

Profits, the Economy and Stock Prices

C15.0042
Lesson 8
Edward M. Kerschner

Does Anyone Really Know . . .

GDP Revisions											
Q	Jan	Apr	Prism	Final	1st	2nd	3rd	4th	5th	6th	7th
1983 Q1	1.7%	1.2%	0.7%	0.2%	0.7%	2.1%	2.7%	3.0%	2.9%		
1983 Q2	2.1	1.7	1.0	1.9	1.1	2.3	2.1	2.6	2.0		
1983 Q3	2.8	2.0	1.2	1.7	1.1	2.1	1.1	1.6	1.1		
1983 Q4	3.2	2.4	1.3	0.7	3.1	3.1	3.0	3.3			
1984 Q1	3.1	1.9	0.8	2.9	2.9	3.4	4.1	4.9	4.8		2.7
1984 Q2	3.4	2.3	1.0	1.4	1.1	1.1	0.8	0.8	0.8		
1984 Q3	4.1	1.9	1.1	1.8	1.4	1.4	1.3	1.3	1.3		2.1
1984 Q4	4.3	4.4	4.8	4.4	4.8	4.8	4.4	5.2	3.3		2.0
1987 Q1	2.8	3.3	3.5	3.5	4.4	4.4	4.2	4.4	4.2		
1987 Q2	3.8	4.1	4.3	4.3	4.3	4.3	4.1	3.9	3.4		
1987 Q3	4.2	4.2	4.2	4.1	4.2	4.2	4.2	4.2	4.2		
1987 Q4	3.3	3.8	3.8	3.4	4.0	4.0	4.1	3.8	3.4		
1988 Q1	2.1	2.2	2.2	2.2	2.2	2.1	2.4	2.2	2.2		
1988 Q2	2.2	2.2	2.3	2.2	2.2	2.1	2.3	2.0	2.1		
1988 Q3	2.0	2.0	2.4	2.1	2.1	2.1	2.4	2.9	3.0		2.8
1988 Q4	2.9	4.2	4.4	3.7	3.6	3.5	3.2	3.2	4.8		2.5
1989 Q1	1.7	2.0	2.4	2.9	2.7	2.7	2.8	2.9	2.9		2.2
1989 Q2	2.0	2.7	3.0	3.0	3.1	3.1	3.0	3.0	3.0		
1989 Q3	2.8	2.8	3.0	3.0	3.0	3.0	3.0	3.0	3.0		
1989 Q4	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5		1.4
1990 Q1	3.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.1		
1990 Q2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2		
1990 Q3	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0		
1990 Q4	3.1	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0		
1991 Q1	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1991 Q2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
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1994 Q3	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1994 Q4	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1995 Q1	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1995 Q2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
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1995 Q4	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1996 Q1	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1996 Q2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1996 Q3	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1996 Q4	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1997 Q1	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1997 Q2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1997 Q3	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1997 Q4	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1998 Q1	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1998 Q2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1998 Q3	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
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1999 Q1	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1999 Q2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1999 Q3	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
1999 Q4	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
2000 Q1	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
2000 Q2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
2000 Q3	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		
2000 Q4	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8		

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Does Anyone Really Know What Time It Is?

GDP Revisions

	<i>Benchmark Revisions</i>										
	Flash	Adv	Prelim	Final	1st	2nd	3rd	4th	5th	6th	7th
1995 Q4		0.9%		0.5%	0.3%	2.2%	2.8%	3.3%	3.2%		
1993 Q1	1.8%	0.9%	0.7%	0.8%	1.2%	0.0%	-0.1%	0.1%	-0.7%	-0.1%	
1991 Q2	0.4%	-0.1%	-0.5%	1.4%	1.7%	1.5%	2.2%	1.7%	2.6%	2.3%	
1985 Q1	2.1%	1.3%	0.7%	0.3%	3.7%	3.1%	3.8%	4.9%	3.4%		

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What is the S&P 500

S&P is not GDP

- ◆ While (1998) exports are only 11% of U.S. GDP, sales of U.S. foreign affiliates are significant. So around 40-45% of the sales of U.S. multinationals are outside the U.S. About half of these foreign sales in Europe with rest split between Asia, Canada and South America.
- ◆ Part of the cause of this discrepancy between GDP and EPS growth lies in significantly different sector weightings.
 - Almost 1/4 of the U.S. economy is not represented in the S&P 500 (11% real estate + 13% gov't).
 - Services are greatly underweighted in the S&P 500 while financials and tech are overweighted.
 - Nondurables are 28% of S&P earnings versus only 7% of U.S. GDP.
 - Agriculture, mining & construction are 2% of S&P earnings and 7% of U.S. GDP.

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What is the S&P 500

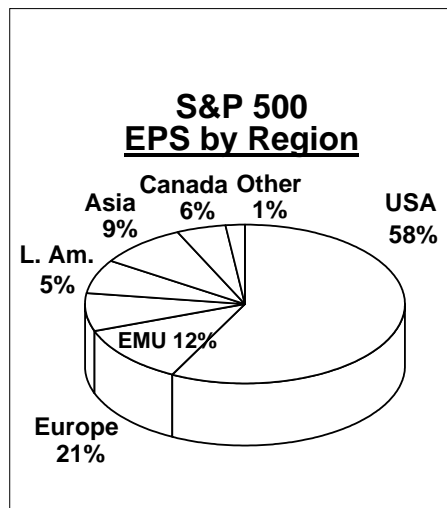
S&P is not GDP

- ◆ Partly because the S&P 500 does not mimic the U.S. economy, GDP growth is not a good input for projecting S&P EPS growth. But “going global” does not help. While profit-weighted real global GDP growth has ranged from +0.2% to +3.8% between 1990 and 1998, S&P EPS growth has ranged from -13.6% to +23.9%. And, profit-weighted GDP growth of +2.0% has produced EPS growth as low as -4.5%, while GDP growth of +2.1% has produced EPS growth as high as +18.5%.

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What is the S&P 500

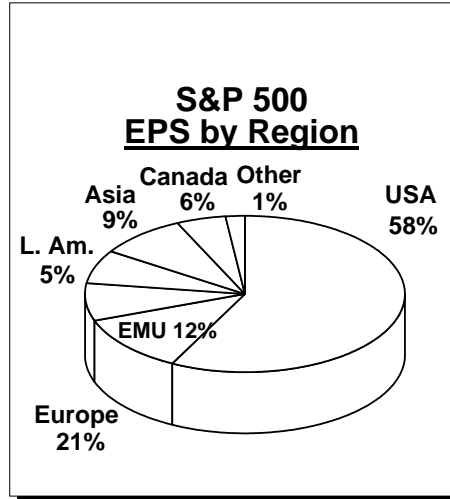
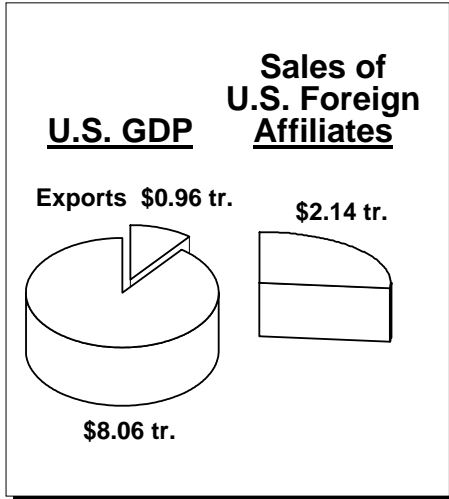
S&P is not GDP



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What is the S&P 500

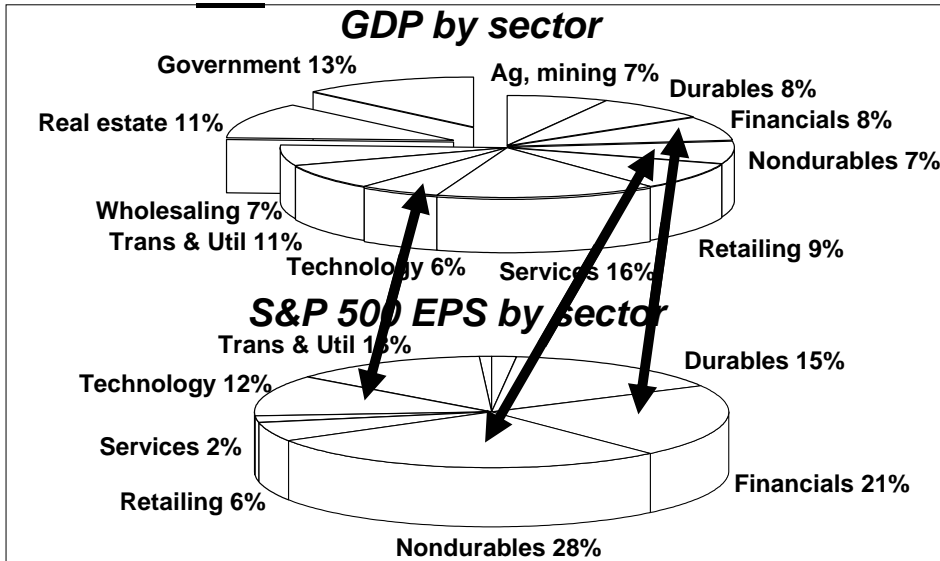
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What is the S&P 500

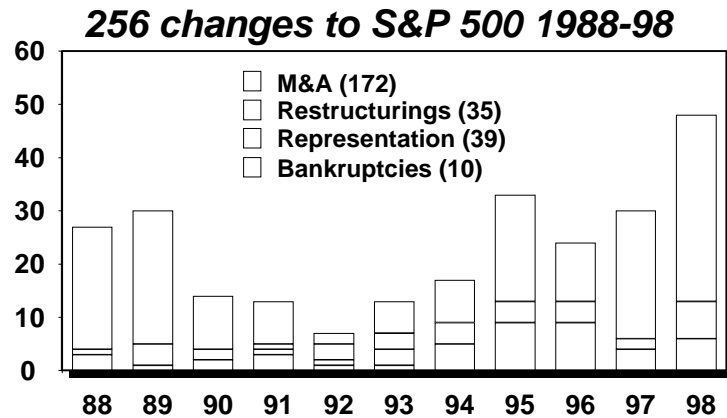
S&P is not GDP



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What is the S&P 500

Not a Passive Index



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What is the S&P 500

Not a Passive Index

- ◆ 256 changes between 1988 and 1998.
- ◆ Record breaking 48 changes to the index in 1998; driven by:
 - **M&A activity** – by far most important driver accounting for 35 of 48 changes in '98 and 172 of 256 since 1988.
 - **Restructurings** – relatively high number in '98; companies trying to uncover hidden value by spinning off attractive businesses.
 - **Representation** – number of companies kicked out for “lack of representation” has increased.
 - **Bankruptcies** – none in last 5 years.

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What is the S&P 500?

Changes in Sector Representation

Sector	S&P 500 Sector Analysis														Company		Net Chg
	Market cap weighting					New companies added								'93	'98		
	'78	'88	'98	Chg	Chg	'93	'94	'95	'96	'97	'98	6-yr Total	% of Total				
Cap Goods	5.9%	9.0%	7.9%	+3.1%	-1.1%	0	0	1	2	1	1	5	4.2%	55	56	1	
Commodities	9.7	8.1	3.2	-1.5	-5.0	2	3	2	1	1	0	9	7.5	59	53	-6	
Cons. nondur	12.6	14.4	14.9	+1.8	+0.4	0	0	0	0	0	3	3	2.5	67	64	-3	
Cyclicals	15.4	16.1	9.2	+0.8	-6.9	0	0	4	2	3	6	15	12.5	102	79	-23	
Energy	18.0	12.2	6.2	-5.8	-6.0	1	0	0	1	2	0	4	3.3	27	24	-3	
Financials	6.1	8.0	15.4	+1.9	+7.4	2	5	6	5	11	13	42	35.0	57	71	14	
Health Care	5.1	8.2	12.1	+3.1	+3.9	0	2	2	1	3	0	8	6.7	29	30	1	
Tech.	12.3	8.4	18.7	-3.9	+10.3	2	3	5	6	2	10	28	23.3	39	64	25	
Transports	2.1	2.3	0.9	+0.2	-1.4	0	0	0	0	0	0	0	0.0	15	10	-5	
Utilities	13.0	13.2	11.5	+0.2	-1.4	0	0	2	1	0	2	6	5.0	50	49	-1	

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What is the S&P 500

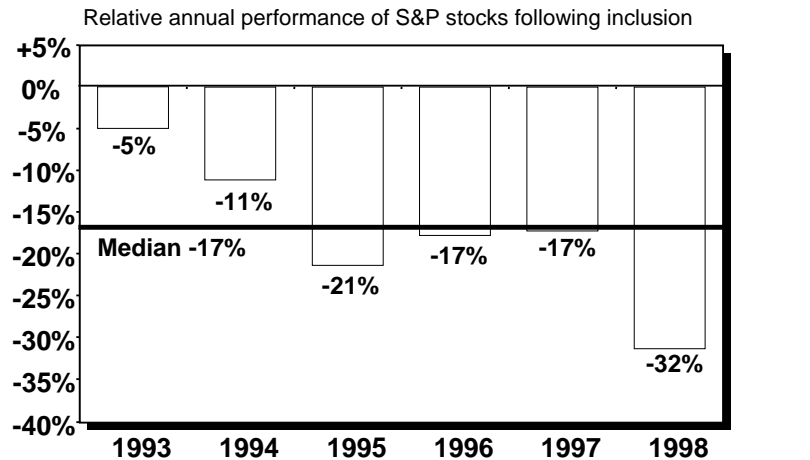
Changes in Sector Representation

- ◆ Between 1988 and 1998 tech sector has exploded from 8.4% of S&P market cap to 18.7% and financials up from 8.0% to 15.4%. These gains have come at expense of cyclicals (-6.9%) and energy (-6.0%).
- ◆ Between 1993 and 1998, 42 companies added to financial sector with a net change of 14; 28 tech companies added for a net change of 25. Cyclicals offset these gains with net decline of 23.

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What is the S&P 500

S&P 500 additions do not outperform



What is the S&P 500

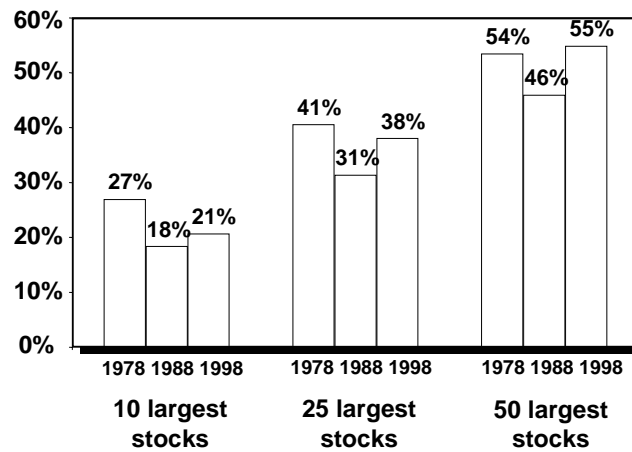
S&P 500 additions do not outperform

- ◆ Companies added in '98 outperformed by 9.7% from announcement date to actual addition to the index (6 days on average). But after their addition companies tend to perform poorly.
- ◆ Of 120 stocks added from '93-'98 average annual underperformance is 13.9% with median underperformance of 17.1%.

What is the S&P 500

S&P is not increasingly big cap

Share of S&P 500 market cap claimed by:



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What is the S&P 500

S&P is not increasingly big cap

- ◆ 1998 is not increasingly big cap versus 1988 and less top heavy, by some measures, than it was in 1978.
- ◆ But, the top decile of the S&P 500 has accounted for more than 50% of performance in each of the last four years and more than two-thirds of 1998's performance.

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What is the S&P 500

Largest stocks are growing faster

Expected earnings growth rates of the largest S&P 500 companies

<u>1978</u>		<u>1988</u>		<u>1998</u>	
<u>Company</u>	<u>Rate</u>	<u>Company</u>	<u>Rate</u>	<u>Company</u>	<u>Rate</u>
AT&T	6.5%	IBM	9.5%	Microsoft	24.0%
IBM	13.0	Exxon	6.5	General Electric	14.0
Exxon	6.0	General Electric	9.5	Intel	17.0
General Motors	5.0	AT&T	9.5	Wal-Mart	15.0
General Electric	9.0	Royal Dutch	7.5	Exxon	4.5
Kodak	12.0	General Motors	6.0	Merck	12.0
Royal Dutch	5.5	Ford	6.5	IBM	15.0
Standard Oil Cal.	6.5	Philip Morris	11.0	Coca-Cola	13.0
Standard Oil Ind.	7.0	Merck	15.0	Pfizer	18.0
Schlumberger	17.5	DuPont	8.5	Cisco	22.0
Average	8.8%		9.0%		15.5%
S&P 500 Index	9.0%		7.5%		6.5%

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What is the S&P 500

Largest stocks are growing faster

- ◆ So what's causing the "narrowness" of the market?
- ◆ Large-cap stocks are driving S&P 500 performance not because the index has become more top-heavy, but because the largest stocks are growing faster than in the past.
- ◆ The top of the S&P is increasingly dominated by fast-growing "Gorilla" stocks that dominate their industries.
- ◆ Average growth rate of top ten today is 15.5% versus 9% in 1988 and 1978 despite lower inflation rate, even as S&P 500 growth slowed.

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