Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Signal or Noise?

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At the close of trading on June 30, 2011 the S&P 500 stood at 1,320.64. As of the time of the writing of this newsletter the index stands at 1,329.04 a change of 0.6%. Yet, during that time the markets experienced an almost 20% drop from July 2011 thru early Oct. 2011, a 30% rise from Oct. 2011 thru Mar. 2012, a 10% drop from Apr. 2012 thru May 2012 and a 2% rise in June 2012. Three market gyrations of more than 10% in twelve months yet a net zero overall. With each major move market prognosticators forecast the death of the Euro zone ("EU"), the re-birth of the EU, and the death once again. Uncertainty over the outlook for the EU has spilled over into wild swings in company earnings forecasts as well. Earnings expectations for the S&P 500 have followed the same wild ride felt by markets. The graph on page 3 displays the earnings expectations diffusion index (number of up minus down changes in earnings expectations divided by the total number of estimates) for the S&P 500 over rolling months for the period June 30, 2011 thru June 27, 2012. Over the past year there has been a 53% correlation between the change in the diffusion index and performance of the S&P 500. The aggregate impact on 2012 S&P 500 earnings expectations has been to reduce forecasts by $8.15 per share ($113.15 to $105) or a drop of 7.2% (dashed black line in graph). While a drop of 7.2% in the aggregate earnings expectations for the S&P 500 is not a positive data point by any means, it is only slightly worse than the average of 12-month declines in earnings expectations over the past 10 years (-6.34%). However, the path to the 7.2% drop has been anything but average, as the diffusion index over the past year averaged -12% v. a -6% historic average.

Recently, the direction of diffusion and the market have diverged (circled in graph). The outlook for earnings has taken a markedly negative tone, despite equity markets bottoming on June 1st. The diffusion index currently stands at the second lowest level of the past 12 months and at a level historically associated with recessionary fears. Smith Group's investment process has felt the impact of this decidedly negative tone to earnings as most earnings related investment factors, such as high forward earnings growth rates, returns on equity, and rising earnings expectations, have all markedly underperformed when adjusted for risk.

Recent economic data has been disappointing, but it is not consistent with the trajectory of downward earnings revisions. Smith Group sees the scales tipping in favor of a modest positive bias relative to expectations for the upcoming earnings season. This should provide a tailwind to investment processes such as Smith Group's which are focused on the outlook for corporate earnings.

While there is likely little relief from market volatility in sight, Smith Group finds U.S. equities to be one of the most compelling investment opportunities globally. It is difficult to say much of anything good is happening in the EU these days and the intransigence of EU leadership has been supportive of a strong dollar and has kept the Federal Reserve in a highly accommodative mode. The Fiscal Cliff presents the greatest risk for a U.S. double dip but it is hard to paint a dire recessionary picture given the lack of excesses in the economic system. Housing is bottoming throughout most of the U.S. and energy prices are more than 20% off their highs providing close to a ½% GDP tailwind.

Smith Group greatly appreciates the confidence and loyalty that our clients have shown us and we look forward to a furtherance of the rewards that are now being afforded our sound time-tested investment process.