

Earnings, not emotions, win in the end.

Negative emotions have been running high this year as our attention has jumped from one issue to the next. The year began with worries that the housing and financial crisis would send the U.S. economy into a recession. Our worries shifted to the incredible run up in the price of oil. This has made the cost of living and manufacturing soar. The most recent reading on Consumer Price Index (CPI) shows the cost of living increasing at a rate of 4.2%. We have not seen prices rise this fast since the early 90's. This increase in prices has individuals worrying about inflation and the effect it will have on them.

Do we need to worry about a recession, inflation or both? A recession is defined as a significant decline in general economic activity extending over a period of time and is normally associated with periods of high unemployment. Inflation is the persistent and appreciable rise in the prices of goods and services normally associated with periods of expansion and high employment.

By definition, it is hard to have both a recession and inflation coexist for very long. If the economy is slowing demand, prices and employment all go down thus eliminating inflation.

There are 2 CPI numbers; one that factors in energy and food, the other without. This is called the core rate. We all eat, drive and use electricity so the 4.2% hike is what we are feeling in our day to day lives. It is easier to predict what the rate of inflation will be in the future without the effects of food and energy.

Over the last 18 months, the price of oil has increased over 70%. Factoring out the inflation caused by oil should give us an idea of inflation caused by economic growth. Excluding food and energy from the CPI you will find that underlying economic inflation is 2.2%. This would tend to point to inflation being under control once the jump in oil prices has worked its way into the CPI.

The Federal Reserve has signaled that the economy is doing better than they had feared a few months ago but that we aren't out of the woods yet. They feel the economy has slowed and feel that a recession (negative growth) may have been avoided.

These concerns, which have no easy answers, have the average individual wondering what to do. The

Conference Board measures consumer confidence. The June reading was the lowest in 16 years and the 5th lowest in history. Without confidence, emotion starts to take over. This is what is currently fueling the market. The first half of the quarter, the S&P 500 was up 3.5%. The second half of the quarter, the S&P 500 gave up this gain plus some, ending the quarter down almost 3%. This happened with much of inter day volatility and makes it hard to be optimistic.

One of the keys to successful investing is factoring out the emotion caused by short-term events. Over time, stock prices move in the same direction of earnings. If you look at the S&P 500 you will find that the companies in it are projected to grow their earnings 9% over the next 12 months.

If you break the S&P 500 down into sectors you will find only three sectors are projected to have earnings decline. The largest is financials where earnings are predicted to fall 22%. The consumer discretionary sector, which includes home builders, earnings are projected to drop 2%. The telecommunications sector's earnings are expected to contract 1%. If you factor these 3 sectors out of the S&P 500 earnings growth would be 12.42%.

Both emotions and earnings are telling us to stay out of the stock of companies in the banking and home building businesses. Emotion has brought the entire market down. This has made many stocks a good value on a price to earnings basis. As we stated in our last newsletter, we feel the market set its bottom in January and March of this year and will end the year higher than it is today. Worries over the run up in oil prices and inflation have caused the market to test these lows again in June.

Marshall & Sullivan's portfolios compare well to the market with the average company projected to grow their earnings at over 14%. As the year progresses and earnings growth becomes clearer, we will add companies to our portfolios. We will stay away from financials and companies in the homebuilding industry not because of emotion but because they are not growing their earnings.

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