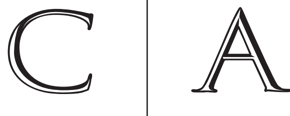

CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT

EARNINGS GROWTH: DON'T BANK ON IT

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Earnings Growth: Don't Bank On It

Introduction

Over the last two years, the S&P 500 experienced cumulative real earnings growth of 104.6%, which is 2.3 standard deviations above the average two-year real earnings growth since 1900 (9.4%). Two-year cumulative growth at least one standard deviation above average (50.9%) has been followed by subsequent average real two-year earnings growth of -3.4%. While there are several outstanding risks that could spur a similar trend change over the next several years, many of them are concentrated within the financial sector.

Tapped Out?

In recent years, financial sector profits have been boosted by persistently low interest rates and the many strategies that reap disproportionately high profits in such an environment (e.g., consumer lending, mortgage lending, proprietary trading, and investment management). Indeed, the financial sector contributed 43%, 32%, and 29% of aggregate S&P 500 profits, in 2002-04, respectively. While the financial sector is relatively cheap based on trailing fundamentals—only two sectors are cheaper on a trailing price-earnings (energy) or price-book (utilities) basis—looking forward, the financials sector's profits are particularly vulnerable to rising interest rates and/or a significant downturn in economic conditions (Table A).

Over the period 2001-04, the spread between yields on high-quality bonds (AA-AAA) and 91-day Treasury bills averaged 449 basis points (bps), compared to 199 bps since 1950. Banks loaned funds at a ratio of more than 4:1 during this period, compared to less than 2:1 on average since 1950 (Table B). This "a penny saved equals four or five earned" scheme provides a juicy incentive for banks to favor a high volume of loans over high quality. However, the ratio of long- to short-term rates fell to 2.5:1 in 2004. Lending margins are likely to follow as banks are forced to reconcile their deposit rates with higher short-term market interest rates.[1]

Another factor temporarily supporting earnings is that historically low rates, combined with the promises to keep them low, enticed the largest Wall Street firms to bet unprecedented amounts of capital in complex derivative transactions. *When* liquidity is high and investment gains are relatively easy to come by, proprietary trading provides a Holy Grail for profit margins; but the costs and risks can be insurmountable when conditions reverse. In addition, many brokerage firms have earned significant profits on leveraged investment vehicles and low-quality credit products, which benefit from a low cost of capital and a risk-rewarding environment that swells assets under management (fee income).

[1] The long-term AAA-AA to T-bill yield ratio only serves as a rough lending proxy and slightly underestimates the spread earned by most commercial and retail banks. Banks tend to delay raising deposit rates as long as possible and most bank loans are issued at a premium to AAA-AA bond yields. Banks' vulnerability to rising rates will vary by institution and be largely dependent on the ratio of fixed to variable rate loans held.

Finally, the lowest long-term interest rates in approximately 40 years resulted in extraordinarily low mortgage rates. This in turn made mortgage lending an enormously profitable *volume* business. Indeed, mortgage lending has been a key engine of growth for both the financial sector and broader economy. According to Bridgewater Associates, U.S. consumers borrowed $820 billion through mortgages in 2004, but bought only $540 billion worth of homes. The difference was used for general consumption and represented 2.4% of GDP.

Conclusion

The bottom line is that the financial sector's profits have swelled due to interest rates that are unsustainably low. This suggests a quite unfavorable risk/reward relationship going forward. For instance, lending long term at low fixed rates today results in a profit squeeze if the yield curve flattens tomorrow—banks could end up paying more on savings deposits than they charged for intermediate-to-long duration loans two or three years earlier. If defaults rise with interest rates, the outlook becomes increasingly murky. Given that the financial sector is the market's largest, making up 21% of the S&P 500's market capitalization at year-end 2004 and 29% of aggregate profits, its health will have a significant influence on the broader market.

Table A

VALUATIONS AND EARNINGS CONTRIBUTIONS OF S&P 500 SECTORS

Valuations as of December 31, 2004

S&P 500 Sectors	Dividend Yield (%)	Price/Book	Price/Cash Flow	Price/Earnings
Consumer Discretionary	1.30	2.64	11.54	31.38
Consumer Staples	2.01	5.80	14.66	24.79
Energy	1.92	3.07	7.16	14.79
Financials	2.51	2.41	---	15.59
Health Care	1.35	4.56	17.18	30.08
Industrials	1.80	3.78	12.73	23.80
Information Technology	0.49	4.55	19.42	29.14
Materials	1.97	3.29	10.83	19.79
Telecomm Services	3.14	2.64	5.90	34.05
Utilities	3.62	2.00	6.69	22.52

Earnings Contributions (%)

S&P 500 Sectors	2002	2003	2004
Consumer Discretionary	1.11	11.07	7.49
Consumer Staples	17.11	10.35	10.77
Energy	6.18	9.87	11.86
Financials	42.93	32.14	29.07
Health Care	19.75	9.71	10.33
Industrials	14.74	10.31	10.04
Information Technology	-5.83	7.71	11.47
Materials	1.37	1.93	3.18
Telecomm Services	-0.27	3.59	1.94
Utilities	2.92	3.27	3.91
S&P 500 Index	100.00	100.00	100.00

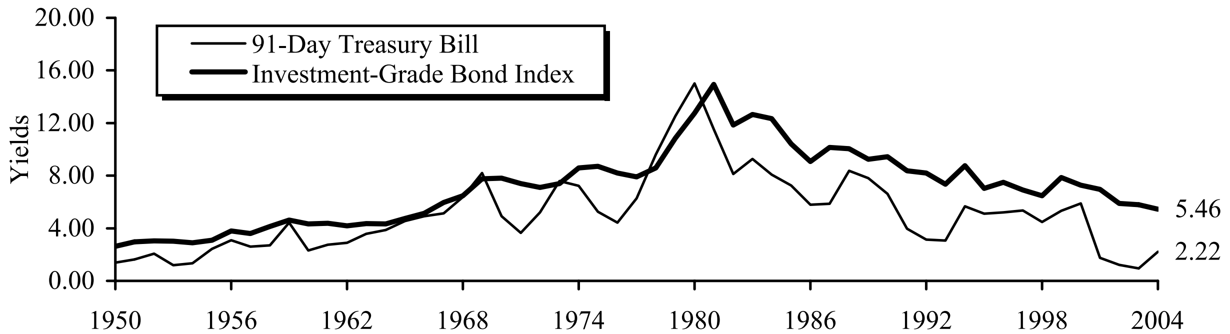
Sources: Standard & Poor's and Standard & Poor's Compustat.

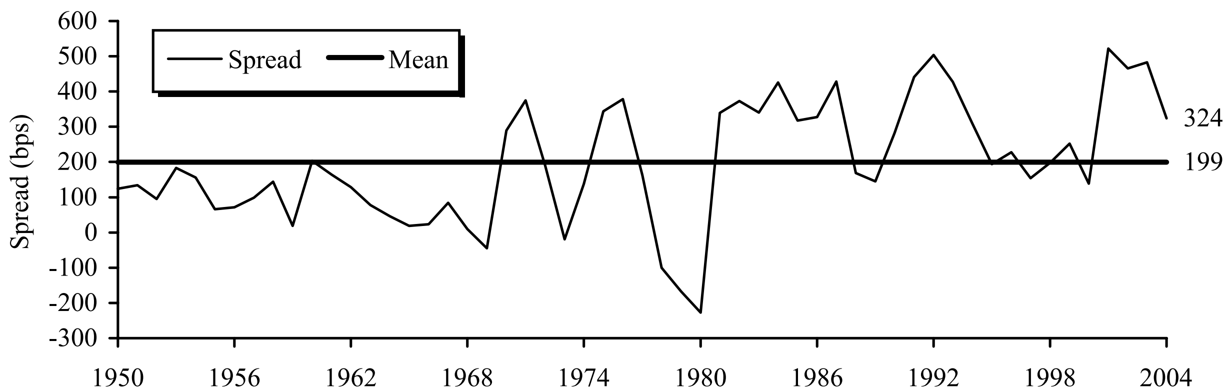
Note: Figures may not total due to rounding.

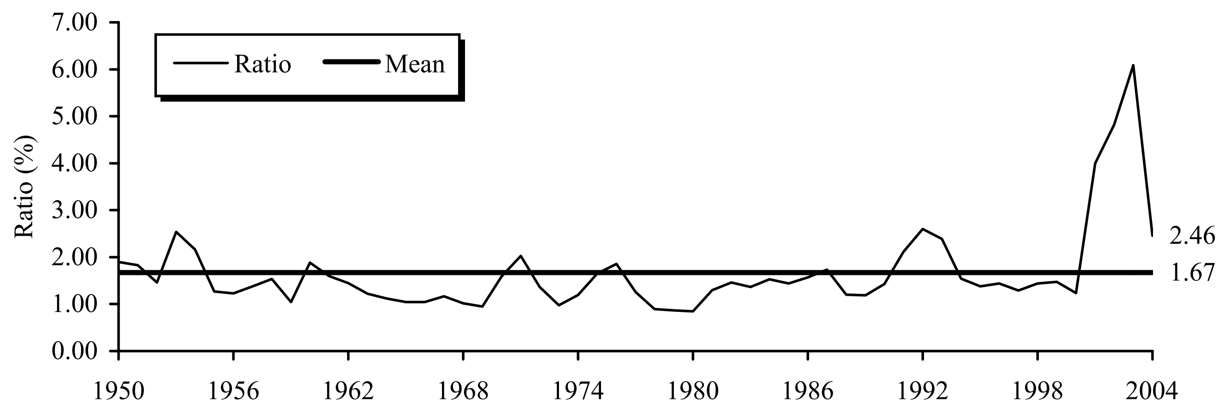
Table B

YIELD SPREAD AND RATIO OF INVESTMENT-GRADE BOND INDEX AND 91-DAY TREASURY BILL

December 31, 1950 - December 31, 2004





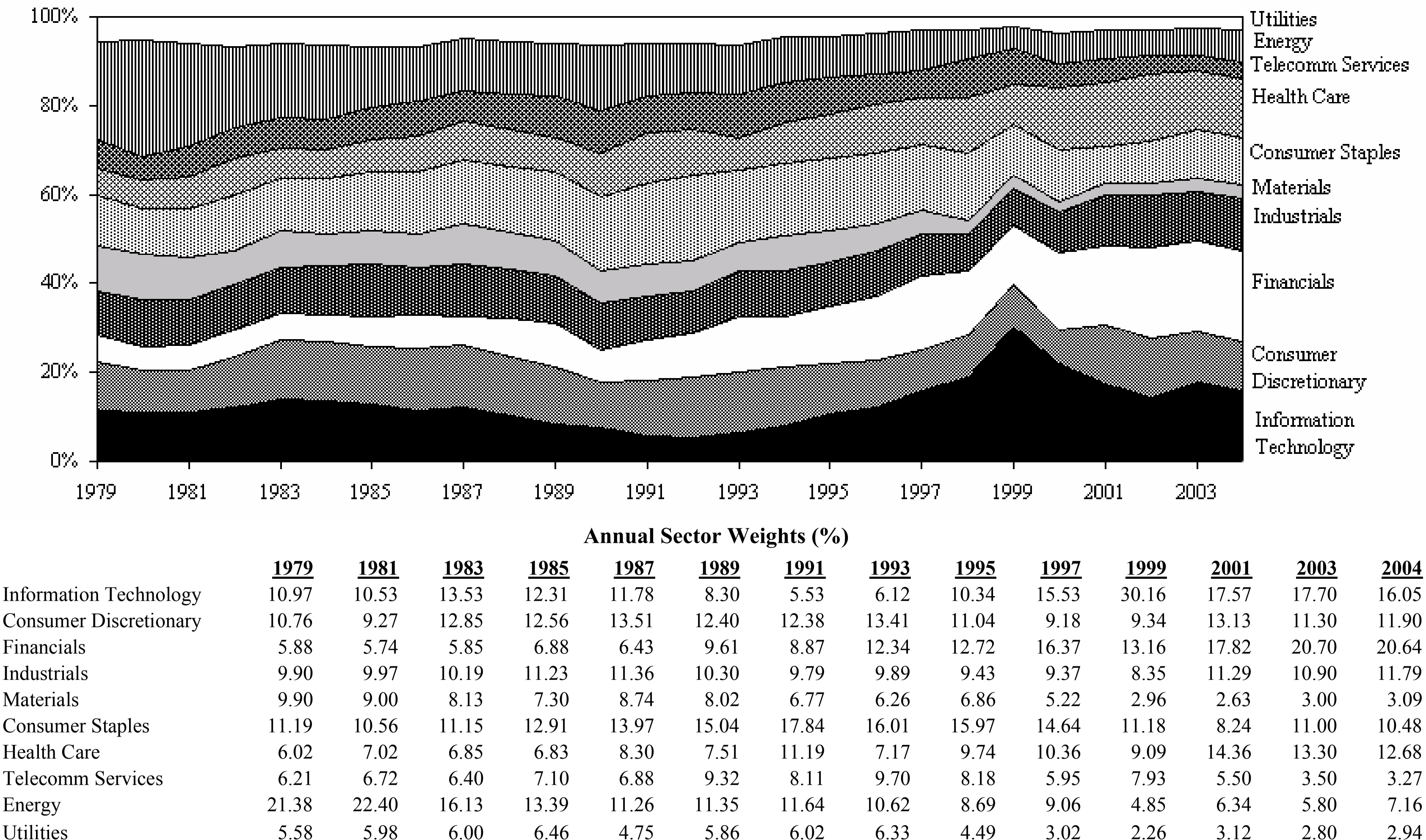


Sources: Citigroup Global Markets, Standard & Poor's, and Thomson Datastream.

Notes: Investment-grade bonds data are represented by Standard and Poor's from 1950 to 1968, Salomon Brothers High-Grade Corporate Bond Index from 1969 to 1979, and Salomon Brothers High-Grade Long-Term Corporate Bond Index, now called Citigroup High-Grade Bond Index, from 1980 to present. Data represent yields on an annual basis.

Table C

S&P 500 ECONOMIC SECTOR WEIGHTS



Annual Sector Weights (%)

	1979	1981	1983	1985	1987	1989	1991	1993	1995	1997	1999	2001	2003	2004
Information Technology	10.97	10.53	13.53	12.31	11.78	8.30	5.53	6.12	10.34	15.53	30.16	17.57	17.70	16.05
Consumer Discretionary	10.76	9.27	12.85	12.56	13.51	12.40	12.38	13.41	11.04	9.18	9.34	13.13	11.30	11.90
Financials	5.88	5.74	5.85	6.88	6.43	9.61	8.87	12.34	12.72	16.37	13.16	17.82	20.70	20.64
Industrials	9.90	9.97	10.19	11.23	11.36	10.30	9.79	9.89	9.43	9.37	8.35	11.29	10.90	11.79
Materials	9.90	9.00	8.13	7.30	8.74	8.02	6.77	6.26	6.86	5.22	2.96	2.63	3.00	3.09
Consumer Staples	11.19	10.56	11.15	12.91	13.97	15.04	17.84	16.01	15.97	14.64	11.18	8.24	11.00	10.48
Health Care	6.02	7.02	6.85	6.83	8.30	7.51	11.19	7.17	9.74	10.36	9.09	14.36	13.30	12.68
Telecomm Services	6.21	6.72	6.40	7.10	6.88	9.32	8.11	9.70	8.18	5.95	7.93	5.50	3.50	3.27
Energy	21.38	22.40	16.13	13.39	11.26	11.35	11.64	10.62	8.69	9.06	4.85	6.34	5.80	7.16
Utilities	5.58	5.98	6.00	6.46	4.75	5.86	6.02	6.33	4.49	3.02	2.26	3.12	2.80	2.94

Sources: Standard & Poor's and Standard & Poor's Compustat.

Notes: Economic sectors of the S&P 500 are shown in order of the sectors' betas relative to the S&P 500 ranked from low (utilities) to high (information technology). Data are through December 31, 2004. Prior to 2001 data represent the old S&P sectors. From December 2001 forward, data are represented by the new S&P Global Industry Classification Standard.

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