C|A

CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENTARY

PROSPECTS FOR U.S. EQUITIES REMAIN BLEAK

May 2006

Celia Dallas
Alice Lin

Prospects for U.S. Equities Remain Bleak

Since the start of 2005, we have warned that earnings were likely at or close to a cyclical peak for the following reasons:[1]

- Real earnings growth had expanded significantly and was well above normalized levels.
- Earnings growth had started to decelerate.
- Earnings have been heavily supported by financials, which accounts for 21% of the market capitalization of the S&P 500, and accounted for 42.9% of earnings in 2002, decreasing gradually to 26.6% in 2005. Financials, whose profits have been boosted by highly volatile businesses such as proprietary trading and issuance of low-quality credit products, appear to be facing narrowing profit opportunities.
- As financials' contribution to earnings growth waned in 2005, the energy sector picked up the slack. Continued support to energy prices, and therefore, energy company profits, cannot be expected to persist.

These concerns remain, and we continue to believe that earnings will begin a cyclical downward adjustment that is not currently priced into the market. Had it not been for the significant increase in energy prices, earnings growth would have been much more subdued, as the energy sector alone accounted for nearly 40% of the 13.9% growth in 2005 earnings (Table A). While earnings continue to climb and are now up 158.9% in real terms from their trough on March 31, 2002 through March 31, 2006, real earnings growth has been decelerating for two years. Compared to the 15 previous earnings cycles since 1900 in which earnings increased at least 15% in real terms, this earnings cycle ranks fifth in terms of magnitude, with real earnings growth well in excess of the 113.8% average and 65.0% median (Table B). In addition, having now lasted 16.3 quarters through the end of April, this cycle has just surpassed the average duration of 16.1 quarters and the median of 15 quarters. Real earnings are now 62.6% above trendline, the highest spread above trendline since 1917, and the third highest spread since our data begins in 1900 (Table C).

Despite the length and magnitude of this earnings cycle, consensus expectations are for earnings to grow 13.1% in 2006 and 10.6% in 2007, and have generally increased for both years since hurricane Katrina hit in September of 2005 (Table D). Financials are expected to contribute 35.0% to S&P 500 earnings growth in 2006 and 22.7% in 2007. Expectations for the energy sector have moderated, however, and are expected to represent 15.3% of earnings growth in 2006 and only 5.2% in 2007. The tech sector is expected to take up the slack in 2007, increasing from 10.5% of growth in 2006 to 18.5% in 2007 (Table A).

While the liquidity that has fueled the financial sector is still accommodative, it appears to be abating, as U.S. policy rates are approaching levels most economists consider to be neutral. Meanwhile, the European Central Bank has started tightening, and the Japanese Central Bank has ended quantitative easing and is expected to begin gradually raising rates this year. The mortgage boom, which also provided a strong source of earnings to financials, seems likely to moderate since home prices appear to have peaked and ten-

[1] See our March 2005 U.S. Market Commentary: *Earnings Growth: Don't Bank On It*, and our September 2005 U.S. Market Commentary: *Are Earnings Running Out of Gas?*

year interest rates have increased modestly, breaking through 5% for the first time since 2002. In addition, the U.S. yield curve, which inverted earlier this year, remains flat and the U.K. yield curve remains inverted, further limiting financial stocks' abilities to earn strong profits. Research by J.P. Morgan reveals that over the last 33 years, a combination of at least a 20% year-over-year increase in oil prices and relatively flat yield curve, defined as a spread of 100 basis points or less between the ten-year yield and the Fed funds rate, were followed by a decline in S&P earnings averaging 11% over the next 12 months. Of course, such occurrences have been rare (17 quarters in 33 years) and were clustered in three periods: 1979-81, 1990-91, and 2000-01. All three periods began while the Fed was tightening and ended in recession, even as they started with strong, albeit slowing, economic growth and slowing or declining earnings growth. While every period is different, there are some important similarities between these historical periods and the current environment including high GDP growth (although it is not yet clear if GDP has peaked), decelerating earnings growth, and Fed tightening.

There are some positive factors for earnings that could result in sustained growth, but it remains difficult to justify above average expectations in the current environment. As *The Bank Credit Analyst* pointed out in their recent special report on the health of U.S. corporations,[2] even though much of the strength in profit growth has been attributable to cyclical factors, a strong secular increase in productivity has led to an improvement in corporate health that has both improved margins and allowed real compensation levels to increase. Corporations' strong financial position and continued drive to increase productivity in the face of stiff global price competition should continue to provide some support to earnings, even as cyclical influences wane. However, it seems unduly optimistic to expect earnings to expand at rates well above historical averages this far into the earnings cycle. The long-term arithmetic average of real earnings growth has been approximately 4%. Assuming the inflation expectations of 2.7% priced into the bond market for the next ten years proves correct, we would expect nominal earnings to fall below 6.7%.

Since the S&P 500's most recent trough on October 9, 2002, returns have been driven primarily by earnings growth, as price-earnings (P/E) multiples have contracted from 25.6 to 18.1 and despite significant increases in dividends, dividend yields remain low and have fallen from 2.0% to 1.7% through the end of April. If we assume, somewhat optimistically, that nominal earnings growth over the next five years is 6.7% and P/E ratios and dividend yields hold at current levels, this would suggest a five-year average annual compound return of roughly 8.5%, somewhat below our long-term, valuation-neutral U.S. equity return expectations of 9.7% (7% real return plus 2.7% inflation). However, if P/E ratios were to contract, as we would expect, a decline back to their post-1960 average of 17.5 would bring the five-year return down to 7.8%, while a more severe P/E contraction to 1 standard deviation below this average, or a P/E of 10.4, would bring returns down to -2.6%. We would also caution that markets are anticipatory and do not always wait for earnings to decline before pricing in lowered earnings growth expectations. In fact, of the 15 most significant peak-to-trough S&P 500 declines since 1926, nine began while earnings were still rising (Table E).

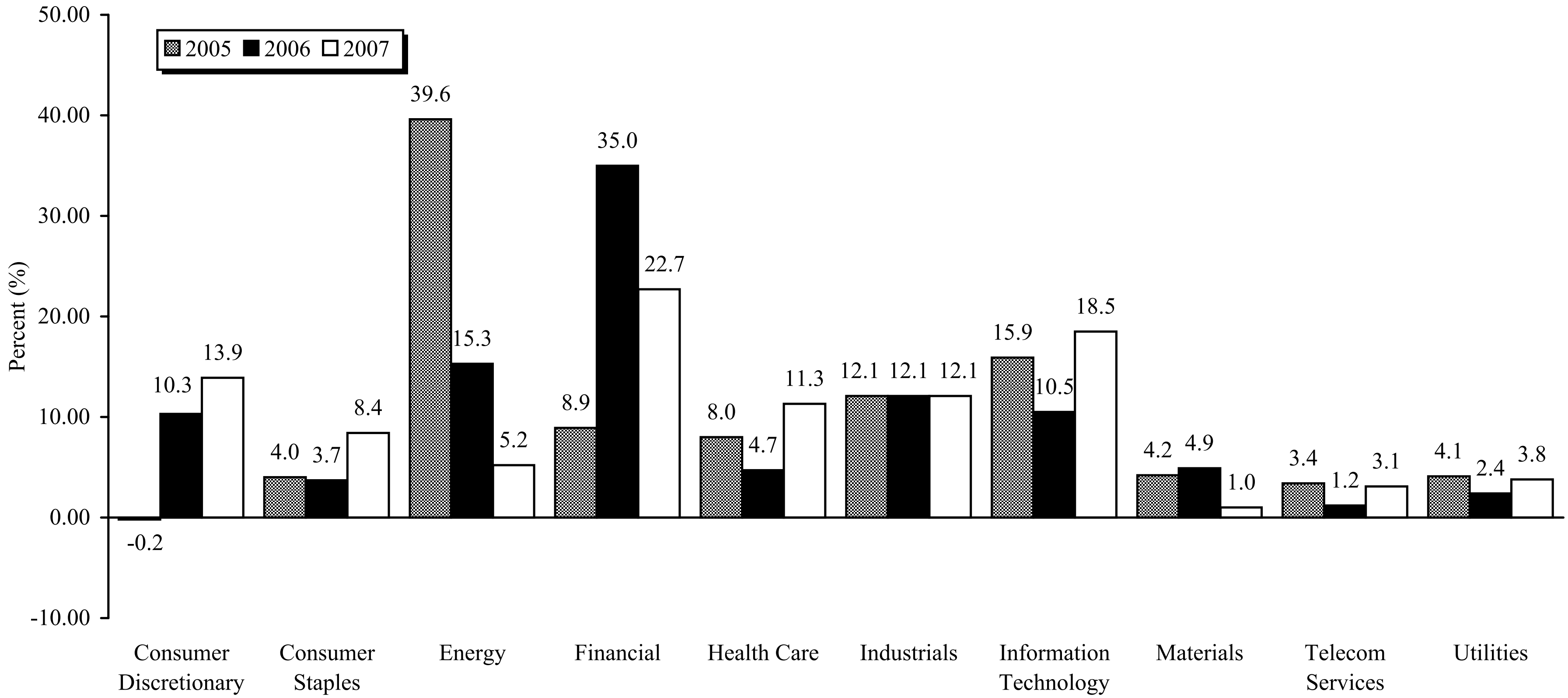
[2] See *The Bank Credit Analyst*, "U.S. Corporate Health: A Glowing Report Card," February 2006.

In short, the risks to U.S. equity investors remain high. Consensus earnings expectations seem too high considering the strong market headwinds and advanced nature of the earnings cycle, while valuations remain elevated.

Table A

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, the S&P 500 earnings grew 13.9% and is estimated to grow 13.1% and 10.6% 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.

Table B

HISTORY OF EARNINGS CYCLES

1900-2006

Rising Earnings Cycles								
Start Date	End Date	Duration (quarters)	Cumulative Real Earnings Growth (%)	Annualized Real Earnings Growth (%)	Cumulative Real Price Appreciation (%)	Annualized Real Price Appreciation (%)	Beginning Period P/E	Ending Period P/E
1Q 1900	4Q 1902	12	22.50	7.66	20.02	6.86	13.04	12.78
1Q 1905	3Q 1906	7	48.84	25.51	20.22	11.10	16.92	13.60
1Q 1909	4Q 1910	8	23.27	11.03	-1.84	-0.93	14.27	12.40
1Q 1915	4Q 1916	8	156.18	60.06	16.09	7.75	12.41	6.41
1Q 1922	4Q 1929	32	458.40	23.98	195.14	14.49	19.85	13.32
1Q 1933	2Q 1937	18	210.64	28.64	103.33	17.08	14.01	11.00
2Q 1938	1Q 1941	12	125.67	31.17	16.35	5.18	20.28	7.97
4Q 1946	4Q 1940	17	160.39	25.25	11.33	2.56	14.43	7.19
3Q 1952	1Q 1956	15	55.93	12.58	92.11	19.02	10.40	13.14
4Q 1958	4Q 1966	33	69.28	6.59	40.96	4.25	19.10	14.47
1Q 1971	3Q 1974	15	39.68	9.32	-45.76	-15.05	19.22	6.97
4Q 1975	3Q 1979	16	37.99	8.38	-4.60	-1.17	11.33	7.47
3Q 1983	4Q 1984	6	24.89	15.97	-6.00	-4.04	12.49	10.05
3Q 1987	1Q 1989	7	60.64	31.11	-9.98	-5.83	20.29	11.81
1Q 1992	3Q 2000	35	166.95	11.88	173.43	12.18	24.93	26.75
2Q 2002	1Q 2006	16	158.89	26.85	0.99	0.25	37.02	18.12
	Mean	16.06	113.76	21.00	38.86	4.61	17.50	12.09
	Median	15	64.96	19.98	16.22	4.71	15.67	12.11
	High	35	458.40	60.06	195.14	19.02	37.02	26.75
	Low	6	22.50	6.59	-45.76	-15.05	10.40	6.41

Table B (continued)

HISTORY OF EARNINGS CYCLES

1900-2006

Falling Earnings Cycles								
Start Date	End Date	Duration (quarters)	Cumulative Real Earnings Growth (%)	Annualized Real Earnings Growth (%)	Cumulative Real Price Appreciation (%)	Annualized Real Price Appreciation (%)	Beginning Period P/E	Ending Period P/E
1Q 1903	4Q 1904	8	-21.35	-11.31	3.64	1.80	13.36	16.84
4Q 1906	4Q 1908	9	-25.50	-12.26	-14.71	-6.83	12.95	15.57
1Q 1911	4Q 1914	16	-34.91	-10.18	-25.79	-7.18	13.41	14.13
1Q 1917	4Q 1921	20	-87.29	-33.81	-49.98	-12.94	6.34	25.21
1Q 1930	4Q 1932	12	-66.56	-30.59	-57.83	-25.01	17.34	16.80
3Q 1937	1Q 1938	3	-59.88	-70.41	-43.63	-53.44	10.27	15.45
2Q 1941	3Q 1946	22	-50.44	-11.98	4.55	0.81	7.94	16.81
1Q 1951	2Q 1952	6	-22.27	-15.46	15.37	10.00	7.56	10.67
2Q 1956	3Q 1958	10	-27.62	-12.13	-4.27	-1.73	13.05	17.38
1Q 1967	4Q 1970	16	-23.59	-6.51	-5.17	-1.32	16.55	17.96
4Q 1974	3Q 1975	4	-21.06	-21.06	22.33	22.33	7.71	10.81
4Q 1979	2Q 1983	15	-35.48	-11.03	15.29	3.87	7.26	13.35
1Q 1985	2Q 1987	10	-19.60	-8.36	68.64	23.25	11.02	21.08
2Q 1989	4Q 1991	11	-43.26	-18.62	25.45	8.59	12.61	26.12
4Q 2000	1Q 2002	6	-55.32	-41.55	-22.40	-15.56	26.41	46.45
	Mean	11.2	-39.61	-21.02	-4.57	-3.56	12.25	18.98
	Median	10	-34.91	-12.26	-4.27	-1.32	12.61	16.81
	High	22	-19.60	-6.51	68.64	23.25	26.41	46.45
	Low	3	-87.29	-70.41	-57.83	-53.44	6.34	10.67

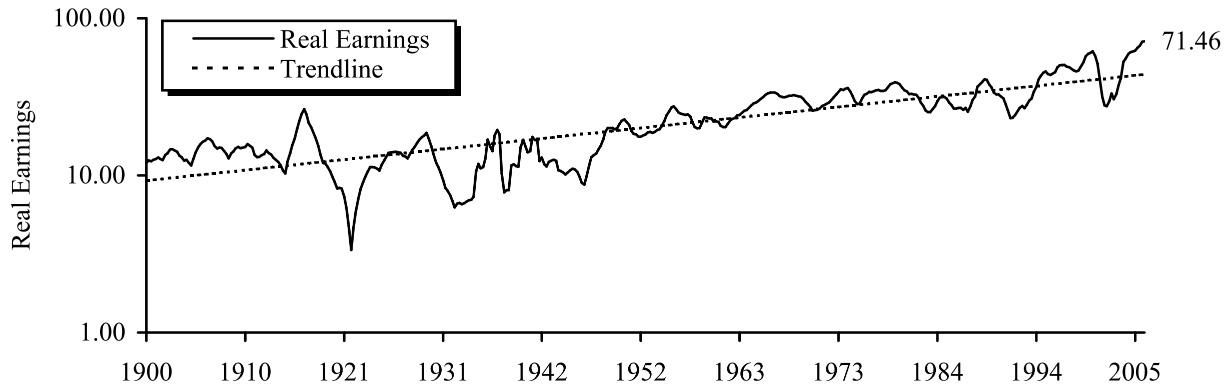
Sources: Calculated from data provided by Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal* .

Notes: P/E ratios are based on trailing 12-month reported earnings. First quarter 2006 data are preliminary.

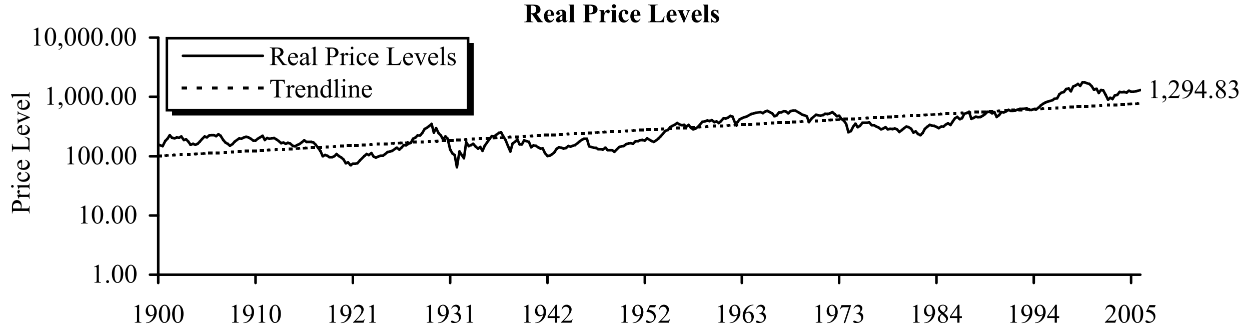
Table C

S&P 500 REAL EARNINGS, PRICE LEVELS AND YEAR-OVER-YEAR EARNINGS GROWTH SINCE 1900

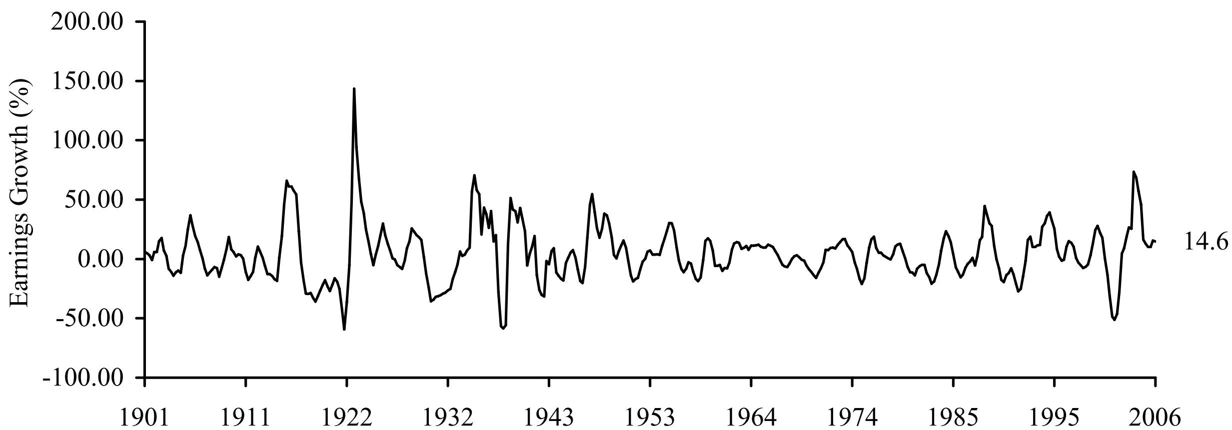
Real Earnings



Real Price Levels



Year-over-Year Real Earnings Growth (%)



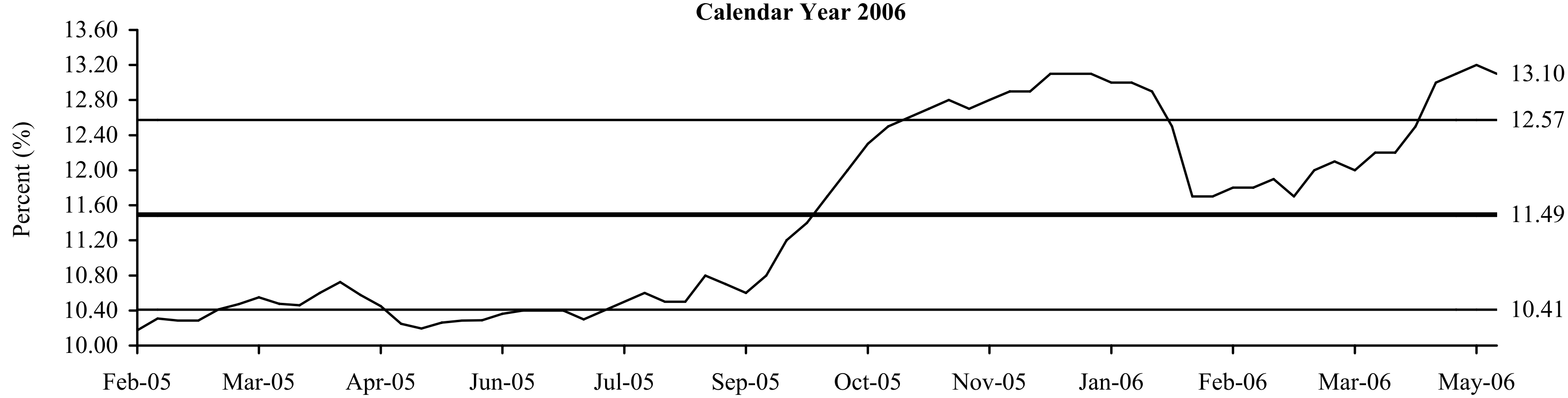
Sources: Calculated from data provided by Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal.*

Notes: Graphs for real earnings and price levels are shown in logarithmic scales. Real price levels are calculated based on 1900 dollars. Data are through first quarter 2006, and first quarter 2006 data is preliminary.

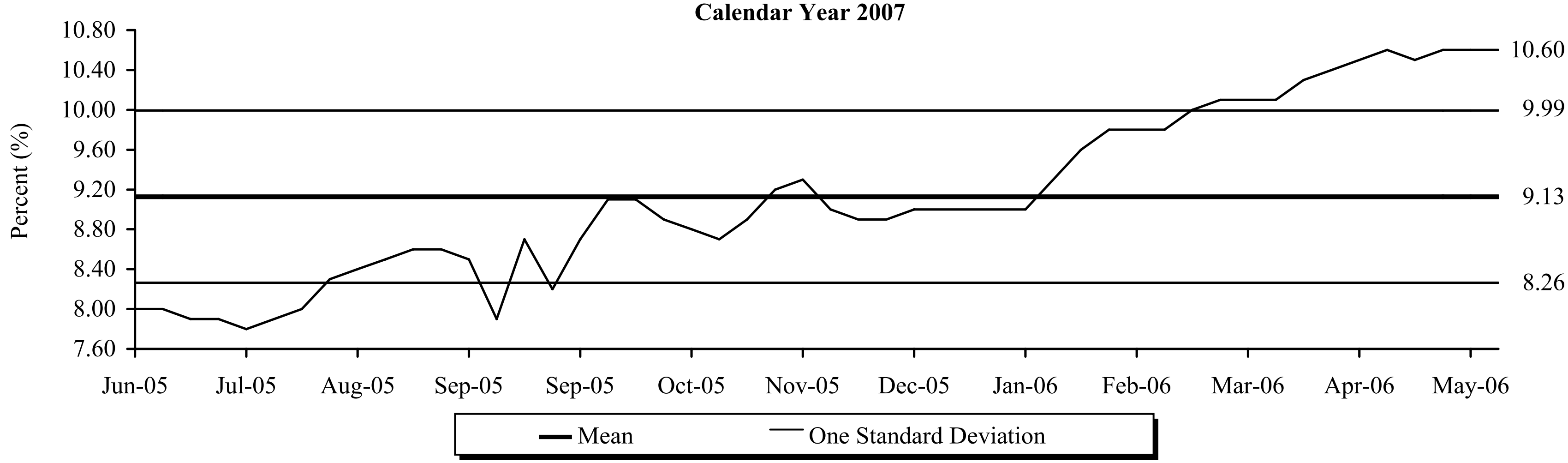
Table D

S&P 500 ANALYST EARNINGS GROWTH EXPECTATIONS FOR 2006 AND 2007

Calendar Year 2006



Calendar Year 2007

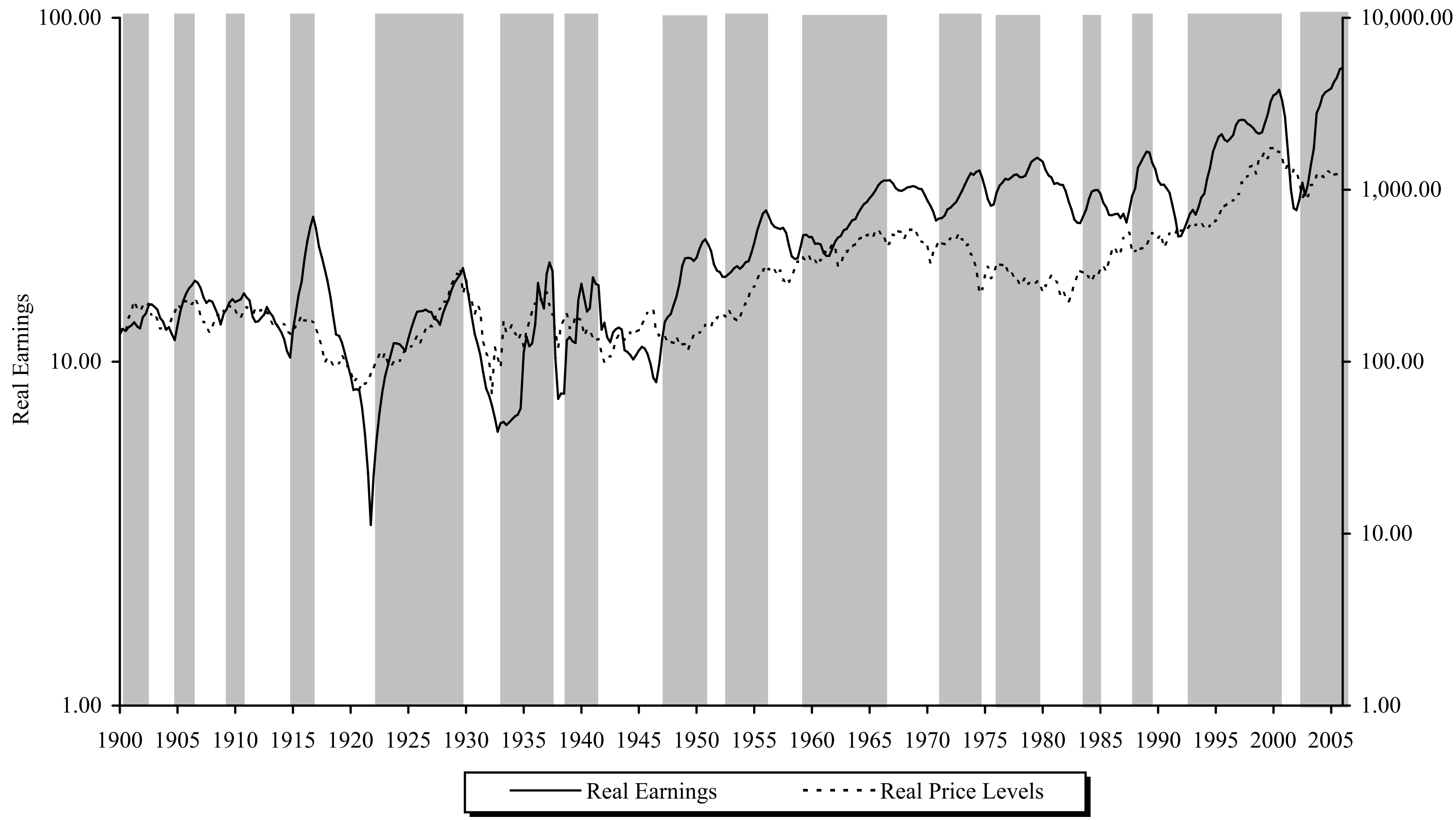


Sources: Factset, Morgan Stanley Research, and Thomson Financial.

Note: On February 3, 2006, an adjustment was made to AT&T earnings for 2004 and 2005 to account for the merger with SBC Communications on a pro-forma basis.

Table E

S&P 500 REAL EARNINGS AND REAL PRICE LEVELS FROM 1900



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

Notes: Real earnings and real price levels are shown in logarithmic scales. Real price levels are calculated based on 2006 dollars. Data are from first quarter 1900 to first quarter 2006, and first quarter 2006 data is preliminary. Shaded areas show rising earnings levels and non-shaded areas show falling earnings levels.