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*Marshall & Sullivan, Inc. / Registered Investment Advisor*

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# THE VIEWPOINT

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While I was considering topics for the newsletter my thoughts kept drifting back to Katrina and Rita. The destruction and human tragedy that they have created is hard to imagine. It is heart warming and reassuring to see the rest of the nation and world reaching out to help those affected. The devastation that has been caused in the Gulf Coast region and the ripple effect across our country is astonishing.

With the news focusing on the human tragedy and destruction, I thought the newsletter should instead focus on how the storms affected the markets and the economy, both short and long-term.

In the short-term, the markets have changed their focus from earnings to energy. Normally the market moves with earnings. If earnings go up the market follows. That is why Marshall & Sullivan invests in companies with past and projected earnings growth. So far this year this has not been the case.

The average company is growing its earnings faster than projected. At the beginning of the year the S&P 500 was projected to grow at 7% for the year. With earnings coming in higher than expected so far this year they are now expected to finish the year with 10% earnings growth. This year the Dow Jones Industrial Average is down 2.00% while the S&P 500 is up 1.4%. Neither index has gone up as much as the earnings have grown.

When you look at energy stocks you find a different picture. The average energy company is up over 42% this year. If you took energy out of the indexes, the Dow Jones Industrial Average would be down over 4% and the S&P500 would be down over 1% for the year. The energy sector started the year at 5.7% of the S&P500 and is now over 10%.

The move in energy stocks has been so dramatic it reminds many people of the way technology stocks went up in the late 90's. Money is flowing into energy stocks at record rates. Lipper data shows more money going into energy mutual funds than all other equity mutual funds

combined. Most of this money is being invested after the stocks have already made a substantial move. Wall Street pros will tell you to sell into strength like this in order to lock in profits. Only time will tell if energy stocks will continue their torrid rise or become the latest investment fad to fade. One thing is for sure, the market will go back to looking at earnings and companies will start to trade on their earnings growth not on news. That is why we will continue to stick to our disciplines of buying companies with growing earnings that are fairly valued.

How will Katrina and Rita affect the economy? The Michigan Consumer Sentiment Index came in weaker than expected. With gas around 3 dollars a gallon in most of the country and reports that heating oil and natural gas prices will be much higher this winter, you can understand the pessimism. It may not be as bad as prior energy crises. Energy is not as big a percentage of spending as it used to be. Coming into this year, 5.7% of disposable income was spent on energy goods and services. This leads us to think that this rise in energy will slow the economy but not throw the economy into a recession.

A big stimulus for the economy will be the hundreds of billions that will be spent to rebuild the Gulf Coast. This will begin to be felt as soon as the reconstruction commences. The rebuilding effort itself will have a longer term impact on the economy as it takes years to rebuild the area.

We think the economy will slow in the fourth quarter to around 2% growth from the 3 ½ % growth we have had so far this year. As refineries come back on line energy prices will drop. The price at the pump will become less of an issue for the consumer and pessimism should subside. We think the economy will be growing at over 3% next year. If the economy continues to grow, then the market should do the same.

Greg Robinson CFA, President  
[greg@msinvest.com](mailto:greg@msinvest.com)