28 February 2008

Three Estimates of Operating Earnings

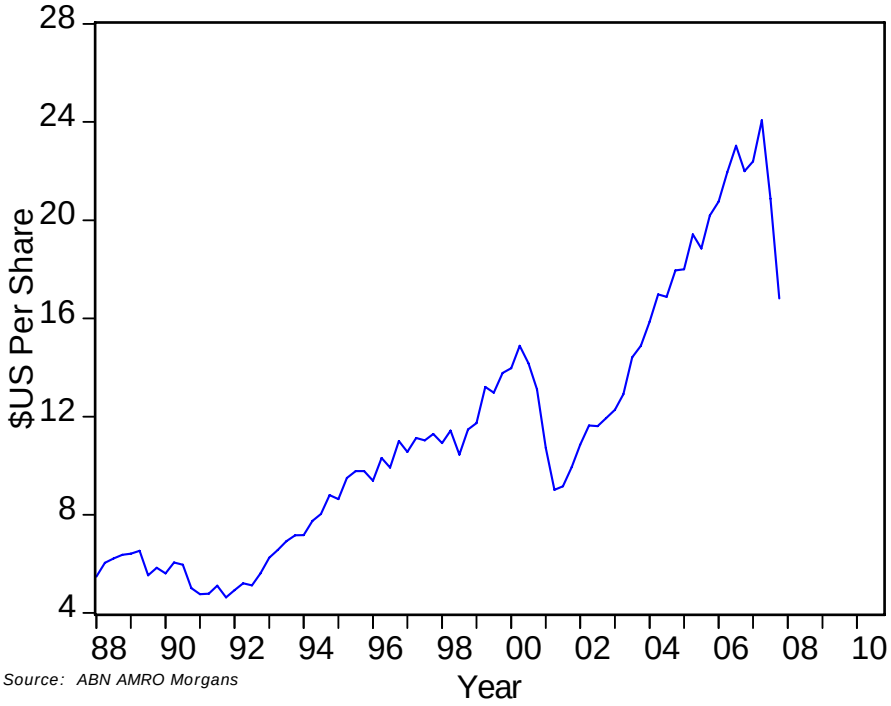
The US stockmarket, as everybody knows, has seen a crash in the first quarter. This crash in prices was brought about by a crash in earnings.

The level of quarterly operating earnings per share for companies listed in the S&P500 is shown in Figure 1. The first thing to remark is that no, I haven't got the numbers wrong. The fall in earnings in absolute terms in the last 2 quarters of 2007 was greater than the fall in earnings in the entire period of the tech crash of 2001.

This earnings collapse is only slightly less dramatic in percentage terms. From a peak level of 24.06c in June 2007, operating earnings first declined to 20.87c in the third quarter of 2007 then collapsing to only 16.81c in the fourth quarter of 2007. Over the 6 months to December 2007, operating earnings per share fell by 30.1%.

This collapse was unanticipated. As late as end of November 2007, the consensus estimate was that operating earnings per share in the fourth quarter would be around 22c. When companies started to report in January, the much lower level of operating earnings shocked the market. The market then fell.

Figure 1: S&P500 Quarterly Operating Earnings Per Share



Source: ABN AMRO Morgans

So where does the market go from here? From what we have already seen in the past quarter, the future path of the market should be determined by the future path of earnings. It is commonly said that the US is in recession. Alan Greenspan (what would he know?) thinks that this recession will be deeper than the recession of 2001.

So far, the US economy has fallen from a 4.9% growth rate in September 2007 to a 0.6% growth rate in December 2007. This sharp slowdown in growth was the reason for the sharp fall in earnings per share. Right now we think the US economy is about to get worse. Our view (not as bad as Greenspan) is that the US economy is going into a shallow recession with a fall in output only as bad as in 2001.
This means that we think that output should fall by around 0.4% in March 2008 and 0.5% in June 2008.

By the time we get to the second half of 2008, the combined effect of cuts in the Fed Funds rate and tax cuts should generate a strong kick to the US economy. Growth should accelerate to 3.4% in September 2008 and 2.7% in December 2008. What this

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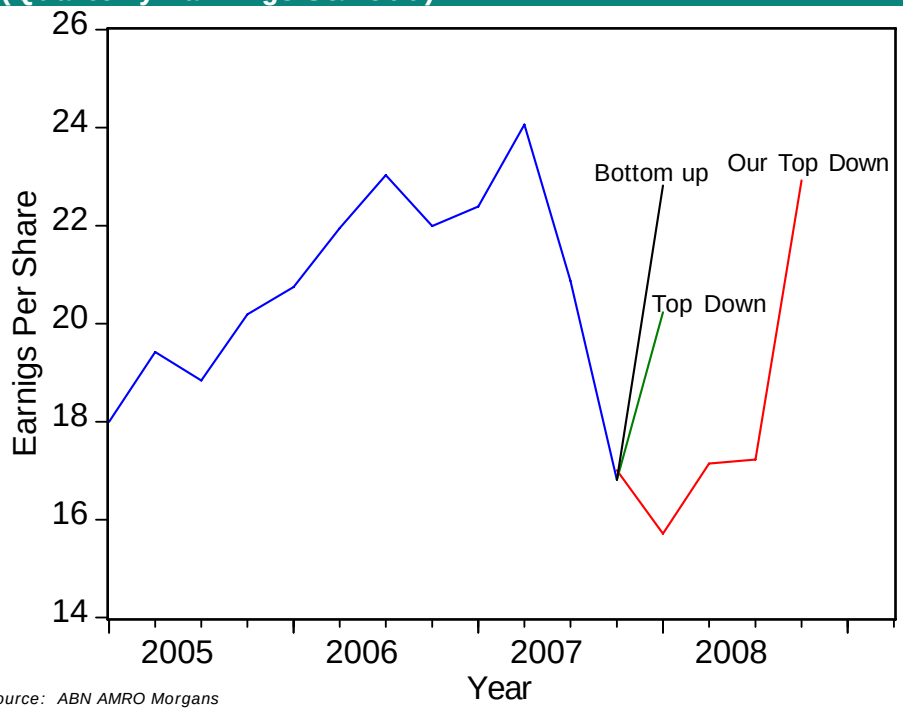
means is that we expect that earnings per share for the S&P500 will be very soft until this recovery arrives.

This is not what the market currently thinks. In Figure 2, we show consensus bottom up earnings per share as published by Standard & Poors as the black line. We show consensus topdown earnings per share as the green line. We show what we think is going to happen (our own topdown estimate) based on the GDP growth we estimated above. This is shown as the red line.

Figure 2: Three Estimates of Operating Earnings Per Share (Quarterly Earnings S&P500)



Source: ABN AMRO Morgans

Market consensus of stock analysts (bottom up estimates) are that earnings per share should rise from 16.81c in the December quarter to 22.82c in the March quarter. Market consensus of market strategists (top down estimates) are that earnings per share should rise from 16.81c in the December quarter to 20.23c in the March quarter. To the extent that the market believes either of those estimates, then the market can sustain a strong rally to the end of March.

Personally, I don't believe a word of it. I think that when the March quarter operating earnings start to be reported in April, the market will realise that operating earnings for the March quarter were down, not up. Our own top down estimate is that operating earnings per share should fall to 15.7c in the March quarter, down from 16.8c in the December quarter. This mild decline in earnings is associated with the beginning of absolute declines in US output. This should recover to 17.1c in the second quarter. Only in the final quarter do we see operating earnings per share recovering back to the level of 22.9c per share or around where bottom up estimates currently put earnings for the first quarter.

If we are right, the US stockmarket is in for more shock and disappointment on a quarterly basis until the good news finally arrives at the end of 2008.

There is more bad news out there. The market has just not yet opened the mail.

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