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Death by a Thousand Cuts!

Thank gosh that's over. Earnings season has taken its toll again. In the last few weeks, company after company has warned that earnings will fall short of expectations. Most of them have cited the same reason – revenues are not growing as expected. The general economy is not recovering as quickly as anticipated. And the disappointments are coming from all over. Sears, General Motors, Intel, EDS, Kroger, etc. are all suffering from the slow economy. As is usually the case, the stocks of those companies who warned were hit hard. By early October, these earnings warnings had taken a serious toll on the broad market. The S&P 500 was once again at the lows it reached in July.

But there is good news! Investors Sentiment has registered a new level of Bearishness. Investors Intelligence reports 43% Bears and only 28% Bulls. This ratio, although not indicative of a final Bear market bottom, certainly suggests that there is sufficient money on the sidelines to drive a rally in the equity market through the end of the year. Already the S&P 500 has risen to 900, 16% from its recent low. We believe that the rally can continue through year end, and a further gain of 10%, or so is quite possible.

Further gains will come mainly in companies that have not had to warn about earnings shortfalls. Many of these are consumer staples, health care, and entertainment companies which have already been outperforming the broader market. Expect that leadership to continue. In fact, last quarter was the first in a long time where "growth" stocks as indicated by the Russell 1000 Growth Index, have out performed the S&P 500. This growth index is no longer dominated by technology, which now represents only 20% of the index. Health care, consumer staples, and other consumer sectors now drive the index. Health care alone is now about 30% of the index. As long as the more cyclical sectors have disappointing top line growth, these sectors should continue to outperform.

It is hard to see how the S&P 500 could extend this rally to much more than 1000 for two reasons. First, a price-earnings multiple of 20X our normalized 2003 earnings estimate of $50 for the S&P 500 implies an Index value of 1000. There is not enough earnings visibility for the markets to be willing to pay a higher multiple.

Second, we will soon roll into next quarter's earnings season. Until the economy manages to get itself into a higher gear we will face another earnings season of death by a thousand cuts.

-Robert C. Davis, CFA
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A copy of our Form ADV, Part II is available upon request.
TWO HOUSTON CENTER 909 FANNIN, SUITE 550 HOUSTON, TEXAS 77010 PHONE: (713) 853-2322 FAX: (713) 853-2308