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# It's the Earnings

The Standard & Poor's 500 returned 24% for the twelve months ending September 30, 2003. The S&P 500 is a relatively high quality index meaning that the performance is dominated by large, established companies with long histories of solid earnings, dividends, etc. The NASDAQ, an index that is much more low quality in nature made up of companies with much less consistency of earnings and almost no dividends returned a phenomenal 53% in the same period.

These numbers certainly qualify as a bull market, whether you call it a cyclical bull market within a secular downtrend, or whatever. What change has allowed this to occur? And can the trend continue?

The change has clearly been in earnings. The table below shows the trend in quarterly and annual operating earnings for the S&P 500. The earnings for the second half of this year and for next year are consensus estimates from First Call.

Earnings Per Share - % change
Latest Qtr (Jun 03) ………up 9 %

Earnings Per Share
Next Expected EPS Date: Nov 14

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|
| Mar | 10.77 | 11.39 | 13.75 | 12.20 | 11.25 | 12.55 | 13.83 e |
| Jun | 11.41 | 12.72 | 14.68 | 11.83 | 12.35 | 13.45 | 14.76 e |
| Sep | 10.66 | 12.84 | 14.29 | 10.70 | 12.25 | 13.42 e | 14.68 e |
| Dec | 11.65 | 13.93 | 13.62 | 10.44 | 12.28 | 14.02 e | 15.30 e |
| Yr. | 44.49 | 50.88 | 56.34 | 45.17 | 48.13 | 52.80 e | 58.27 e |
| Yr.to Yr. | | 14% | 11% | -20% | 7% | 10% | 10% |

The story is clear. After a devastating drop in earnings of 20% in 2001 from 2000, earnings started to rise again. It shows up particularly well on a quarterly basis. Starting in the third quarter of 2002 earnings have been dramatically higher on a year over year basis every quarter and estimates are that this trend continues throughout all of next year.

In fact, forecasts are now such that earnings will pass the peak numbers seen in 2000, the year that the markets peaked. If the forecasts are reasonable, by this time next year earnings for the S&P 500 companies will be running at an annualized rate of over $60, by far an all time high.

I would also add that operating earnings in today's environment are a lot "cleaner" than in 1999 and 2000. Regulatory changes and better accounting transparency have resulted in higher quality earnings than in the last cycle. Yet price/earnings multiples are hardly excessive. With the S&P 500 at 1045 today, the PE on the market sits at 18x the consensus estimate for 2004. This is right in the middle of a range of 16x – 20x that is reasonable with the current level of interest rates.

Could the trend continue? Certainly, if earnings continue to come in better than expected. Since the Spring quarter, the majority of companies have exceeded expected results. This is the outcome of cost cutting during the recession, and an improving top line from faster economic growth fostered by stimulative fiscal and monetary policies. The most probable outcome is that earnings continue to outpace expectations, at least until the Federal Reserve decides to slowdown money growth and raise short term interest rates. It is not reasonable to expect the Fed to do so until the elections of 2004 are somewhat closer at hand, especially with our ongoing international issues.

No market trend goes in straight line, but for now the path of least resistance for the U.S. equity market remains upwards. It's the earnings.

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