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THE VIEWPOINT

Winter 2007

Record high oil prices, a slowing real-estate market and three years of positive stock market returns had some predicting flat to negative returns for 2006. Half way through the year it looked as though they would be right. Marshall & Sullivan felt differently because the economy looked like it was going to continue to grow slowly and companies' earnings were going to continue to rise. We wrote in our Summer 2006 newsletter:

"The current fear driven market sell-off is similar to three other downturns in the past 3 years and is healthy for the market, but hard on investors' patience. Periods of uncertainty give us an opportunity to buy companies at a discounted price. We will use the cash that has been building in our accounts to do just that."

This paid off as markets rose during the final six months of the year.

In 2006 international markets outperformed U.S. markets, small companies outperformed large companies and value outperformed growth. This has been the pattern over the last 7 years and it is the reverse of what happened during the previous 7 years that ended in 1999. At the beginning of 2006, pundits felt that large U.S. companies would be the best performing asset class with growth stocks leading the way. This has not materialized yet but there are a number of reasons it could this year.

The past is always interesting to review, especially at year end, but the future is what we care about when investing. To us the future still looks positive, especially for the U.S. markets.

We like the market because of the earnings growth projected for the year. The average analyst is projecting 6% earnings growth in 2007. We think they will grow faster than projected. Earnings have come in better than expected over the last four years because the economy has grown faster than expected. We expect this trend to continue. Even if it doesn't and earnings come in line with analyst projections the market should rise 6%.

Along with earnings growth we feel price earnings multiples (P/E) will expand helping to push the market upward even more. This is because the U.S. markets are under valued on a price earnings basis (P/E). Over the past 15 years the S&P500 has traded between 14 and 31 times earnings with an average of 20. Currently the market is trading at 16.29 times trailing earnings. If P/E multiples expand to 18 times earnings, the S&P500 would go up a little more than 10%.

Two items affect the price individuals are willing to pay for earnings; interest rates and emotions. Unlike the latter half of the 1990's when P/E multiples hit 31 times, confidence in the economy is low. This is because individuals are worried about high commodity prices, the political environments in the Middle East and the slowing housing market. Emotions are running low and individuals are not willing to pay up for earnings. As the economy continues to grow, confidence should build and P/Es should expand.

P/Es should also expand if the Federal Reserve starts lowering interest rates to keep the economy growing. This is because interest rates and P/Es have an inverse relationship. As interest rates rise, all else being equal, stock prices fall and vice versa. Thus, if the Federal Reserve lowers interest rates you can expect a return higher than the company's earnings growth rate. This occurs due to price P/E expansion. (For a more in-depth explanation see our Summer 1999 newsletter)

We feel positive about the U.S. Stock market in 2007. If earnings continue to climb as projected, equities should go up. If individuals' emotions turn more positive about the economy or the Federal Reserve lowers interest rates we could have market returns even better than the projected earnings growth.

Greg Robinson CFA, President
greg@msinvest.com