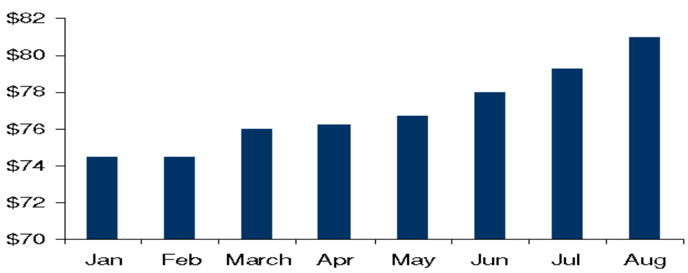
September 2010

GARCIA HAMILTON & ASSOCIATES, L.P.

The Other "E's"

Late last year, in a letter entitled "Now Earn It", I tackled the prospects for corporate earnings growth in 2010 and the likelihood for these earnings to support further upside in stock prices following the meaningful returns delivered off the market's bottom in March of 2009. The bottom line was that investors could no longer count on further multiple-expansion to drive stock prices higher and that it was up to the "E" in the classic P/E (Price-to-Earnings) equation to provide the needed fuel.

2010 S&P 500 EPS Estimates



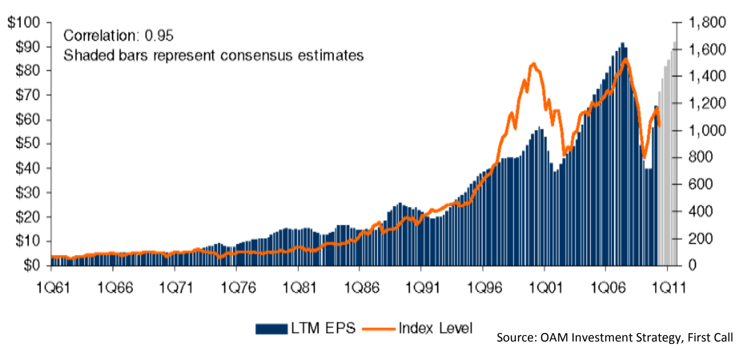
Source: First Call

Entering 2010, earnings looked poised to deliver nice growth relative to 2009 and as the table above shows, 2010 S&P 500 earnings not only remain on track to meet the beginning of year expectations but have steadily increased as the year has progressed. Despite this, the price level of the S&P 500, along with most other major indices, remains largely unchanged this year.

Though still near beginning-of-year levels, this is not to say that stock prices have not seen more than a fair share of volatility in recent months. However, rather than a reflection of underlying fundamentals, this market has had the feel of one that has swung on a pendulum based on whether the "Risk On / Risk Off" switch is in the up or down position. A notion well-supported by the high degree to which all categories of risk assets have come to move in lock-step reflecting a macro-driven trade with little relevance given to the actual risk vehicle utilized, be it stocks, bonds, currencies, commodities, gold, etc.

From this perspective, investors have come to be indifferent to actual stock fundamentals and current market logic is ignoring one major (perhaps THE major) principle of stock investing – stock market valuation and EPS levels tend to move very closely together over time, with the correlation between the two at 95% over the past 50 years.

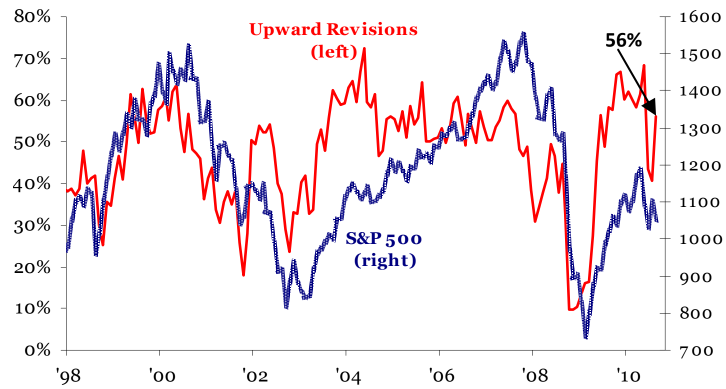
S&P 500 Price Level Moves With EPS



Source: OAM Investment Strategy, First Call

While there is truth to this assertion, recent action is not inconsistent with the premise that over the long run stock valuations are a function of underlying earnings – the "E" in the P/E formula. Rather, it reflects that in the short run there are two other "E's" that tend to matter more than actual earnings, these "E's" being Macro Expectations and Estimate Revisions. In the shorter run, actual earnings (what companies are reporting) take a back seat to expectations for broad macroeconomic activity and a set of resulting estimates – more specifically the direction of revisions to analysts' estimates for future growth.

S&P 500 Index vs. Upward 12 Mo. Forward Earnings Estimate Revisions as Pct. Total Revisions



Source: Strategas

As the chart above highlights, swings in the S&P 500 tend to have a rather tight relationship with the degree to which analysts are adjusting forward estimates. When more than 50% of revisions to component companies' forward earnings estimates have been positive, the S&P 500 has moved higher in price. When less than 50% of revisions have been positive, the S&P 500 has declined in price. Along these lines, recent volatility can be explained by a dip in positive revisions down to 40% of total that coincided with the double-digit drop in stock prices during the 2nd Quarter of 2010 and a more recent improvement in revision trends during July & August that has been followed by very strong stock performance in the month of September.

As I sit here and write this today, all three "E's" appear constructive for the market heading into the final months of 2010. The market appears cheap relative to the 1st "E" – actual earnings. Expectations – the 2nd "E" – have started to improve as more evidence emerges that we are not quite on the verge of a double-dip recession. So it will basically boil down to the 3rd "E" as the swing factor over coming months. If estimate revisions continue to remain positive, this should prove to be the needed fuel to keep stocks moving higher. Here's to the health of the "E's"!

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