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Independent Research Providers to the
Professional Investment Community

March 2004

Special Report

Spotlight on US Equity Valuations Earnings: Good News and Bad News Nice Recovery; Still Below Trend and Expectations



All Graphs in this Report were created based on data as of 27 February 2004
Source data came from the Federal Reserve and Standard & Poor's

US Equity Market Remains Overvalued by Our Measures

The graphic on this page shows by how much the S&P 500 index earnings have made a robust recovery following their post-bubble collapse. Please note, however,

that the latest reported earnings are still below their long-term trendline, and have not even recovered to the level that they enjoyed in the 1997-1998 period, just prior to the big run-up of the bubble years.

Despite this failure, PE ratios remain high (see the graphic on this page) and analysts' forecasts are optimistic. Those who are comfortable with today's level of stock prices often point to low fixed-income yields to support higher PE ratios, and recent robust economic growth to underpin optimism over future earnings.

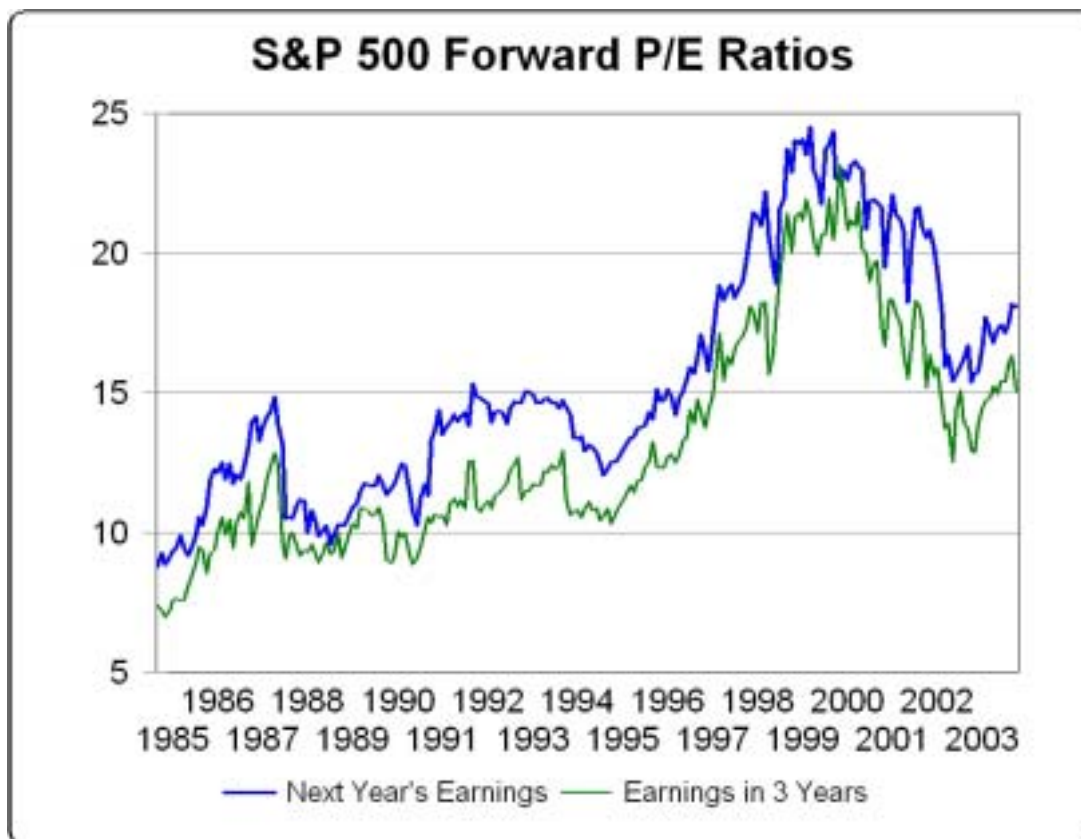
We continue to raise warning flags that these assumptions do not, in our view, hold up under close inspection. Our conclusion remains that US equities are overvalued, although we recognize that this state of overvaluation may continue for a time, or even become more extended, as long as expectations continue to run at a level we consider unrealistically high.

In this report, we update a few of the charts we have used in past reports. For a more detailed treatment of these and other graphics, see our December [report](#) on this same subject. (Also available in [high-resolution](#) for printing.)

Current PE Levels

A glance at the graphic below reveals that forward-looking PEs (that, is PE ratios based on predicted earnings [in this case, consensus estimates as collected by IBES]) are now higher than at any time since these data have been collected, except for the bubble years.

The two variables that could justify higher PEs are (1) a willingness by investors to accept lower rates of return going forward, and (2) an expectation that dividends will grow more rapidly in the future.

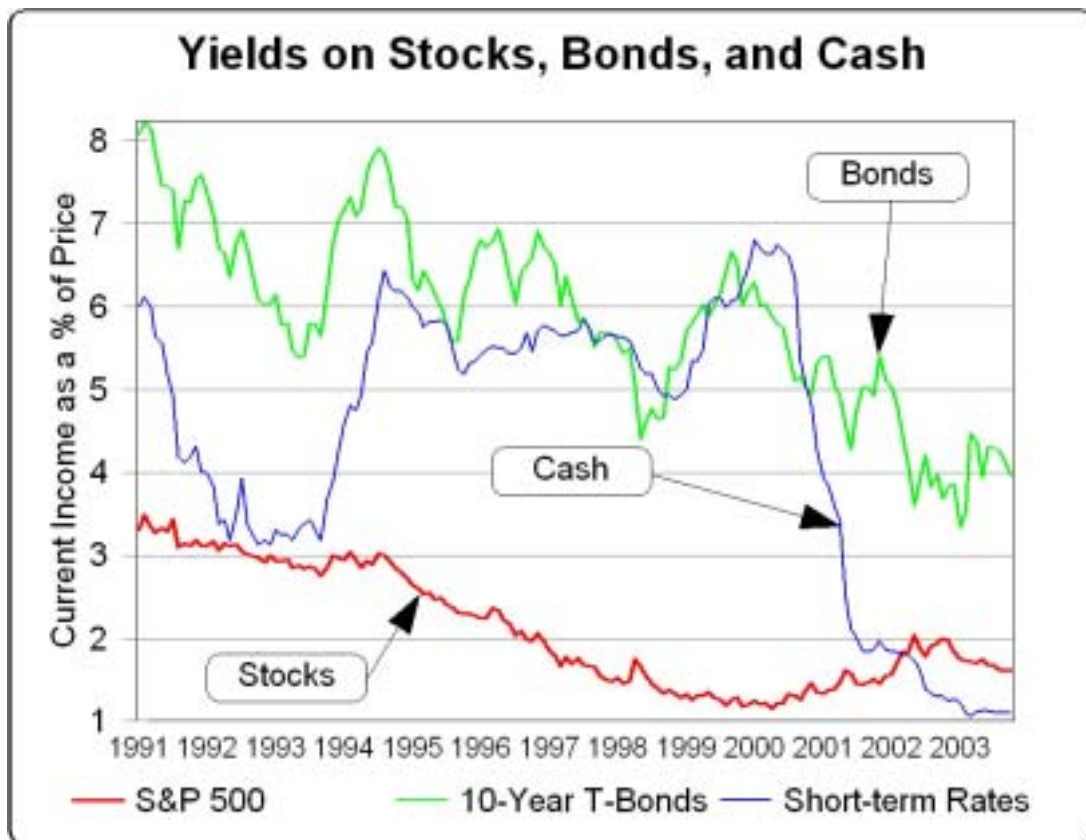


Lower Rates of Return

Investors might be willing to accept lower prospective returns on equities for two underlying reasons. One is that a lower risk premium for the asset class is in order. Indeed, during the bubble years, we saw articles in the popular press suggesting that there was no need to price in a risk premium at all. Given our post-bubble sensitivities, this seems an inadequate explanation, to say the least.

A more convincing argument has to do with the competition that comes from fixed-income alternatives. As we pointed out in our previous report (mentioned on page 2), the relationship that had existed between [inverted] 10-year bond yields and PEs seems to have broken down in recent years. Still, in theory, PEs should be sensitive to this measure.

Here is a chart showing where 10-year bond yields have been over the past few years. Clearly, there is some justification for arguing that higher PEs could be supported by recent, lower, levels of bond yields. Again, however, not much has changed since our last report, and in that document we mentioned some calculations which show that even under the most optimistic scenarios, the expected returns for equities are modest, at best.



Our worry here is that there are plenty of scenarios in which equity returns could be downright ugly. Leaving aside the question of earnings and dividends (addressed in the next section), the fixed-income markets may be flashing their own warning signs.

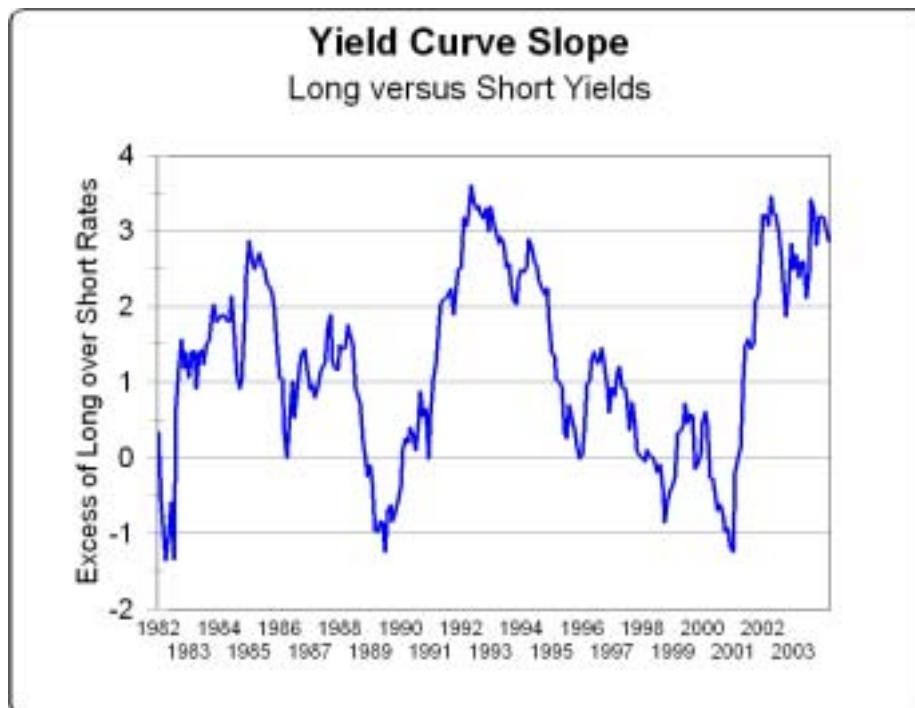
At the top of the next page, we present the recent history of short-term rates, as well as a look at their "real" counterpart (adjusted for changes in the CPI).



With nominal rates at remarkably low levels, and real rates solidly in negative territory, there would seem to be limited room for any downside movement in these rates. The Fed's aggressive rate cuts were mostly "damage control" in the wake of the collapse of the internet bubble. The idea was to stimulate the economy and to stave off the possibility of deflation (partly through the mechanism of a weaker currency). So far, so good. But what if, as we believe,

equities remain (or have again gotten) overvalued? (An argument could be made that much of the Fed's liquidity has gone to fuel bubbles in the bond and property markets.) What will the Fed's response be if the asset markets collapse again? We're not predicting that, we are simply pointing out that this endgame represents a one-sided bet. There is very little room for rates to go lower (although Japan serves as a warning that it is not impossible), but there is plenty of room on the upside.

Another worrisome perspective is provided by looking at the slope of the yield curve. The excess of long yields over short is about as extreme as its been over the



past couple of decades. The last two peaks were resolved through vigorous growth in the economy, in response to which the Fed raised short rates to the point that the curve became flat or even slightly inverted. In this cycle, the Fed has clearly signaled its reluctance to raise rates anytime soon, giving further impetus to the “carry trade” of borrowing short and buying long-dated bonds. Thus, although the Fed has direct control over short rates, it may be providing the fuel to keep long rates at artificially low levels.

Our point in all of this is simply that, while it is possible to use fixed-income yields as a partial justification for paying higher prices for equities, this seems to us to be a dangerous, one-sided game. With yields at low levels, not only are the current rates of return low by historical standards, but the prospects of higher yields somewhere down the road suggests that long-term fixed-income returns (especially at the long end of the curve) are likely to be even worse. Why should equities, under such a scenario, have superior returns?

Higher Growth Expectations

The other possible factor leading to higher PEs has to do with dividend growth. If dividends are expected to grow faster in the future compared with past expectations, that would suggest returns from equities might be maintained at prior levels even if PEs are higher.

Dividend growth is influenced by at least two things; earnings growth, and the amount of earnings paid out as dividends. Given recent changes in the tax laws, there is another angle here, too. It could be argued that dividends are now more valuable and thus desirable than they have been in the past, relative to capital gains. If so, that should prompt shareholders, at the margin, to favor companies that pay larger proportions of their income as dividends, creating a demand for cash payouts that companies would presumably respond to. Although there is some anecdotal evidence that this is happening, it is probably too soon to determine whether this trend is a secular one, or is simply a response to improving economic conditions. Here is a chart that shows the history of how much of their earnings the S&P 500 companies have paid out as dividends.

As of now, it seems difficult to make the case that the long downward trend will be dramatically reversed, though that is certainly a possibility.

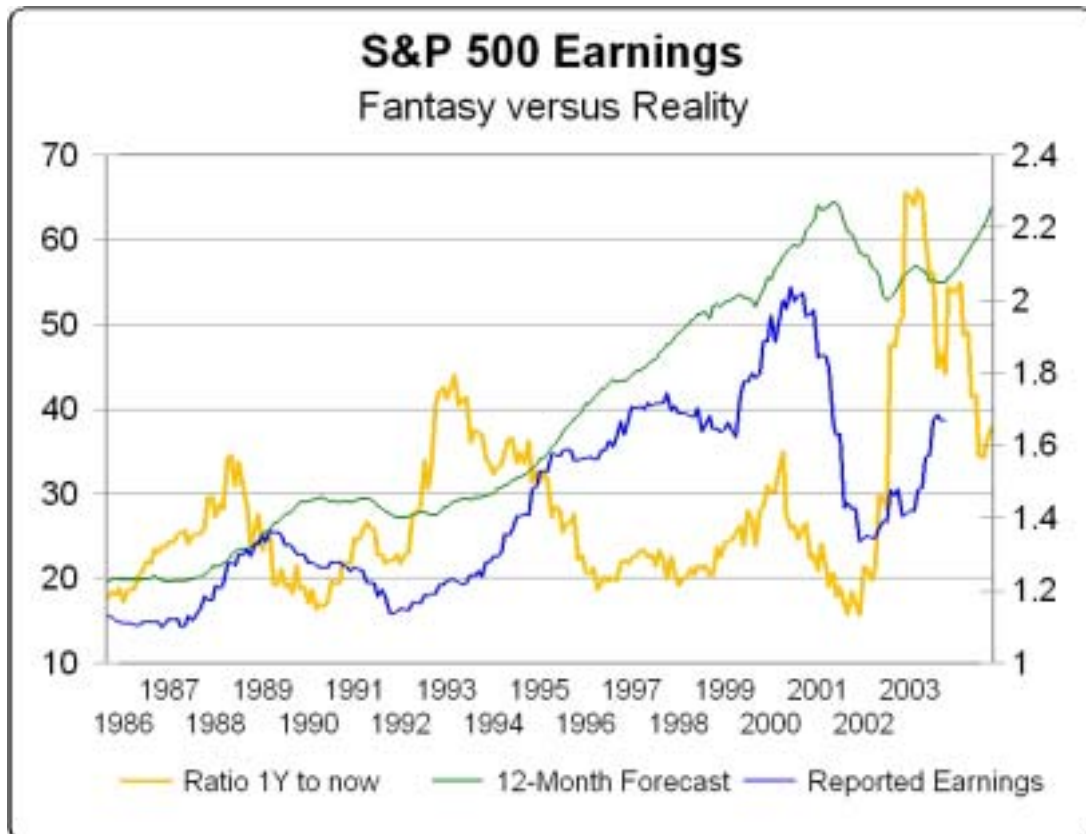


A more likely source of dividend growth will be from increased earnings. Here, too, we remain skeptical that expectations currently embedded in stock prices will be borne out. We provide here an updated version of our “fantasy versus reality” chart, showing how well the consensus forecast has predicted actual earnings. The forecast has always been too optimistic, though it has come close on a couple of occasions.

Our concern here is that Wall Street analysts have not downgraded their outlook at all since the heady days of inflated (even fraudulent) earnings associated with the excesses of the late-1990s. Even during the go-go years of the mid-1990s, the consensus earnings forecast was generally for about a 30% year-over-year rise in EPS for the S&P 500. Today, analysts are looking for more than 60% growth over the next year. While we concede that a genuine earnings recovery is underway, we suspect that these expectations may be overly optimistic. Yet, the PEs based on these numbers appear to be high by historical standards.

Bottom Line

Our conclusion is that equity prices seem to embed a best-of-all-possible-worlds mentality, in which everything has to go right. Our concern is twofold; one, that even if that happy scenario comes to pass, equity returns will be nothing to write home about. Two, if something should go wrong, and earnings disappoint or fixed-income yields rise, equity returns could be very disappointing (read: negative).



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