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So when will we make money in stocks?

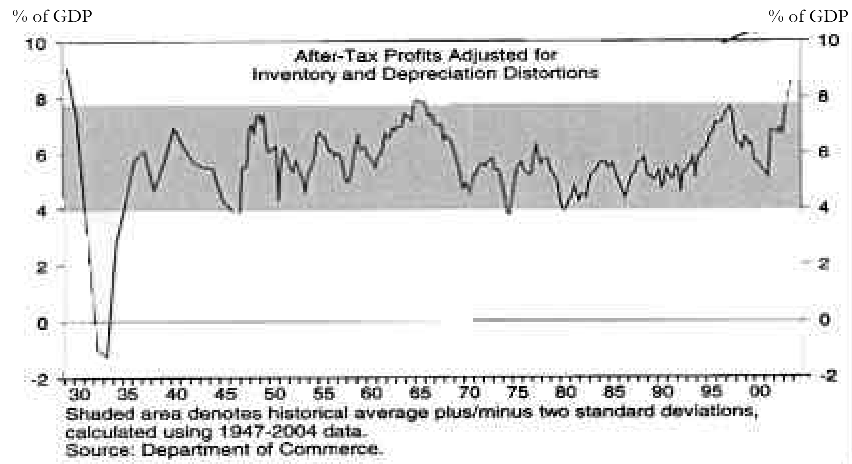
The question that is nagging all of us is when will we make money in stocks? The U.S. stock market had a tremendous recovery rally in 2003, but in spite of that, stocks have not provided a positive return over the last five years. It is enough to make even so-called long-term investors suffer a little creeping doubt. Clearly, no one can predict the future, but we'll take a shot at describing the scenario that could end this purgatory by this time next year.

Stock prices over time reflect the earnings and dividend prospects of companies. Prices paid for these expected future cash flows should allow investors to earn something in excess of a risk free security, such as Treasury bonds, to compensate for the extra risk of stocks. Historically, equities have provided about 5 percentage points over the return of intermediate Treasuries.

Over shorter time periods, however, expectations can move above or below the realistic long-term outlook for earnings and dividends, causing the market to become "overpriced," or "underpriced." Obviously, this is a simplistic model and in the short run, there are many factors that affect the demand and supply of stocks. But this is a one page letter, not the tome that we may someday write.

One reason that expectations may get too high or too low is that projections often are simply an extrapolation of the current trend. For example, in the late 1990's investors extrapolated an unsustainable level of earnings growth and profitability and the market became "overpriced." A large part of the difficult equity environment over the last five years can be attributed to the process of bringing expectations back to reality. Where are we now in this process? We are getting there, but I think we have a bit further to go. Last year's recovery rally was pretty typical of recovery rallies in the late stages of a bear market.

Coming out of the recession, companies were extremely lean. Any kind of growth in revenues resulted in tremendous leverage to the bottom line. Thus it should be no surprise that profits have exploded over the last few quarters. This has been great news for stock prices. As the chart below shows, profit margins have reached unprecedented levels. In typical fashion, analysts have extrapolated these margin levels into their earnings forecasts. But based on history, these margins are unsustainable and are likely to decline. As this happens, expectations will grudgingly ratchet down.



Earnings estimates for 2004 for the S&P 500 are about $67 per share, which is probably achievable. But estimates for 2005 are currently over $70 per share. That probably won't happen. In fact, if profit margins return to about 6% of GDP as history implies, profits next year are more likely to be down than up. This is even more likely with monetary and fiscal policy becoming more restrictive going forward. The market is still in the process of digesting this possibility, and we may have a little bit more indigestion before we start a new uptrend.

Although we may worry about the death of equities, we know that ultimately the system rewards risk taking. Eventually, stocks will be priced to achieve the long-term positive returns necessary to fund this economy. Real GDP will grow 1-2% and S&P 500 earnings will grow about 7%. Dividends will grow even faster than earnings, causing yields to rise above 2%.

By this time next year, those realistic expectations will have become the consensus. Stock prices will reflect these expectations and we can begin a more sustainable uptrend in the U.S. stock market. The current movement out of stocks into "alternative" investments is very similar to the movement into Tactical Asset Allocators (say market timers) in the 1970's, another prolonged period of poor performance by equities. In the near term the market is getting oversold. Who doesn't already know about terrorism and high oil prices? Some fear is finally beginning to show up in the Sentiment statistics. The market has drifted down to the bottom of a trading range that has been tested many times. Over the next few weeks we could see a market rally from this oversold position that could continue through the election. This would not be the beginning of a new Bull trend. That will come later. High quality stocks with favorable outlooks for consistent earnings and dividend growth will provide better relative returns as we continue this transition to a lower expectation environment.

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A copy of our Form ADV, Part II is available upon request.
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