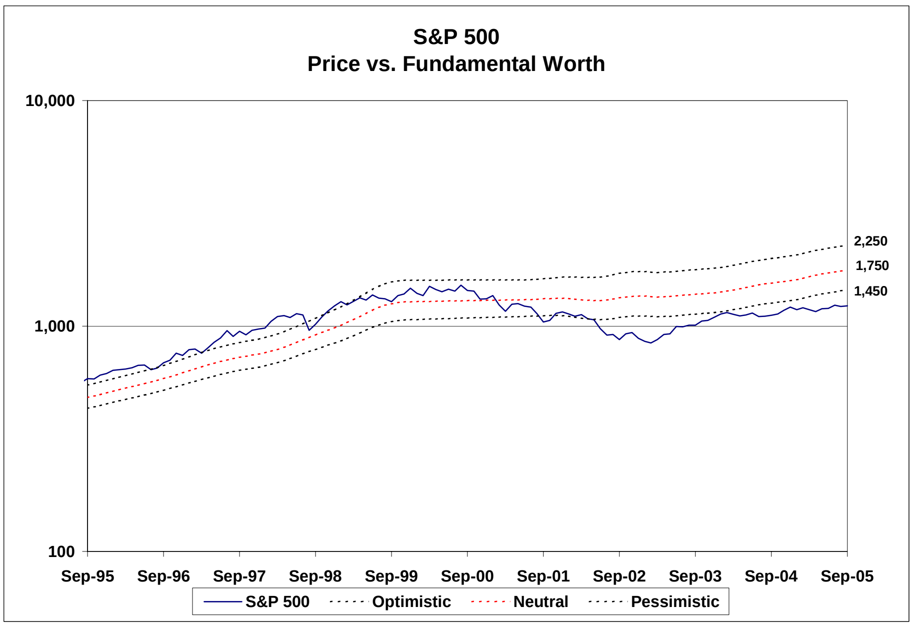
October 12, 2005

Note

RE: Oct05 P/V Update

"Corporate earnings have been on the rise for much longer than most investors realize..."

Last year when we published an update on this topic, we began that Note with this statement. While still accurate today, an under-appreciation for the recent rate of earnings growth can be added. What confuses investors is the loose link between change in earnings and the corresponding change in share prices. Over time, the former clearly drives the latter, but the connection is weak as time intervals shorten.



As an example, from Sep94 to Sep00, corporate earnings grew at an average annualized rate of about 10% while stock prices advanced at more than twice that rate. Some of that differential was due to the fact that long bond rates dropped about a percentage point, making stocks relatively more attractive, but a big part of it was simply investor over-exuberance. As we know, this is a double-edged sword. From Sep00 to Mar03, while corporate earnings declined about 10%, stock prices were whacked almost 40%. The chart above displays the market's routine overshooting of the mark.

So where are we today? From Sep03 to Sep04, corporate earnings grew about 15% while stock prices advanced 10%. From Sep04 to Sep05, corporate earnings grew another 18% while stock prices again advanced about 10%. Over the past two years stock prices are clearly not keeping up with earnings, widening the gap between share prices and underlying fundamental worth.

How long investors will continue to ignore this impressive corporate performance is anyone's guess. Certainly it can last a while longer, but have faith, as it won't last forever.

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