

C A M B R I D G E A S S O C I A T E S L L C

U.S. MARKET COMMENT

The Financial Sector: A Giant Octopus and Its Tentacles

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The Financial Sector

A Giant Octopus and Its Tentacles

The financials sector currently comprises 20.7% of the market weight of the S&P 500, up substantially from 4.5% in November 1980. In 2002, its profits accounted for 41.1% of the entire index's earnings, down slightly from its 2001 peak of 47.1% (see Tables A and B). Not since the oil shock of the early 1980s has a single sector accounted for such a large percentage of market earnings; the closest precedent occurred in November 1980 when energy contributed 30% of the S&P 500's earnings and accounted for 29.2% of its market weight. The technology sector, even at its peak market weight of 34.5% in August 2000, never contributed more than 15% of the index's total earnings.

Focusing only on the financial sector understates the importance of financial services for the overall equity market, as many nonfinancial companies—including Ford, Boeing, GE, GM, Sears, Caterpillar, Deere, and IBM—earn significant revenue from their various financing operations. While this exposure is reflected in the market valuation accorded to some of these companies, the market's earnings are nonetheless "circularly tied" to its own fortunes, argues Steve Galbraith, head of U.S. equity strategy at Morgan Stanley.

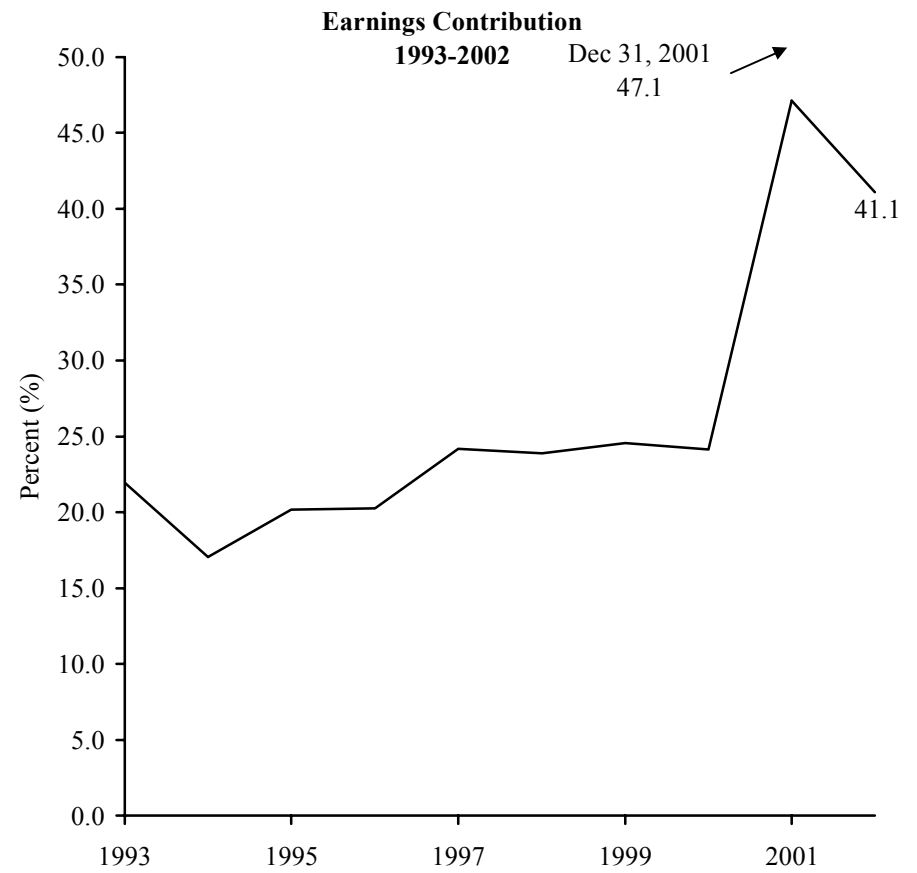
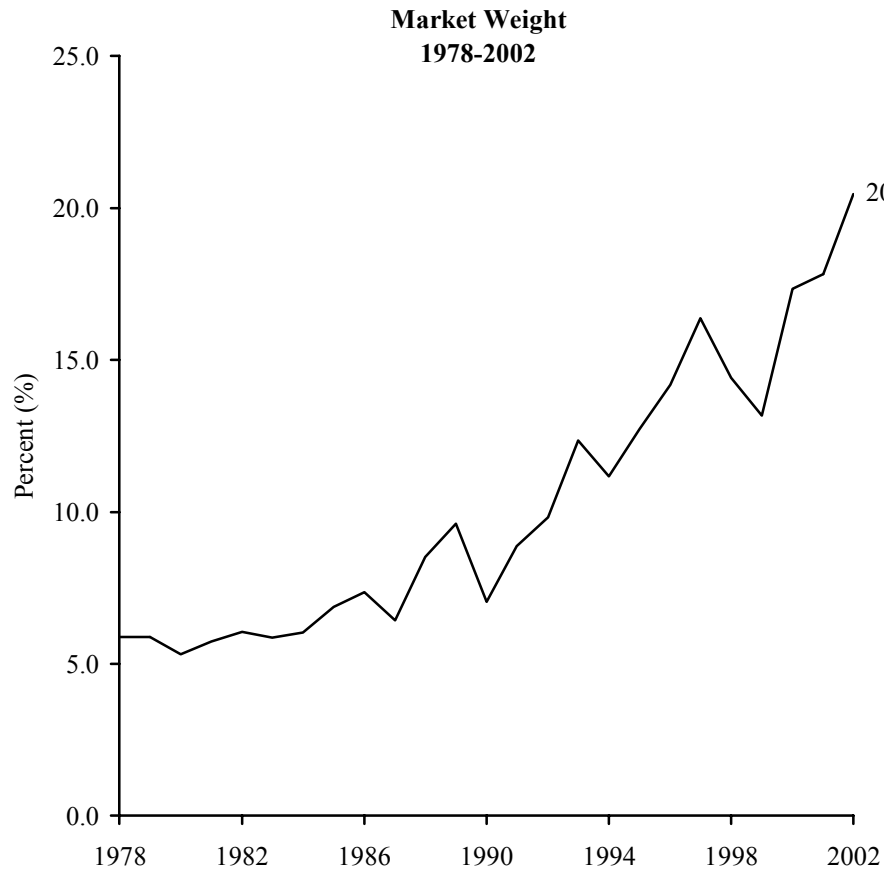
High Expectations

Over the near term, the financial sector should benefit from the tailwinds of the Fed's record monetary stimulus, consumers' resilient spending, and improving corporate credit quality. The consensus currently expects the sector's profits to grow 17.2% in 2003, compared to 12.4% for the S&P 500, and in 2004, 12.4%, with most of that growth occurring in the fourth quarter, according to I/B/E/S. Banks and diversified financials comprise 39.9% and 36.2% of the sector's market weight, respectively, and the operating profits of these two industries are expected to grow 11.5% and 20.9% in 2003, while earnings insurance and real estate (the next most significant sector components) are forecast to expand 28.8% and -8.4%, according to I/B/E/S. Longer term, financials is widely expected to be the market's fastest growing sector over the next decade as a result of consolidation, the democratization of capital markets and home ownership, and globalization.

However, because they are leveraged, the earnings of financial companies have tended to be more volatile and cyclical than those of many other sectors, and many such companies are exposed to complex risks (e.g., derivatives) that can be difficult to manage. As financials become a much larger percentage of the total economy and equity market, both will become increasingly vulnerable to any crisis afflicting this sector.

Table A

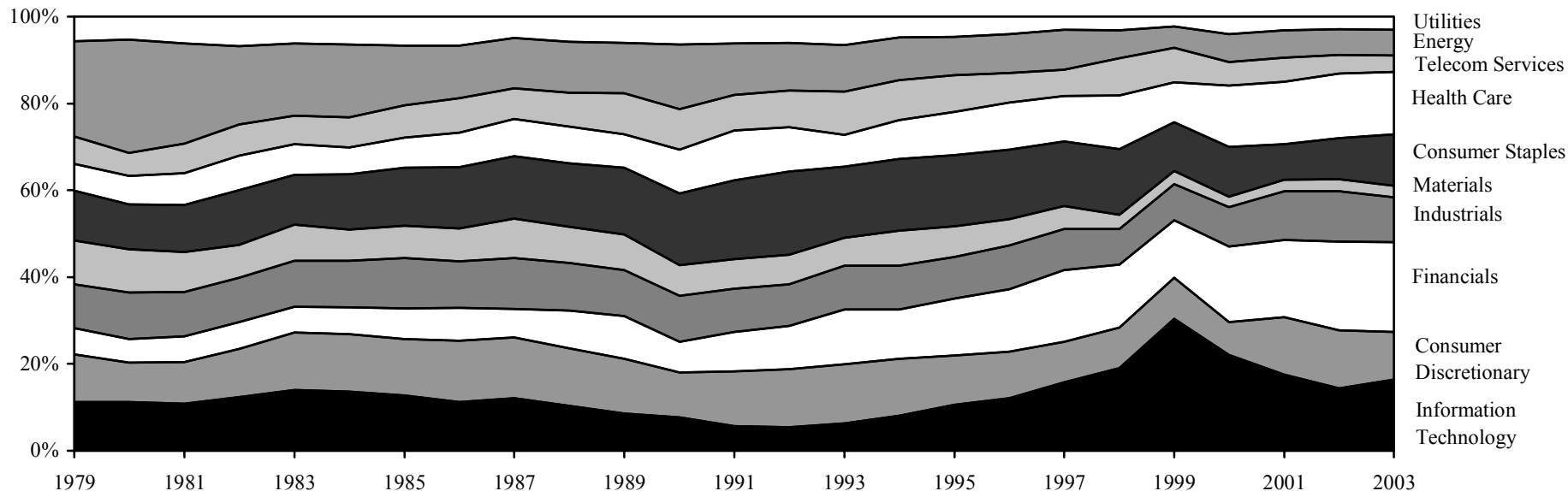
S&P 500 FINANCIAL SECTOR MARKET WEIGHT AND EARNINGS CONTRIBUTION



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

Table B

S&P 500 ECONOMIC SECTOR WEIGHTS



Annual Sector Weights (%)

	<u>1979</u>	<u>1981</u>	<u>1983</u>	<u>1985</u>	<u>1987</u>	<u>1989</u>	<u>1991</u>	<u>1993</u>	<u>1995</u>	<u>1997</u>	<u>1999</u>	<u>2001</u>	<u>2003</u>
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	16.34
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	11.04
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	20.69
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	10.36
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	2.67
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	11.78
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	14.42
Telecom 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	3.78
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	5.93
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	2.99

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 May 31, 2003. 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 (GICS).

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Table C

S&P 500 SECTOR MARKET WEIGHTS

<u>Sector</u>	<u>Current Weight (%)</u>	<u>Peak Weight (%) and Date</u>	<u>Trough Weight (%) and Date</u>
Consumer Discretionary	11.0	17.3 - June 1986	9.4 - Aug 2000
Consumer Staples	11.8	16.1 - Dec 1991	6.6 - Aug 2000
Energy	5.9	29.2 - Nov 1980	4.9 - Jan 1999
Financials	20.7	21.0 - Aug 2002	4.5 - Nov 1980
Health Care	14.4	15.7 - Mar 2003	3.9 - May 1977
Industrials	10.4	11.9 - July 2002	5.7 - Mar 2000
Information Technology	16.3	34.5 - Aug 2000	7.5 - Dec 1992
Materials	2.7	14.6 - Mar 1981	2.6 - Oct 2002
Telecom	3.8	10.0 - Aug 1993	3.6 - Sept 2002
Utilities	3.0	6.5 - Feb 1978	1.5 - Mar 2000

Sources: Standard and Poor's Compustat and The Leuthold Group.

Note: Current weight data are as of May 30, 2003.