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CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENTARY

THE GHOST OF LAURELS PAST

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The Ghost of Laurels Past

Like the standout athlete whose high price as a free agent looks entirely justified given his phenomenal stats, U.S. corporations have been delivering on investor expectations so consistently that paying 17.9 times last year's earnings to buy pieces of those corporations seems downright reasonable. The key question is: can this franchise player avoid injury or a slump?

The market's strong 2006 returns stemmed from earnings growth. In fact, the S&P 500's trailing price-earnings (P/E) ratio is slightly lower than it was one year ago, and is only marginally above the post-1900 average of 14.9 (Table A). Balance sheets are healthy, and corporations are delivering solid cash flow. In addition, while dividend yields have remained low, companies are engaging in massive share buybacks, returning cash to shareholders and elevating earnings-per-share (EPS) growth. The dollar amount of net share buybacks by S&P 500 companies over the first three quarters of 2006 was twice that of the index's dividends (Table B). Thus, it appears that there is cause for some optimism.

So why do we continue to view U.S. equities as overvalued? Because investors are paying $17.89 for every dollar of last year's earnings, even as profits are likely near their cyclical peak.

One way to smooth out earnings cyclicality is to compare stock prices to the average inflation-adjusted earnings over a more extended period (our preferred time frame is a decade). This "normalized real P/E ratio" makes the current valuation picture less rosy. On a normalized basis, the S&P's P/E ratio is 27.1—more than 1 standard deviation above its long-term mean of 15.9 (Table C).

And if the normalized P/E picture for large caps is a bit of a downer, the comparable outlook for small caps looks almost bleak. The Russell 2000®'s current normalized P/E of 36.8 is just a hairsbreadth less than the nearly two-decade high of 37.8 set in 1998, despite the fact that earnings have since risen 79% in nominal terms or 44% in real terms (Table D).

It appears that current U.S. equity valuations are predicated on earnings growth continuing at yesterday's and today's exceptionally high levels, rather than reverting to historical trendline levels (Tables E and F).[1] Overall, sell-side analysts have baked into their models an EPS growth for the S&P 500 of 8.2% in 2007, slightly higher than the long-term historical average of 8.0% in nominal terms and somewhat more above the 6.9% earnings growth based on average historical real earnings growth of 4.6% and inflation expectations of 2.3% priced into the bond market. While the status quo could certainly continue, and no one knows for certain when reversion to the mean will occur, it is instructive to evaluate the key drivers of earnings growth today and whether they still have legs.

[1] For an examination of current earnings growth relative to the post-1900 trendline, see our September 2006 U.S. Market Commentary: *Deconstructing the Bullish Case on U.S. Equities.*

Miracle-Gro?

Financial and energy firms contributed nearly three-fifths of the S&P 500's 15.4% estimated EPS growth for calendar year 2006, according to Morgan Stanley research using Thomson Financial analyst estimates. Insurance firms accounted for one-fifth of the S&P 500's EPS growth, as EPS grew an estimated 65%, boosted by rising premia and a blissfully calm hurricane season. Traditional banks grew estimated EPS by less than 4%—nearly flat in real terms—as an inverted yield curve and slowing mortgage environment took their toll. Diversified financial firms, on the other hand, contributed about one-sixth of S&P earnings growth, profiting from the merger and acquisition (M&A) boom and successful proprietary trading. Obviously, insurance firms are unlikely to replicate such spectacular growth even if the waters of the Atlantic Ocean remain placid in 2007 (they are expected to grow earnings at just 4% in 2007). Consensus estimates peg financial sector EPS growth at 7%; this may be achievable if enough of the following transpires: expected Fed funds rate cuts bring the yield curve back into a normal posture, the M&A and buyout booms keep rolling, the housing market regains its footing, and proprietary trading remains a strong profit center.

Energy firms were the second largest contributor, accounting for roughly one-fifth of S&P 500 earnings growth, as EPS expanded by an estimated 21%, on top of 2005's 48% increase. Energy stocks may grow earnings modestly in 2007 if oil prices recover some of the ground they lost in the last days of 2006 and the initial weeks of 2007, but sustained high levels of growth seem unlikely. In fact, consensus analyst estimates peg 2007 EPS growth for energy stocks at just 1%.

What is expected to take the high-growth mantle in 2007? Technology stock earnings, which grew a bit less than 10% in 2006, accounting for an estimated 7% of S&P 500 earnings growth, are expected to grow by 20% in 2007 and to contribute one-quarter of the overall EPS growth for the S&P 500—more even than the 21% contribution expected from financials. Much of the EPS growth is expected to come from Internet and e-commerce firms leveraged to the consumer. The software and services subsector of the S&P 500 is tipped to grow EPS nearly 29% in 2007, accounting for 11% of overall EPS growth of the S&P 500. It is worth noting that the return of boom times for technology have been "just around the bend" before, but things have not quite played out as expected (one year ago, consensus estimates pegged software and services to grow EPS by 18% and semiconductors to grow by 22% in 2006; now analysts expect that 2006 growth will come in at just 5% and -4%, respectively).

Of course, EPS has two components: dollar earnings in the numerator and share counts in the denominator. The numerator has been expanding during this very robust phase of the business cycle, while companies have been aggressively shrinking the denominator by completing stock buybacks well in excess of employee stock issuance or secondary offerings. S&P 500 component firms purchased an estimated *net* $275 billion of their own stock during the first three quarters of 2006, nearly double the total dividends these firms paid. Selling by corporate insiders, meanwhile, has reached extreme levels that historically have been harbingers of disappointing profits.

M&A

Another factor boosting today's valuations is the belief M&A will continue at the current blistering pace. To date, M&A activity has primarily benefited small- and mid-cap firms. The Russell 2500™ Value Index, which includes small- and mid-cap (collectively "SMid-cap") value stocks, is currently trading at a P/E ratio that is 43% higher than that of the Russell Top 200® Value Index, which is dominated by mega-cap firms. This compares to an average 12% premium for the SMid-cap index over the past two decades and a 20% *discount* in 2000 when relative valuations for small caps were at their nadir. Buyout firms have been key participants, raising capital at a break-neck pace (Table G). Indeed, David Rubenstein, co-founder of the Carlyle Group, told the *Financial Times* in December to expect to see a $50+ billion buyout within the next year and a $100+ billion buyout within two years.[2] Such mega-transactions would likely be headline-grabbing exceptions to the SMid-cap rule that has characterized most buyouts to date. We expect M&A to continue to be robust unless the pace of U.S. economic growth declines or the cost of capital increases rather dramatically. Given the magnitude of the buyout fund raising,[3] the low level of interest rates and credit spreads, and the high level of cash on corporate balance sheets, M&A may continue to provide positive tailwinds to U.S. equities for some time. However, M&A booms have historically been followed by bear markets in public equities, as was the case in 1987, 1990, and 2000.

Beyond Valuations

As markets price in benign conditions with above-trendline growth, several issues give us cause for concern. As noted in our December 2006 Global Market Commentary: *Triumph of the Optimists?*, investors' appetite for risk assets continues unchecked, with the boom in M&A buyout activity, excessively narrow credit spreads, and aggressive junk issuance. The liquidity that supports this type of environment cannot be sustained indefinitely.

From a secular perspective, there are also important risks to consider, such as the risk of rising protectionist policies. In the United States, while the gap between low income and the wealthy has been growing for some time, the gap between the middle class and the wealthy has also started to expand. At the same time, it is not completely clear at this stage whether the Democratic majority in both houses of Congress is more inclined to impose additional restrictions on imports, exports, and services outsourcing than their Republican predecessors. The stakes would be raised if there were a recession, as policymakers could seek to limit the export of jobs to foreign locations.

And the falling dollar? While dollar weakness has aided exports, a rise in exports alone cannot be expected to materially reduce the current account deficit. A combination of rising exports, reduced consumer spending, and rising savings will be necessary. Any sharp decline in consumer spending should be a significant negative for equities. Further, any unexpectedly sharp decline in the U.S. dollar would likely

[2] "View from the Top," www.ft.com, December 7, 2006. Transcript available at http://www.ft.com/cms/s/7e77465e-8616-11db-86d5-0000779e2340.html
[3] Buyout firms have an estimated $700 billion in untapped capital available.

have a negative impact on all markets, but particularly U.S. markets. Depending on the catalyst for such a sell-off, a U.S. recession might either accompany such a development or be triggered by the higher interest rates that ensued, and shrinking U.S. consumer demand would certainly be detrimental to global growth, even if domestic demand in Japan, China, and Europe remained reasonably robust (itself a questionable hypothesis). In addition, the massive U.S. fiscal deficit could make foreign holders of U.S. Treasury securities increasingly nervous, particularly in an environment in which the US$ is plunging. And, of course, any significant moves by non-U.S. central banks (or non-U.S. investors in general) to shift away from the U.S. dollar might cause U.S. interest rates to rise, pushing up the cost of capital to U.S. businesses and exacerbating the U.S. government's liabilities. In short, a monetary policy designed to stimulate a weak economy could be undermined by the constraining effects of a massive fiscal deficit funded to a significant extent by foreign money.

While rising trade barriers and a steep plunge in the US$ are not part of our base expectations, they are two prominent examples of secular headwinds that are not reflected in current market pricing.

Positioning the Portfolio

With U.S. equity valuations pricing in continued exceptional growth, what is the prudent investor to do? Given that generous liquidity conditions and strong corporate earnings could be sustained over the short to medium term, we continue to recommend investing in U.S. equities despite building signs for concern. However, we would underweight U.S. equities relative to other markets, particularly those of Asia. Given that risks are high, investors should overweight mega-cap and quality equities, which trade at reasonable valuations and should prove defensive (Table H).[4] We believe that overweighting the largest-capitalization firms within a U.S. equity allocation provides some reasonable protection against the possibility of an earnings slowdown *or* a broad compression in earnings multiples. Large-cap and particularly mega-cap firms may have more diverse revenue streams and may weather a falling dollar better than small caps.

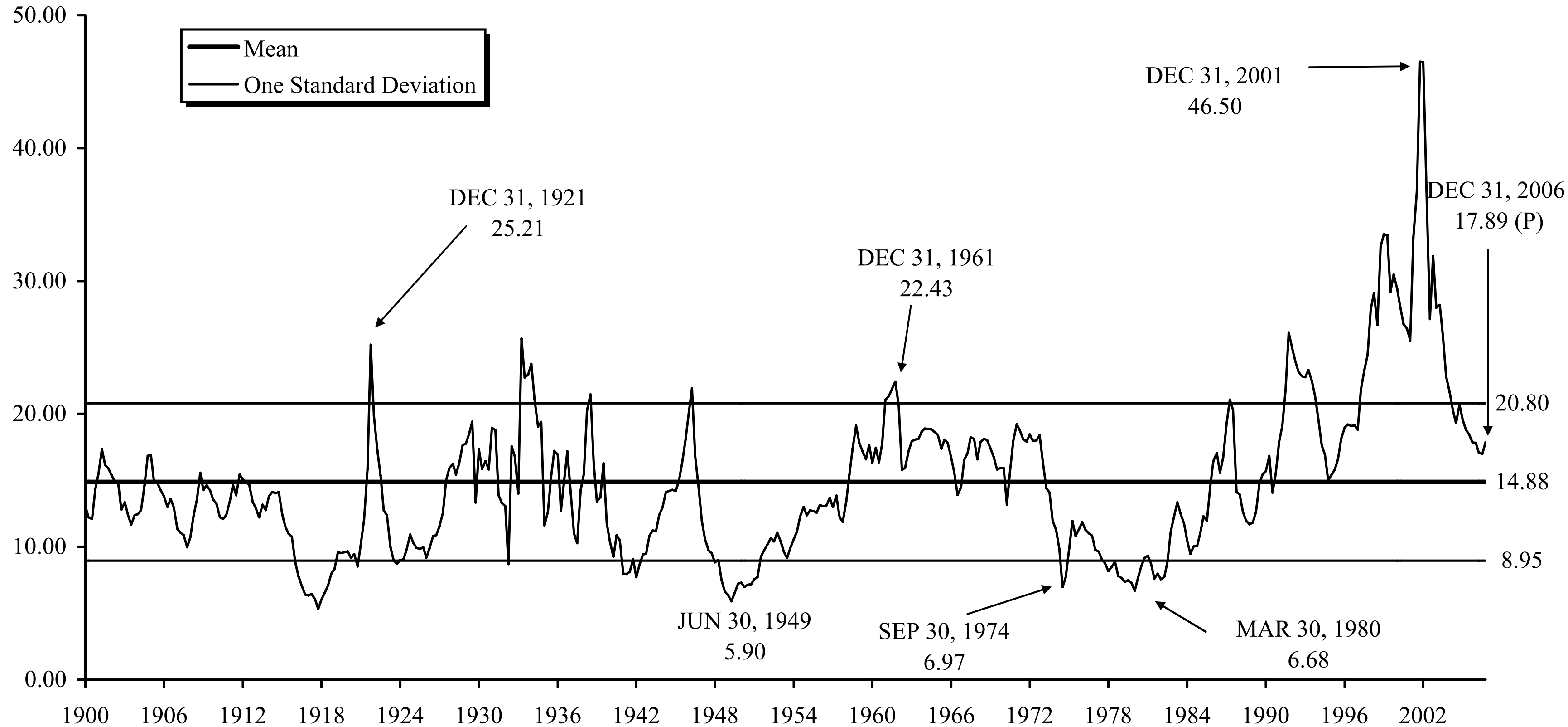
Similarly, stocks of high-quality firms are currently reasonably priced, and their defining characteristics (low debt, steady earnings, and solid profitability) should position them very well relative to lower-quality stocks if earnings overall disappoint. The large-cap and high-quality universes are not synonymous, but they have significant overlap.

[4] For more on mega-cap and quality stock valuations, please see our August 2006 U.S. Market Commentary: *The Unloved Mega-Caps* and our June 2006 U.S. Market Commentary: *Still Pounding the Table on Quality*.

Table A

S&P 500 PRICE-EARNINGS RATIOS

March 31, 1900 - December 31, 2006



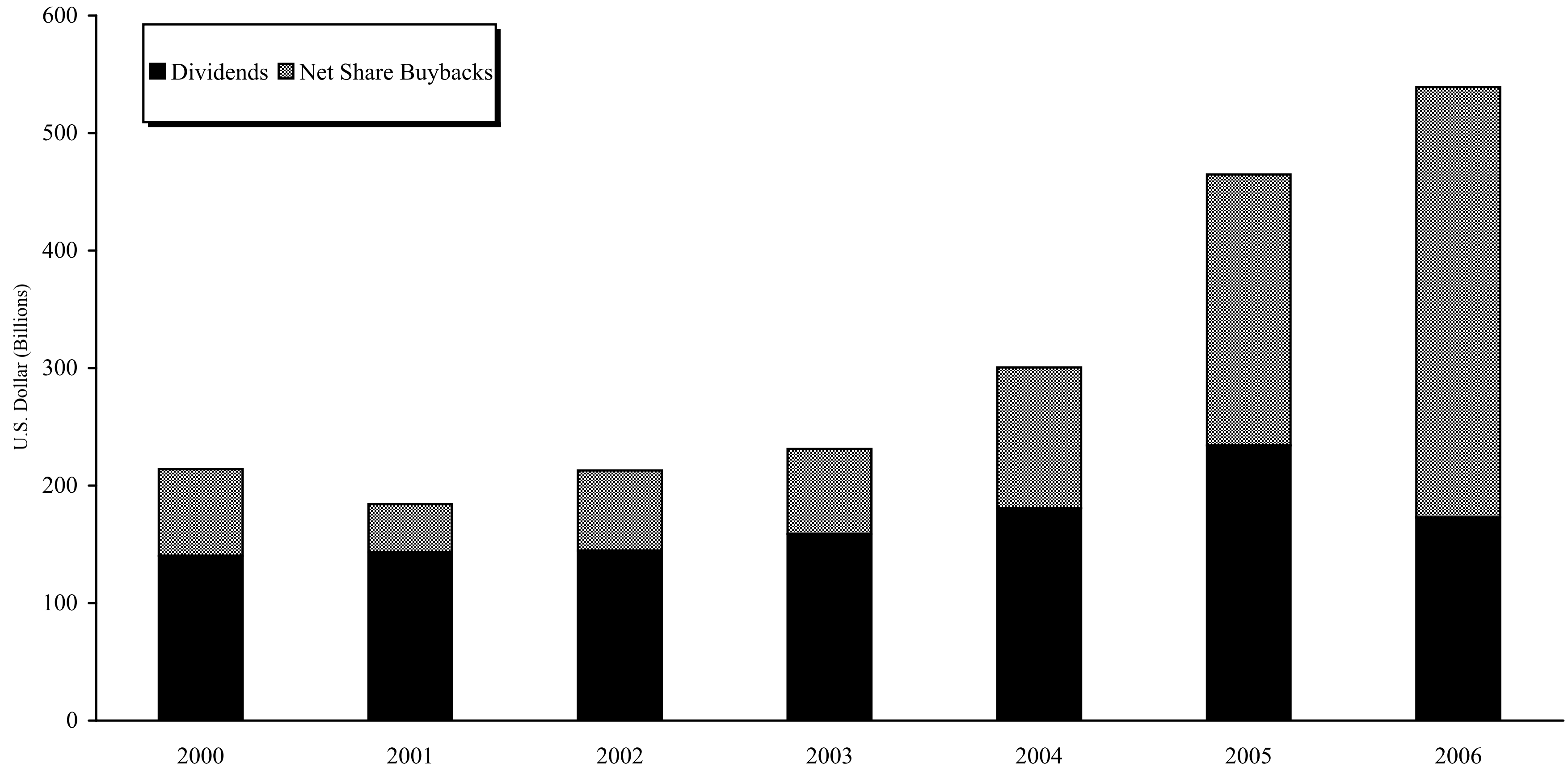
Sources: Calculated from data provided by Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal* .

Notes: (P) Preliminary. Data are from first quarter 1900 through fourth quarter 2006.

Table B

S&P 500 NET SHARE BUYBACKS COMPARED TO DIVIDENDS

2000-06

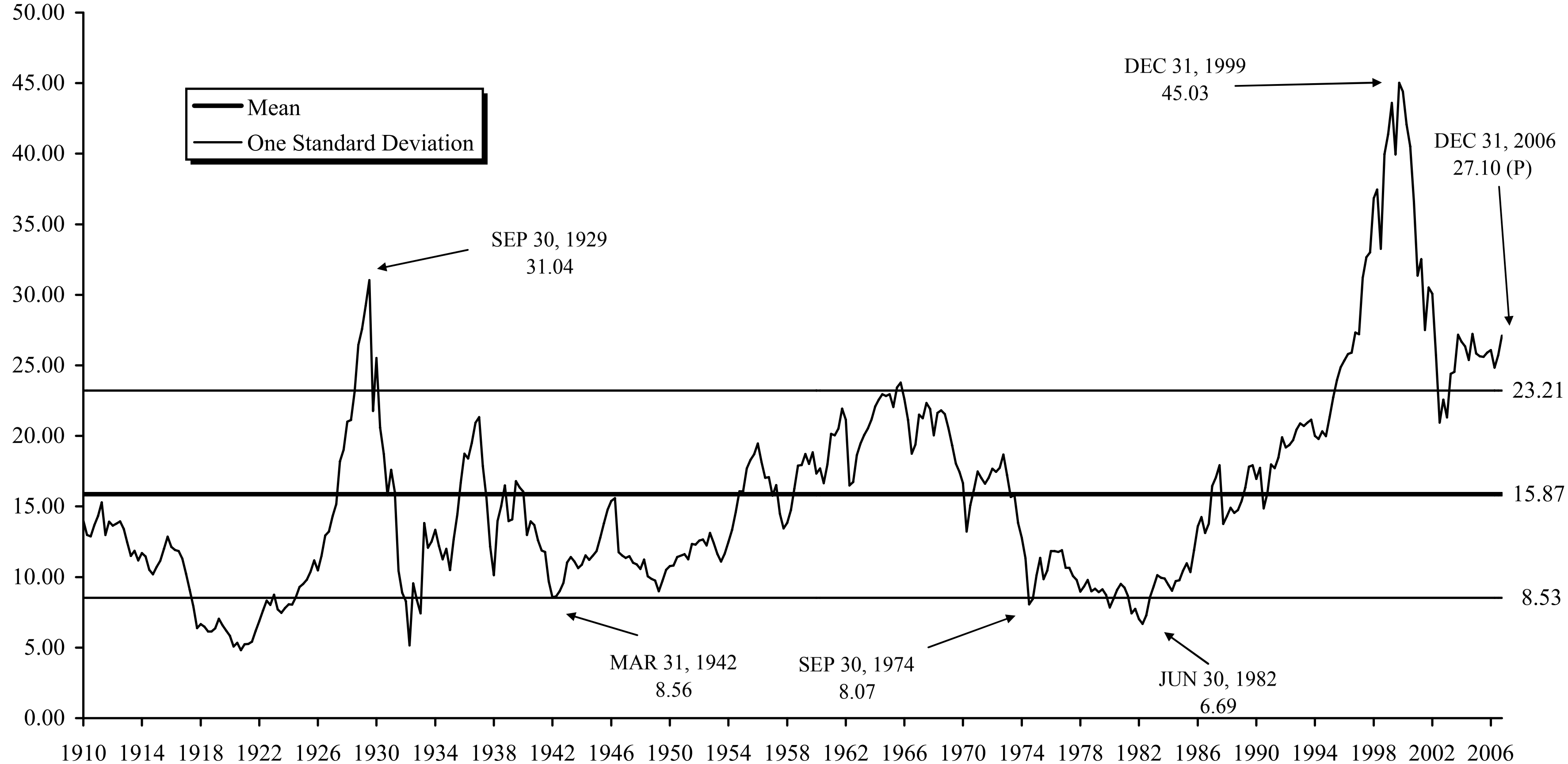


Source: Factset Research Systems.

Notes: Data for 2006 are annualized based on the first three quarters. Share buybacks are net of equity issuance, including executive stock grants and option exercise.

Table C

S&P 500 NORMALIZED REAL PRICE-EARNINGS RATIOS SINCE 1910



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. Normalized real price-earnings ratios for the S&P 500 are calculated by dividing the current index value by the annualized average real earnings for the trailing ten years. CPI-U data are through November 30, 2006. Graph represents quarterly data through fourth quarter 2006.

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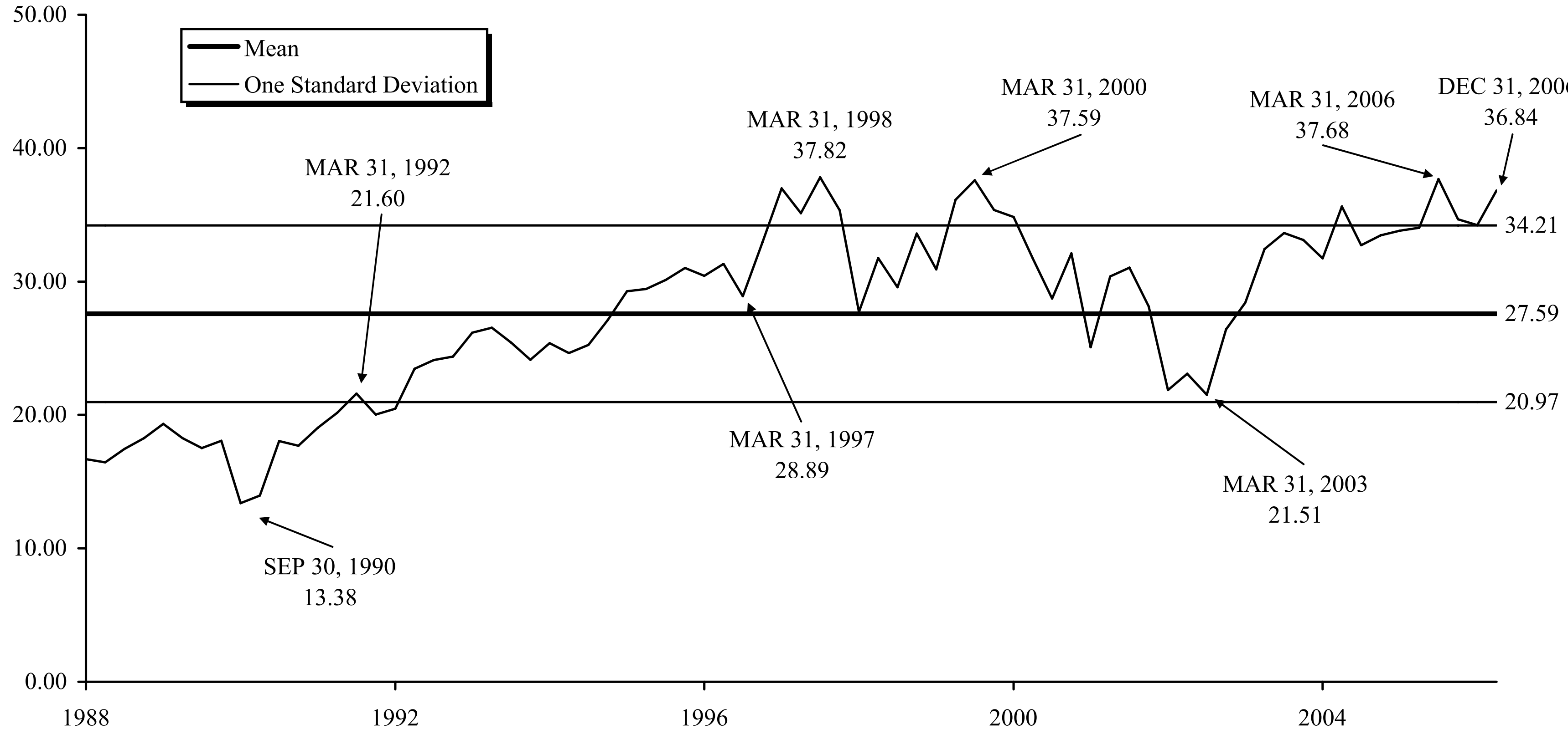
Table D

RUSSELL 2000® NORMALIZED REAL PRICE-EARNINGS RATIOS

December 31, 1988 - December 31, 2006

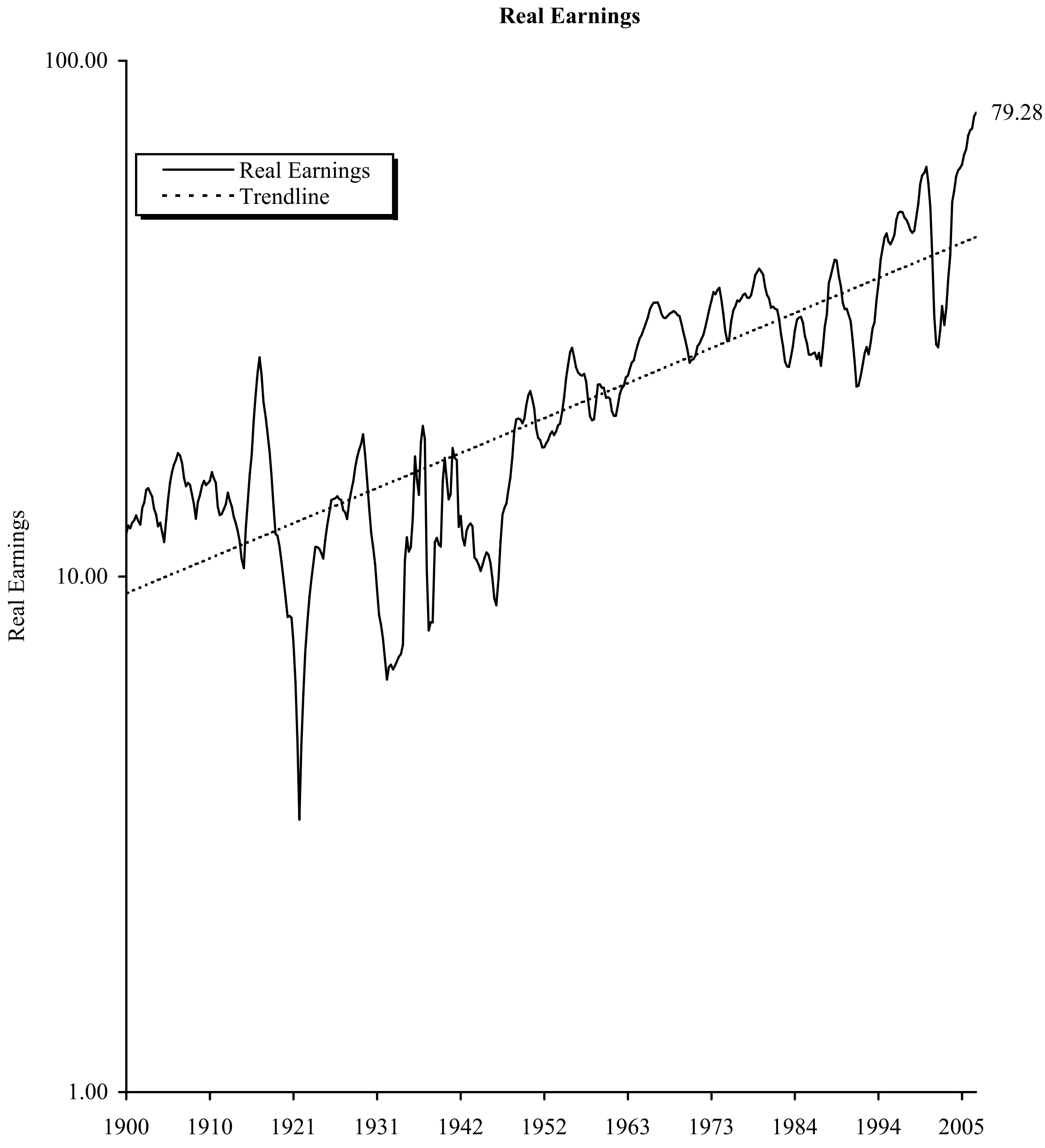


Sources: Frank Russell Company and Thomson Datastream.

Notes: Data are from third quarter 1988 through fourth quarter 2006. Normalized real price-earnings ratios for the Russell 2000® are calculated by dividing the current index price by the annualized average real earnings for the trailing ten years. CPI-U data are through November 30, 2006.

Table E

S&P 500 REAL EARNINGS SINCE 1900



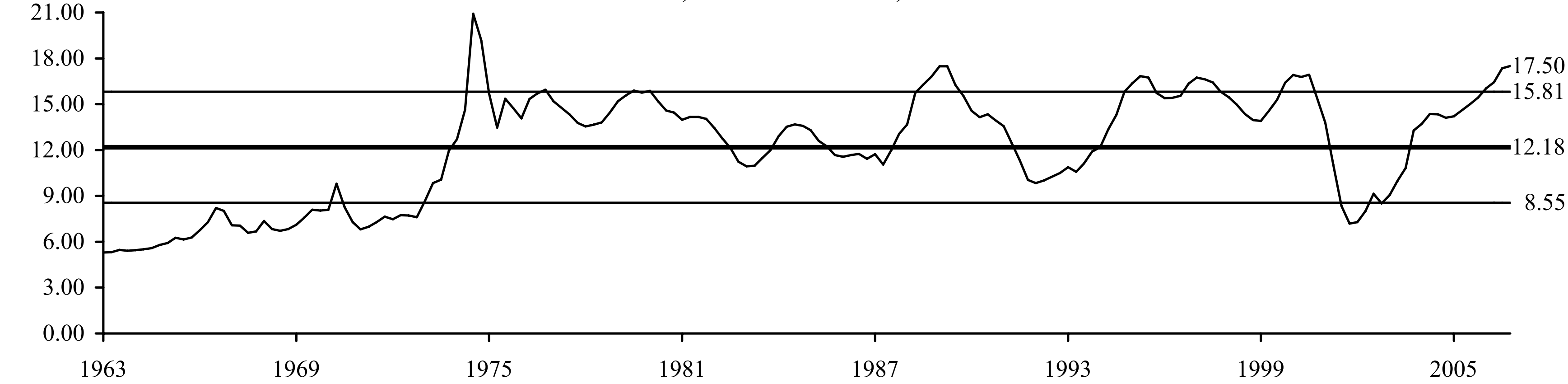
Sources: Calculated from data provided by Bureau of Labor Statistics, Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal.*

Notes: Graphs for real earnings and price levels are shown in logarithmic scales. Real price levels are calculated based on November 30, 2006 dollars. Data are through fourth quarter 2006 and are preliminary.

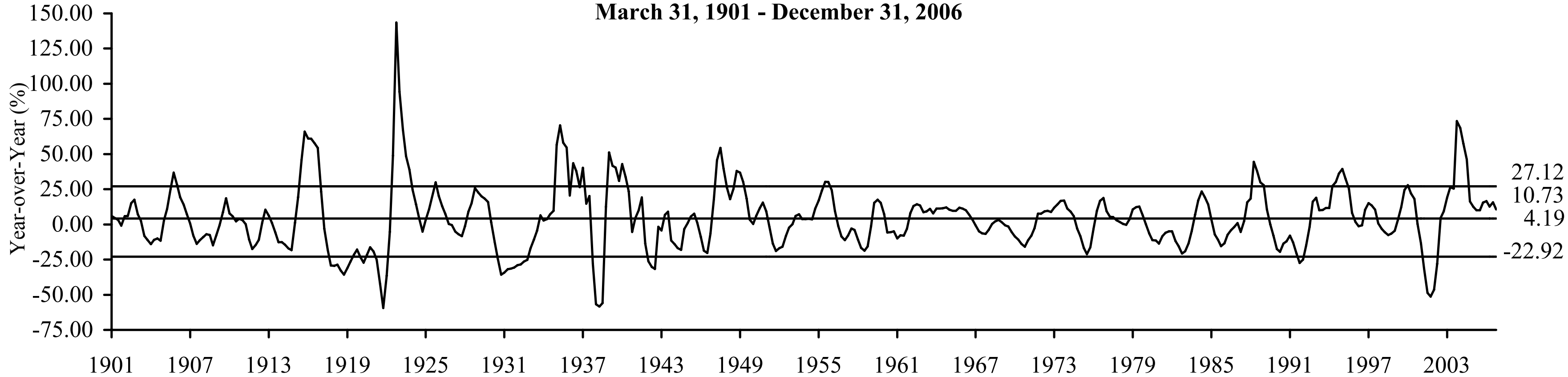
Table F

S&P 500 RETURN ON EQUITY AND REAL EARNINGS GROWTH

Return on Equity
March 31, 1963 - December 31, 2006



Real Earnings Growth
March 31, 1901 - December 31, 2006



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

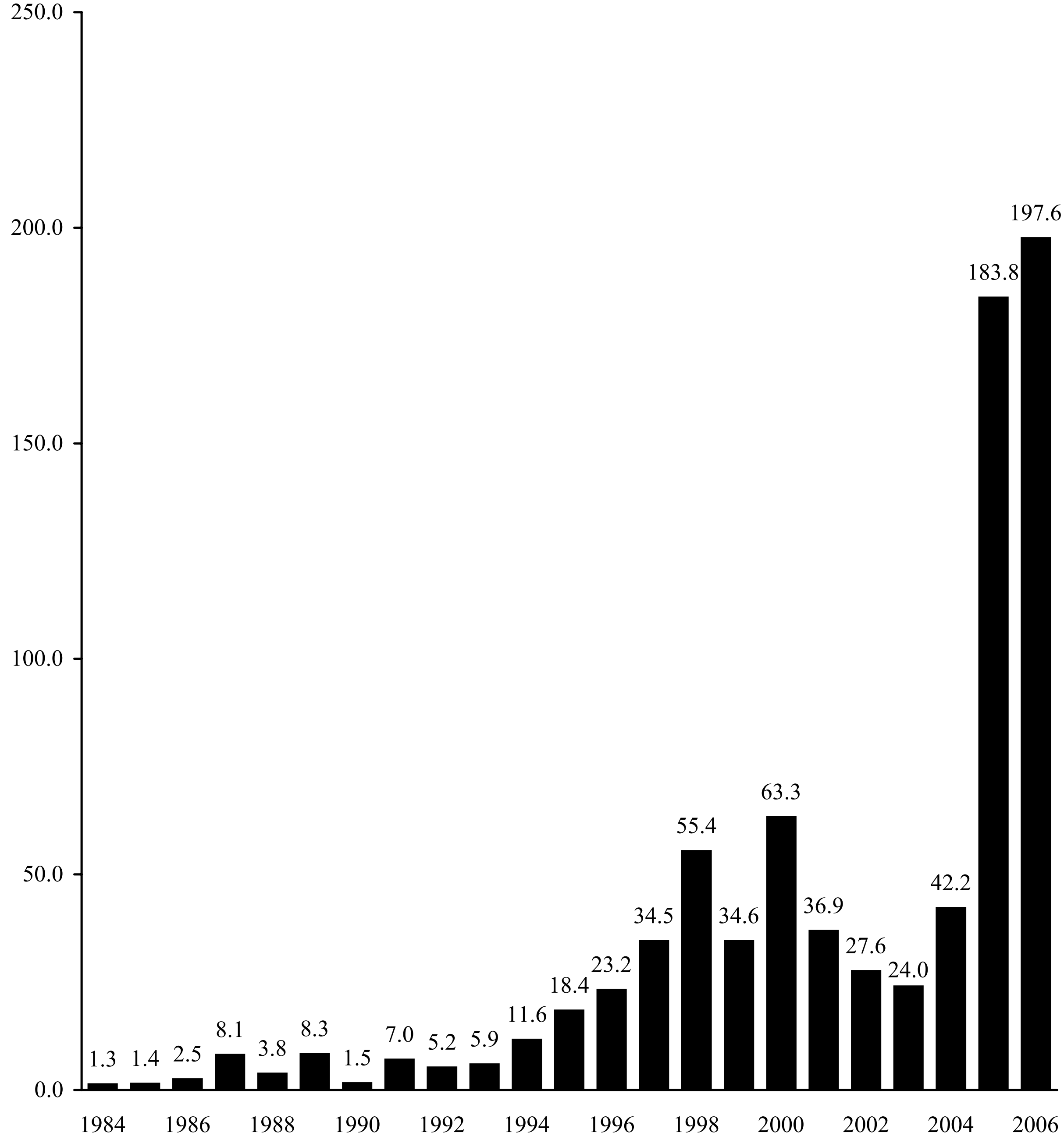
Notes: Earnings are in US$ and deflated by U.S. CPI. Real price levels are calculated based on November 30, 2006 dollars. Fourth quarter 2006 earnings data are preliminary, as are 2006 return on equity data.

Table G

CAPITAL COMMITMENTS TO DOMESTIC LEVERAGED BUYOUT FUNDS

January 1, 1984 - December 31, 2006

($ billions)



Source: *Buyouts.*
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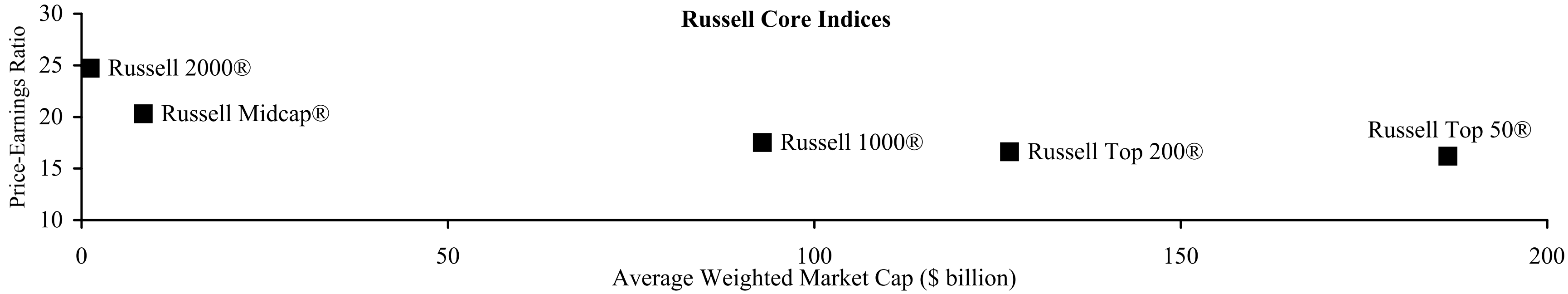
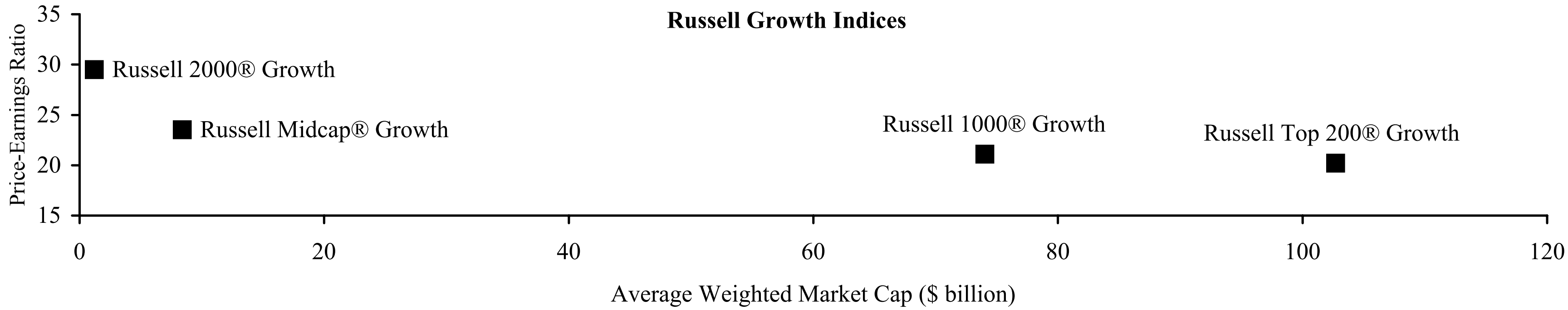
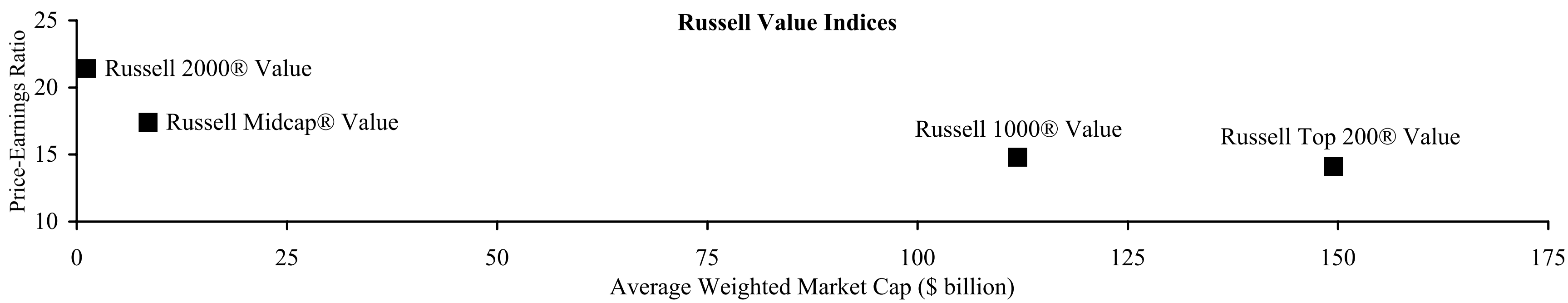
Table H

PRICE-EARNINGS RATIOS BY MARKET CAPITALIZATION

As of December 31, 2006







Source: Frank Russell Company.