The stock market is a weighing machine in the long run

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INSIDE CURVE

The short-term direction of the stock market is always tough to predict. Right now, though, it is particularly so. That is because there are two offsetting factors working against each other, and it is difficult to know which one will win out.

First, the bull case: valuation. At its present value of about 15 times estimated 2007 operating earnings, the *S&P* 500 index is not overvalued by historical measures. This is especially true when taking into account the low level of interest rates on long-term US Treasury bonds of about 4.6 per cent. At this interest rate level, bond investors are essentially paying 21.7 times pre-tax "earnings" (interest payments) from Treasury bonds. For an investor in the 30 per cent tax bracket, the after-tax interest yield on Treasuries becomes about 3.2 per cent, implying a bond price/earnings ratio of 31 (one divided by 3.2 per cent).

Compare this with an after-tax p/e of 15 for stocks, and stocks would seem to be at a big discount to bonds. This valuation difference is increased when one takes into account the tax advantages of owning stocks (the ability to defer capital gains indefinitely) and the fact that earnings tend to rise over time, providing some measure of relief from inflation. With a bond, no matter what happens with inflation the interest pay-out never changes, so you are not protected.

By this logic, stocks would seem to be a screaming bargain at today's prices. For a taxable investor, stocks sell at about a 50 per cent discount to. Treasury bonds and even sell at a discount to most corporate bonds.

(On a side note, there is a reason' this gap will probably never close. Investors consider bonds to be less risky, with "risk" defined as volatility of cash flows. In the long run, an investor is almost assured of getting a better after-tax return from stocks than bonds but, as John Maynard Keynes said, in the long run we are all dead. A huge proportion of investors gladly gives up the assurance of greater long-term wealth for the assurance of lower short-term volatility. Because stocks offer no guarantees, investors who are afraid of volatility avoid them. This is irrational in my view, but the majority does not agree with me.)

But even though relative valuation levels paint a bullish picture for stocks, another factor is working to offset this: declining earnings expectations.

In August I wrote an article about earnings expectations and stock price movements. Stocks with increasing consensus earnings estimates tend to go up, even when the overall market is weak. In that article, I recommended MasterCard at $53.30 (up 101 per cent since the article appeared) and Chipotle Mexican Grill (up 25 per cent) because analysts' earnings expectations were rising.

In a follow-up article in October, I wrote about CBOT Holdings, another stock with rising earnings expectations.

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That stock is up 62 per cent since the article appeared. If you can identify stocks where the consensus earnings outlook is too low and due to rise, you can make easy money. (Don't quit your day job - it is very hard to identify these types of stocks and you are competing against hundreds of hedge funds that are trying to find these same stocks.)

Valuation takes a back seat to momentum when earnings estimates are in flux. To put it another way: when analysts' near-term earnings estimates are going up, an overvalued stock will probably continue to rise despite its rich valuation. And by the same token, an undervalued stock will stagnate or decline further while analysts' earnings expectations are falling.

And that is what worries me about the US stock market today. In spite of an attractive valuation, the consensus earnings expectation for the S&P 500 index is probably going to come down as we go through this year. In the past few months, stock analysts have been ratcheting down their first-quarter earnings expectations for US companies and continue to do so.

According to Briefing.com, the expected first-quarter earnings growth for S&P 500 companies has fallen from 8.2 per cent two months ago to 6 per cent one month ago, to less than 5 per cent today. When the expected growth rate in earnings is declining, stocks will go down no matter what their valuation level.

So far, though, analysts have not taken down their full-year 2007 estimates very much, despite revising downward the next couple of quarters. Apparently analysts expect faster growth in the second half of this year to make up for slower growth in the first half. If this turns out not to be the case, look out below.

Investors who are worried about the next six to 12 months should be careful. To paraphrase Benjamin Graham, in the long run the stock market is a weighing machine. In the short run, it is a voting machine. Valuation is more "weighty" in the long term but, for the rest of this year, declining expectations may cause investors to vote against stocks.

• Last month, I wrote that Charles de Vaulx had been the sole manager of the First Eagle Global fund since 1999. This is incorrect. Although de Vaulx has worked on the fund for many years and has managed it since January 1 2005, the legendary fund manager Jean Marie-Eveillard managed the First Eagle Global fund until the end of 2004, when he retired.

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