Investment Strategy Weekly

OAK ASSOCIATES, *ltd.*

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GLOBALIZATION IS PROFITABLE

I am starting to think that profits growth might be stronger than expected this year. During the past two years, my forecast for profits topped the list among Wall Street's strategists.[1] I started this year with the highest S&P 500 operating earnings forecast too, and now I am raising it from $72.00 per share to $75.50 per share. I am also raising my 2006 estimate to $80 per share from $77 per share. If my latest estimates are correct, profits would be up 12% this year—rather than 7%—and 6% next year (Tables A and B). Profits recoveries tend to be stronger than expected. S&P 500 earnings rose 18% and 21% during 2003 and 2004, respectively. At the start of this year, I joined the crowd that is expecting profits will grow roughly 7%. After all, that has been the trend growth in earnings since at least 1960, and profits are back on that trend. However, recent data on business revenues and forward earnings suggest that there might be an upside surprise underway. Profits might be up 10% to 13% this year (Figures 1 and 2). Why?

Big Trade. If profits are better than expected this year, it will be because of the boom in world trade. U.S. manufacturers are shipping more exports and distributors are distributing more imports. U.S. manufactured exports now account for 15% of factory shipments excluding petroleum products. That's up from 14.3% and 12.7% five and 10 years ago (Figure 3). Nonpetroleum factory shipments are up 10.7%, with comparable exports up 11.3% over the past 12 months through January (Figure 4). The weaker dollar and booming overseas economies are boosting the demand for U.S.-made goods abroad. The export boom is broad-based with consumer goods, capital goods, and industrial supplies all participating (Figure 5):

1) Capital goods exports are up 12.5% over the past 12 months through January to $334 billion.
2) Industrial supplies and materials exports are up 18.8% over this same period to a record high of $207 billion.
3) Consumer goods exports are up 15.6% to a record high $104 billion.

Retailers and wholesalers have plenty of imported goods to distribute. The year-over-year growth in the sales of these distributors is highly correlated with the comparable growth in nonpetroleum manufactured imports (Figure 6). The recent widening in the spread between the growth rates of wholesalers' sales and retail sales may be attributable to surging imports, which probably show up at the warehouses before they are sold at the stores (Figure 7).

[1] At the start of 2003, my forecast for S&P 500 operating earnings was the highest at $53.50 per share. The actual result was $55.43 per share. At the start of 2004, I was the highest with $62.50 per share. The actual result was $67.22 per share.

Table A: S&P 500 Operating Earnings: Bottom-Up vs. Top-Down Forecasts

	2005	2006	Date of Latest Change
Bottom-Up Analysts' Forecast	**74.18**	**82.06**	**03/22/05**
Top-Down Strategists' Forecasts			
Oak Associates, *ltd.**	**75.50**	**80.00**	**03/21/05**
Alta Vista	72.00		01/05/05
Lehman Brothers	72.00	77.50	02/07/05
ISI	71.75	76.25	02/15/05
McAdams Wright	71.00		03/10/05
Bernstein	70.00		12/16/05
Prudential	70.00	72.00	12/20/04
CIBC World Markets	70.00	75.00	03/09/05
UBS Warburg	69.50		03/12/05
****Average**	**71.31**	**76.15**	**03/22/05**

***Earnings are not adjusted for options expensing. Stock options expensing should lower earnings by $1.50 in 2005 and $2.50 in 2006.**

** Average excludes Bottom-Up Forecast

Source: Oak Associates, *ltd,* , and Thomson Financial.

Table B: S&P 500 Earnings: Yardeni vs. Analysts' Consensus Forecasts

	Proforma Operating Earnings Forecast (as of 3/22/05)*			
	Yardeni		Analysts' Consensus	
	Level	YOY %	Level	YOY %
2003	**55.43 a**	**18.3**	**55.43 a**	**18.3**
2004	**67.18**	**21.4**	**67.19**	**21.2**
Q1	15.87 **a**	26.3	15.87 **a**	26.3
Q2	16.74 **a**	24.8	16.74 **a**	24.8
Q3	16.59 **a**	15.0	16.59 **a**	15.0
Q4	17.90	18.4	17.91	18.5
2005	**75.50 ****	**12.4**	**74.18**	**10.4**
Q1	17.75	11.8	17.20	8.4
Q2	18.50	10.5	18.28	9.2
Q3	19.25	16.0	18.82	13.4
Q4	20.00	11.7	19.88	11.0
2006	**80.00 ****	**6.0**	**82.06**	**10.6**

* Proforma earnings are adjusted for accounting and index composition changes. a = actual

**** Earnings are not adjusted for options expensing. Stock options expensing should lower earnings by $1.50 in 2005 and $2.50 in 2006.**

Source: Oak Associates, *ltd.* , and Thomson Financial.

Looking Good From Top To Bottom. The bottom line is that S&P 500 forward operating earnings per share is highly correlated with business sales (Figure 8). Business sales is the sum of manufacturers' shipments, wholesale sales, and retail sales. It is the most comprehensive measure of business revenues. Forward earnings is the time-weighted average of current and next years' consensus earnings estimates. It is my favorite measure of earnings because I believe it is the one that is "in" the market.

At the start of this commentary, I raised my forecast for operating earnings in 2005 and 2006. More relevant for my market forecast, I am also raising my target for forward earnings at the end of this year and next year to $80 per share and $86 per share, respectively (Figure 2).[2] I believe that I am one of the few strategists who focuses on and forecasts forward earnings rather than actual operating earnings when projecting the outlook for the stock market. If the P/E based on forward earnings remains where it is now at 15.7, then my forward earnings forecasts suggest that the S&P 500 will rise to 1256 by the end of 2005 and 1350 by the end of 2006. I am actually expecting that the valuation multiple will rise to 17 later this year and remain there through next year. My S&P 500 targets are 1360 and 1462 for the end of 2005 and 2006, respectively (Table C).

I have found that there is a fairly dependable 2-to-1 relationship between the growth rates in forward earnings and business sales. So for example, over the 12-month period through January, sales are up 11.1% and earnings are up 17.9% (Figure 9). The cycles in these two series are nearly identical; their peaks and troughs coincide. What is unusual about the latest cycle is that the growth rate of sales appears to have peaked during May 2004 at 12.4%, but it has remained remarkably steady around 10% through January of this year. It has yet to go into a cyclical decline. If it continues to hang in there around 10%, then even my latest upward revisions to earnings are too conservative.

Even assuming a "normal" cyclical decline in revenue growth to 5% by the end of this year would still imply profits could grow 10%. Any way that I slice and dice the numbers suggests that if world trade continues to boost the growth rate in business sales, then we should expect a positive profits surprise, possibly a very significant positive surprise!

LargeCaps Win The Derby. In my *Topical Study #70* titled "What's In Style?" and dated February 23, 2005, I explained why I believe that LargeCap stocks will outperform SmallCaps this year.[3] Here is my list of reasons:

- Over the business cycle, the worst environment for companies is just before and during recessions. At the tail end of economic expansions, the costs of doing business typically rise faster than revenues. Productivity gains are harder to achieve when capacity utilization is high.

[2] My previous targets were $77 per share for the end of this year and $82 per share for the end of 2006.
[3] See http://www.yardeni.com/pub/t_050223.pdf.

Table C: Ed Yardeni's Target Scenario (as of 3/22/05)

	S&P 500 **Forward EPS**	X	***S&P 500*** **Forward P/E**	=	***S&P 500***	***DJIA***
Mar 22, 2005	75.85		15.5		1172	10,471
Dec 2005	80.00*		17.0		1360	12,150
Dec 2006	86.00*		17.0		1462	13,000

2005 Scenarios: subjective probability and assumptions

Target: S&P 500 = 1326 (70% probability)

Economy: Real GDP increases 3.5%-4.0% during 2005. Consumer spending continues to grow as employment expands and real pay per worker increases along with productivity. Capital spending gets a boost from ample corporate cash flow, including a big inflow of repatriated earnings. Core inflation remains low around 2% as the price of oil stabilizes around $50 a barrel. The Fed raises the federal funds rate to 3 1/2% by the end of the year. The dollar falls to 1.35 euro by the end of 2005 and then starts a gradual recovery.
Earnings increase as profit margins remain near cyclical highs while business sales grow at solid pace. Sales are boosted by exports and profits are boosted by the weaker dollar.

Better: S&P 500 = 1450 (20% probability)

Liquidity pours out of savings deposits into the economy and the stock market as consumer confidence rebounds. M&A activity booms. The resulting consolidation removes some excess capacity in several industries and boosts profitability. U.S. employment grows at a faster pace. Home prices rise at 10%-plus pace.
Earnings grow above consensus expectations (i.e., 10%). Corporate operating leverage is better than expected and the quality of earnings improves significantly as write-offs plunge. The forward P/E rises because inflation and bond yields remain low.

Worse: S&P 500 = 800 (10% probability)

Economy falls into a recession as bond yields rise because foreign investors reduce their purchases of U.S. Treasuries. The weaker dollar boosts inflation. Wage inflation increases at a faster pace. The Fed raises the federal funds rate to 4 1/2%. The ensuing economic downturn averts higher inflation as fears of deflation resurface.
Geopolitical turmoil is widespread. Terrorists destabilize Saudi Arabia. Oil prices soar. China invades Taiwan. Commodity prices plunge. Iraq is torn by a civil war.

*** Options expensing likely to lower actual earnings in 2005 by $1.50 and in 2006 by $2.50.**

Source: yardeni.com

- Recessions are often triggered by credit crunches. This scenario is especially tough for smaller businesses, which are often at greater risk of going out of business than larger companies that have more financial resources and more ways to cut their costs. Therefore, during major bear markets, SmallCaps should drop faster than LargeCaps.

- During economic recoveries, SmallCaps should rebound faster because they should experience the greatest "relief rallies." Investors are relieved that the SmallCap survivors actually survived. Moreover, smaller firms have tremendous earnings leverage at this point, because credit conditions have already eased significantly and business activity is rebounding.

- As the expansion matures, SmallCaps should start to underperform partly because they are no longer cheap, and they are still riskier than larger, more mature companies. Also, larger companies may start to benefit more from their exposure to a rebound in the global economy, which often lags the U.S. upturn. The foreign-exchange value of the dollar is often weaker during economic expansion. This will tend to boost the profits of larger, multinationals more than the profits of smaller companies that might be more limited to the domestic market. This stylized business cycle model suggests that now is the time for LargeCaps to outperform SmallCaps.

Again, the business cycle suggests that sales and earnings growth rates peaked last year and should be lower this year. This seems to be happening for the SmallCaps. It isn't happening yet for the LargeCaps and MidCaps (Figures 10 and 11):

1) The yearly rate of change in S&P 600 SmallCap forward earnings peaked at 29.9% at the end of last year. In mid-March, it was down to 22.4%

2) The yearly rate of change in S&P 400 MidCap forward earnings peaked at 25.3% last summer. It is now down to 17.9%. But it seems to have stabilized around this rate since the beginning of the year.

3) The rate of change in S&P 500 LargeCap forward earnings peaked earlier last summer. Compared to MidCaps and SmallCaps, it peaked at a lower rate of 21.4%, but it has been coming down more slowly and has also been stable around 18.0% since the start of the year.

4) The 13-week percentage changes in these three forward earnings confirm that SmallCap earnings momentum is decelerating much faster than the comparable growth rates for LargeCap and SmallCaps (Figure 11).

All this makes sense in the context of my thesis that globalization is very profitable for companies that benefit from more trade. Large companies are more likely to do so than smaller ones.

Winning Sectors. Let's drill down now to see which sectors within the S&P 500 LargeCap universe are benefiting from globalization. We have compiled a database of forward earnings for the 10 sectors as well as 113 of the major industry groups in the

S&P 500. Our *Earnings Month* shows how all these data are derived using our Earnings Squiggles™ charting methodology.[4] Looking at the forward earnings of the 10 sectors from 1997 through March 2005, here is what I find (Figures 12, 13, 14, and 15):

1) The best short-term momentum is in Energy, Materials, and Information Technology. All three are rising faster than the forward earnings of the S&P 500. Energy has been nearly vertical since early 2004. Materials has been outpacing the S&P 500 since mid-2003. Information Technology recovered smartly in 2003 through mid-2004, but then forward earnings stalled. In the past few months, it's back to the races for IT.

2) Keeping pace with S&P 500 forward earnings in recent months are Consumer Staples, Industrials, and Utilities.

3) Losing momentum in recent months are Financials, Health Care, Consumer Discretionary, and Telecommunications Services.

I believe this pattern is broadly consistent with my globalization theme. The sectors that have the most global exposure are showing the best earnings momentum. The ones with the most domestic exposure are losing momentum.

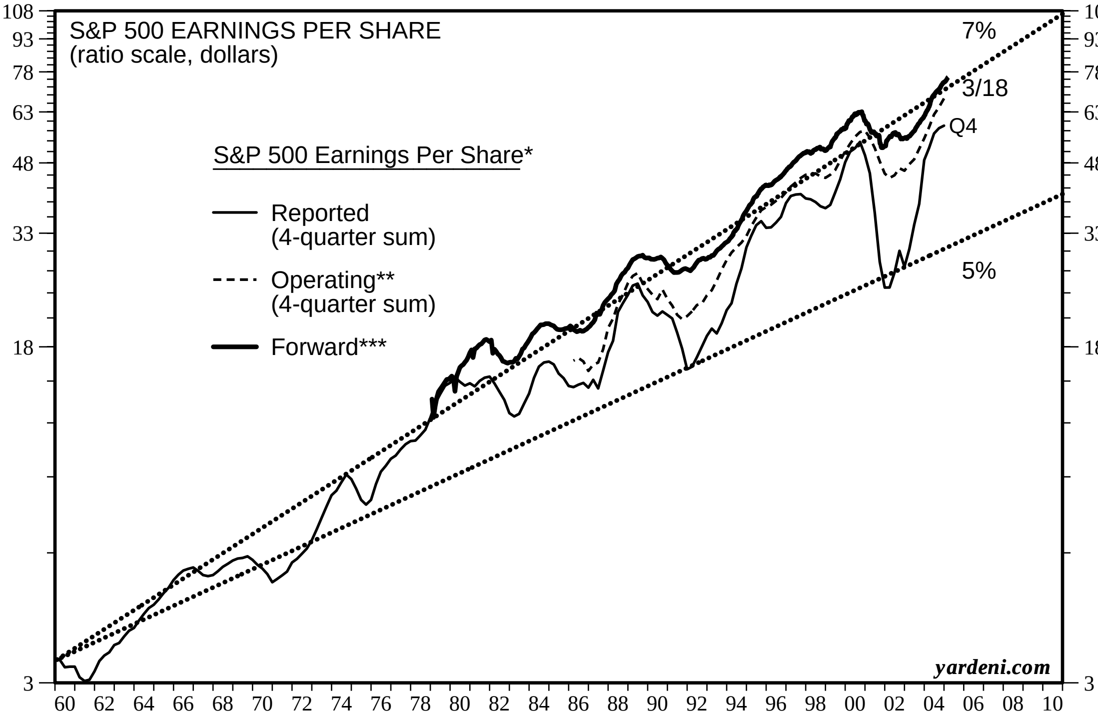
* * *

[4] See http://www.yardeni.com/pub/em.pdf.

- Forward Earnings -

Earnings are back on 7% long-term trendline. Growth rate might exceed trend growth this year.

Figure 1.



* Growth paths are compounded monthly to yield 5% and 7% annually.

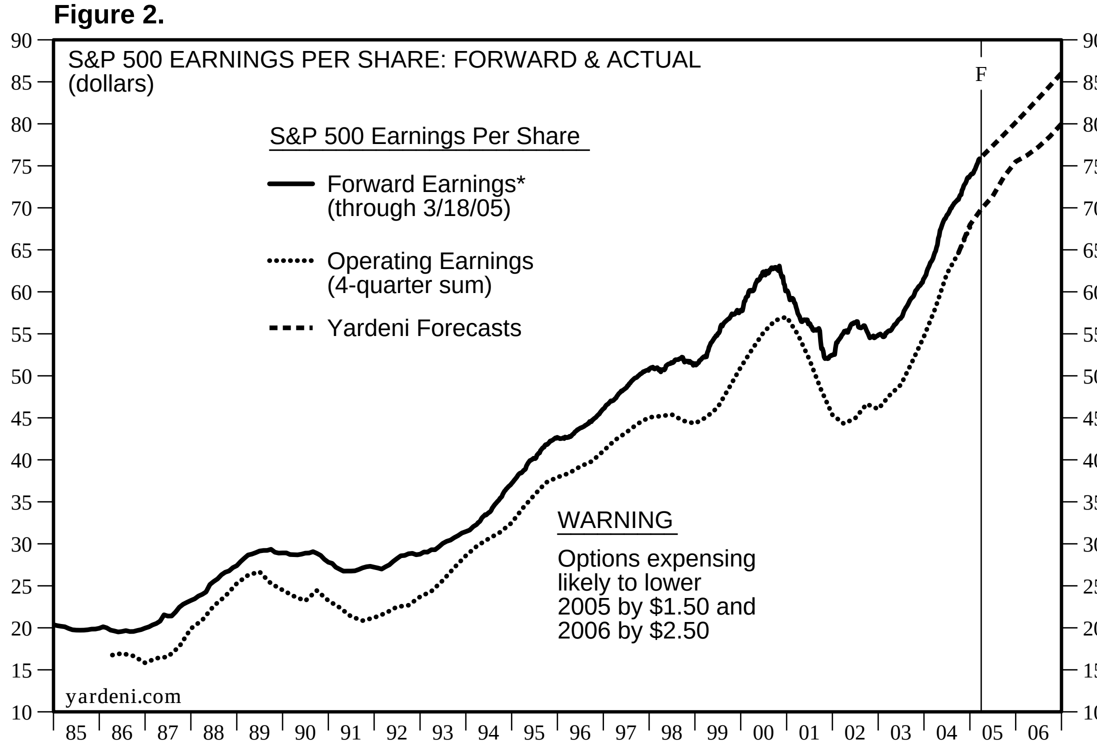
** Excludes write-offs.

*** 52-week forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current and next year's consensus earnings estimates. Monthly through April 1994; weekly thereafter.

Source: Standard & Poor's Corporation and Thomson Financial.

I am raising my forward earnings targets to $80 and $86 for the ends of 2005 and 2006, respectively. (Previously used $77 and $82). Projecting that actual earnings will be up 12% and 6% in 2005 and 2006.

Figure 2.



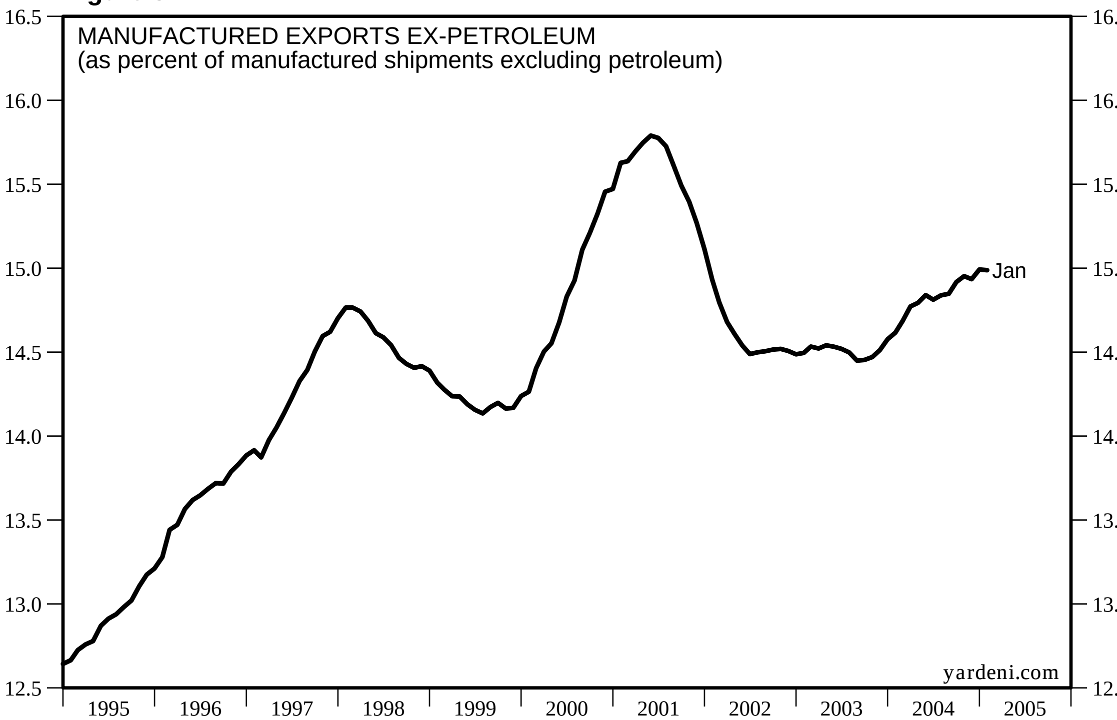
* 52-week forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current and next year's consensus earnings estimates. Monthly through April 1994; weekly thereafter.

F = Ed Yardeni's forecasts as of March 21, 2005.

Source: Thomson Financial.

- U.S. Manufacturers Exports -

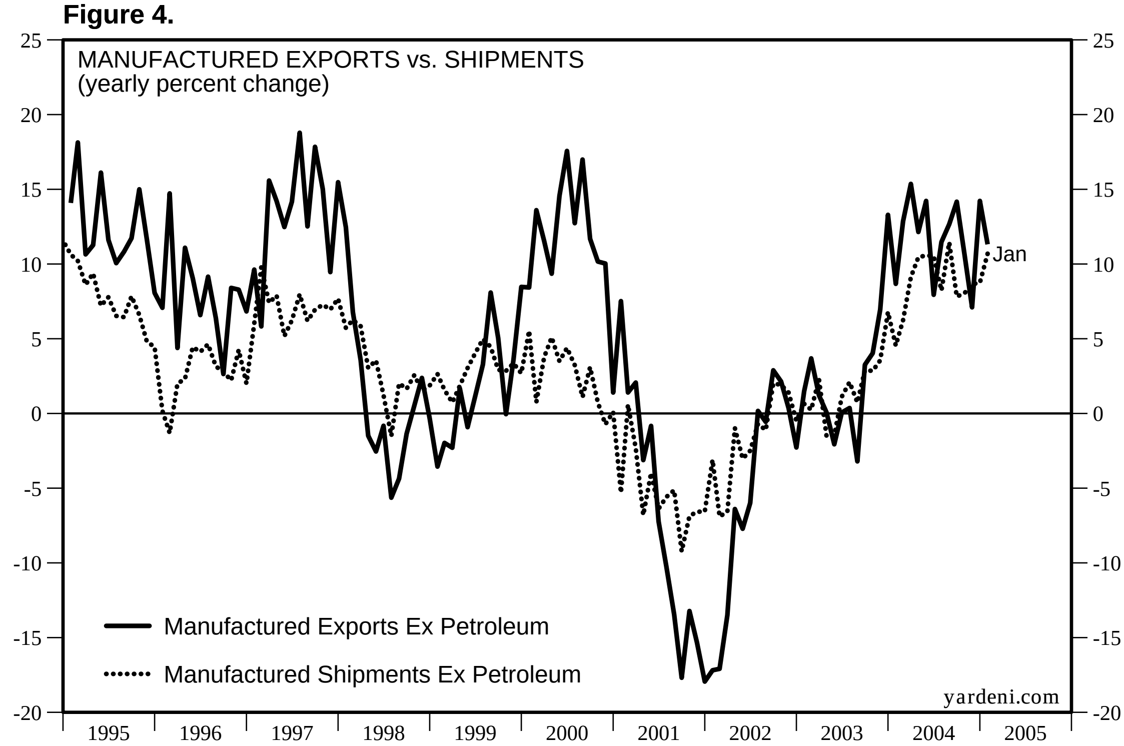
Figure 3.



Source: Department of Commerce.

Exports account for 15% of nominal factory shipments and are an important source of sales growth for manufacturers.

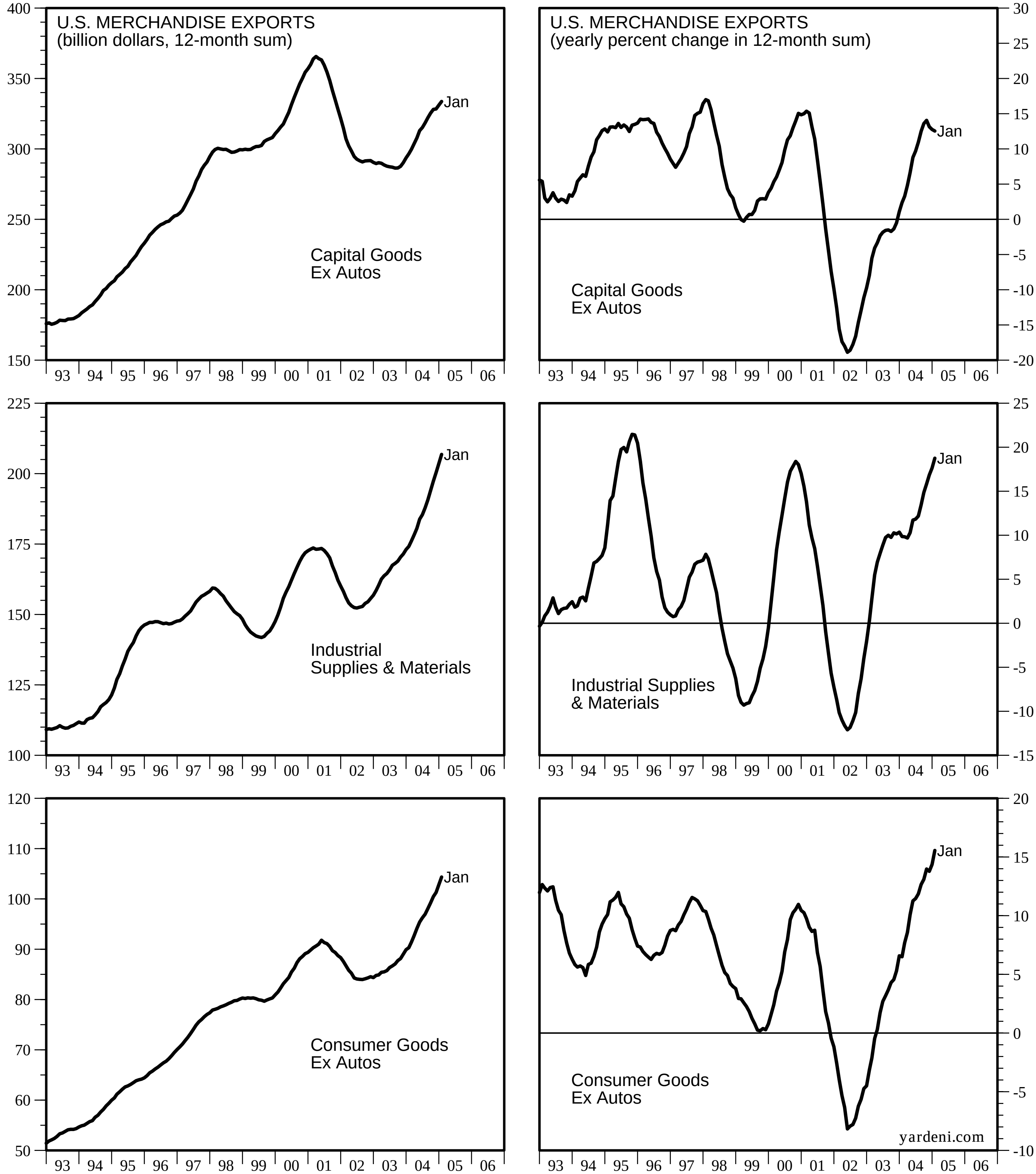
Figure 4.



Source: Department of Commerce.

- U.S. Manufacturers Exports -

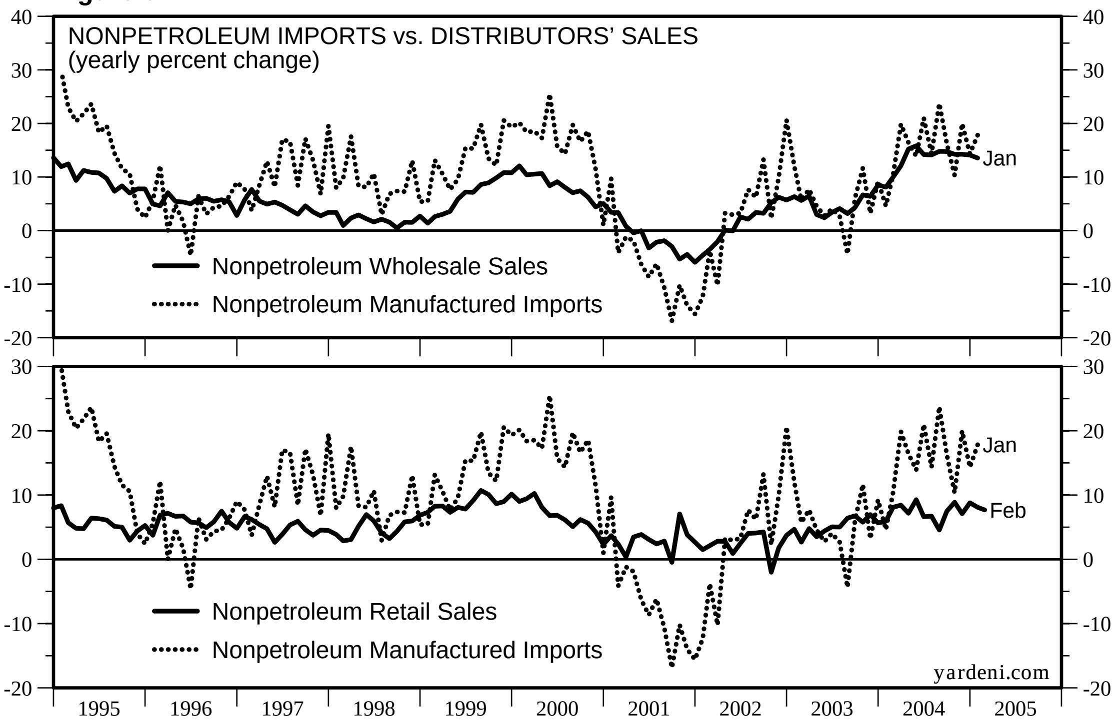
Figure 5.



Source: U.S. Department of Commerce, Bureau of the Census.

- Distributors' Sales & Imports -

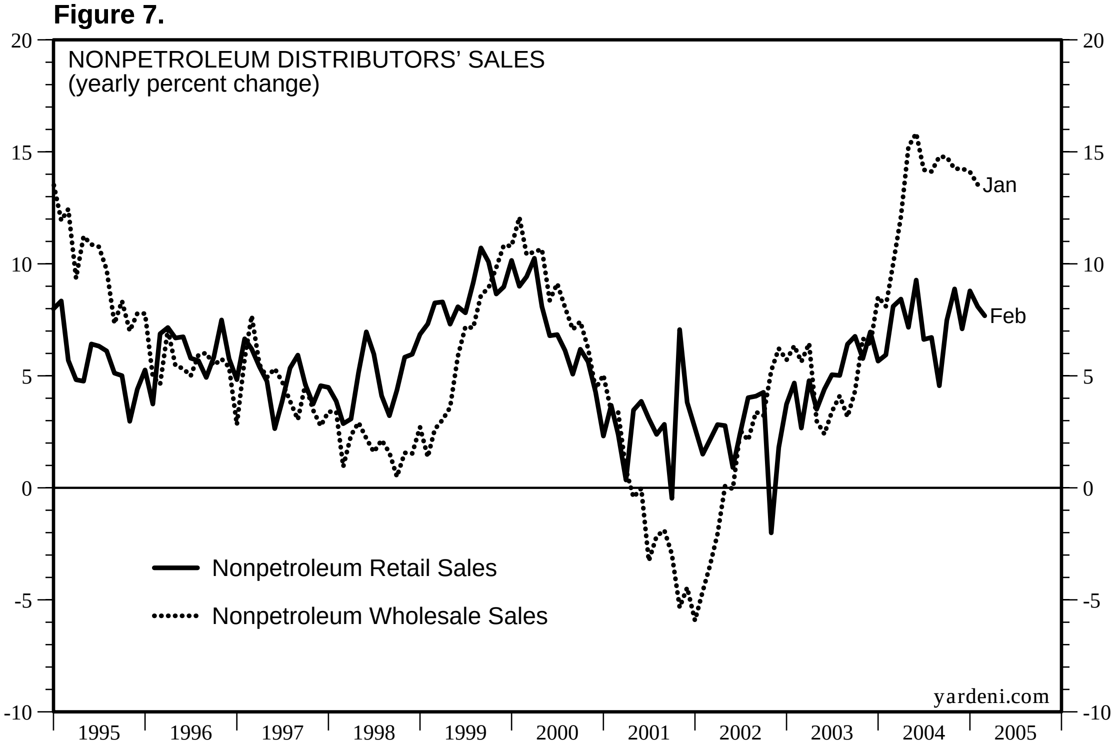
Figure 6.



Source: Department of Commerce, Bureau of the Census.

Good correlation between distributors' sales and imports

Figure 7.

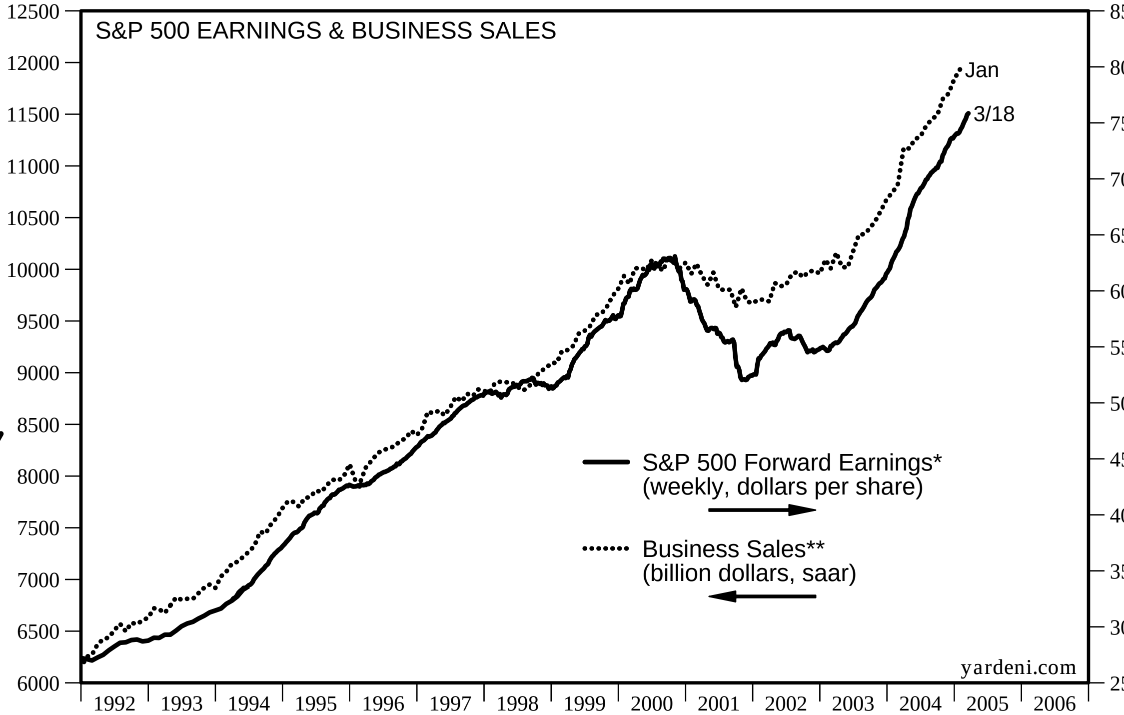


Source: Department of Commerce, Bureau of the Census.

- Business Sales & Earnings -

S&P 500 forward earnings are highly correlated with business sales. Notice that earnings tend to grow twice as fast as sales. The growth rates of both are probably at a cyclical peak.

Figure 8.

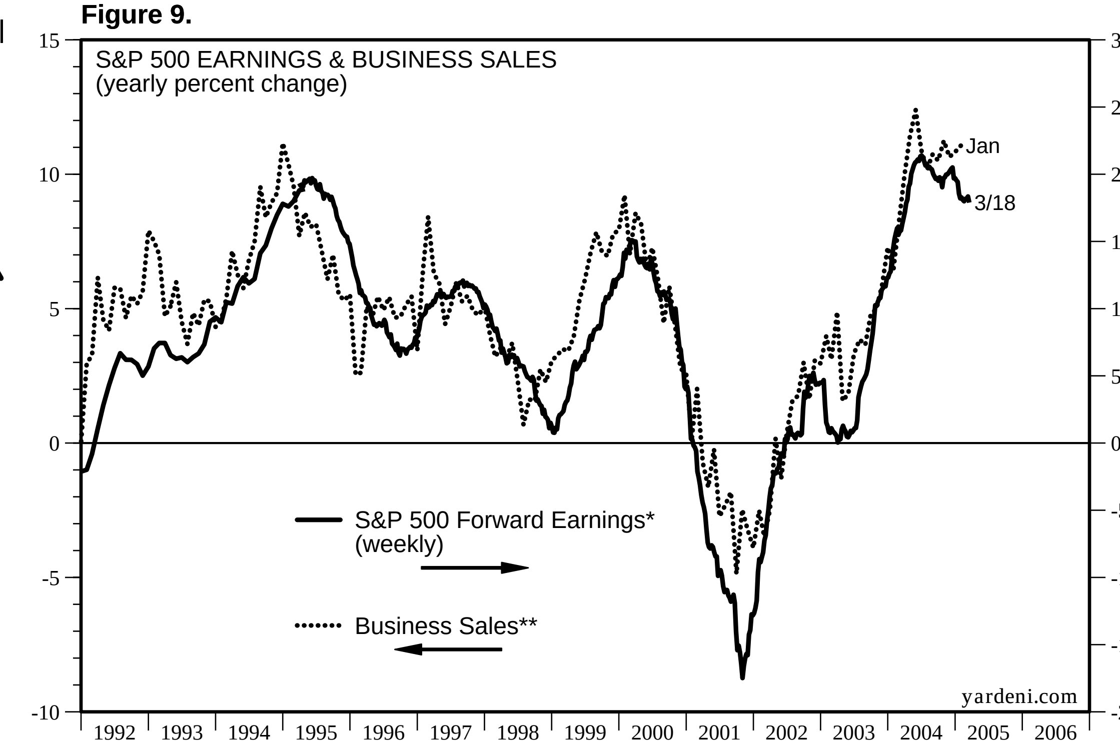


* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly thereafter. Time-weighted average of current and next year's consensus earnings estimates.

** Manufacturing and trade sales.

Source: Thomson Financial and U.S. Department of Commerce, Bureau of the Census.

Figure 9.



* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly thereafter. Time-weighted average of current and next year's consensus earnings estimates.

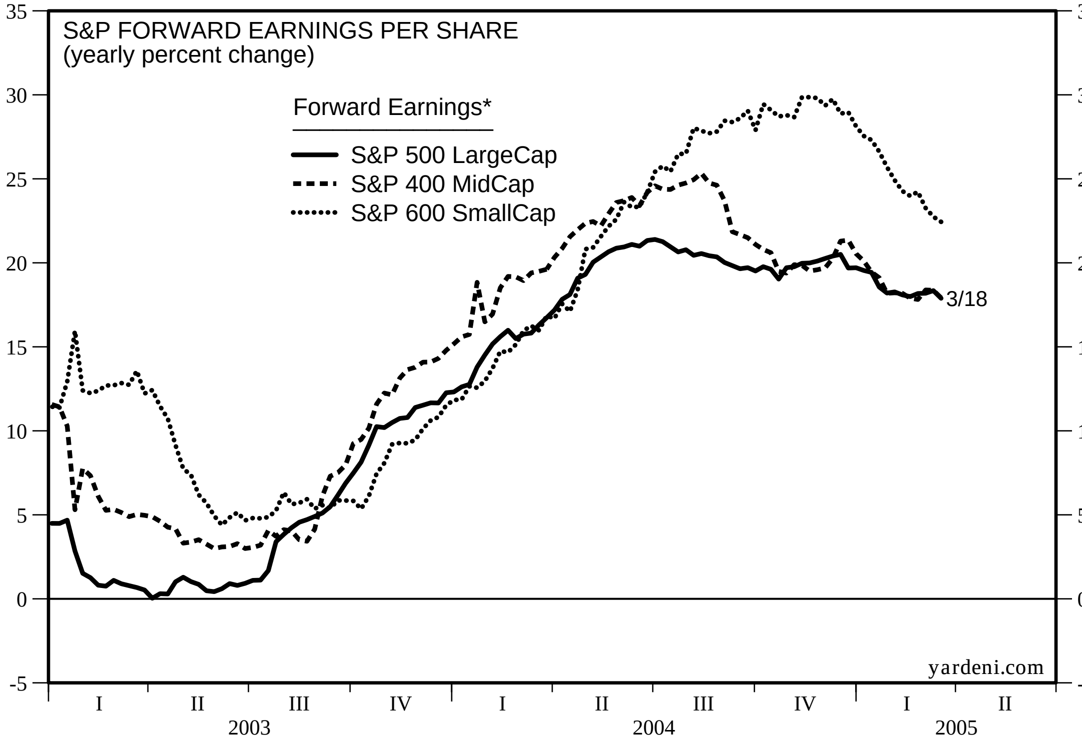
** Manufacturing and trade sales.

Source: Thomson Financial and U.S. Department of Commerce, Bureau of the Census.

- Forward Earnings Change -

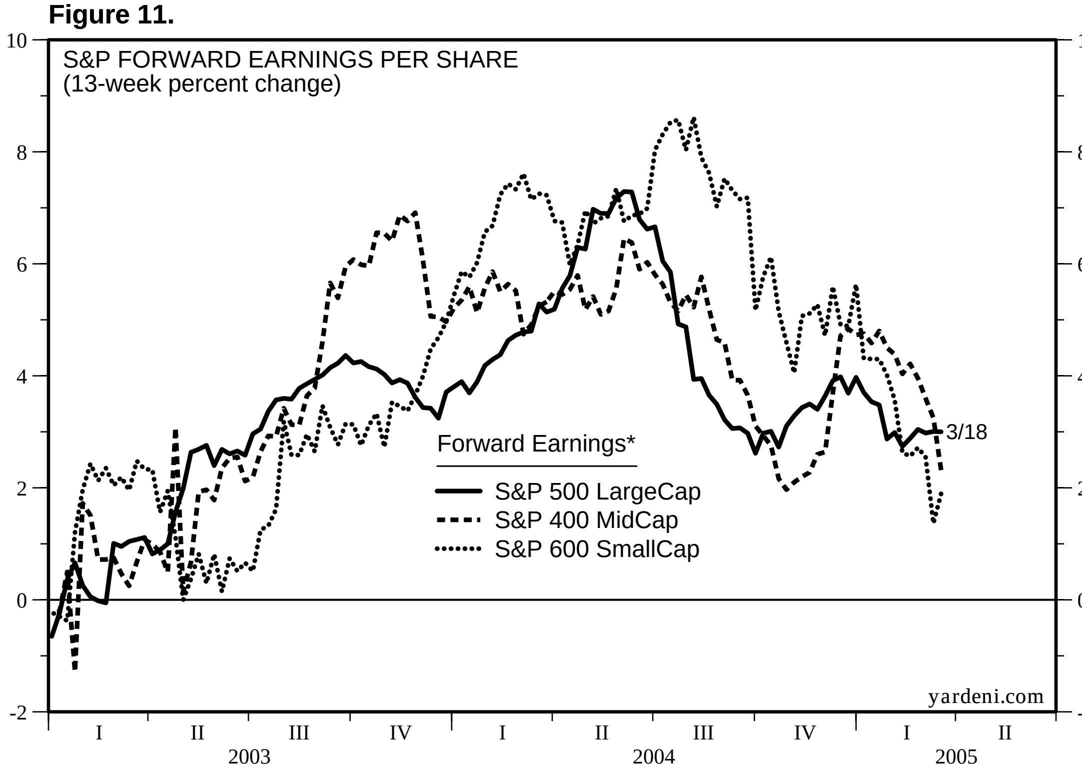
SmallCaps enjoyed the best earnings recovery, but now the rate of change is slowing faster relative to both LargeCaps and MidCaps.

Figure 10.



* 52-week forward consensus expected operating earnings per share. Time-weighted average of the current year's and next year's consensus forecast.
Source: Thomson Financial.

Figure 11.

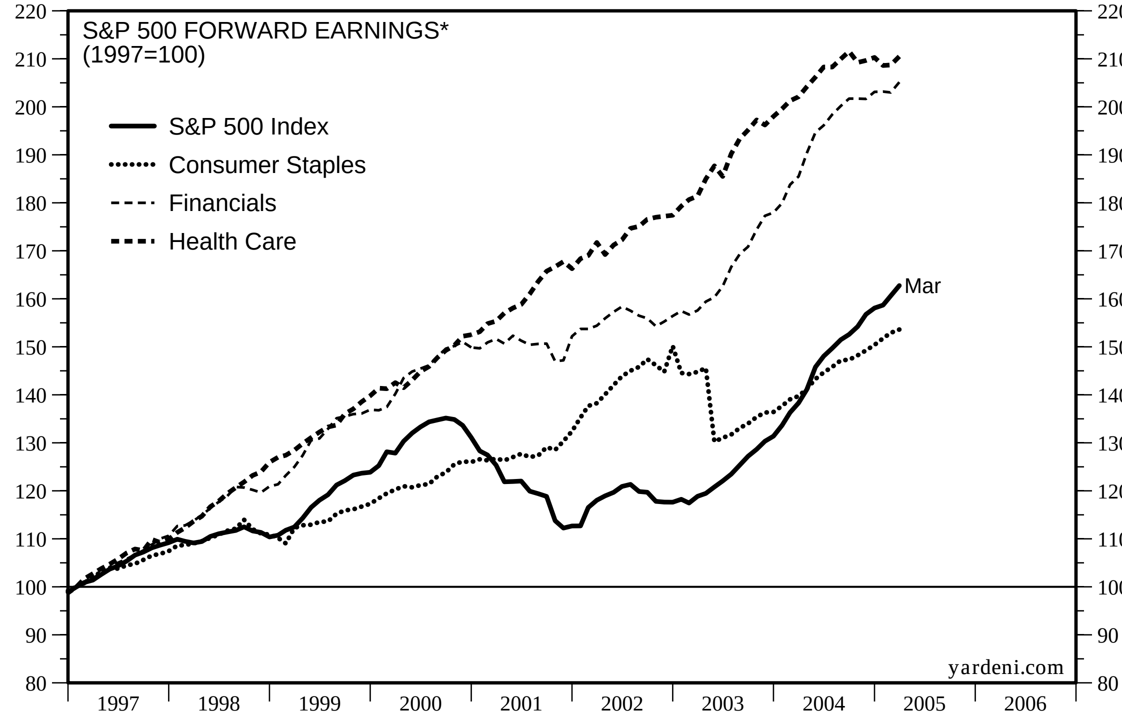


* 52-week forward consensus expected operating earnings per share. Time-weighted average of the current year's and next year's consensus forecast.
Source: Thomson Financial.

- Relative Earnings: S&P 500 Sectors -

Among these relatively stable earnings growers, Financials and Health Care are losing momentum. Consumer Staples on solid uptrend.

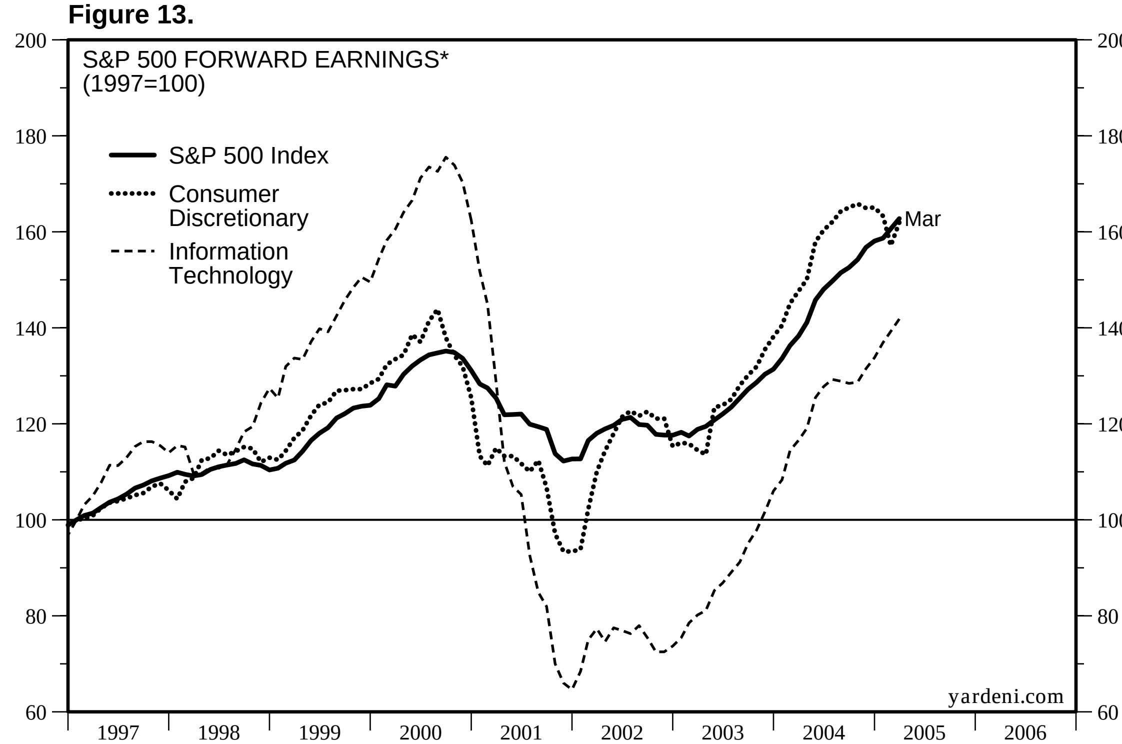
Figure 12.



* 12-month forward consensus expected operating earnings per share. Time-weighted average of current and next years' consensus forecasts.
Source: Thomson Financial.

Among these cyclicals, Consumer Discretionary is turning down led by Autos. Technology is turning up led by Systems Software and Computer Hardware.

Figure 13.

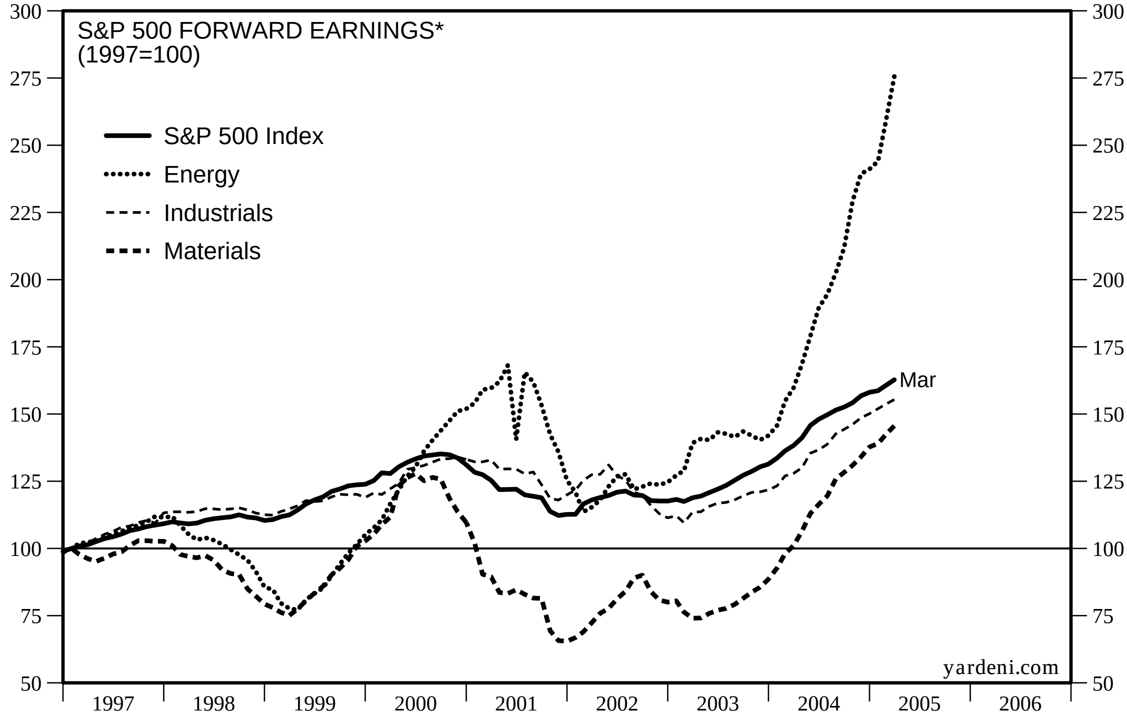


* 12-month forward consensus expected operating earnings per share. Time-weighted average of current and next years' consensus forecasts.
Source: Thomson Financial.

- Relative Earnings: S&P 500 Sectors -

Among these Basics, Energy is soaring, while Industrials and Materials are in cyclical upswings.

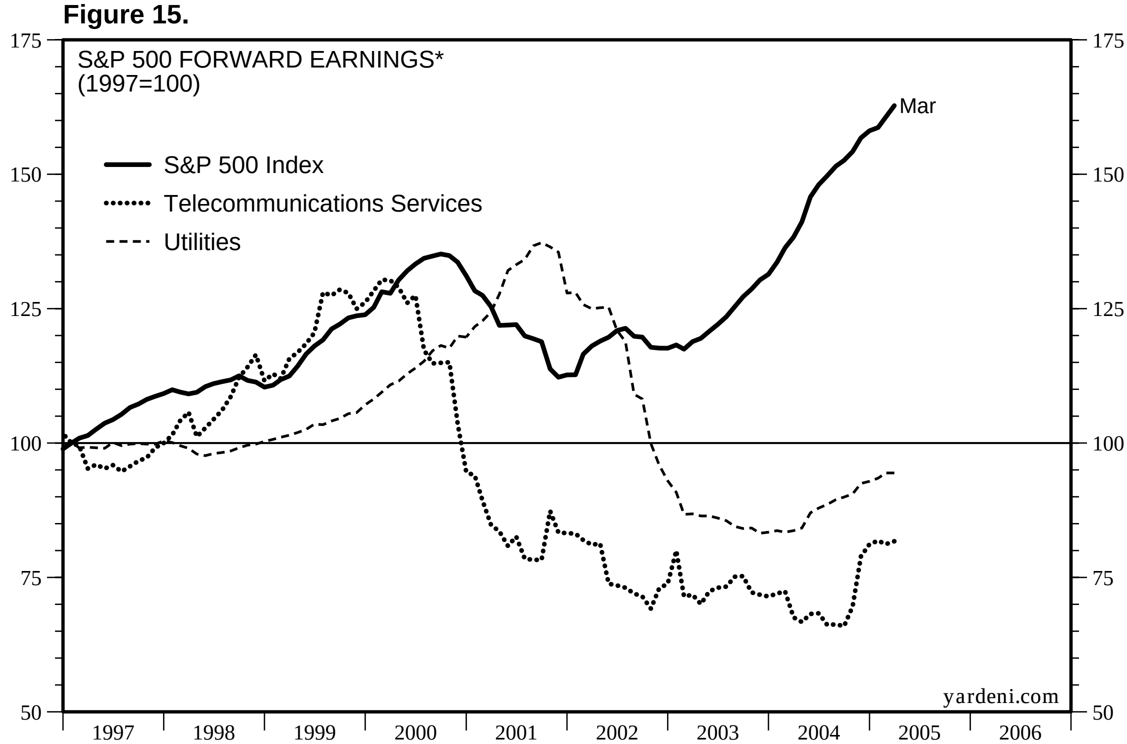
Figure 14.



* 12-month forward consensus expected operating earnings per share. Time-weighted average of current and next years' consensus forecasts.
Source: Thomson Financial.

These utilities are bottoming.

Figure 15.



* 12-month forward consensus expected operating earnings per share. Time-weighted average of current and next years' consensus forecasts.
Source: Thomson Financial.

Additional Information Available on Request.