

U.S. Stock Market Outlook

THE OUTLOOK for the U.S. stock market is mixed. Of the four major factors contributing to stock market returns — economic growth, corporate earnings growth, earnings valuations, and market sentiment — one is neutral to positive, two are neutral, and one is negative. As a result, organizations basing their endowment allocation and return expectations on recent stock market performance would do well to match the returns of the past ten years, during which the market had average annual returns of 10.7% for large-cap stocks. On a near-term basis (3 to 5 years), U.S. stocks are likely to return less than the long-term averages of 12.3% for large-cap stocks and 17.4% for small-cap stocks. Our current outlook is for total returns of 8.9% for large-cap and 11.1% for small-cap stocks over the next three to five years.

On balance, **economic growth** prospects for the U.S. are neutral regarding stock market returns, with a favorable long-term outlook being offset by near-term concerns.

Of the major industrialized nations of the world, the United States has the largest and most robust economy with the best prospects for sustained long-term growth. An educated, highly productive, and growing labor market with reasonable wage and benefit expectations, well established legal and regulatory systems for the conduct of commerce and the protection of investors, and a creative and entrepreneurial spirit with large resources of capital to support it have made the United States the world's economic engine and a haven for investment capital. In the long term, although the U.S. shares with other nations the challenges of providing social security and health care for a large segment of its population, projected population growth in the U.S. will make this challenge less daunting than in Europe, Japan, or China.

On a near-term basis, however, the U.S. faces the prospects of slower economic growth as housing sales cool, high energy prices reduce discretionary consumer spending, and little-noticed regulatory changes in minimum credit card payments reduce the ability of Americans to maintain spending with credit card debt. Although late summer economic forecasts project reasonable growth for next year, the prospect for very slow or no growth for next year is increasing.

Consensus growth projections for the U.S. gross domestic product (GDP) are for nominal growth of 6.6% in 2006 and 5.3% in 2007, or 3.4% and 2.9% real growth respectively after inflation, according to the Philadelphia Federal Reserve Bank's third quarter Survey of Professional Forecasters. (Real growth must exceed approximately 1% annually to support the nation's population growth.)

Prospects for **corporate earnings growth** are negative regarding stock market returns.

Corporate earnings growth has been very strong since the end of the 2001 recession and has been the primary driver behind the stock market's recovery since 2004. In the five years 2001 through 2005, corporate earnings increased 62.7%, while GDP increased 26.9%. GDP grew at 4.9% per year. Corporate earnings grew at more than double that rate, 10.2% per year (both on a nominal basis).

Earnings growth cannot continue for long at a more rapid pace than growth in the nation's GDP, and the slowdown appears imminent. Corporate earnings (pre-tax) as a percent of National Income and GDP are now at or near the highest level they have been since 1929, and at levels not seen in more than a generation (see figure SM0.1).



CORPORATE PROFITS AS % OF GDP AND NATIONAL INCOME

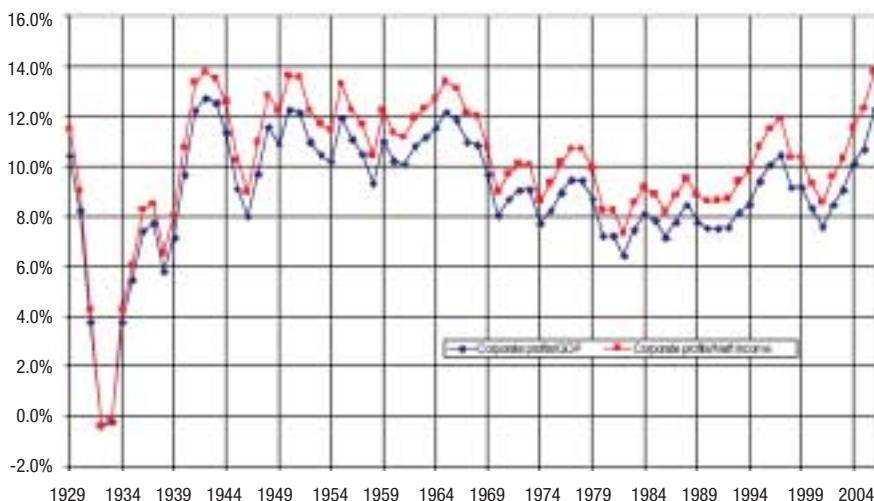


Figure SM0.1: Corporate Profits (pre-tax) as a percent of GDP and National Income
Source: Bureau of Economic Analysis and *Asset Allocation Advisor* (*Advisor*) calculations

On an annualized basis, pre-tax corporate earnings as of June 30, 2006 stood at 12.3% of GDP, a level last reached in 1950 and only ever exceeded in 1941 and 1942. Since 1929, the median annual ratio is 9.1%.

Although increasing labor productivity and moderating labor costs may have contributed to the increase in the proportional share of national income attributable to corporate profits, figure SM0.1 suggests that this trend will moderate in the future and that the growth in corporate earnings will decelerate. This view is reflected in consensus forecasts for corporate earnings growth. Corporate profit growth is projected to slow to 4.8% for 2007 from 20.7% for 2006 according to the Philadelphia Fed's Survey of Professional Forecasters. The latest Livingston Survey of forecasters, a separate survey also conducted by the Philadelphia Federal Reserve Bank, projects slower corporate profit growth for both 2006 and 2007 at 17.7% and 3.5% respectively. Reuters mean estimates for operating earnings for the S&P 500 (which accounts for two-thirds of all corporate profits) call for earnings growth of 10% in 2007 and 5% in 2007. If these estimates are in the ballpark, the period of rapid earnings improvement is over.

Valuations of corporate earnings have returned to levels at or below recent historical averages and appear to be a potentially positive factor for stock market returns. Fundamental analysis, however, shows that valuations may do well to stay at current levels.

Figure SM0.2 reports late-October market P/E ratios for three size segments of the U.S. stock market. Reported ratios are based on estimated forward earnings for the current P/E ratio and a combination of actual and estimated forward earnings for historical medians. We use forward earnings since investors buy the future and not the past.

CURRENT VS. HISTORICAL MONTH-END PRICE/EARNING RATIOS

(based on 12 month forward operating earnings, actual and/or estimated)

	Current (10/27)	10-Year Median	20-Year Median
S&P 500 large-cap	15.8	23.2	17.8
S&P 400 mid-cap	17.6	20.6	n/a
S&P 600 small-cap	18.8	21.9	n/a

Figure SM0.2: P/E Ratios, Price to Forward-year Operating Earnings, estimated or actual for U.S. Large-, Mid-, and Small-cap Stocks
Source: Bloomberg and Advisor calculations

P/E ratios for every segment are below recent medians and, in the case of the S&P 500, are below the longer-term median. This improvement in valuations to more rational levels is entirely due to the increase in corporate earnings over the past several years. In the case of every size segment of the market, earnings have increased more than prices since December 2000, and in some cases dramatically more. Figure SM0.3 shows the change in earnings per share before extraordinary items (here on a trailing twelve month basis), and the change in the index price between December 2000 and August 2006.

CHANGES IN STOCK INDEX PRICES AND EARNINGS

December 2000 to August 2006

Index	Change in EPS (trailing twelve months before extraordinary items)	Change in Index Price
S&P 500 large-cap	48.9%	-1.2%
S&P 400 mid-cap	65.3%	45.1%
S&P 600 small-cap	70.0%	68.0%

Figure SM0.3: Changes in Stock Index Prices and Earnings, December 2000 to August 2006, for U.S. Large-, Mid-, and Small-cap Stocks
Source: Bloomberg and Advisor calculations

Corporate earnings (pre-tax) as a percent of National Income and GDP are now at or near the highest level they have been since 1929, and at levels not seen in more than a generation.

There are no fundamental reasons for the market P/E ratio to increase and some risk that it may decrease.



Figure SM0.4 shows month-end price, earnings, and P/E ratios for the S&P 500 since April of 1986. As can be seen from the chart, although the index price has increased more than 50% from its low point in 2002, the increase in earnings has been much more dramatic, resulting in a modest decrease in the forward P/E ratio since 2003.

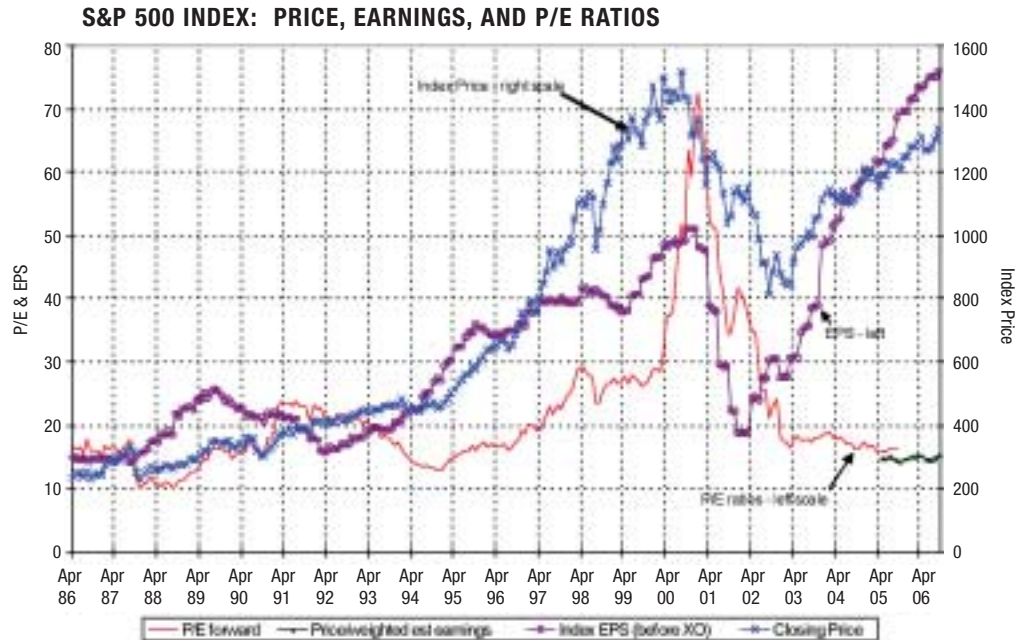


Figure SM0.4: S&P 500 Index: Price, Earnings, and P/E Ratios
Source: Bloomberg and Advisor calculations

All other things being the same, it would appear that the market has some upside potential through increasing valuations alone. An increase in the forward P/E ratio for the S&P 500 from 15 to 18 would add 20% to market values, with no change in earnings!

But all other things aren't the same, unfortunately. From a fundamental perspective, the market P/E ratio theoretically is a function of five factors: earnings growth, the average dividend payout, the real interest rate, expected inflation, and the equity risk premium – the premium that stock investors expect to realize above simple Treasury returns for taking the risk of investing in stocks rather than T-bills. Assuming a constant dividend payout ratio, higher earnings growth translates into a higher P/E ratio, as do lower rates for the real interest rate, expected inflation, or the equity risk premium. None of these factors, however, are likely to drive valuations higher in the near future. Corporate earnings growth appears to be slowing down. The market's inflation expectations are modest (see the U.S. Bond Market Outlook on page 10) and do not have much room to go lower. Both the real rate of interest and the implied equity risk premium currently are near to historical averages and may be more likely to increase than decrease. In short, there are no fundamental reasons for the market P/E ratio to increase and some risk that it may decrease. On balance, therefore, corporate earnings valuations, from a fundamental perspective, are a neutral factor for stock market returns.

On a **market sentiment** basis, since valuations have steadily but modestly declined over the past several years during a time when corporate earnings growth has been very strong, it would appear unlikely that valuations would increase once earnings growth slows down and interest rates move higher. We would be well cautioned, however, not to judge future market sentiment on the basis of fundamental analysis, since market sentiment is not a rational factor.

Measures of late summer stock market sentiment show no strong bullish or bearish signs. The number of index shares sold short in expectation of a decline in the index is at the low end of the narrow range in which it has fluctuated since April 2004 (at between 1 and 2.5 times average daily trading volume on the SPDR Trust). Expectations of increasing stock prices have been reported by the International Securities Exchange (ISE) sentiment index throughout 2006, although the index has declined on average throughout the year and has reported expectations of falling stock prices on several occasions since May. The ISE sentiment index measures the ratio of opening long call options bought by customers to opening long put options bought by customers. Since holders of long call options benefit when prices go up, an index value of greater than 100 (the ratio multiplied by 100) reflects expectations of an increase in stock prices, on balance. Conversely, an index value below 100 reflects expectations of a decrease in stock prices. The ISE sentiment index has been above 100 throughout most of 2006, but has declined on average, and has fallen below 100 on several occasions since May.

All in all, current market sentiment appears to be a neutral factor for stock market returns. Market psychology does not appear primed to inflate or to deflate current earnings valuations. We should bear in mind, however, that market psychology can change rapidly and for reasons that may be difficult, if not impossible, to anticipate.

Our expectations for U.S. stock returns are for returns of 8.9% for large-cap stocks and 11.1% for small-cap stocks. These expectations are based on the assumptions in figure SM0.5.

U.S. STOCK MARKET RETURN ASSUMPTIONS AND PROJECTIONS

	Large-cap stocks (S&P 500)	Small-cap stocks (S&P 600)
Earnings growth per year	7.0%	10.0%
Sept. '06 P/E (to estimated forward earnings)	15.0	17.5
June '06 P/E multiple	15.0	17.5
6/30/09 Index	1,556.00	500.00
Price appreciation per year	7.0%	10.0%
Dividend return per year	1.8%	1.0%
Total return per year	8.9%	11.1%
Nominal GDP growth per year	5.4%	5.4%

Figure SM0.5:
U.S. Stock Market
Return Assumptions
and Projections

The key assumptions in these return projections are that P/E multiples will stay at current levels and that earnings will increase at 7.0% per year for large-cap stocks and 10.0% per year for small-cap stocks. Although these growth rates are modest compared to the past several years, they may prove to be unsustainable without more rapid growth in GDP. Even at the projected levels, corporate profits will increase to a share of national income unprecedented in the past seventy-seven years.



We expect annual total returns of 8.9% for large-cap and 11.1% for small-cap stocks over the next three to five years.