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I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

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STANDARD & POOR'S 500 EARNINGS

How Much Will They Grow And Will Stocks Advance Further?

Earnings forecasts for the Standard & Poor's 500 Index (S&P) are one of the most important factors impacting the stock market. While such forecasts may use sophisticated analytical tools and high powered computer models, in the end, they are subject to a great deal of subjectivity and revision.

These forecasts are primarily generated by either economists or security analysts. Each has a very different methodology and their forecasts may differ markedly. The economist takes a holistic "top down" approach, focusing on trends in the overall economy, worker productivity, consumer liquidity, interest rates, foreign exchange rates, and a comparison of inflation rates for the cost of production versus selling prices to the consumer. Analyzing these general trends and relationships between various sectors of the economy, the economist arrives at an estimate of upcoming corporate profitability.

Security analysts, on the other hand, focus on a select number of companies primarily in a single industry sector. They project specific company earnings based on a micro analysis of that particular sector. While they often work with models of company income statements, they are also guided by interviews with company management as well as suppliers to the company and buyers of products from the company. When the analysts' estimates are aggregated for all 500 companies in the S&P, then Wall Street has a "bottoms up" estimate.

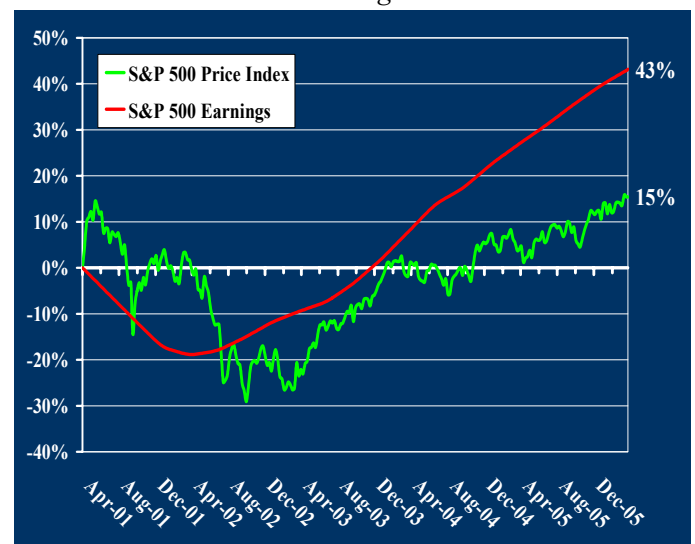
The results of these two methods can vary significantly. In the beginning of 2005, economists expected earnings for last year to rise about 6%, whereas the aggregation of analysts' estimates projected a 10% increase. Earnings actually rose 14%, more than double the growth originally projected by the economists and 40% higher than projected by security analysts.

A similar disparity exists at the outset of 2006, with economists projecting S&P earnings to rise 6% and the security analysts 12%. The more conservative economists'

estimates expect a deceleration in consumer spending later in the year as well as a softening housing sector in response to higher interest rates. Weakness in those sectors could have a dampening influence in the balance of the economy. The security analysts, on the other hand, expect profitability to improve later in the year based on discussions with corporate management.

Stock prices generally move in tandem with earnings. Over the past five years, however, stocks did not keep pace with earnings growth. They declined more than earnings during 2002, and during the subsequent rebound, the S&P Index also lagged strong earnings growth. Last year, for example, the S&P Index had a marginal price gain of a mere 3.0% when earnings surged at a double digit pace. As a result, the 15% rise in the S&P Index over the last five years is quite shy of the 43% earnings gain (Chart I).

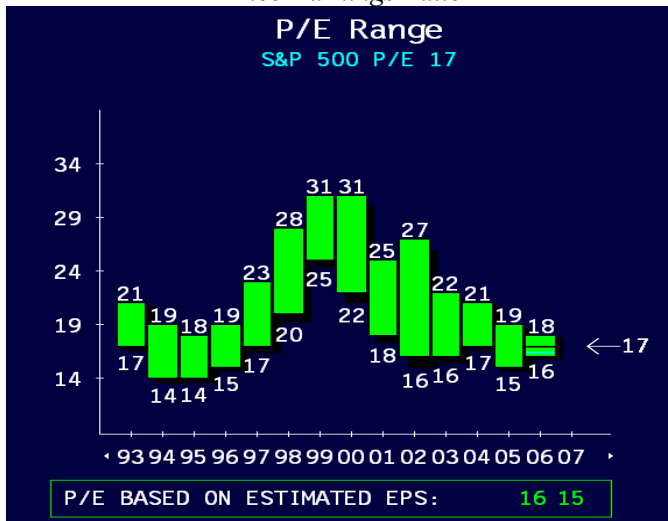
CHART I
Standard & Poor's 500 Index
Price vs. Earnings Growth



Now, the S&P price-earnings ratio is near the bottom of the ten year range (Chart II). Currently, it is 16 times the more conservative 2006 earnings estimate by economists (15

times the more aggressive analysts' estimate). Thus, any advance in the price-earnings ratio from the low end of its historical range would enable stocks to advance at a better pace than underlying earnings growth.

CHART II
Standard & Poor's 500 Index
Price-Earnings Ratio



INVESTMENT STRATEGY

The projected 2006 trading range for the S&P has been upward revised since beginning of the year to 1,200-1,450 from 1,175-1,400. Further improvement in corporate profits accounts for the change. With share earnings now estimated at \$81.64 (based on economists more conservative "top down" approach), the 1,200 level is consistent with the low end of the price-earnings multiple range over the last ten years. To account for rising interest rates and decelerating economic growth later in the year, the upper end of the projected range is 1,450, based on a 17.8 price-earnings ratio, which is less than that experienced during most of the post-recession period (2002-2005). Including dividends, the return potential for the S&P to the top of the range of 13% is more than twice as large as the 6% negative return to the bottom of the range.

While larger capitalization companies significantly underperformed their smaller counterparts over the last several years, this sector should not be ignored in the future. On an absolute valuation basis, the argument for large companies is appealing. Their quality is higher than for the overall market, and as the economic environment becomes more challenging, investors are likely to be more attracted

to the larger, more diversified, and financially stronger firms. These companies are now selling at less than 15 times projected 2006 earnings.

CHART III
Standard & Poor's 500 Index
Projected Value Range



On the fixed income side, intermediate- and longer-term bonds generated a marginal to negative return for the first three months of this year in response to a one-third to one-half percentage point rise in interest rates.

For the balance of this year, bonds are expected to continue to generate weak return numbers. The Federal Reserve has indicated that further rate increases may occur in their campaign to curb inflationary pressures and to neutralize the impact of high energy prices, firming labor markets, and rising utilization rates at factories. Therefore, our cautious outlook for the bond market continues.

TABLE I
Market Performance Comparison
(Including Interest and Dividend Income)
Year to Date*

MARKET INDEX	12/31/05	03/31/06	Return
Standard & Poor's 500	1248	1294	4.2%
Dow Jones Average	10,718	11,109	4.2%
NASDAQ	2,205	2,340	6.1%
EAFE Index	1,684	1,828	8.5%
3 Mth U.S. Treasury Bill	4.1%	4.6%	1.0%
10-Yr U.S. Treasury Bond	4.4%	4.9%	-2.5%
10-Yr AAA Tax-Exempt	3.8	3.9%	.2%

*Estimate

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