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STRATEGIES

## If Profits Grow, How Can the Market Sink?

By MARK HULBERT

**T**HE faster corporate earnings grow, the better the stock market performs. That is a tenet of Wall Street, but like so much other conventional wisdom, it turns out to be false.

In fact, since 1927, according to data from Ned Davis Research of Atlanta, the market has performed best during quarters when earnings are as much as 25 percent below year-earlier levels. When earnings are growing strongly, as many expect them to do this year, the market has tended to have below-average performance.

Of course, these findings for the overall market run counter to the experience of specific companies. For many of them, the relationship of earnings growth and stock price is often positive - especially when a company exceeds profit expectations.

But according to a recent study, it makes sound economic sense that what sometimes prevails for one company does not apply to the overall market. The study, "Stock Returns, Aggregate Earnings Surprises, and Behavioral Finance," by S. P. Kothari, an accounting professor at the Massachusetts Institute of Technology; Jonathan W. Lewellen, an M.I.T. finance professor; and Jerold B. Warner, a finance professor at the University of Rochester, has been circulating as an academic paper since last year. A copy is at <http://papers.ssrn.com>

/abstract=380127.

The reason that the overall market usually fails to react more favorably to rapidly rising earnings is not that earnings growth is bearish itself. The problem, the professors say, is that such growth usually leads to higher interest rates. When rates rise, the net present value of future earnings, cash flow and dividends automatically falls, and this generally causes the market to decline.

The professors say the Federal Reserve is unlikely to feel pressure to raise rates when just one company reports better-than-expected earnings. So the company's profit growth can be expected to translate into a

higher stock price. But the Fed will certainly feel that pressure when aggregate market earnings rise quickly.

To be sure, the professors' findings are based on a long-term average, and exceptions are inevitable. One occurred in the last couple of years, when earnings grew at a double-digit rate and the overall market performed well, too. But Professor Lewellen says that this recent experience is "the exception that proves the rule," because the Fed kept interest rates artificially low over much of this period. That prevented the fast growth of marketwide earnings from having usual negative consequences.

The powerful role of interest rates in the stock market's valuation also explains why the market tends to perform best when aggregate corporate earnings are falling. Ned Davis Research says that since 1927, the Standard & Poor's 500-stock index has risen at a 28 percent annualized rate - nearly triple its historical average - during quarters in which earnings were 10 to 25 percent lower than where they were in the periods a year earlier.

This bullish effect vanishes, however, when earnings are falling too much. Ned Davis Research found that during those few quarters since 1927 when earnings were more than 25 percent below their year-earlier levels, the S.& P. 500 declined at a rate of 28 percent, annualized. Professor Lewellen says that this is consistent with the results of his research. "The positive effects of lower interest rates, though strong enough to overcome the negative consequences of more modest declines," he said, "are unable to overcome them when earnings are falling by a huge amount."

An implication of the professors' study is that the market's performance is likely to be below average this year, because of the consensus expectation for double-digit profit growth accompanied by rising interest rates. S.& P. estimates that per-share operating earnings of the S.& P. 500 companies in the first quarter will be 14 percent higher than in the year-earlier period. Earnings for all of 2005 are projected to grow 12 percent. In quarters since 1927 when profit growth has been in the neighborhood of what S.& P. is projecting this year, according to Ned Davis Research, the S.& P. 500 has appreciated at an annualized pace of 5.8 percent. That is about half the market's long-term average rate.

The pattern discerned by the professors could create buying opportunities down the road. That is because investors tend to drive market valuations way down when interest rates rise over a sustained period. A diversified stock portfolio bought at a time of depressed valuations can be expected to appreciate when interest rates fall. But if the pattern holds this time, it's way too early for the market to start going much higher.

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