Jan 2009

Getting a handle on the S&P 500

As expected, horrible economic news continues to come from all corners. The Madoff debacle, the rapid deterioration of the automaker's balance sheets, the painful New York real estate market, and the unemployment numbers have buffeted the markets with a succession of blows. The encouraging news is that the muted market reaction would indicate that the financial disaster scare has largely been contained. In our last market update, we noted that the market tends to anticipate the end of recessions by about six months, and that as a forward looking mechanism it is probably safe to assume that the market would stabilize sometime in mid 2009, as we expect the recession to last until the fourth quarter of next year. Since that update, the recession has been verified by the National Bureau of Economic Research and has been dated to the beginning of 2008, the date that Dr. Alan Sinai had proposed weeks ago. It is clear that events are moving quickly and unpredictably, as the severity of the recession is being weighed against the unprecedented fiscal and monetary stimulus that is planned by the incoming administration.

One of the most challenging aspects of the market action, from a purely historical perspective, is placing the current crisis into the framework of valuations for stocks that have characterized previous bear markets. While we have a decent idea of the P/E ratios that typify the bottom of a recessionary cycle for stocks, the rapid deterioration of the consensus earning estimates for the S&P 500 have made the historical parallels extremely imprecise. The declining earnings estimates make the possible scenarios for forward P/E ratios extremely volatile and make any guess on whether the market is expensive or cheap a moving target. These consensus earnings estimates for the S&P 500 represent the combined estimates from a large number of analysts working independently of each other, and in the last quarter of 2008, the deterioration of the estimates has been stark. In late September, the consensus estimate for December 2009 earnings stood at $59.53 and by year end, that number had been reduced to $42.24. With the "E" moving so drastically, the ratio becomes problematic.

What we do know is that historically, a PE ratio of 10 for the S&P 500 represents a bargain, and that the current valuation of trailing reported earnings of between 16 and 17 places the index right on the average level of it's 82 year existence. Looking ahead, the PE ratio for year end 2009 looks fully priced at around 20 times earnings, but one thing to keep in mind is that the unprecedented size of the write-offs in the financial services industry has created an anomaly that must be taken into account. The earnings that we are using in all of the calculations above are "reported" earnings as opposed to "operating" earnings. In a normal environment, the distinction between these two numbers is slight, and over time, the distinction diminishes almost totally. However, the enormous write-offs we have seen have amplified the difference between reported earnings and operating earnings, to the point that the current estimates for operating earnings for the four quarters ending in December, 2008 is $69.73 versus reported earnings of $51.37. The average PE ratio of operating earnings is typically a lower number than that of the reported earnings, but the differences is clearly much larger than usual in this environment.

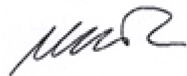
All of this has made the task of placing the current value of the S&P 500 in historical context a difficult task. One way to look at the forward looking estimates and the

resultant valuation of the market based upon those estimates is to remember that write-offs by their nature are non-recurring events. As we know, the lion's share of the write downs and the most uncertainty in the market has occurred in the financial sector. Corporate profits have held up fairly well except in financial services, where profits have been wiped out by the subprime-mortgage crisis and the credit crunch. One bullish indicator may be that the financial companies have to date written down over $600B in assets in 2008 alone. It is fairly safe to assume that due to the nature of the general crisis on Wall Street, most CFOs have "kitchen-sinked" those numbers rather than played it cute. The just released fiscal year end results for Morgan Stanley and Goldman Sachs clearly illustrated that analysts woefully underestimated the size of the write-offs these firms have taken in the painful process of downsizing their absurdly leveraged business models. It would be hard to imagine that those companies did not include all of the possible bad news in those results. If the consensus estimates for 2009 are for flat growth in S&P earnings for next year, unless the analysts expect the same level of write downs, we may return to a more normal cycle, closing the gap between operating and reported earnings.

Certainly, there is an incredible variation in the current earnings estimates and the task of assigning a historically reasonable PE ratio to forward looking earnings is an imprecise exercise. That said, should the consensus estimates stabilize at current levels, the S&P, at 17 or 18 times earnings looks to be valued fairly fully. Bears would conclude that the growth in the S&P over the next twelve months would roughly reflect the flat to down earnings growth of the consensus estimates. Bulls would look at the historical data and conclude that the higher PE is likely due to the unusually large discount that reported earnings have to operating earnings, a discount that will diminish dramatically as the financial crisis abates. The current 2009 consensus estimate for operating earnings translates to a more reasonable forward PE ratio of 10.

Mathematician and writer John Allen Paulos said that "The Internet is the world's largest library. It's just that all the books are on the floor." In that spirit, I'll point out that those interested in creating various scenarios based upon growth assumptions of the S&P 500 can use the interactive and real-time model created at StocksDaytoDay.net. The model can be accessed here: http://stocks.daytodaydata.net/SP-500-PE-Ratio.aspx.

Best regards,



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