

U.S. Portfolio Strategy

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Market Commentary/Strategy

July 28, 2005

Not Your Average Bull

- **Longer, but not as much fun**
It might not feel this way, but we are actually in the midst of the *fifth* longest running bull market ever recorded since 1928, according to our calculations. However, despite its length, it has not been the boon to equity investors that the average bull market has been. Equity investors have enjoyed an annualized return of just 20.0% versus the 38.2% average for the top 20 bull markets we measured.
- **The current rally is atypical in that it has been driven by earnings, not P/E**
The current bull run is a powerful, *earnings-driven* market. This distinction is important, as we found that earnings-driven rallies typically rise and fall based on the health of the economy, not long-term rates. If there is good news in our analysis, it is that earnings-driven bull markets tend to last 1.5x as long as P/E-driven rallies.
- **The current bull market may be unusual, but it is not without precedent**
Of the 20 longest bull markets, we found seven where earnings growth explained more than 50% of the total price appreciation. These earnings-led rallies resemble the current environment in several important ways. Most notably, they were also characterized by rising oil prices, Fed tightening, and stable dividend yields. On the other hand, inflation has historically been more problematic in the aftermath of earnings-driven up-cycles.
- **Learning from the past**
The aftermath of an earnings-driven bull market tends to be particularly painful. These periods are characterized by negative earnings growth *and* multiple contraction. Adding insult to injury, we also found that almost 60% of earnings-led bull markets have ended with a recession. As such, we will continue to keep a sharp eye on the leading indicators as they come out.
- **No change to target, key themes, or Focus List**
We maintain our 1,250 year-end target and \$73.50 '05 EPS estimate for the S&P 500. From a stock perspective, our Focus List, which includes BA, BAX, CVS, GE, HSIC, PAYX, PFE, SLB, TYC, and WMB, embodies our three-pronged attack of Rising ROEs, Yearn for Yield, and Stable Growth.

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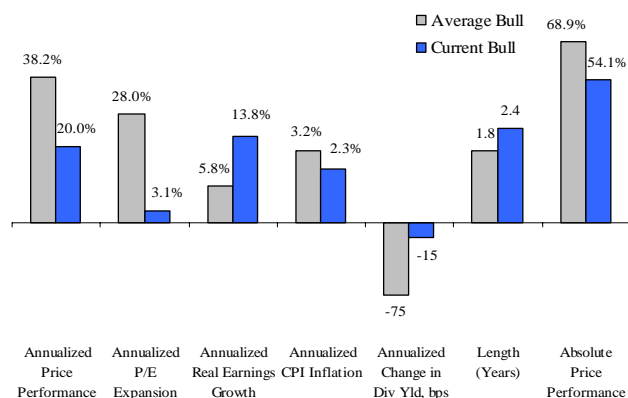
Not Your Average Bull

We are often reminded that looks can be deceiving.

I couldn't agree more, particularly when it comes to analyzing this current bull market, which we think started in March '03. It may surprise clients that — measured by the length of time without a 10% correction — the present rally is already *the fifth-longest-running bull market* since 1928. But, when it comes to overall returns, this is somewhat of a poor man's rally. Equity investors have enjoyed an annualized return of just 20.0% versus the 38.3%, on average, for the top 20 bull markets we measured. In absolute terms, the news is not much better: The overall price return for the current rally is 54%, a full 15% less than the average long-running bull market.

Exhibit 1

Current Bull Market Is Long on Earnings and Short on Multiple Expansion and Absolute Return



Note: Bull markets defined here as 10% reversals in the S&P 500; see Ex. 5 for further details. Source: Ibbotson, Robert Schiller, S&P, BLS, Ned Davis Research, Federal Reserve of St. Louis, Haver, Morgan Stanley Research.

What also sets the current rally apart from other bull markets is that it has been largely earnings driven. In fact, only 16% of its price appreciation is linked to any multiple expansion, which is a far, far cry from the 70% that typically accompanies the average bull market. In our humble opinion, this dependence on earnings growth is the 'swing factor' on which to focus, particularly in light of the fact that 57% of all earnings-led bull markets *end coincident with a recession*. So, if there is one variable in the current equation on which to concentrate, it's the economy.

For our nickel, things, including GDP growth, look pretty good, particularly when one considers that 10-11% of

Corporate America's assets are still in cash. So, this bull may still have some legs. Our favorite industry groups remain capital goods, energy, and healthcare equipment & services. From a stock perspective, our Focus List, which includes BA, BAX, GE, HSIC, PAYX, PFE, SLB, CVS, TYC, and WMB, embodies our three-pronged attack of Rising ROEs, Yearn for Yield, and Stable Growth. But, as we detail below, when growth does turn south, investors should run, not walk for the exit, as subsequent price performance after earnings-led bull markets is generally nastier than usual.

This is not your typical bull market. Looking back at the 20 longest-running bull markets since 1928, we found that on average, P/E expansion explained roughly 70% of market performance. To put this in more concrete terms, prices rose at an average rate of 38% per year, with P/E expansion accounting for nearly 3/4 of the total. By comparison, *only 16% of the current bull market's price performance is attributable to P/E expansion*. The rest is explained by earnings growth. In fact, since the start of this bull market in March '03, we have seen P/E expansion of only 3.1% per year. See Exhibit 5 for details, but only the 1979 and 1937 bull markets have relied so little on multiple expansion for price appreciation.

But it is not just lack of multiple expansion that distinguishes the current rally. Just consider that in the average bull market, dividend payouts typically do not keep up with rising prices, which causes dividend yields to fall. In fact, the longest-running bull markets usually experience a yield contraction of 75 basis points per year. But, spurred by rapid earnings and cash flow growth, the current rally has seen dividend yield contraction of just 15 bp per year, significantly below the historical average. Of course, with a dividend yield of just 1.9% in 2Q03, it probably helps that we started from such a low base this time around.

The next layer: Drilling down on earnings-driven bull markets. Of the 20 longest-running rallies, we found seven where earnings growth explained *more than 50%* of the total price appreciation. For the purposes of this analysis, we term such situations "earnings led" bull markets. See Exhibits 2, 4, and 5 for details, but the earnings-led bull markets in our sample resemble the current environment in several important ways. First is the Fed tightening. On average, earnings-led bull markets coincided with 74 basis

points of rate *hikes*, as compared to 75 bp of rate *cuts* for P/E-led markets. Second, past earnings-led bull markets, like the current one, have faced rising oil prices. On average, earnings-led bulls have confronted 16% oil price *increases*, which is a notable contrast to the 4% oil price *decreases* that the typical P/E-led bull encountered. Finally, the duration of the current bull market — 2.4 years and counting — is very much in line with the average duration of earnings-led bulls of 2.3 years. P/E-led bull markets have tended to be a bit shorter, running 1.6 years on average.

Exhibit 2

Currently in an 'Earnings Led' Bull Market

	P/E Led	Earnings Led	Current
S&P 500 PERFORMANCE			
Annualized Price Performance	43.8%	27.9%	20.0%
Annualized P/E Expansion	39.6%	6.3%	3.1%
Annualized Real Earnings Growth	1.0%	14.7%	13.8%
Annualized CPI Inflation	2.1%	5.1%	2.3%
Annualized Δ Dividend Yield, bps	-106	-19	-15
MACRO ENVIRONMENT			
Change in LT Treasury Yields, bps	-26	-18	-58
Change in Fed Policy Rate, bps	-75	74	177
% Change, WTI Oil Price	-3.7%	15.6%	67.7%

Note: 'Earnings Led' bull markets = those where earnings growth explains > 50% of total performance. Includes #s 1, 2, 7, 12, 15, 19 and 20 in Ex. 5.

Source: Ibbotson, Robert Schiller, S&P, Bureau of Labor Statistics, Ned Davis Research, Federal Reserve of St. Louis, Haver, Morgan Stanley Research.

While the current bull shares the above characteristics with its earnings-led peers, it has its own unique features. First, it stands apart with a below-average annualized inflation rate of 2.3% and a distinctively above-average Fed tightening of 177 bp. More important, though, could be how high oil has surged during this current uptick in equities. Since the start of the current bull market, oil prices have risen a spectacular 68%, while inflation has remained surprisingly low. The only other bull market that experienced comparable oil price increases — 1978-79 — overcame 13% inflation and significant Fed tightening activity.

The only way in which this bull market and its earnings-led peers are *remarkably* similar to the more common P/E-led bull markets is with respect to long-term Treasury yields. Surprisingly, while we might have expected more dramatic yield contraction in the P/E-led markets, there is actually no meaningful difference in the movement of long-term yields in P/E-led versus earnings-led bull markets.

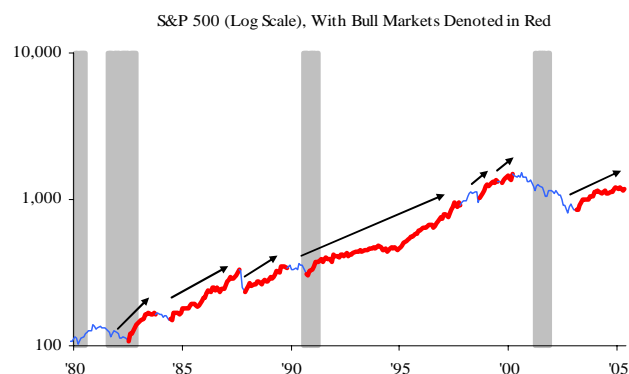
Knowing when to run, not walk, out the door. To our surprise, we found that since 1928 only 35% of all bull

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markets have ended coincident with an economic recession. (We define “coincident” here as bull markets that end anywhere from two months after to 12 months before the start of a recession.) Interestingly, over the same period, 39% of *all* months were coincident with recessions, under our definition. For those who were lucky enough to miss statistics in college, the punch line is that the odds of a bull market ending around the time of a recession are no greater than random chance (see Exhibit 3 below).

Exhibit 3

You Don't Need a Recession to End a Bull Market

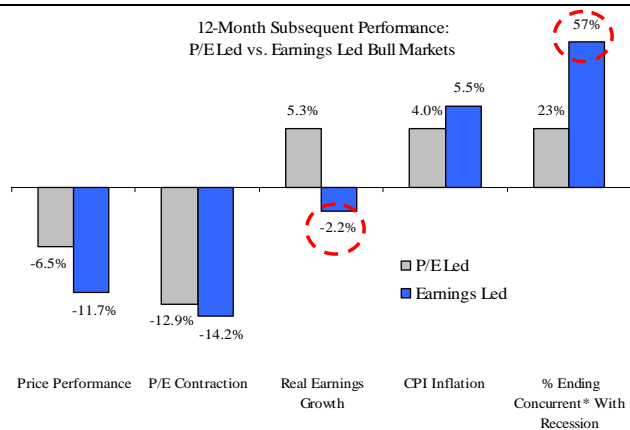


Gray shading denotes periods of economic recession. Source: S&P, Ned Davis Research, Morgan Stanley Research.

However, recessions do matter when it comes to earnings-led bull markets. How much? Well, what we found is that 57% of lengthy, earnings-led bull markets ended coincident with a recession, compared to just 23% of lengthy, P/E-led markets. So, if there was ever a time to listen to what our colleague Dick Berner is saying, it is now. It is probably also worth mentioning that earnings-led bull markets that coincided with recessions all suffered from above-average inflation levels, considerable Fed tightening, or both. We think the Fed may still have work to do (see *A Fed Pause?* from June 2, 2005), leading us to the conclusion that the current bull market could be — at some point — susceptible to the same conditions that hampered its predecessors.

Adding insult to injury, investors have faced a “double-whammy” at the end of earnings-led bull runs. Indeed, as Exhibit 4 shows, not only do earnings collapse, but the multiple falls too. The one-two punch of lower earnings and a contracting multiple generally results in nastier-than-average market downturns, with average price performance of negative 11.7% in the subsequent year.

Exhibit 4

What to Watch for at the End of Bull Markets

* Defined as bull markets that end between two months after to 12 months prior to the start of a recession. Source: Ibbotson, Robert Schiller, S&P, BLS, Ned Davis Research, Federal Reserve of St. Louis, Haver, Morgan Stanley Research.

We thank Nicole Davison for her research assistance with this report.

Stocks mentioned: Boeing (BA, \$66), Baxter Int'l (BAX, \$40), General Electric (GE, \$35), Henry Schein (HSIC, \$43), Paychex (PAYX, \$35), Pfizer (PFE, \$27), Schlumberger (SLB, \$85), Questar (STR, \$70), Tyco (TYC, \$31), Williams Cos (WMB, \$21).

Exhibit 5

Appendix: Top 20 Longest-Running S&P 500 Bull Markets Since 1928 ⁽¹⁾

Rank	Low Date	High Date	%Gain	Annualized % Gain	Duration (Years)	Annualized P/E Expansion / (Contraction) ⁽²⁾	Annualized % Change in Real Operating EPS ^{(2),(3)}	Annualized % Change in CPI ⁽³⁾	Annualized % Point Change in Dividend Yield ⁽²⁾	Note: Performance, % Attributable to P/E Expansion	% Point Change in LT Treasury Yields ⁽³⁾	% Point Change Fed Policy Rate ^{(3),(4)}	% Change In WTI Oil Price ⁽³⁾	Price Performance	Subsequent 12-Months ⁽⁵⁾ P/E Expansion / (Contraction) ⁽⁵⁾	Change in Real Operating EPS ⁽⁵⁾	Change in CPI
* 1	10/11/1990	10/7/1997	233%	19%	6.99	8.4%	6.6%	2.8%	(0.32%)	45%	(2.75%)	(2.60%)	(40.8%)	11.8%	10.9%	(0.7%)	1.5%
* 2	10/23/1962	2/9/1966	76%	19%	3.30	5.4%	10.9%	1.6%	(0.21%)	29%	0.82%	1.71%	(1.7%)	(7.7%)	(11.0%)	0.8%	2.8%
3	7/24/1984	8/25/1987	128%	31%	3.09	31.6%	(3.8%)	3.1%	(0.73%)	103%	(3.57%)	(4.43%)	(29.5%)	(22.3%)	(43.4%)	31.9%	4.0%
4	7/17/1950	1/5/1953	60%	21%	2.47	24.6%	(6.8%)	4.1%	(0.66%)	118%	0.66%	0.50%	0.0%	(2.2%)	(6.6%)	3.5%	1.1%
5	11/29/1943	2/2/1946	70%	28%	2.18	31.8%	(4.9%)	1.8%	(0.74%)	115%	(0.50%)	0.00%	N/A	(17.5%)	(36.8%)	9.8%	18.8%
6	9/14/1953	9/23/1955	101%	41%	2.02	21.7%	15.9%	0.0%	(1.17%)	53%	0.14%	0.25%	0.0%	(0.6%)	(1.2%)	(1.3%)	1.9%
* 7	12/4/1987	10/9/1989	61%	29%	1.85	9.0%	13.2%	4.7%	(0.21%)	31%	(1.11%)	2.12%	16.5%	(15.5%)	(10.2%)	(11.5%)	6.3%
8	10/22/1957	8/3/1959	28%	28%	1.78	28.6%	(2.0%)	1.8%	(0.72%)	101%	0.54%	0.00%	(3.3%)	(6.2%)	(1.8%)	(5.8%)	1.4%
9	6/12/1928	9/7/1929	74%	56%	1.24	30.9%	18.4%	0.9%	(0.89%)	55%	0.49%	0.50%	N/A	(41.8%)	(20.0%)	(24.1%)	(4.0%)
10	4/28/1942	7/14/1943	69%	54%	1.21	45.8%	(0.7%)	6.6%	(3.14%)	84%	(0.01%)	0.00%	N/A	0.6%	20.4%	(17.9%)	1.7%
11	8/12/1982	10/10/1983	69%	57%	1.16	56.9%	(2.9%)	2.9%	(1.22%)	100%	(0.66%)	(0.76%)	(10.4%)	(3.8%)	(21.5%)	17.5%	4.3%
* 12	11/23/1971	1/11/1973	33%	29%	1.14	13.1%	9.9%	3.6%	(0.49%)	45%	0.89%	0.94%	0.0%	(19.7%)	(35.6%)	14.0%	9.4%
13	10/25/1960	12/12/1961	39%	34%	1.13	36.6%	(2.7%)	0.6%	(0.73%)	109%	0.24%	0.00%	0.0%	(13.1%)	(24.5%)	13.5%	1.3%
14	3/14/1935	4/6/1936	92%	85%	1.07	65.7%	11.5%	0.0%	(1.46%)	77%	0.01%	(0.50%)	N/A	5.9%	(23.1%)	32.0%	4.4%
* 15	9/16/1975	9/21/1976	31%	31%	1.02	6.8%	16.1%	5.4%	(0.75%)	22%	(0.81%)	(0.94%)	24.6%	(10.5%)	(20.9%)	6.2%	6.6%
16	6/13/1949	6/12/1950	43%	43%	1.00	35.4%	6.3%	(0.4%)	(0.42%)	82%	(0.01%)	0.00%	0.0%	8.0%	0.9%	(1.6%)	8.8%
17	10/7/1966	9/25/1967	33%	35%	0.97	40.5%	(6.2%)	2.2%	(0.60%)	117%	0.50%	(1.51%)	3.4%	5.2%	(1.5%)	2.2%	4.5%
18	5/26/1970	4/28/1971	51%	56%	0.92	65.1%	(9.0%)	4.2%	(1.26%)	115%	(1.23%)	(3.83%)	6.3%	2.8%	(8.4%)	8.4%	3.5%
* 19	11/14/1978	10/5/1979	20%	23%	0.89	(0.9%)	9.8%	13.1%	0.14%	(4%)	1.58%	3.92%	95.3%	14.6%	15.5%	(12.0%)	12.8%
* 20	4/29/1936	3/6/1937	38%	46%	0.85	2.3%	36.8%	4.3%	0.51%	5%	0.11%	0.00%	N/A	(54.5%)	(47.9%)	(12.0%)	(0.7%)
Average:			69%	38%	1.81	28.0%	5.8%	3.2%	(0.75%)	70%	(0.23%)	(0.23%)	4.0%	(8.3%)	(13.3%)	2.7%	4.5%
Current:	3/11/2003	7/22/2005	54%	20%	2.37	3.1%	13.8%	2.3%	(0.15%)	16%	(0.58%)	1.77%	67.7%	N/A	N/A	N/A	N/A

* Denotes "earnings-led" bull markets (i.e., EPS growth explains > 50% of price performance).

(1) Bull markets defined here as 10% reversals in the S&P 500 stock index close.

(2) EPS and dividends measured on a last twelve months basis.

(3) Measured from end of first month of bull market through end of last month of bull market.

(4) Policy rate measured here using FRB discount rate prior to 1961 and effective fed funds rate thereafter.

(5) Measured from the date of the market break until the end of that month one year later.

Source: Ibbotson, Robert Schiller, S&P, Bureau of Labor Statistics, Ned Davis Research, Federal Reserve of St. Louis, Haver, Morgan Stanley Research.

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
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