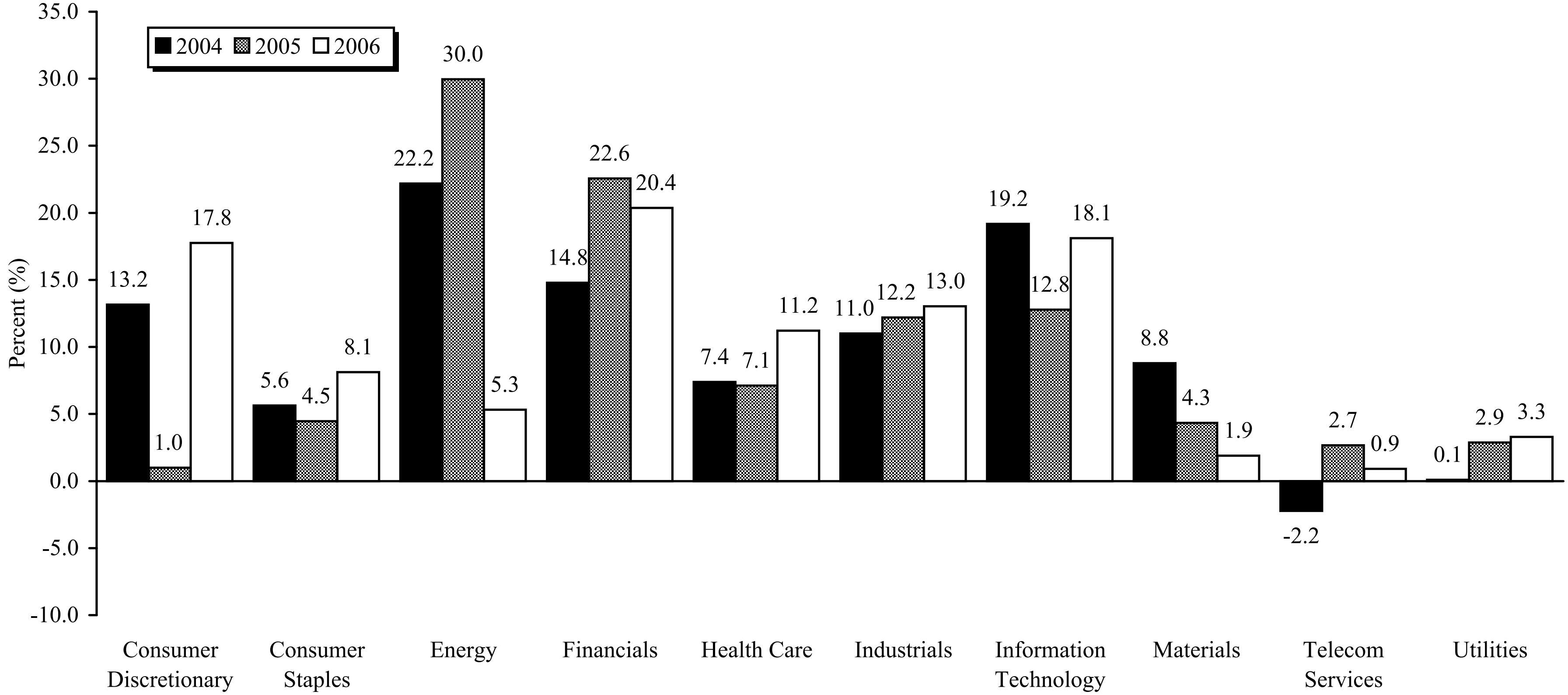
Sources: Calculated from data provided by Bureau of Labor Statistics, Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal.*

Notes: (P) Preliminary. Trendline earnings are shown on a logarithmic scale. Boxed portions represent NBER-defined recessionary periods. The longest sustained rise and fall represent the longest periods of year-over-year consecutive positive and negative growth, respectively. Average growth and average recession growth in the table are calculated using year-over-year data, while the peak and trough periods are determined by trends in the real reported earnings per share.

Table B

EARNINGS GROWTH CONTRIBUTION OF S&P 500 SECTORS—ACTUAL AND FORECAST

2004-06 Estimates



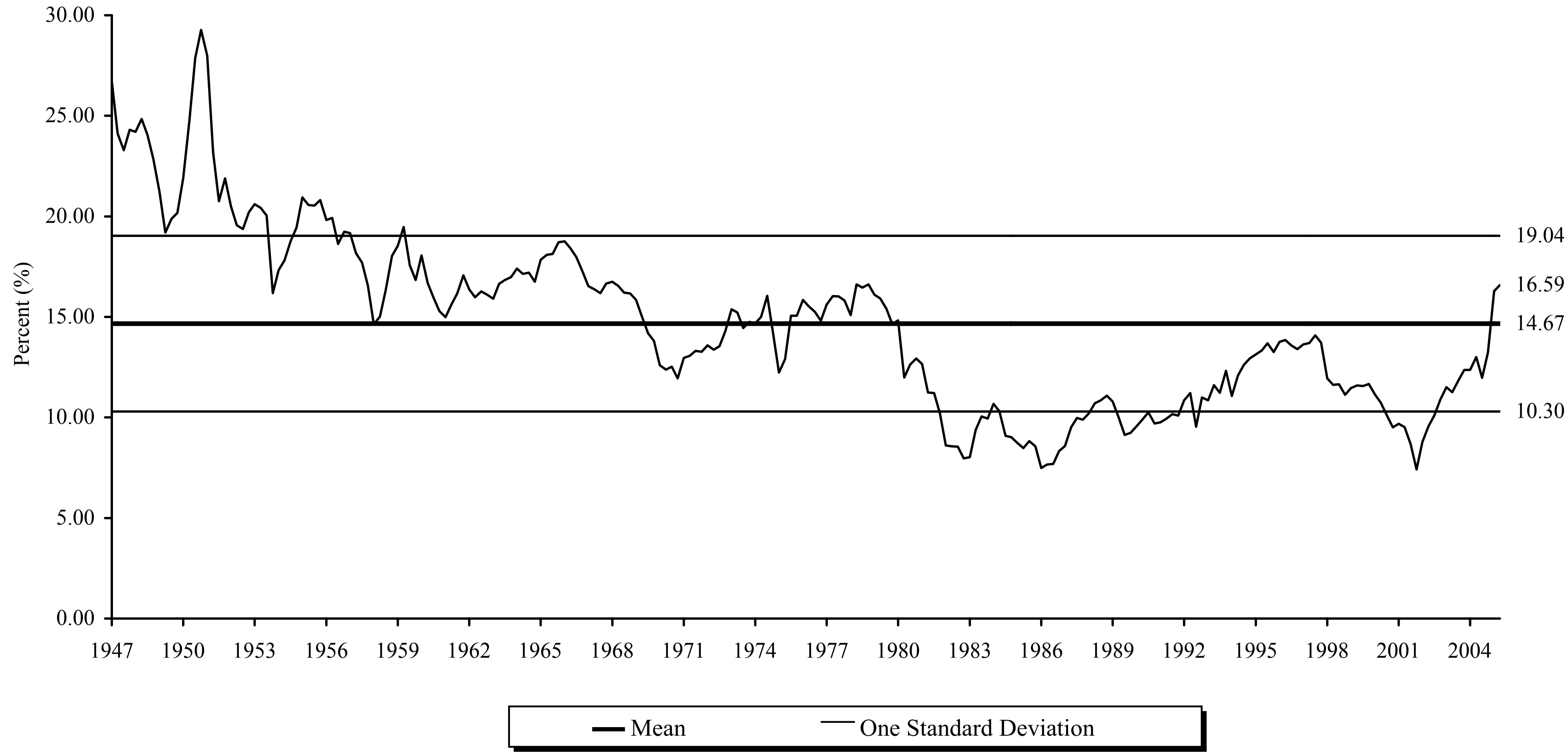
Sources: FactSet, Morgan Stanley Research, and Thomson Financial.

Notes: In 2004, S&P 500 earnings grew 20.0% and is estimated to grow 14.3% and 10.8% for 2005 and 2006, respectively. The earnings growth contribution numbers divide the US$ change in earnings per sector by the overall US$ change for the S&P 500 Index.

Table C

CORPORATE PROFIT MARGINS

January 1, 1947 - June 30, 2005



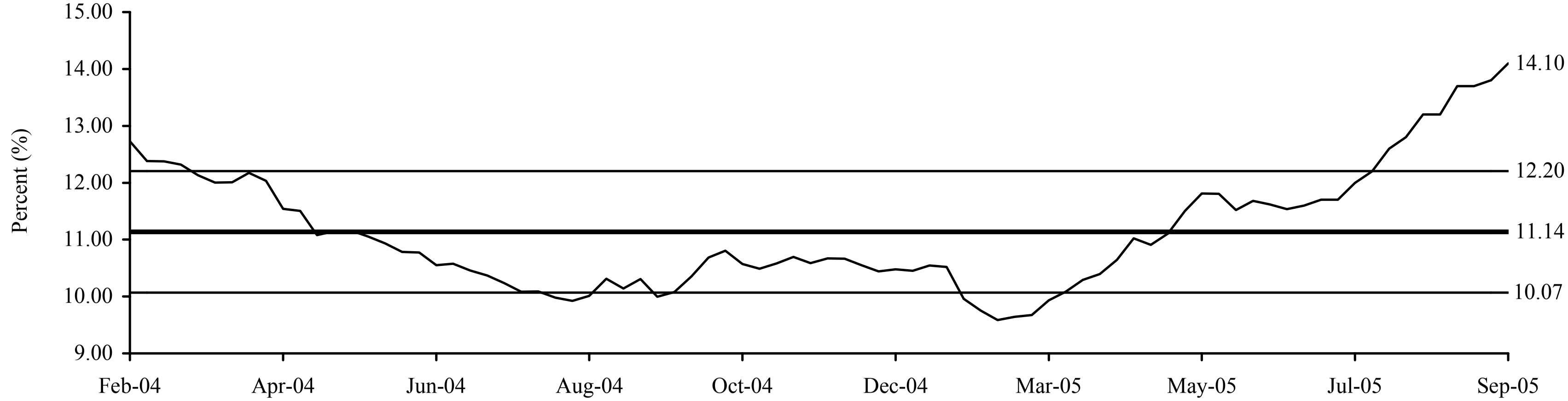
Source: Bureau of Economic Analysis.

Notes: Corporate profit margins are calculated by dividing corporate profits before tax by the gross value added of corporate business. All data are seasonally adjusted at annual rates.

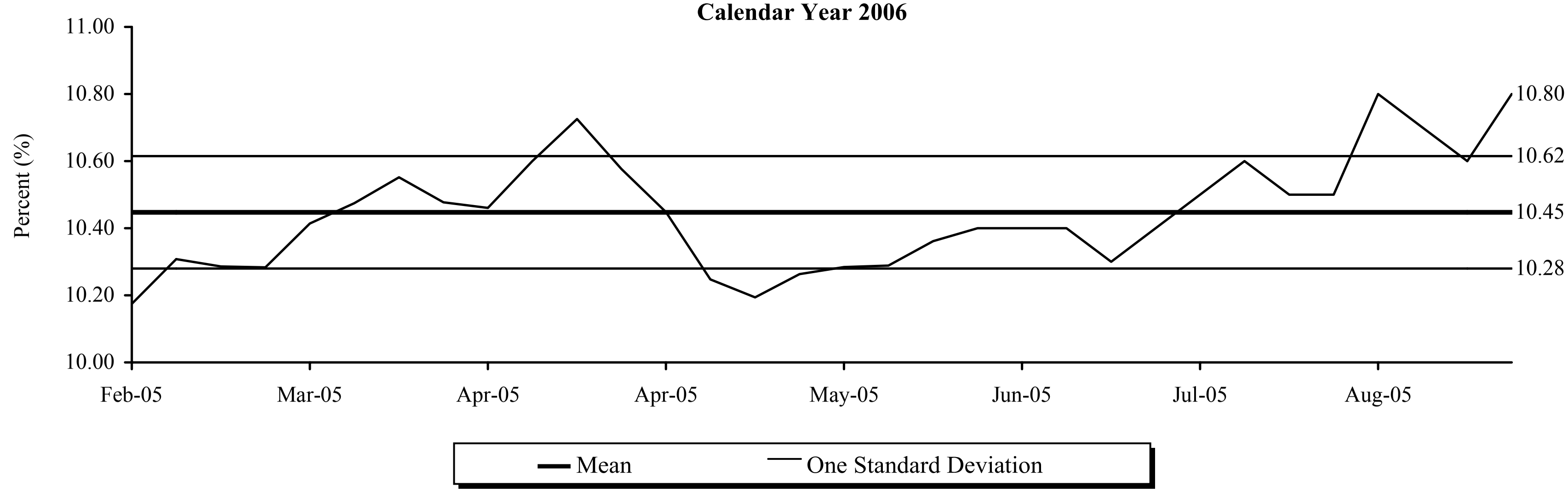
Table D

S&P 500 ANALYST EARNINGS GROWTH EXPECTATIONS FOR 2005 AND 2006

Calendar Year 2005



Calendar Year 2006



Sources: Factset, Morgan Stanley Research, and Thomson Financial.