

# INVESTMENT OUTLOOK

## Second Quarter 2006 Review

By Whitney Brown

- Stocks volatile due to inflation fears.
- Interest rates continue to rise.
- Latest Fed rate hike may signal future pause.
- Mid-term election year usually weak for stocks.



The fireworks simply couldn't wait until the 4<sup>th</sup> of July. The stock market treated, some would say mistreated, investors to a real show beginning in early May. After a strong and steady start to the year carried through to April, stocks traded in a very volatile manner throughout May and June. A big move up on the next-to-last trading day brought the Dow and S & P 500 back to nearly even and really disguised the rocky nature of the market action through most of the quarter.

From May 11<sup>th</sup> through the end of the quarter, only 35 trading days, there were 15 trading days on the New York Stock Exchange where almost all (over 80%) of the volume of shares traded and the points moved by those shares were in the same direction, either up or down. That is to say the market has been making a strong move up or down almost every other day. In a more typical market environment an 80% or 90% day is considered a significant event and harbinger of a trend reversal. In the recent environment, there has been a definite bias to the downside, but it has been difficult to determine whether the cyclical bull market dating back to March of 2003 has ended or not.

The primary catalyst for all this volatility has been inflation. The U.S. economy has been strong in recent quarters, and costs for many inputs such as energy and raw materials are up. Along with those trends there has been an up tick in the Consumer Price Index. It's hard to say which is worse for investor sentiment, the fear of inflation or the fear that the Fed will wreck the economy trying to prevent it.

The inflation jitters have not been confined to the stock market. The bellwether 10-year Treasury yield has

<u>Market Measures</u>	<u>2nd Qtr 2006</u>	<u>YTD 2006</u>
S & P 500	-1.9%	1.8%
Dow Jones Industrial Average	0.4%	4.0%
NASDAQ Composite	-7.2%	-1.5%
Morgan Stanley EAFE	0.7%	10.0%
Lehman Bros. Intermediate Gov't Bond Index	-1.15%	-1.18%

	<u>6/30/06</u>	<u>12/31/05</u>	<u>6/30/05</u>
10-Year Treasury Bond Yield	5.15%	4.39%	3.94%
Three-month Treasury Bill Yield	5.00%	4.08%	3.13%

been on a tear all year. After meandering throughout 2004 and 2005, rates surged 0.75% in the first six months of this year rising above 5% for the first time since 2002. The implications of higher borrowing rates for the housing market may finally be hitting home (no pun intended). There is plenty of evidence now that home sales and growth in home prices are slowing.

The Fed has continued to raise short-term rates under the new leadership of Chairman Bernanke, but June's announcement gave hint of a pause. There are many conflicting signals regarding the strength of the economy and inflationary implications, but a reasonable view is that

*(Continued on page 2)*

### ***Also in This Issue***

**Page 2:** Second Quarter 2006 Review and Outlook continued.

**Pages 3-4:** Price, Earnings and the Price-to-Earnings Ratio.

## Second Quarter 2006 Review and Outlook

(Continued from page 1)

the higher interest rates are starting to have the desired dampening effect by cooling the housing market and slowing the economy. The likely-case scenario is that the economy slows without going into recession; the housing market moderates without collapsing; and the Fed ends the rate hike cycle allowing longer-term rates to ease. From there the economy can regroup for another leg up. Capital spending will continue to enhance productivity, keeping unit labor costs under control and underpinning strong, though past peak, earnings growth.

For several years now we have been intrigued by the four-year stock market cycle based on the presidential election. This year is a mid-term election year, and this well-established cycle anticipates that a mid-term election year is usually a

weak one for stocks with the market declining from spring through fall, making a significant low, and rallying strongly thereafter. Reasons for the market weakness in a mid-term election year include the diminishing benefits of fiscal stimulus previously applied in the year or two before the presidential election, and the uncertainty surrounding the political impact of the mid-term election results. This year so far is right on track, and we do expect further market weakness throughout the summer.

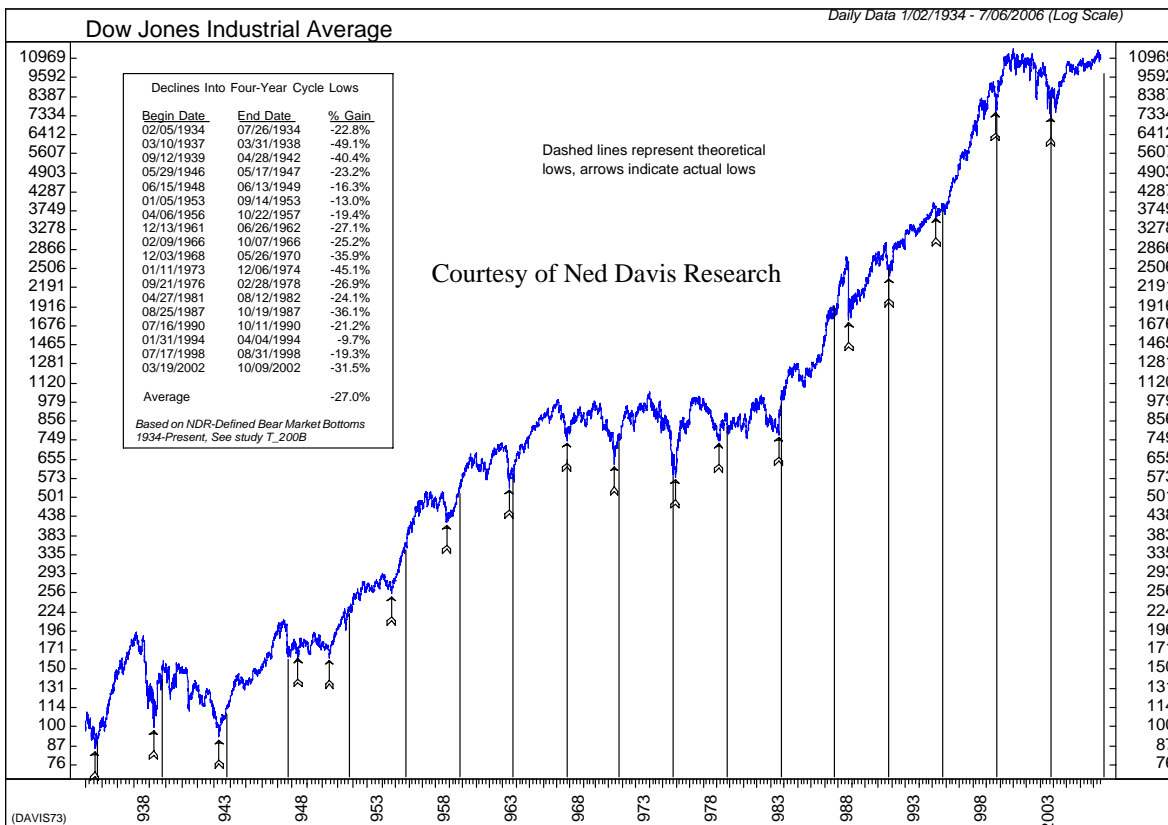
We do not want to put too much emphasis on this cycle, or any single indicator, because extenuating circumstances can either minimize or exaggerate its impact. However, a look at the accompanying chart reveals the striking regularity of the cycle. The chart shows the Dow Jones Industrial Average from 1934 to present with the vertical lines marking

four-year intervals. The vertical arrows mark the actual cyclical market lows. The actual low has seldom been more than few months away from the anticipated low.

The chart gives us reason for caution as well as a sense of opportunity because we are approaching the time when we could expect a significant market low. What concerns us is not knowing how low the market may go. What encourages us is that there should follow a good cyclical opportunity to increase exposure to equities.

Much of our other quantitative and technical analysis argues for being careful about stocks until signs of a market bottom are evident. The clearest sign would be that selling has been exhausted and investors have begun aggressively accumulating stocks again, i.e. the market starts trending up on heavy

volume. On the other hand, much of our fundamental analysis based on valuation and the economy is more upbeat, arguing that with strong corporate finances and a healthy economy, especially relative to the rest of the world, the conditions for a bear market don't exist. The fundamental view depends on investors taking a rational view of the markets which is not always the case, at least in the short run. We are willing to be patient and let the market tell us when and what to do.



# Price, Earnings, and the Price-to-Earnings Ratio

By Walter Dixon



Price-to-earnings ratio is the most commonly used indicator of investor confidence in the outlook for the stock market. Very simply, it represents the cost in dollars per share an investor must pay to buy \$1

of a company's earnings. It can be calculated for an individual stock or for an index of stocks such as the S&P 500 or the Dow Jones Industrials. The formula is:

$$\text{Price-to-earnings ratio (P/E)} = \text{Price}(\$) \div \text{earnings per share}(\$)$$

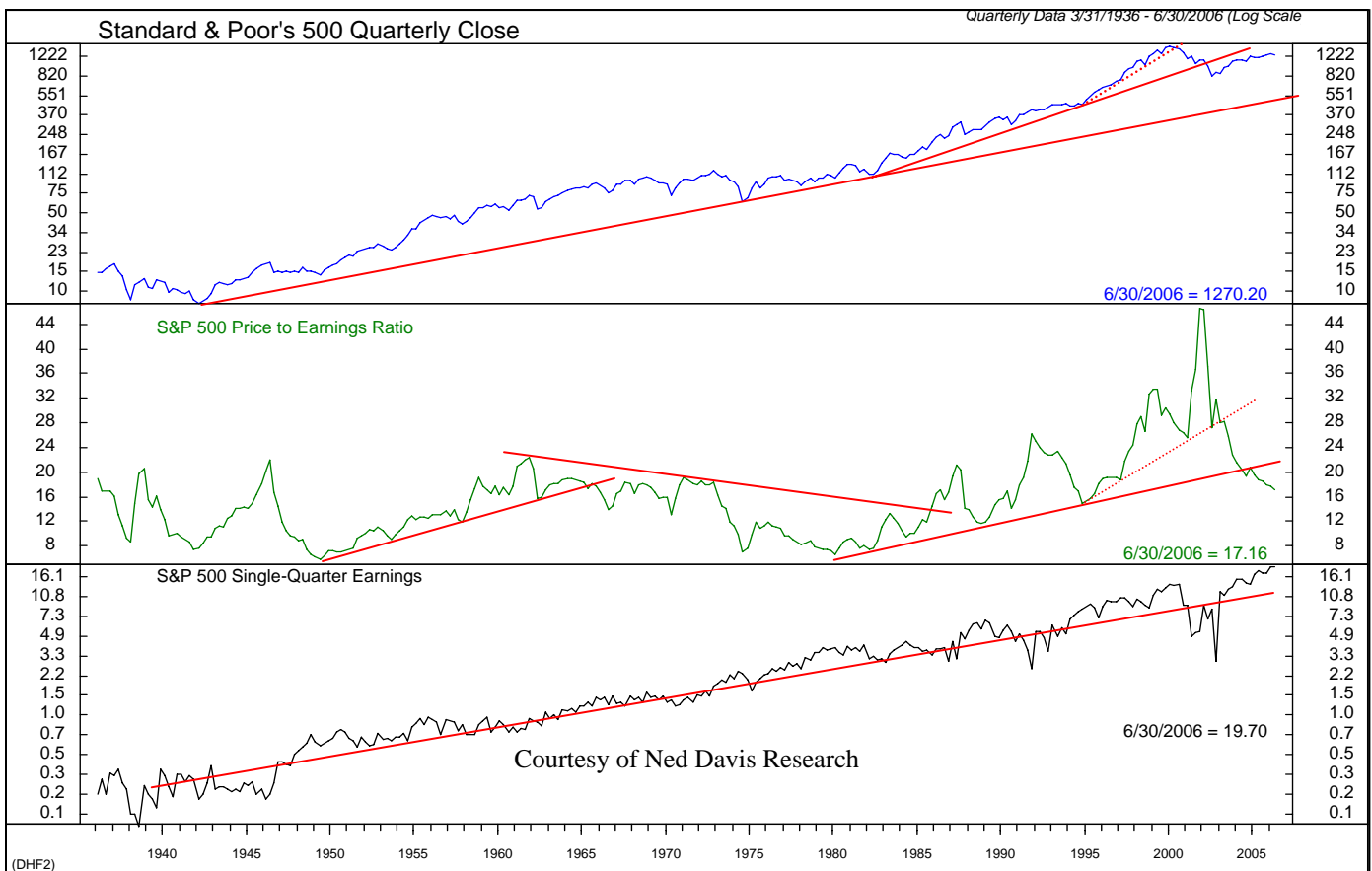
The P/E fluctuates based on changes in a stock's price, its earnings, or both. A high P/E reflects investor willingness – for whatever reasons – to pay a high share price for a dollar of earnings, while a low number indicates just the opposite.

Historically, investors usually are willing to pay a high price when their confidence in the market outlook is greatest. Conversely, they are willing to pay much less when their confidence is low.

The middle section of the accompanying graph displays the P/E for the S&P 500 over the past seventy years. For most of this period the P/E has ranged between a high of around 23 to a low of about 8. However, in the late 1990's the ratio rose sharply higher than 23, spiking to nearly 50 in early 2002. It has since fallen back to its current reading of 17, which is slightly above the middle of its historic range.

In the long run, stocks rise in value as earnings per share grow. The bottom section of the graph charts S&P 500 quarterly earnings growth for the same seventy-year period. Despite several recessions since the end of WWII, the upward long-term trend in earnings growth has been remarkably steady, though increasingly volatile during the past

*(Continued on page 4)*



## **DIXON, HUBARD & FEINOUR, INC.** **INVESTMENT COUNSEL**

PROVIDING INVESTMENT MANAGEMENT SERVICES FOR ...  
INDIVIDUALS & FAMILIES  
TRUSTS & ESTATES  
RETIREMENT PLANS  
ENDOWMENTS & FOUNDATIONS  
BUSINESSES

WALTER M. DIXON, JR., CFA  
W. STEBBINS HUBARD, JR.  
EDWIN R. FEINOUR  
C. WHITNEY BROWN, JR., CFA  
WALTER M. DIXON, III  
JONATHON E. GRACE  
DAVID A. CAMPER

601 S. JEFFERSON STREET, SUITE 410  
POST OFFICE BOX 2768  
ROANOKE, VIRGINIA 24001-2768  
TELEPHONE (540) 343-9903  
FAX (540) 343-7684  
E-mail: *last name@dhfinc.com*

### **Price, Earnings, and the Price-to-Earnings Ratio**

*(Continued from page 3)*  
two decades.

For the past several years, earnings growth has been rising steadily at a rate higher than most expectations, but the continued decline in the P/E has had a dampening effect upon share prices. Prices have traded modestly upward since mid-2002 but are still well below their peak in early 2000. One might conclude that investor confidence is not as high now as it was in the late '90's, despite continuing earnings growth at essentially the historic long-term rate.

If the current earnings growth rate slows significantly, as expected by some analysts, the P/E will have to rise to compensate for the earnings slowdown. Otherwise, stock prices will decline. Occasionally, earnings growth and P/E levels decouple for short periods, as the graph shows; but earnings growth must resume in the long run to support steady or higher share prices.

Our concern regarding the current P/E ratio is for

the longer term. The middle section of the graph shows a history of long-term cyclicity. It also seems that when the long-term trend is decisively broken, as it was in 2002 for the 7-year uptrend, and again in 2004 for the much longer, more important uptrend that began back in the mid-1970's, the newly established trend persists for quite a few years. (Compare 17-year periods 1949-1966 and 1985-2002.)

We conclude from these studies that the continuation of above average stock market returns is highly dependent upon strong earnings growth, because it appears that the P/E ratio is no longer in a rising trend. To put it differently, we agree with most analysts that 17 times earnings (middle of the historic range) indicates that stocks are much more reasonably priced than they were several years ago, though not yet cheap. More critically, the trend in investor confidence – as reflected in the break in the 20-year uptrend of P/E ratios – is a major concern.