

U. S. Stock Market Outlook

We have reduced our total return expectations for U. S. equities. Over the next three to five years, we expect the total return from the U.S. stock market will be below historical average. The high probability of a U. S. recession and the impact the recession will have on earnings is the fundamental reason for the reduced expectations.

The case for a U. S. recession has been well made, and perhaps best by Nouriel Roubini at the September 2007 International Monetary Fund seminar on the risk of a hard landing in the United States. Mr. Roubini is a professor of economics and international finance at the Stern School of Business at New York University and a former adviser at the U. S. Treasury. Last year he correctly predicted that the sub-prime mortgage problem would have broad ramifications for the economy. A transcript of his presentation is available on the IMF web site. Readers may also be interested in Professor Roubini's website and blog at www.rgemonitor.com.

The factors likely to cause a recession are several and include:

- a dramatic reduction in new home construction,
- tighter credit conditions for individual and business borrowers,
- sharply reduced housing values and a sharp reduction in home-equity cash outs that fueled a good portion of consumer spending up to 2007,
- slow growth in business capital spending,
- low consumer and business confidence.

Consumer confidence and spending are likely to be further impacted by energy costs and by the multiplier effects of job losses and home foreclosures. Although consumers have felt the impact of higher gasoline prices on transportation costs, the escalation in crude oil prices over the past year has yet to be felt by consumers in winter heating costs. Even after July's drop in crude prices, residential heating costs this winter are expected to increase 20% to 25% over the previous year. Should oil increase beyond \$125 per barrel (the forward price for January '09 as of the end of July), heating expense increases will be greater. In early July, when oil was approximately \$140 per barrel, the Energy Information Administration of the Department of Energy projected residential natural gas and home heating oil prices would be 42% higher this winter compared to last.

Since July of 2007, the U. S. economy has lost over 400,000 private sector jobs. Total employment has been reduced by only 67,000 jobs as gains in government employment have partially offset private sector losses. However, the gains in public employment have been almost entirely at the local government level, where budget constraints are likely to force job reductions (see the next paragraph). Just as job gains and increased spending have a multiplier effect on the economy—one new job helps to create additional new jobs through the expenditures of the new job holder, job losses have a negative multiplier effect—one job lost is likely to cause additional job losses as spending is curtailed by the unemployed. The multiplier effect lags initial job losses and is partially offset by stabilizing factors such as unemployment insurance. Nevertheless, anecdotal evidence of

the multiplier effect is evident with casual dining restaurants reporting sharply lower sales, Bennigan's filing for bankruptcy, and Starbucks closing stores.

Tight state and local government budgets are compounding the consumer factors as reductions in spending and employment are being forced on both in the face of lower tax revenues and higher energy costs. Higher energy costs, in particular, are impacting local school budgets. Since state and local government spending account for more than 60% of total government consumption and more than 10% of GDP, cut-backs in state and local government spending are likely to reduce employment and compound the factors contributing to a recession.

Against these strong headwinds, export growth remains the only sustained positive factor supporting output. In fact, as noted in the advance estimates for second quarter economic activity released by the Bureau of Economic Analysis on July 31st, real gross domestic purchases decreased 0.5% in the second quarter. Had it not been for export sales, real GDP would have declined in the most recent quarter as it did in the fourth quarter of 2007, according to the revised data.

On balance, we think it unlikely that the U. S. economy can avoid a recession. This opinion is not universally shared by economists. Forecasters in the most recent (May) Survey of Professional Forecasters by the Federal Reserve Bank of Philadelphia assigned a fifty percent probability of a decline in real GDP in the second quarter of 2008. The probabilities of declines in subsequent quarters ranged between twenty and thirty percent. Since a recession is technically a contraction in the economy that lasts for two quarters, the professional forecasters would put the probability of a recession somewhere between fifteen and thirty percent.

Economic forecasting, of course, is a notoriously difficult task, and the track record of economists in forecasting turns in the economy is not particularly good. Forecasters are just as likely as the rest of us to believe current conditions will continue and to have a hard time seeing a future divergence from today's conditions. What inclines us to believe that the slow down in the U. S. economy will turn to a real contraction is not just all of the factors cited above but our judgment that the unknown factors we cannot anticipate are more than likely to be negative. Future economic output will certainly be affected by factors and events beyond those listed above. Although we have a fundamental belief in the resilience of the U. S. economy, we also believe that risks from other factors and events are decidedly negative. Global politics, domestic politics, weather and climate conditions, and world health conditions all pose more risks than opportunities to the U. S. economy.

A recession would have a significant impact on corporate earnings. In the past two recessions, 1990-91 and 2001, earnings of the S&P 500 declined 38% and 64% respectively from peak to trough, based on trailing twelve month earnings before extraordinary items. The earnings trough occurred twelve months after the end of the 1990-91 recession and four months after the end of the 2001 recession. Trailing earnings before extraordinary items on the S&P 500 most recently peaked at \$85.71 per share in

July 2007. As of June 2008, earnings had declined to \$60.26 per share for a decline of nearly 30%.

What's to come? Although some of the earnings decline has been due to losses in the finance sector brought on by the sub-prime crisis, these only account for a portion of the decline (no more than one-third, by our calculations). In a recession, further declines would be yet to come. A decline of magnitude midway between those of the last two recessions would decrease earnings 51% to a level of approximately \$42.00 per share on the S&P 500. A more modest decline, equal to the 38% decline in 1990-91, would have earnings trough at approximately \$53.00 per share.

What is perhaps more relevant is not the trough but the subsequent earnings recovery. Figure SMO.1 shows the price, earnings, and earnings valuations of the S&P 500 since 1987. What is particularly informative about Figure SMO.1 is the growth rate of earnings. Between January 2002 and January 2007, earnings increased at the most rapid rate in the past twenty-one years, increasing from just less than \$20.00 per share to over \$80.00 per share. The most rapid acceleration occurred between January 2003 and January 2005, when earnings increased at a rate of roughly \$15.00 per share per year. Outside of this period, when consumer spending was being supported by an expansionary monetary policy and a booming housing market, the rate of earnings growth has been more modest. If the post-recession rate of earnings recovery is more modest, it is possible that earnings will not recover to their pre-recession peaks for three or four years—a scenario that does not bode well for equity returns.

This outlook contrasts rather strikingly with median analyst projections. The median forecast as of July 15 for current year earnings for the S&P 500 is just over \$89 per share. The median forecast for next year is just over \$108 per share. These projections are derived from the median forecasts of more than 6,800 analysts on individual S&P 500 stocks.

Do the analysts know something we don't? No. Analyst forecasts are lagging indicators. They suffer from over-optimism (or over-pessimism, if pessimism is the prevailing mood), and they are time lagged, since forecasts are often weeks or months old. We won't know the current state of analyst sentiment for months.

Evidence that analyst forecasts are lagging indicators can be seen by changes in the market valuation of estimated earnings. Figure SMO.2 reports the observed price to estimated earnings ratios for large-cap, mid-cap, and small-cap indices. As of mid-July, all valuation multiples were well below recent levels and longer-term historical medians. In other times, we might see these depressed P/E levels as an opportunity to buy into future robust returns. Today we see these levels as an indication that the market expects earnings to decline. Compared to valuation levels of one year ago, current valuation levels would appear to expect earnings to drop between 15% and 20%, all other things being the same.

Figure SMO.3 tracks an alternative view of corporate earnings, as a percentage of GDP and national income. As we observed in previous issues, corporate earnings as a percent of GDP and national income reached historical high points in 2006. Both measures declined from the 2006 peak in 2007 and are on track to decline further this year. Since 1929, the ratio of corporate profits to GDP has peaked thirteen times. Following a peak, the ratio has declined on average for three years, with declines ranging from just one year to five years in duration. The average decline in the ratio from peak to trough has been 2.8% of GDP. Based on a current GDP level of approximately \$14 trillion, a 2.8% decline in earnings would be the equivalent of a decline of \$392 billion, or 24.6% of 2006 earnings. The underlying mechanics of how the ratio of corporate earnings to GDP and national income change are not well understood. Nevertheless, the turn in the measure is not a welcome sign.

None of this is very comforting. If S&P earnings suffer a decline comparable to declines during the past two recessions; if the trough does not occur until mid-to-late 2009, as would be in keeping with previous recessions; if earnings recover at a rate more in keeping with normal rates of growth; and if future valuations are no more than median historical levels, then total returns on large-cap stocks are likely to be only 3% to 8% per year through 2012, with nearer-term negative returns likely to be offset with future positive returns.

As likely as we think a recession to be, however, we can't bet the ranch on this outcome. By other measures including the long-term equity risk premium and long-term earnings growth estimates and normalized valuation ratios, projected equity returns are substantially more robust. For the purpose of determining optimal asset allocations, we have averaged the expected returns under the assumption of a moderately severe recession with earnings declining 50% with the expected returns using longer-term growth and valuation parameters. Figure SMO.4 shows the results. Over the next three to five years, we expect returns on large-cap and small-cap U. S. equities to be 9.0% and 12.0% respectively compared to historical arithmetic averages of 12.3% and 17.1% respectively.

Stock Market Outlook Charts

S&P 500: PRICE, EARNINGS, AND P/E RATIOS

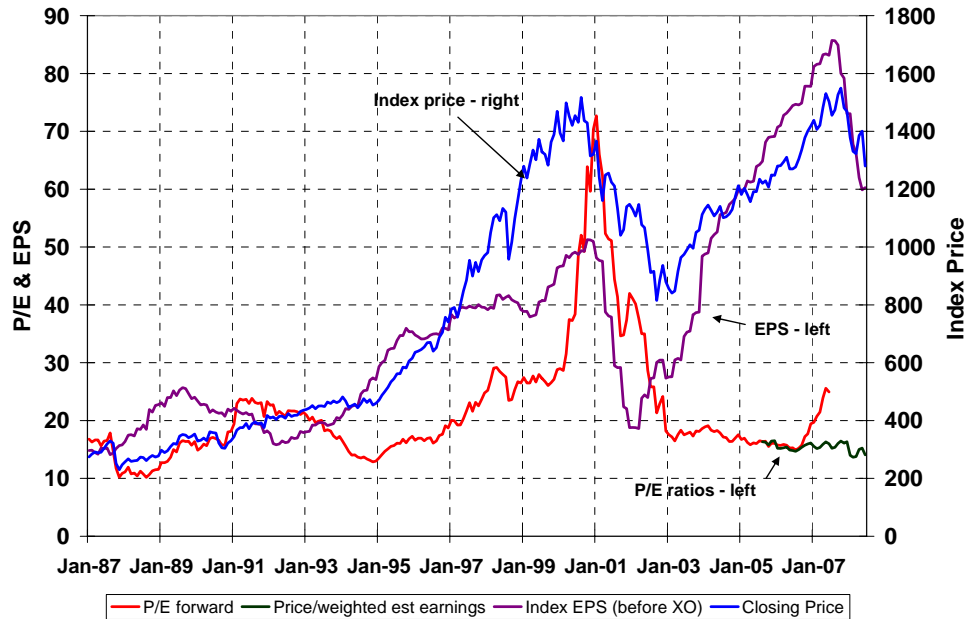


Figure SMO.1: S&P 500 Large-cap Index: Price, Earnings, and P/E Ratios
Source: Bloomberg and *Advisor* calculations

CURRENT VERSUS HISTORICAL PRICE/EARNINGS RATIOS (based on ratios to 12 month forward earnings, actual and/or estimated)

	Observed P/E ratios					Median of month-end ratios	
	7/15/08	1/24/08	6/12/07	2/2/07	10/27/06	10 yr	20 yr
S&P 500 large-cap	13.5	14.9	16.0	15.9	15.8	23.2	17.8
S&P 400 mid-cap	15.3	16.6	18.7	18.5	17.6	20.2	n/a
S&P 600 small-cap	16.8	16.8	19.9	19.9	18.8	21.2	n/a

Figure SMO.2: Current versus Historical Price/Earnings Ratios
Source: Bloomberg and *Advisor* calculations

PRE-TAX CORPORATE PROFITS, SHARE OF GDP AND NATIONAL INCOME

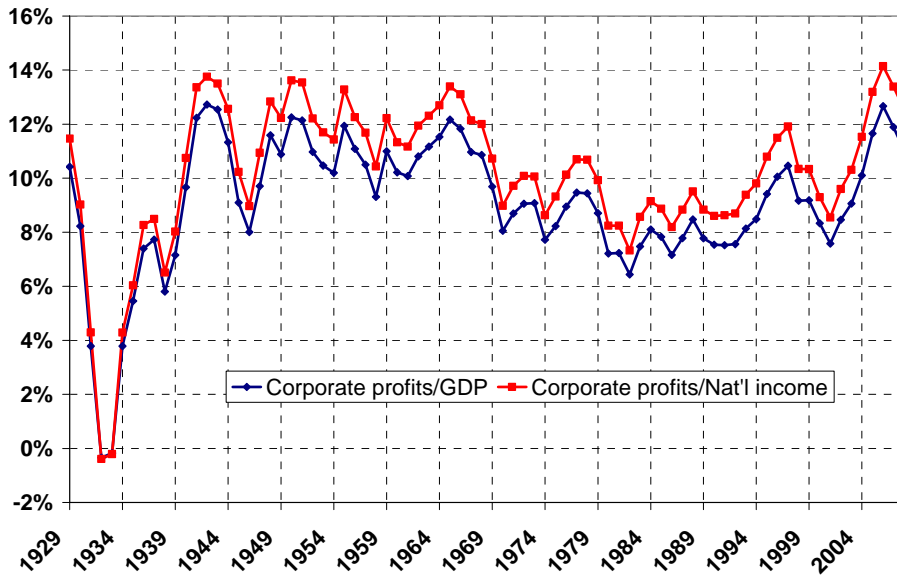


Figure SMO.3: Corporate Profits (Pre-tax) Share of GDP and National Income
Source: Bureau of Economic Analysis and *Advisor* calculations

PROJECTED U. S. EQUITY RETURNS, 3 TO 5 YEARS

	Large-cap	Small-cap
Expected returns in case of recession	5.4%	8.5%
Expected returns under long-term valuations	12.6%	15.5%
Average (with equal weighting)	9.0%	12.0%
Long-term arithmetic average	12.3%	17.1%

Figure SMO.4: Projected U. S. Equity Returns, 3 to 5 Years
Source: *Advisor* projections