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CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENTARY

GRAYING AROUND THE EDGES?

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Graying Around the Edges?

The earnings expansion cycle is looking long in the tooth, after four years of strong expansion in which S&P 500 earnings have increased 158% in real terms. After an amazing 16 consecutive quarters of double-digit growth, real earnings are now 74% above their trendline over the past century.[1]

At the same time, forward *growth* expectations are fairly sober. Analysts' consensus earnings growth expectations for 2007 are only moderately above their long-run average, according to Morgan Stanley. Analysts expect the stocks in the S&P 500 Index to grow operating earnings at 7.9% during 2007. Expectations seven months ago for 2007 growth were much higher at 10.6% (Table A), and every sector save technology has seen analysts' 2007 growth expectations stagnate or diminish since June. The equity market's average annual real earnings growth since 1901 has been 5%, so using bond market-based inflation expectations of roughly 2.3%, next year's growth expectations are only modestly above average. These current growth expectations do not seem wildly optimistic; the question is, are they achievable?

Concentration

The market has been very concentrated during this earnings expansion. Strategist Tom McManus of Bank of America Securities, in fact, calls it a "30/40/50" market, with just two sectors—energy and financials—accounting for more than 30% of the market capitalization, 40% of the expected profits, and 50% of 2006 profit growth of the S&P 500.[2] Financials contributed two-fifths of the overall earnings growth in 2006 (half of this contribution came from insurance firms, which saw massive profits growth over the hurricane-free year), and energy contributed an additional 18%.

With those sectors tiring (energy firms, for example, are expected to see little if any profit growth in 2007), analysts have pinned their hopes on the technology sector. Technology firms, which make up about 15% of the S&P 500's market cap, are expected to grow earnings by 18% and contribute nearly one-quarter of overall earnings growth in 2007. Such optimism for the sector is not new; a year ago, analysts expected technology firms to grow earnings by 18% in 2006, while actual growth came in at 10% (Table B). While we have no particular insight into the technology sector, we are a bit nonplussed at the current enthusiasm surrounding the release of Microsoft's new Vista operating system. (Analysts are expecting Vista's release to have positive knock-on effects in many parts of the technology sector.) Such releases have long ceased to be much of an event for corporate spending plans; indeed, if anything companies (and consumers) are likely to defer purchases until Microsoft has worked out initial bugs in the system.

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[1] For more on long-run earnings growth trends, please see our September 2006 U.S. Market Commentary: *Deconstructing the Bullish Case on U.S. Equities*.

[2] "Irreparable Cracks," by Marc Faber of *Gloom, Doom, and Boom Report*, *welling@weeden*, January 16, 2007.

Still, even when we take the reliance on technology profits into account, overall earnings growth expectations for 2007 are more broad based than in the recent past (Table C). Six of the S&P 500's ten economic sectors, for example, are expected to contribute more than 10%+ of growth, compared to only three that did so in 2006.

However, the question remains what will pick up the slack if technology estimates turn out to be overly optimistic. Last year's technology undershoot was more than made up for by huge (and almost certainly not repeatable) growth in insurance earnings, but it is not clear which (if any) sectors would be capable of picking up the mantle in 2007. While financials may seem the obvious choice, insurance and real estate earnings are hardly coming off a low base level, and banks are dealing with an inverted yield curve and a housing slowdown. The private equity boom and strong proprietary trading results *may* continue to serve as a tailwind for large diversified financial firms; however, it is difficult to imagine already-buoyant conditions in these areas actually improving further. Overall, with earnings of six of the ten economic sectors expected to hit double digits, there is not too much room for significant upside surprises.

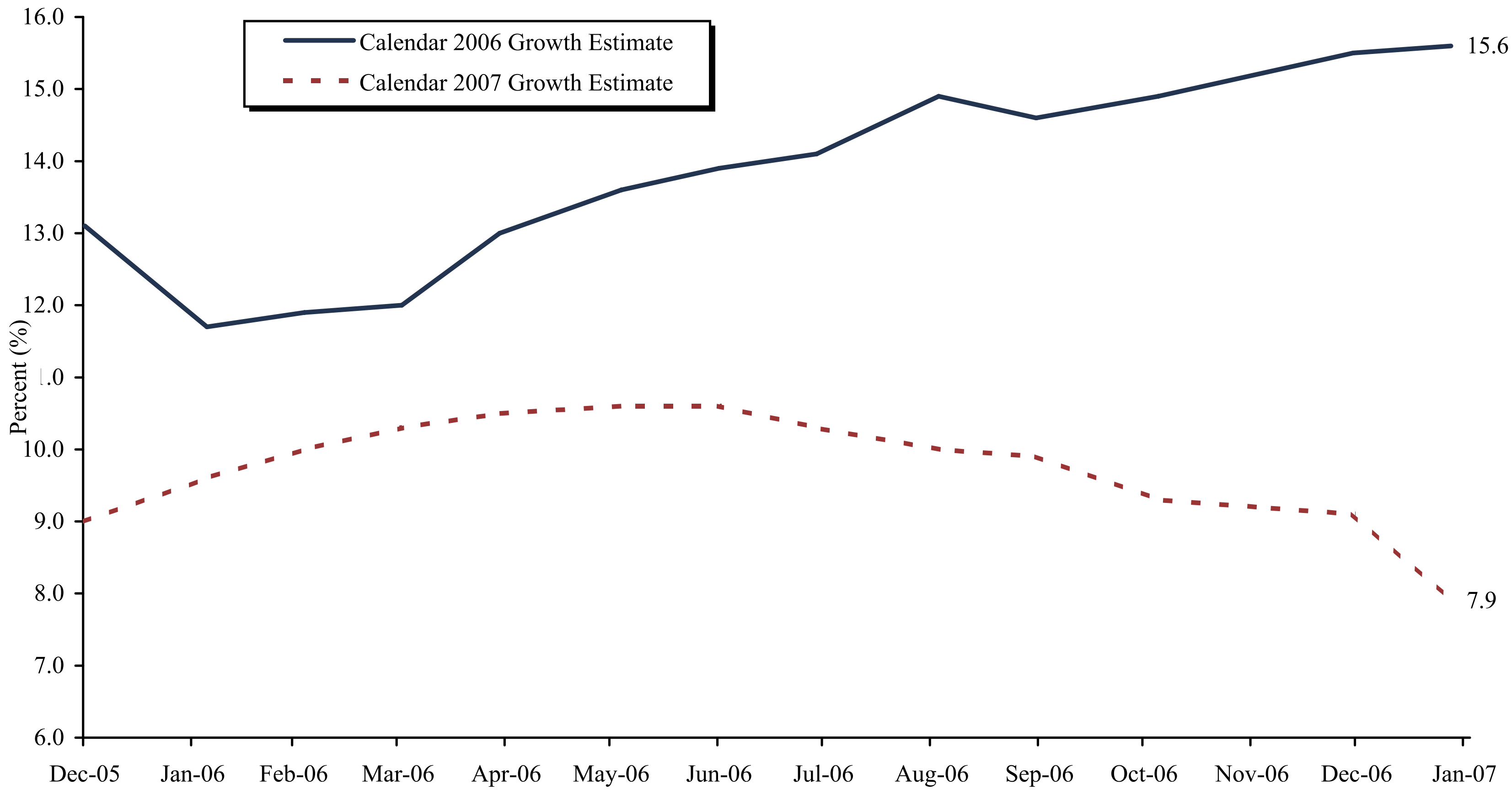
Conclusion

While earnings growth expectations for the equity market *on the whole* seem relatively reasonable (although on the high side if we have already passed a cyclical profit peak), the reliance on the technology sector strikes us as a key vulnerability. Further, while expectations for more broad-based growth outside technology are encouraging, the extraordinary strength in recent profits continues to give us pause. If technology earnings disappoint for a second straight year, overall earnings are likely to fall short as well.

Table A

ANALYSTS' CHANGING EARNINGS GROWTH EXPECTATIONS FOR THE S&P 500

2006-07



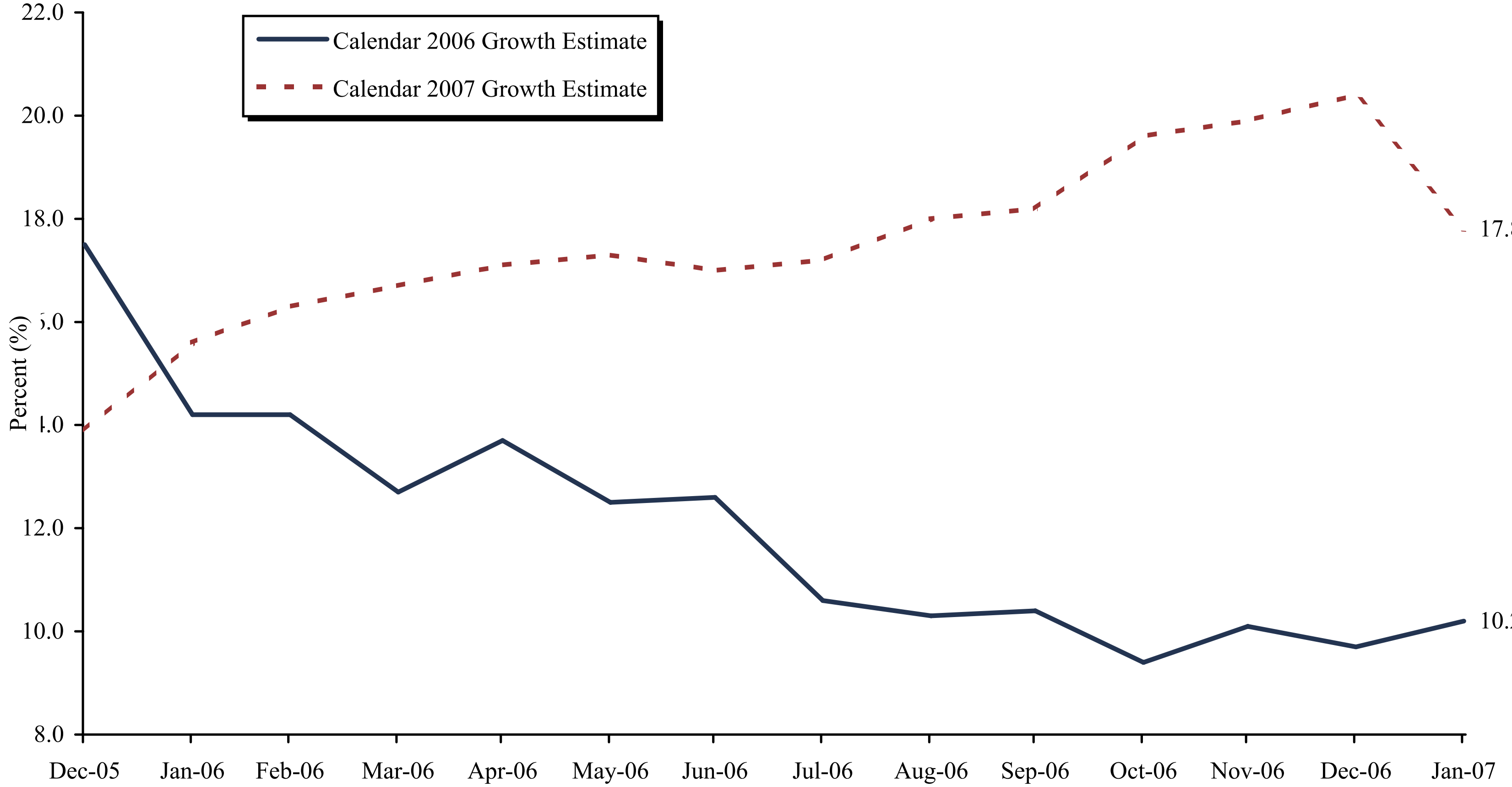
Sources: Factset Research Systems, Morgan Stanley Research, and Thomson Financial.

Notes: Growth expectations are based on month-end, or near month-end estimates. Data are bottom-up estimates of year-over-year growth in earnings, on a calendar year basis.

Table B

ANALYSTS' CHANGING EARNINGS GROWTH EXPECTATIONS FOR INFORMATION TECHNOLOGY SECTOR

2006-07



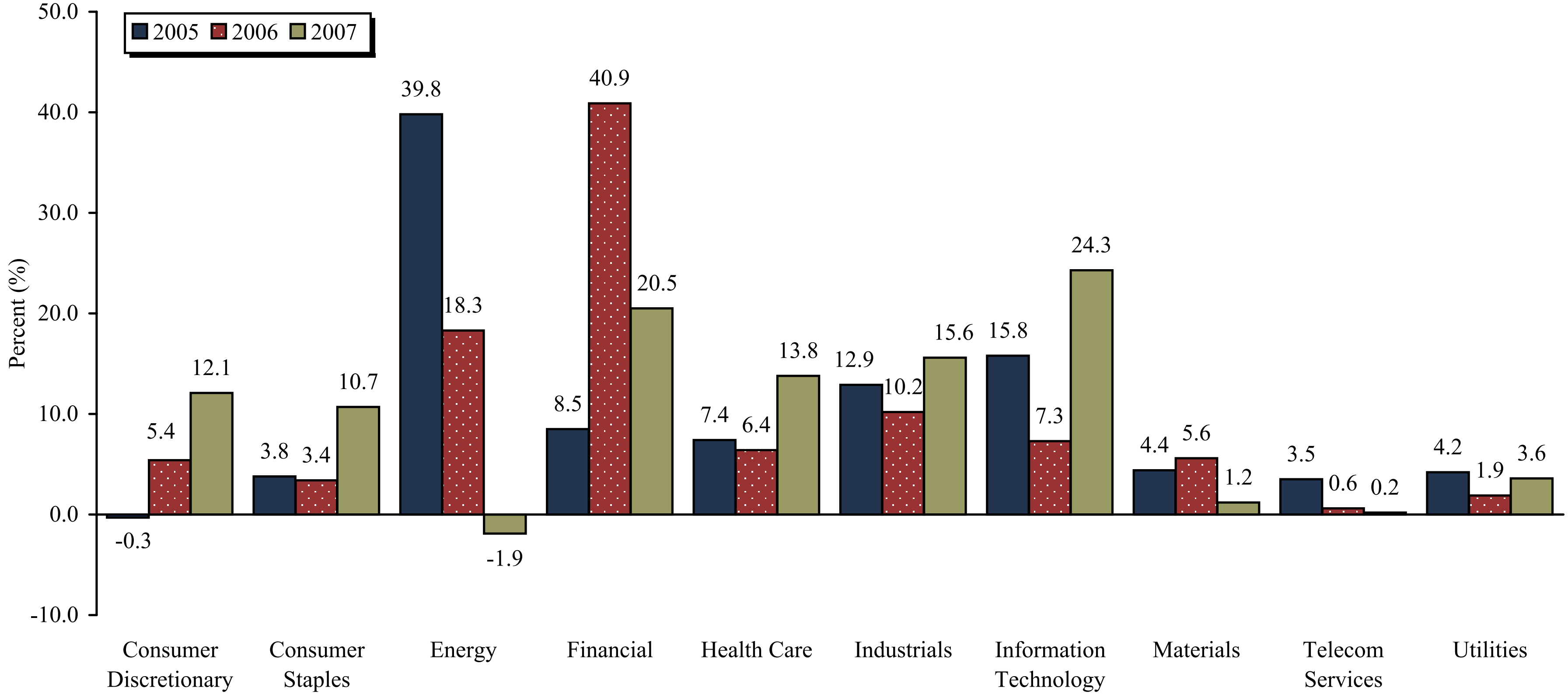
Sources: Factset Research Systems, Morgan Stanley Research, and Thomson Financial.

Notes: Growth expectations are based on month-end, or near month-end estimates. Data are bottom-up estimates of year-over-year growth in earnings on a calendar year basis. Data represent stocks within the information technology sector of the S&P 500 as defined by GICS sector classifications.

Table C

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

2005-07 Estimates



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

Notes: In 2005, S&P 500 earnings grew 14.4%, and they are estimated to grow 15.6% and 7.9% for 2006 and 2007, 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. Graph data represent operating earnings.