

August 11, 2008

Gary Thayer, Senior Economist

## Trend Earnings, Market Valuations and Economic Fundamentals

Long-time readers of The Week are familiar with the Wachovia Securities market analysis based on trend earnings. This approach to market valuation compares the current value of the S&P 500 index with the long-term trend of the composite earnings of the companies that make up the S&P 500. When the stock market rallied faster than the growth in trend earnings, the price-to-trend-earnings ratio would increase indicating potential market over-valuation. Similarly, when the stock market declined relative to the growth in trend earnings, the market became potentially under-valued.

The art of market analysis involved discerning when the market was significantly overvalued or undervalued relative to trend earnings. This disciplined approach helped investors determine when it was better to be "lightening up" rather than "loading up" on equities. Unfortunately, history shows that markets can stay overvalued or undervalued for extended periods of time. This meant that investors using trend earnings as a guide could get out of a market advance too early or jump into a market decline too soon. Adding economic fundamentals to this analysis helps explain why market valuations move above long-term trends some times and below long-term trends other times.

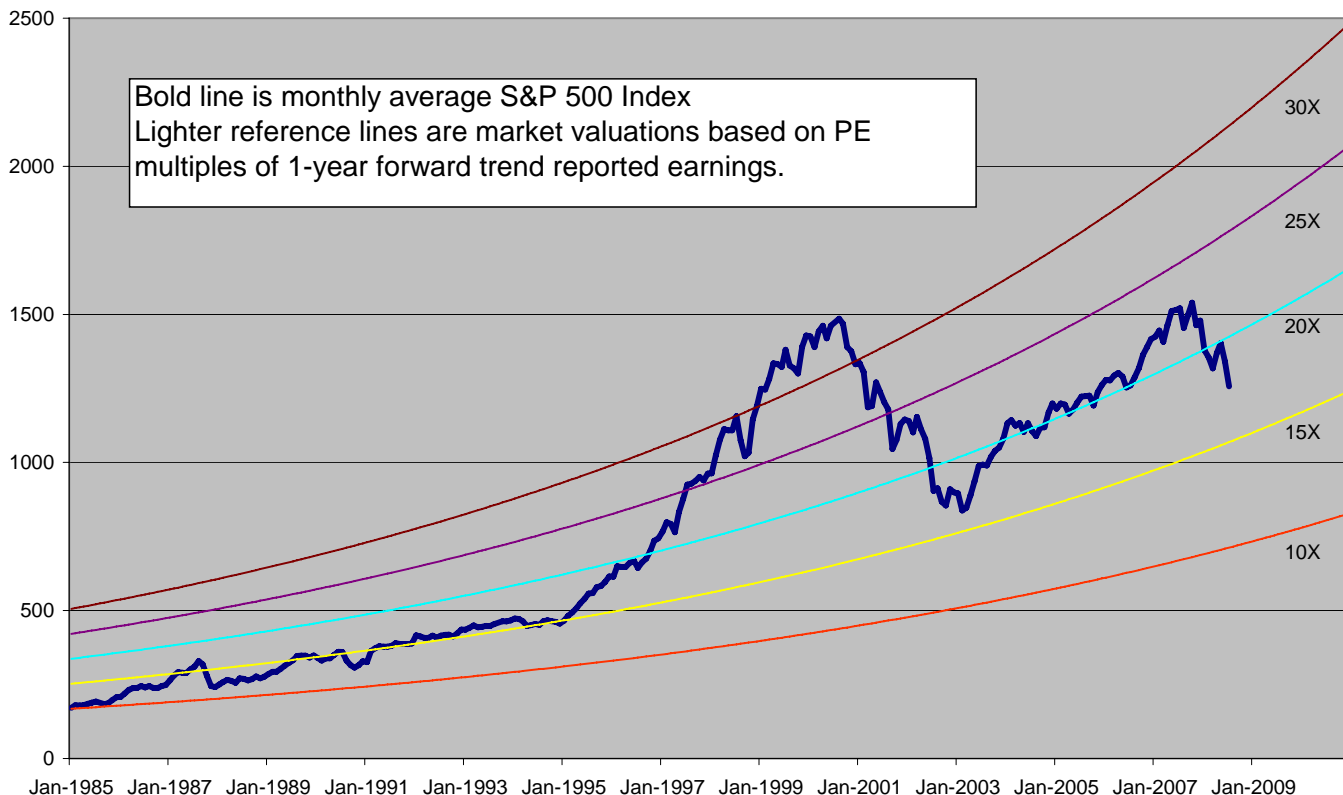
Our work shows that three economic factors can account for a great deal of the variation in market values versus long-term trend earnings. These factors are widely watched by many investors and changes in these fundamentals can affect market psychology. They include the rate of inflation, the level of unemployment and the size of the federal budget deficit as a percent of gross domestic product (GDP). Our analysis shows that market valuations can stay high when inflation is low, unemployment is low and the budget deficit is small. The confluence of these conditions appears to have boosted market valuations far above long-term trends in the late 1990s.

Unfortunately, these conditions changed during the past decade. In particular, the rise in inflation, the increase in unemployment and the growth in the budget deficit during the past year have weighed on market sentiment and reduced market valuations relative to trend earnings. In other words, the decline in market valuation relative to long-term trend earnings this past year was partly because of deteriorating economic fundamentals not just a return-to-trend market correction. This analysis indicates that investors should look at economic fundamentals as well as technical analysis in order to determine when the stock market is likely to return to trend growth.

At this point, the S&P 500 appears to be below the level of valuation consistent with the current inflation rate, unemployment rate and budget deficit. However, that undervaluation is not as extreme as it has been at some previous market bottoms. That does not mean that the market has to go lower. An improvement in the economic fundamentals could make current market valuations even more attractive. Unfortunately, the employment situation is likely to get worse before it gets better. In addition, the government is projecting a larger budget deficit during the next year. This means that inflation is critical to market valuations going forward in our view. The good news is the recent downturn in commodity prices may dampen inflation in coming quarters. This may increase market valuation relative to trend earnings. We believe this partly explains why the stock market has recovered modestly since commodity prices turned down in July.

## Chart of the Week:

### S&P 500 Index vs. Trend Earnings Valuations



*For illustrative purposes only. This does not reflect the performance of any specific investment. Past performance is no guarantee of future results*

Sources: Wachovia Securities, Haver Analytics

**Gary Thayer**

*Technical analysis is based on the study of historical price movements and past trend patterns. There is no assurance that these movements or trends can or will be duplicated in the future.*

*Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.*

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The S&P 500 is an unmanaged, weighted index of 500 stocks providing a broad indicator of price movement. Individual investors cannot directly purchase an index.  
**Additional Information Available Upon Request**

Wachovia Securities is the trade name used by two separate, registered broker-dealers and nonbank affiliates of Wachovia Corporation providing certain retail securities brokerage services: Wachovia Securities, LLC, Member NYSE/SIPC, and Wachovia Securities Financial Network, LLC, Member FINRA/SIPC. A.G. Edwards is a division of Wachovia Securities, LLC, Member SIPC 0808-95286

Securities and Insurance Products		
Not Insured by FDIC or Any Federal Government Agency	May Lose Value	Not a Deposit of or Guaranteed by a Bank or Any Bank Affiliate