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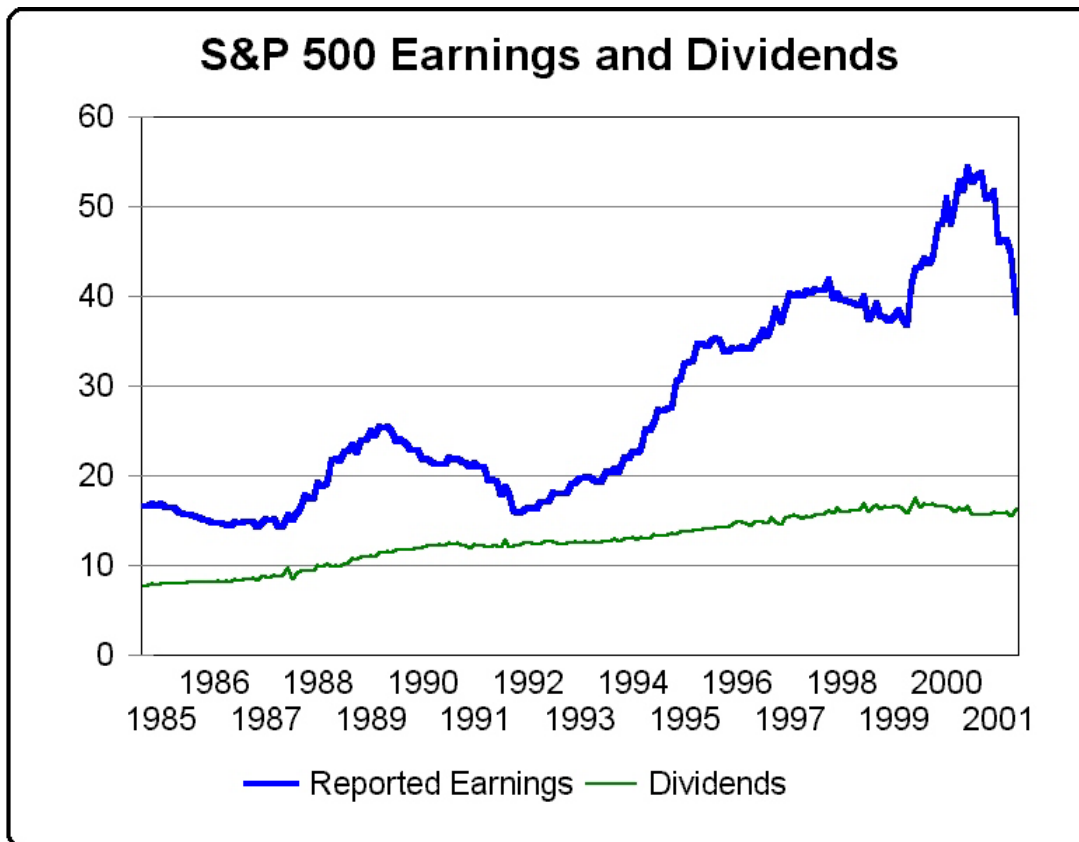
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Independent Research Providers to the  
Professional Investment Community

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# Special Report

## Spotlight on US Equity Valuations Bad News: Earnings Have Slumped Worse News: More To Come



All Graphs in this Report are as of 1 October 2001

### Earnings Fall Off the Table

As the chart on this page makes clear, reported earnings for the S&P500 index are now rapidly approaching their lowest point in the last 5 or 6 years. Given that fourth quarter earnings are generally expected to be abysmal when compared with last year, this number is likely to recede even further.

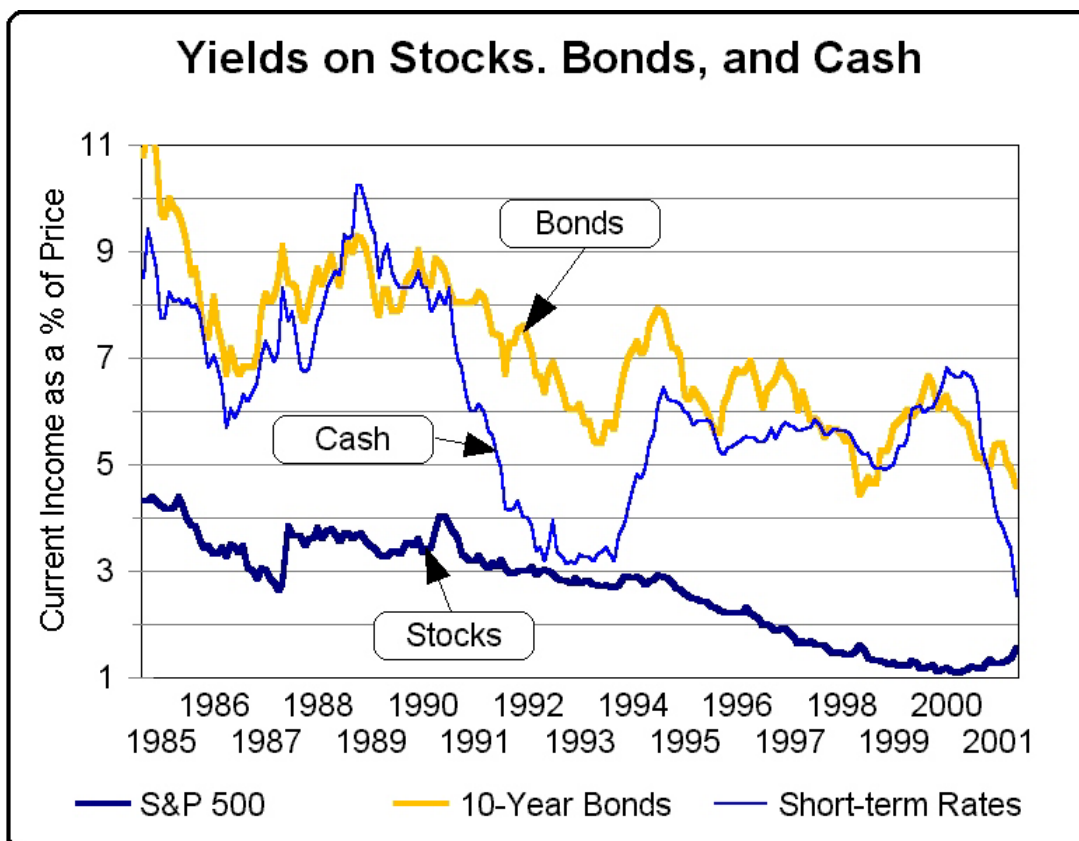
## A Cautionary Tale

We are forecasting that the long years of dollar hegemony are coming to an end. Part of our reasoning was included in our special report of 12 October entitled "[Spotlight on Inflation & Real Rates](#)" in which we pointed out that real interest rates in the US are now lower than in Japan and Europe.

We have also made the case in previous reports for superior performance in the near future by the Euroland economy over that of the US. We believe the current economic downturn in Europe will be less severe and will be reversed more quickly than will be the case in the US.

This report addresses a further vulnerability of dollar-based investments. In our view, the US equity market is currently overpriced, given the dismal outlook for earnings and the clear risk aversion that investors are now displaying toward other long-term investments. We make the case here that equity prices will have to come down to restore valuation parameters to be more in line with historical norms. If that doesn't happen, then it is our view that the US stock market will provide very poor returns going forward. In either case, our advice is clearly to avoid buying US equities at the present time.

In a subsequent special report, we will provide international comparisons to address the question of where it might be more beneficial to invest.



## Yield Levels

The graphic on this page provides an historical perspective on the relationship between dividend yields (on the S&P500), bond yields (on 10-year treasury bonds), and short-term yields (3-month Eurodollar rates).

As can be seen, short-term rates have now fallen below the levels they saw during the last US recession. In fact, these short-term yields are at their lowest levels in

about 4 decades. Some would argue that this is a positive sign for stocks, since lower rates can justify a higher PE. However, we are quick to point out that the proper comparison should be longer-dated fixed-income securities, and although those yields have declined as well, the picture there is less heartening. More on that in a moment.

Dividend yields have increased slightly of late, but please note that the current yield on the S&P500 index is well below (in fact, about half of) its average level during the decade prior to the runup in the market in the second half of the 1990s. Given that dividend payments on the index have been declining lately (see the graphic on page 1), a doubling of dividend yields over the next few months would require the halving of stock prices. We are not predicting that, but simply wish to point out that this is a risk which must be taken seriously.

## Caveats

The lines on our first graph (earnings and dividends for the S&P500) must be interpreted with some caution. In turn, therefore, any conclusions based on price ratios (dividend yields and price/earnings [PEs]) must also be interpreted carefully.

There are many subtleties having to do with the way these numbers are calculated which make them hard to compare with other earnings statistics and time series, such as the national accounts version of corporate profits or individual company patterns. In this report, we focus the reader's attention on only one of these complications, and leave aside the issues related to the treatment of special items such as goodwill and extraordinary write-offs.

It is important to keep in mind that the S&P500 index is a capitalization-weighted index. Much attention has been given in the press to the fact that the performance of this (or any capitalization-weighted) index is dominated by the larger companies in the index. Thus, if highly-capitalized companies are doing well, the index will rise regardless of the fortunes of the smaller companies in the index.

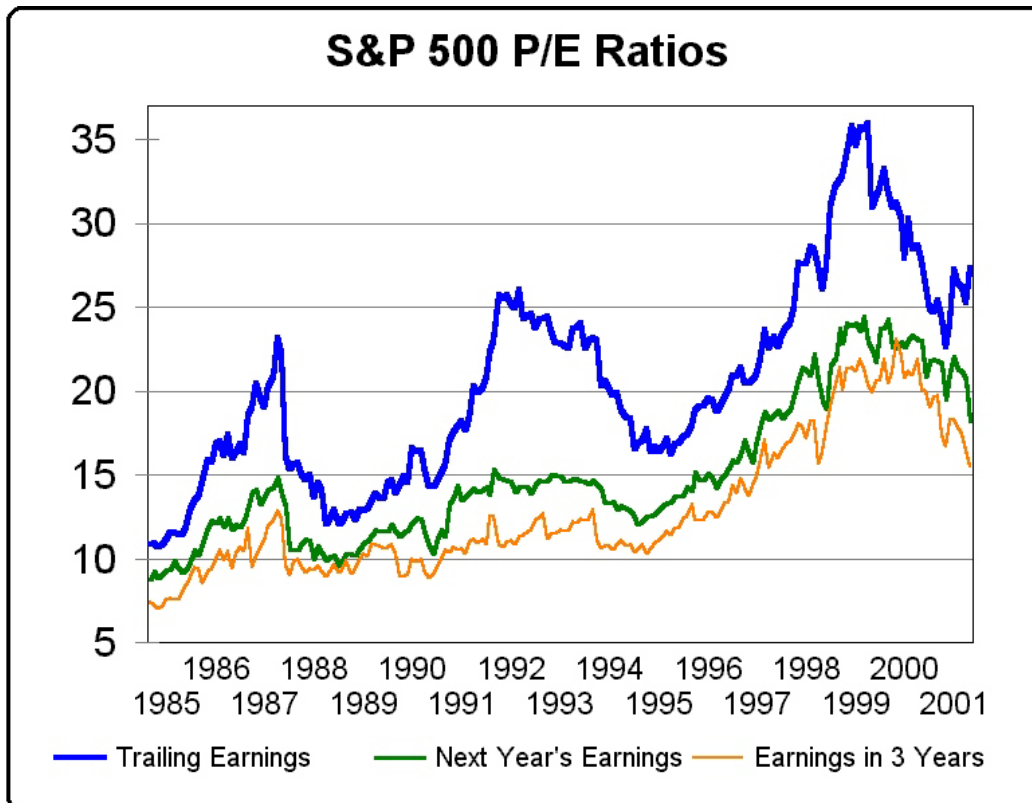
What is perhaps less widely appreciated is that the statistics that S&P publishes in connection with the index are also capitalization-weighted. The reported PE, for example, of the index is really the ratio of the index price to the aggregate (capitalization-weighted) earnings of the constituent stocks, not an average of the PEs of the stocks in the index.

Why is this distinction important? Well, quite frankly, most of the time, it is not. But at a time like the present, when the market leadership is changing dramatically, this peculiarity of reported index statistics can help explain why, for example, the earnings figure in our first graph is plunging so dramatically. As the previously high-flying (high-PE) companies have seen their stock prices fall, so too the weight of their dollar earnings has been reduced in the index computation. Compounding this drop has been the fact that their earnings are lower. Thus, the 29% decrease in the earnings reported for the S&P500 so far this year is probably an overstatement of the actual decline in aggregate dollar earnings for this group of companies.

The moral of this story is that it is very difficult to interpret current PE levels (or dividend yield levels, for that matter), or to predict them, or to put them in historical context, because the levels of these valuation gauges change not only with the fortunes of the constituent companies but as their stock prices fluctuate, too. And all of this is without even worrying about the accounting issues we mentioned, which have a substantial impact in their own right. That said, these difficulties will not stop us from commenting on these crucial variables.

## PEs Are Off Their Highs, But Still Elevated By Historical Standards

So far this year, even though the price of the index is down 21%, the PE of the S&P500 has risen 11%, from 24.7 to 27.3, mostly as a result of the 29% decrease in reported earnings. (Remember, this decline in calculated earnings for the index is a combination of a decline in actual earnings and a shift in the way the constituent earnings are weighted.)



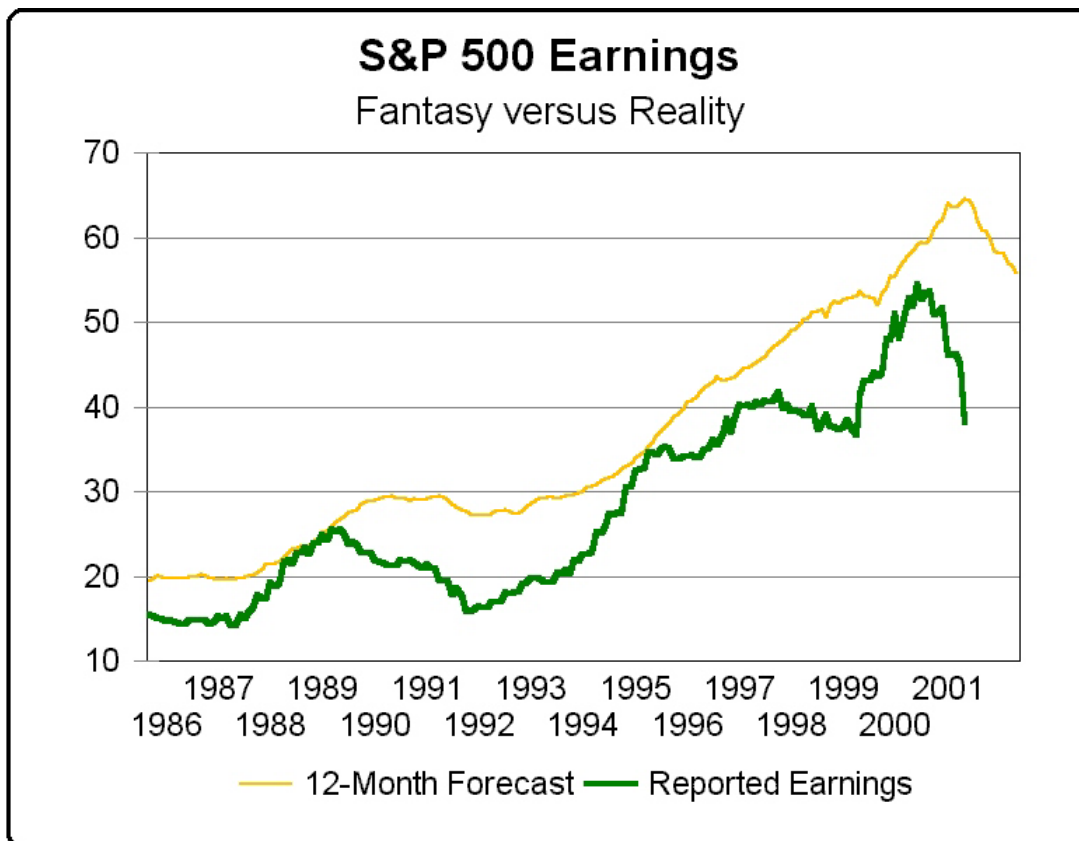
## Examining Projected Earnings Provides No Comfort

Looking out at forecast earnings, however, the PE picture is not the same. (See the graph above.) In the case of one-year out earnings, the PE has in fact declined by 17% (from 21.9 to 18.2) on the back of a 10% fall in the consensus outlook. (Again, these numbers don't add up because of the change in the weightings of the various sectors.) Interestingly, however, the 3-year look-ahead has seen a 21% decrease in the PE (from 19.7 to 15.5), which is entirely attributable to the price decline in the index, since the analysts' estimates have hardly budged!

Thus, despite the greatest one-day shock that our economy has perhaps ever seen, both investors and analysts appear to us to be amazingly complacent about not only keeping their future earnings targets nearly unchanged, but about paying fairly high prices for those earnings. To be sure, the PE ratios on this graph have been higher than they are now over most of the past 3 or 4 years, but going back before that for a decade or more (a period of nearly uninterrupted prosperity), one would be hard pressed to find times when these PEs were higher. In fact, only two prior peaks stand out. One was right before the 1987 crash, a time when many observers felt the market was overvalued and at risk of correction. (Note, however, that bond yields were noticeably higher at that time.) The other time was in the 1992-1993 period, following a plunge of 25% in reported earnings.

## Cyclical Patterns Are Worrisome As Well

To be fair, analysts have not had time to fully evaluate the impact of what has happened. Given a few more weeks, we suspect earnings forecasts will be revised downward significantly. Nonetheless, one additional piece of disturbing evidence (see the chart on this page) is to be found in the enormous gap that now exists between just-reported earnings and the consensus of analysts' estimates one year into the future. While this departure (as a percentage) is not the highest it's ever been (that peak came during the earnings slump of 1992), we see worrisome portents that conditions will continue to worsen for this ratio. For one thing, analysts' forecasts, at least in aggregate, have almost never been fully realized. One might be tempted to conclude that investors must therefore know to factor in analyst overoptimism, but we see a pattern that is disturbing nonetheless. The only times that reported earnings have come close to registering levels predicted by analysts a year earlier were two brief periods, in 1989 and 1995, when earnings were near the end of a long period of recovery from downturns. At present, it seems clear that earnings have not yet hit bottom, and are therefore a long way from enjoying a sustained recovery. Granted, these observations are anecdotal in nature, and we are truly living through extraordinary times, but it seems to us that some sequences have a way of playing out over and over again, and this may be one of them.



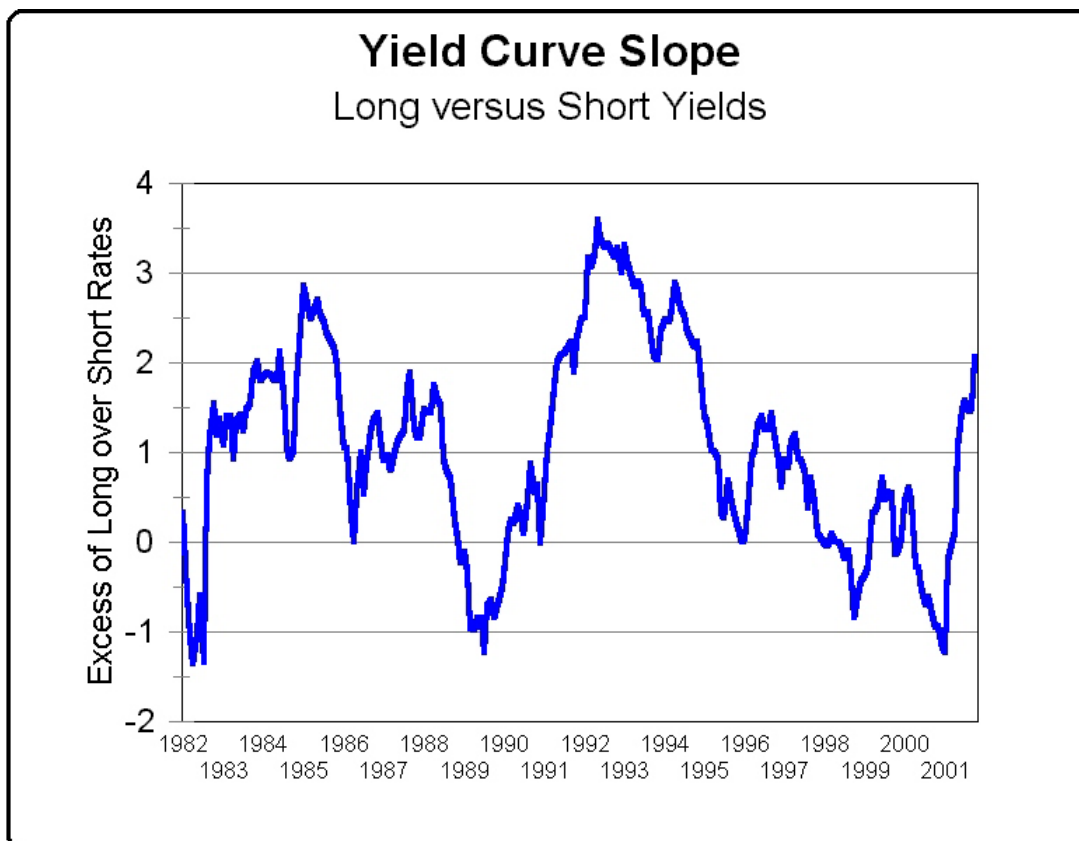
Likewise, the high probability of ongoing downward revisions to earnings estimates seems to us to be intuitively obvious, so we are left with the mystery of why investors are so keen to pay lofty multiples for overblown earnings estimates.

## Risk Premia Should Expand In Times Like These

Clearly, the risk of owning equities has risen. During times of uncertainty, it is natural that risk premia on long-dated assets should rise. In fact, that very phenomenon (an expanded maturity risk premium) is very much evident in the fixed-income markets these days. The difference in yields charted on this page is between 10-year treasury bonds and 3-month paper. Over the past few weeks, the slope in this part of the yield curve has risen dramatically, to levels not seen in nearly seven years.

Yet, the risk premium for owning stocks does not seem to have risen much, if at all. PEs are still higher than they were at any time in the recent past, with the exception of the past 4 years. Obviously, we have oversimplified the analysis, because reported (or even forecast) earnings are not all that matter in valuing equities. Earnings growth prospects must be taken into account, as well as the level and possible future course of dividends (as both a percentage of price and of earnings), and the possibility of companies adding value through acquisitions or other corporate actions, including share buybacks.

In the wake of the September Shock, however, we fail to see how any of these other variables can have changed in a way that is favorable to holders of US equities.



Some would argue that the underlying discount rate has fallen, given the Fed's aggressive easing campaign this year. Yields on long-dated bonds, however, have not fallen significantly. We grant that this could be a mitigating factor, but does not fully justify the premium PEs still being accorded to future earnings.

## Conclusion

Risks have clearly risen in recent weeks for holders of US equities. At the same time, expected rewards, as measured (indirectly, to be sure) by PE ratios, do not appear to have risen much, if at all.

Based on this observation alone, it would appear to us that there is greater risk than usual of stock prices declining. But our discomfort does not end there. In addition to worrying that PE ratios may adjust downward, we perceive that both reported earnings and estimates of future earnings have a way to go before they bottom out.

These two factors, taken together, ought to give investors in US equities reason for pause. Naturally, one must also consider what other competing opportunities exist in other equity markets around the world, but that is the topic of a separate report. Looking only within the US capital markets, equities are not now priced attractively relative to fixed-income alternatives, especially given the higher than usual level of uncertainty over the future course of the economy.

From our vantage point, we can see no way to predict the ultimate severity of the decline in the economy nor the level or timing of the trough in earnings for this cycle. Beyond that, the strength and speed of the recovery, when it ultimately comes (as it will), is completely unfathomable, in our opinion. Our hunch, nonetheless, is that the economy will return to a lower base and enjoy slower growth than would have been the case had the turmoil of the past few weeks not ensued. For our money, a bet on US equities at this point in time is a risky one indeed.

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