Prudential Equity Group, LLC

Research

April 6, 2004

PROFITS OUTLOOK: DOW 18,000 BY 2010

Topical Study #65

All important disclosures can be found beginning on page 21.

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I. Introduction

I have been among the most bullish investment strategists on the outlook for corporate profits since early last year. Nevertheless, even I have been impressed by the extraordinary operating leverage of corporations as the economy has recovered. Most impressive is that profits reported to the Internal Revenue Service soared to new highs last year despite big increases in depreciation expenses resulting from tax law changes in 2002 and 2003. Somewhat less surprising is that profits on a cash flow basis rose dramatically over the past two years. At the same time, the quality of earnings has improved significantly as write-offs have plunged.

Unless the accelerated depreciation provisions are extended by Congress, tax-reported depreciation expenses will fall next year, which should be positive for reported profits but negative for corporate cash flow, as shown in the National Income and Product Accounts (NIPA) compiled by the Bureau of Economic Analysis (BEA) in the U.S. Department of Commerce. This should have no impact on S&P 500 earnings, which are based on financial accounting rather than tax accounting. The latter is biased toward faster depreciation of recently acquired assets than the former. If companies are required to expense employee stock options when issued starting next year, this would tend to depress S&P 500 earnings. It would have no impact on NIPA profits since the BEA expenses these options when they are exercised.

Industry analysts' consensus expectations for 12-month forward earnings continue to grow along a 7% trend line that suggests S&P 500 earnings could rise to about $110 per share in 2010, up 72% from today's level. If the market's valuation multiple remains unchanged, then the S&P 500 and the Dow Jones Industrials would hit 1900 and 18,000 by 2010, respectively. In my 1990s Replay Scenario, a doubling in stock prices by the beginning of the next decade is conceivable. The triumph of capitalism in Asia during the present decade could be just as bullish as was the end of the Cold War during the previous decade. My 18,000-by-2010 scenario assumes a relatively optimistic outcome of many of today's geopolitical risks.

II. Operating Leverage

During March 2002, Congress enacted a package of tax cuts, which included a provision allowing corporations to immediately expense 30% of capital equipment purchased retroactively to September 11, 2001, and through September 10, 2004. In last May's tax-cutting extravaganza, Congress raised the percentage to 50% and extended the term through December of 2004. In the National Income and Product Accounts (NIPA), the impacts of these changes have been to depress after-tax profits reported to the Internal Revenue Service as a result of higher depreciation allowances while boosting "after-tax profits from current production."

Yet despite higher depreciation expenses, NIPA after-tax profits based on tax returns soared to a record $715 billion, at a seasonally adjusted annual rate, during the fourth quarter of last year, up 21% from a year ago (Figures 1 and 2). In NIPA, tax-reported depreciation expense is the sum of economic depreciation (i.e., the Capital Consumption Allowance) plus the Capital Consumption Adjustment (CCAdj), which restates depreciation to the current cost measures

used in GDP. In other words, subtracting the CCAdj from tax-reported depreciation yields economic depreciation. While economic depreciation was relatively flat over the past two years, the CCAdj jumped from $27.8 billion during the third quarter of 2001 to a record $269 billion at the end of last year as a result of the 2002 and 2003 tax law changes (Figures 3 and 4).[1]

NIPA's measure of profits from current production, which reflects profits on a cash flow basis, rose to a record high of $962 billion, at a seasonally adjusted annual rate, during the fourth quarter of last year, up 87% from the third quarter of 2001 (Figure 5).[2] Corporate cash flow hit a record $1,277 billion at the end of last year (Figure 3).

How do the comprehensive NIPA measures of after-tax profits relate to the profits data compiled by Standard & Poor's for the 500 biggest corporations in America? NIPA tax-reported profits exclude write-offs, so they are more like S&P 500 operating earnings than reported earnings (Figure 1). Employee stock options are not expensed in the financial accounting used by the S&P 500 companies. In NIPA profits, they are expensed when exercised. Figure A provides a detailed comparison of the NIPA and S&P 500 profits data.

The ratio of the total net income of the S&P 500, on an operating basis, to NIPA after-tax profits reported to the IRS was 0.71 at the end of last year, close to the average of 0.65 since 1989. When this ratio is well above the average, as it was during 1999 and 2000, S&P 500 earnings are probably overstated. During those two years, S&P 500 earnings were bolstered by numerous accounting gimmicks. When the ratio is well below the average, as it was during 1992, the NIPA data suggest that the S&P 500 earnings may be understated (Figure 6).

What impact did the tax law changes of 2002 and 2003 have on the S&P numbers? Not much, as can be seen by comparing the NIPA profits measures based on tax returns and the NIPA profits based on current production with S&P 500 reported earnings (Figures 1 and 5). In the financial accounting used by the S&P 500 companies, depreciation expense tends to use less accelerated depreciation.

In any case, I believe that equity investors tend to discount forward earnings, which is the time-weighted average of industry analysts' consensus expected earnings for the current and coming years. These estimates are for operating earnings, since analysts can't forecast write-offs. Furthermore, analysts are not adjusting their numbers to account for the impact of the recent tax laws on profits. So I conclude that S&P 500 profits haven't been depressed by higher depreciation expenses. However, cash is cash, and corporate cash flow has definitely been boosted by the federal government's generous incentives to stimulate more capital spending.

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[1] The 2002 tax law change for depreciation expensing was retroactive to 9/11/01, so it started to boost this expense during the fourth quarter of 2001 in NIPA.

[2] It is the sum of reported after-tax profits and the CCAdj plus IVA, the Inventory Valuation adjustment, which restates the historical cost basis used in profits tax accounting for inventory withdrawals to the current cost measures used in GDP.

Figure A: Comparing NIPA With S&P 500 Profits

1) Corporate profits in national income is the income earned from current production by corporations. Because national income is defined as the income of U.S. residents, its profits component includes income earned abroad by U.S. corporations less income earned in the United States by foreign corporations. S&P 500 earnings include profits earned abroad.

2) The estimates of national corporate profits are based on tabulations of data reported by corporations under two sets of accounting principles—financial accounting and tax accounting. Financial accounting measures that reflect "generally accepted accounting principles" underlie the reports to stockholders and to government regulatory agencies, and tax-accounting measures underlie corporate income tax returns. Both calculate profits as the difference between receipts and expenses, but they differ with respect to the definitions of some receipts and expenses and the timing of the recording of some receipts and expenses.

3) In financial accounting, the most common type of employee stock options are usually not recorded as expenses, whereas under tax accounting rules, these options are deducted from profits when exercised. In addition, the appreciation of securities in corporate-sponsored, defined benefit pension plans can result in increased earnings under financial accounting but not under tax accounting. In financial accounting, the expenditures associated with plant closings and company reorganizations are recorded as current expenses when companies establish reserves for their estimated future costs, but in tax accounting, these expenditures are recorded only when they are actually made. Such differences can result in substantial short-term divergences between the S&P and NIPA measures of profits. In addition, the adjustment of S&P earnings to an operating-earnings concept depends on the interpretation of what constitutes special or extraordinary items and the degree to which corporations disclose or quantify the amounts.

4) The S&P 500 universe is continuously changing because of corporate actions—such as mergers and acquisitions, bankruptcy, or restructuring—and because of market actions that limit liquidity or industry representation. In 1998, the S&P 500 index reflected 48 corporate compositional changes; in 1999, it reflected 42 changes; and in 2000, it reflected 58 changes. The NIPA data cover all incorporated businesses—both publicly traded and privately held—and all industries. In 1998, 4.8 million corporate tax returns were filed. Because the earnings of small and mid-sized corporations do not necessarily move in concert with the earnings of large corporations, changes in NIPA profits may differ from changes in S&P 500 earnings.

5) The S&P 500 measures of profits—consisting of reported earnings, operating earnings, and earnings per share—reflect the aggregate earnings of the 500 corporations that compose the S&P 500 stock index, and they are measured on a financial accounting basis. Reported earnings are based on the after-tax earnings that are publicly reported by corporations; operating earnings are reported earnings that exclude the impact of cumulative accounting changes, discontinued operations, extraordinary items, and special items.

Source: Excerpts from Kenneth A. Petrick, "Comparing NIPA Profits with S&P 500 Profits," *Survey of Current Business*, April 2001.

III. Four Ways To Slice & Dice Profits

There are actually four measures of profits for the S&P 500 (Figure 7 and Figure B):

1) Reported earnings are equal to revenues less expenses. They do not exclude write-offs (a.k.a. "bad stuff"), so they are the most volatile measure of earnings.

2) Operating earnings are equal to reported earnings less write-offs. The idea is to show investors the performance of earnings on an ongoing basis, excluding one-time charges.

3) Forward earnings are a time-weighted average of industry analysts' consensus expected earnings for companies included in the S&P 500 for the current year and coming year. Forward earnings necessarily exclude bad stuff because analysts can't be expected to forecast write-offs.

4) Core earnings—as calculated by Standard & Poor's starting in 2001—are even more volatile than reported earnings (at least in theory), because this approach explicitly forswears accounting techniques used to smooth certain expenses, such as pension funding (Figure B).

Figure B: Standard & Poor's 500 Core Earnings

	FY-2001	FY-2002	FY-2003
Reported EPS	**24.69**	**27.59**	**49.08**
+Employee Stock Option Grants	-5.31	-5.31	-3.92
+Pension Interest Expense	-5.07	-5.01	-0.29
+Other Net Pension Adjustments	-2.26	-1.99	-1.71
-Goodwill Impairment Charges	-2.47	-6.91	-1.77
-Gain/(Loss) on Sale of Assets	-1.58	-1.19	-0.69
+Other Post-Employment Retirement Benefits	-0.39	-0.35	-0.32
-Settlements & Litigation	-0.40	-0.83	-0.91
-Reversal of Prior Period Charges	0.10	0.19	0.08
Core Earnings*	**16.00**	**23.66**	**46.13**

* Figures may not add due to rounding.
Source: Standard & Poor's Corporation.

Bearish investment strategists can be unforgiving. They claim that corporate managers shouldn't be forgiven for their one-time write-offs of "bad stuff" expenses mostly attributable to costly mistakes, which presumably won't happen again. The bears prefer reported earnings—a.k.a. "earnings including bad stuff"—rather than operating earnings, which are "earnings before bad stuff" (or EBBS). The bears don't have much to growl about anymore because write-offs plummeted last year and should remain low this year and next year (Figure 8).

Why is this happening? Corporate managers succumbed to the bubble mentality of the late 1990s. They started to believe in the New Economy, with endless prosperity driven by technological innovations. They invested heavily in technology and in technology companies. Mergers and acquisitions (M&A) soared as the rush was on to refashion corporations to compete and take advantage of the opportunities in the New Economy networked by the Internet. The bursting of this latest New Era bubble forced management to write off the expensive, speculative bets that turned bad during the past three years. M&A activity plunged along with stock prices during the bear market of the past three years. During 2002—after WorldCom admitted that its earnings had been fraudulently inflated for at least two years—top corporate executives were forced to review their accounts and to certify that they were legit. There simply hasn't been much time and there have been fewer opportunities to make dumb speculative decisions that eventually become large write-offs.

Figure C: Top 5 Contributors to S&P 500 Write-Offs*

Calendar Year	Write-offs (Million $)	% Of Total Write-offs
2003		
Cisco Systems	-1432	24.4
Lincoln National	-761	13.0
Waste Management	-587	10.0
PNC Financial	-567	9.7
MetLife	-293	5.0
Sum of Top 5	**-3640**	**62.1**
2002		
Time Warner	-54235	41.2
Qwest Communication	-22800	17.3
Clear Channel	-16779	12.7
Aetna	-2966	2.3
Du Pont	-2944	2.2
Sum of Top 5	**-99723**	**75.7**
2001		
ChevronTexaco	-643	19.6
General Electric	-444	13.5
Coca-Cola Enterprises	-302	9.2
Verizon	-201	6.1
Citigroup	-158	4.8
Sum of Top 5	**-1748**	**53.2**
2000		
Tyco International	-683	15.2
Viacom	-452	10.0
Microsoft	-375	8.3
KLA-Tencor	-306	6.8
Walt Disney	-278	6.2
Sum of Top 5	**-2095**	**46.5**

*Limited to current components of S&P 500, e.g., Enron is not included.
Source: Compustat.

Figure C shows the five companies with the greatest write-offs during the first quarter of each year from 2000 through 2003. They are rarely the same companies, but the top five together accounted for more than 45% of the total write-offs during each period. In other words, even when write-offs were significant, they were mostly attributable to a handful of companies in the S&P 500. This supports my contention that investors were right to focus on forward operating earnings over the past three years rather than on trailing reported earnings. The bear market would have been much worse if investors accepted the advice of bearish strategists who promoted reported earnings as the best measure of corporate performance.

Figure B shows how Standard & Poor's derives core earnings, the most bearish, unforgiving, and volatile measure of corporate profitability. The adjustments shown in this table reduced reported earnings from $49.08 per share in 2003 to $46.13 per share in core earnings. Standard & Poor's estimates that stock options cost $3.92 per share last year, or 8% of reported earnings, if fully expensed. That was down from $5.31 per share in 2002. Pension interest expense dropped from $5.01 in 2002 to only $0.29 in 2003, reflecting the rebound in pension plan asset values. In a position paper dated October 31, 2002, Standard & Poor's explains:

> As each year passes, the time when the future pension benefit obligations must be paid becomes one year closer and the present value is the interest cost. If the pension fund is properly managed, it should earn enough each year to cover the annual interest cost. If the fund consistently fails to cover the interest cost, it will become more and more underfunded over time.

IV. Looking Forward To 18,000

The most bullish of the four earnings concepts is forward earnings. It also happens to be the measure I use for valuing and forecasting the market. Fortunately for us bulls, the stock market hasn't paid much, if any, attention to either reported or core earnings. The market continues to follow the operating earnings projections of industry analysts instead. Last year, I argued that after two years of major downward earnings revisions, analysts (who generally have an optimistic bias) might be closer to the mark for 2003 and 2004. Indeed, since early 2003, their consensus estimates for both years have been remarkably stable (Figure 9).

At the end of last year, forward earnings were $60.94 per share. By March, it was up to $64.15 per share, a new record high (Figure 9). The rebound in forward earnings over the past year has been truly remarkable. Actually, it is very reminiscent of what happened from 1999 to 2000. Over these two 12-month periods, forward earnings rose 10% in 1999-2000 and 16% this time.

Should we be alarmed? The first run-up in earnings expectations was followed by a very nasty three-year bear market. I am not alarmed. On the contrary, I am very encouraged by the quality of the latest rebound in forward earnings. It is much more broadly based, with analysts covering most sectors and industry groups raising their forecasts. During 1999 and 2000, Tech-industry

analysts, much more so than others, were the most exuberant about the prospects for their companies. Moreover, with the benefit of hindsight, the Tech analysts were irrationally exuberant as they raised their estimates to catch up with soaring stock prices in their sector. During 2003, industry analysts were consistently conservative. They underestimated each of last year's four quarters. Their estimates just before the start of each of the four quarters were below the actual results by 0.6%, 1.8%, 5.3%, and 3.6%, respectively.

I am currently forecasting that forward earnings should rise to $67.00 per share by the end of this year and to $72.00 per share by the end of next year (Figure 10). I still believe that the market's forward P/E could rise to 20 from 17 currently. Therefore, my S&P 500 targets are 1340 and 1440 by the end of this year and next year.

What about 2010? That is a long time off, and anything could happen. However, if history repeats itself, then forward earnings should continue to grow along the 7% compounded annualized trend line that has been intact for earnings since at least 1960. Projecting this line to 2010 shows that earnings per share should rise to $110 per share. If the P/E multiple remains unchanged, then the S&P 500 should rise to 1900, a 70% increase over this period. If the multiple rises to 20, than the S&P 500 would double to 2200 in 2010. The Dow Jones Industrials would be at 20,000.

V. The 1990s Replay Scenario

I make these bullish long-term projections with some trepidation. Just before the Great Bull Market crashed, books were published with titles such as *Dow 36,000* and *Dow 100,000*. Several widely followed and wildly bullish investment strategists of the 1990s overstayed their welcome in the bullish camp. They were fired during the bear market, well before Donald Trump's recent attempt to trademark "You're fired!" I was one of the survivors; I was also very bullish during the 1990s, although I did turn more cautious in 1999 because of my concerns about the quality of earnings, valuation, and the Year 2000 Problem.[3]

In my Topical Study #18, "Dow 5000," dated May 9, 1990, I predicted that the Dow Jones Industrials could nearly double, from 2700 to 5000 by 1993, if earnings and the valuation multiple each rose by 50%, as I expected. It took a little longer than I expected. The Dow rose to 5000 on November 21, 1995. I then wrote Topical Study #27, "10,000 In 2000," dated November 6, 1995. This time, it happened a bit ahead of schedule: The Dow rose to 10,000 on March 29, 1999. Another one of my studies was Topical Study #25, titled "The High-Tech Revolution In The US of @, dated March 20, 1995, in which I argued that technology stocks would be great performers over the coming years.

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[3] For example, in my Topical Study #45, "Earnings: The Phantom Menace," dated August 16, 1999, I sided with both Warren Buffet and Arthur Levitt, who railed against the accounting gimmicks used to boost earnings.

Before you conclude that I am doing a Gloria Swanson act—nostalgically recalling her great film career in silent movies before the talkies in *Sunset Boulevard*—let me explain the relevance of the above to investing today. The Dow Jones Industrials doubled from 1995 to 1999. In my 1990s Replay Scenario, it could happen again from now through 2010. It could happen for more or less the same reason. During the 1990s, I wrote several Topical Studies explaining why the end of the Cold War was extremely bullish for stocks.[4] Today, I believe that China entering the World Trade Organization on December 11, 2001, is an equally bullish "Big Bang."[5] Both of these events unleashed globalization, more free trade, and more competition. Globalization has benefited consumers around the world, boosting their prosperity by providing better and cheaper goods and services. To compete, producers have been forced to provide better and cheaper goods and services. Because raising prices is hard to do in competitive markets, they've had to cut costs and boost productivity, increasingly relying on technology to do so.

In some ways, the latest Big Bang is potentially more bullish than the first one. The triumph of Capitalism over Corruption in Asia is likely to create economic freedom and opportunity for many more people than the end of the Cold War did.[6] Bringing prosperity to the people of China, India, and other Asian nations is bound to be good for the American economy and the stock market.

VI. Issues: Valuation, Terrorism, Margins, & Options

So will it be déjà vu all over again? Will my 1990s Replay Scenario give us another stock market double during the second half of this decade, as occurred during the second half of the previous one? Or is the bullish outlook just déjà voodoo? One big issue is valuation. The S&P 500's forward P/E was 14.2 when the S&P 500 rose to 615.93—and the Dow Jones industrials rose to 5117—at the end of 1995. The P/E is now 17, with the S&P 500 just north of 1100 and the Dow just north of 10,000. The bears say the multiple is too high. I say they are wrong. The multiple was just as high during the early 1960s, when inflation rates and interest rates were just as low as they are now. In my opinion, it makes no sense to compare the current P/E to a historical average, that includes the very depressed multiples of the 1970s and 1980s, when inflation rates and interest rates soared to historical highs. However, even doing so shows that the multiple is back to about the average since 1960 (Figure 11).

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[4] These include Topical Study #17, "The Triumph of Capitalism," August 1, 1989; Topical Study #19, "The Triumph of Adam Smith," July 17, 1990; Topical Study #20, "The Collapse of Communism Is Bullish," September 4, 1991; and Topical Study #23, "The End of the Cold War Is Bullish," September 10, 1993.

[5] See Topical Study #62, "China For Investors I: The Growth Imperative," November 7, 2003, and Topical Study #63, "China For Investors II: The Games," January 21, 2004. Both are posted at www.prudential.com/yardeni.

[6] There are only two alternative economic systems, in my opinion, Capitalism and Corruption. Communism is simply one of the many mutations of Corruption.

The bullish scenario presented in this study clearly assumes a relatively optimistic outcome of many of the geopolitical risks confronting investors today. Terrorism could be the fatal flaw in my analysis. In his March 22, 2004, column for *The Wall Street Journal*, Jesse Eisinger stated the counterpoint rather well as follows:

> Terrorism means stock prices should be lower. It is convenient to think that when the stock market has a reaction similar to the one it has had in the days following the recent bombings in Madrid, that it is an emotional outburst from skittish traders. Instead, it is possible to read in the recent stock weakness and volatility yet another investor revelation that there is something new about the world that wasn't around in the late 1990s. The global terrorist threat seems more potent. Governments, peoples and corporations understand the threat as ever-present. The bombings in Madrid affected a Western European country's elections. American investors shook off terrorist attacks in Turkey, Bali and in Africa. But they are finding it tougher to ignore Madrid. The conclusion is that stocks carry higher risks and should be accorded lower multiples as a result.

I could be wrong, but I believe we are making good progress on the geopolitical front. The trains are running in Spain, and passengers are back riding them. The suspected terrorists have been either rounded up or killed near Madrid. The police averted a major attack by a terror cell in London recently. Fallujah's bad guys are surrounded by U.S. Marines. Pakistan's military forces are scouring the countryside for remnants of the Taliban and Al Qaeda in their country. Meanwhile, India is playing cricket in Pakistan for the first time in 14 years as the two nations stand down from their long-standing confrontation. I expect that the Chinese will solve the North Korean problem for us. The regimes in Iran and Syria are likely to become more unstable as the lights stay on in Baghdad and as increasing oil revenues bring some prosperity and even stability back to Iraq. The interests of China and the United States are converging as both nations become more and more dependent on the natural resources of other countries. We both need global stability.

Two other issues, at least for the short-term outlook, are profit margins and employee stock options. Profit margins soared dramatically last year. So did profits' share of National Income (Figure 12). Some of this was attributable to the weak dollar, which boosted profits last year. If so, then there should still be enough operating leverage to keep profit margins high and perhaps even boost them this year. Furthermore, the recent rebound in employment suggests that the economic expansion is self-sustaining. At the end of March, the Financial Accounting Standards Board proposed that stock options compensation be treated as an expense when it is granted in corporate financial statements, starting next year. Undoubtedly, once options become a normal compensation expense, then companies will adjust their total compensation costs to leave room for profits. In other words, they'll use options much less aggressively.

Finally, it is worth noting that, earlier this year, the Commerce Department's Bureau of Economic Analysis (BEA) reported the results of the latest comprehensive revision of the National Income and Product Accounts, which included a whopping upward revision in profits for the past two years. Prior to the revisions, after-tax profits reported on tax returns were $515.4 billion, at a seasonally adjusted annual rate, during the third quarter of last year. Now the number is $635.4 billion for the third quarter (Figure 13). Apparently, there were more profits from the rest of the world than previously estimated. In addition, the BEA has a new stock-options adjustment to the extrapolation of the tax return data, which suggests that fewer options were exercised by employees over the past two years.[7] It seems that higher depreciation expense was offset by lower employee stock options expense over the past two years.

The bottom line is that there is more in the bottom line.

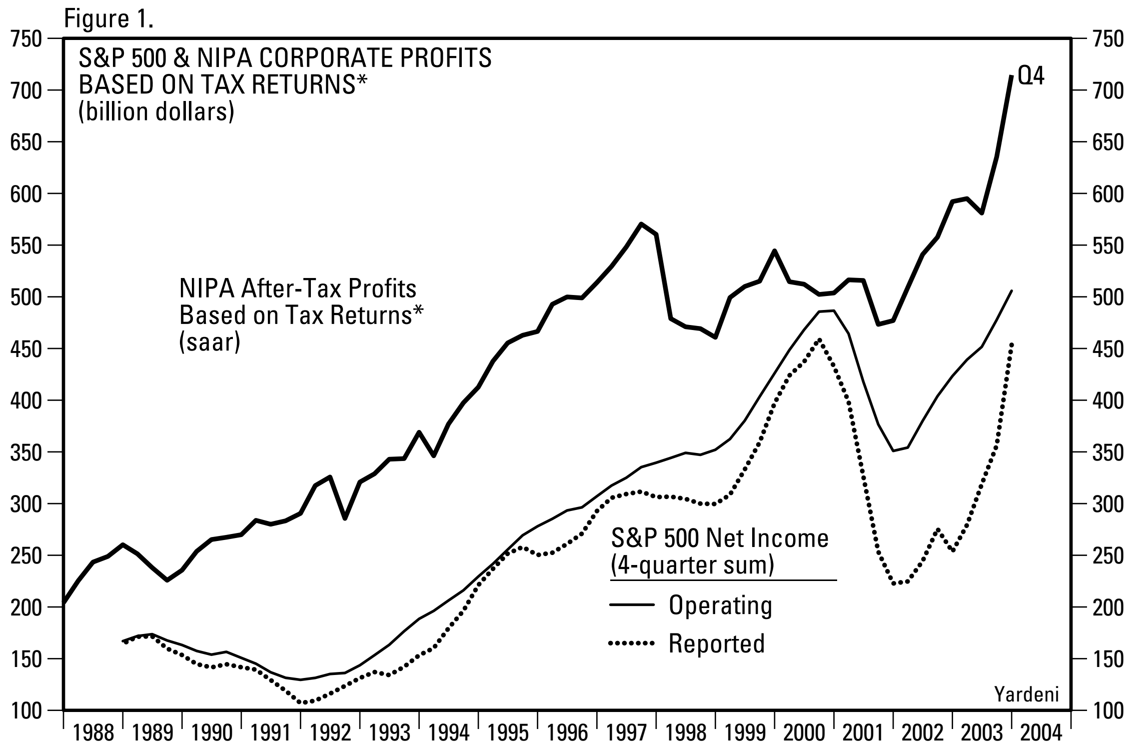
* * *

[7] Interestingly, the revisions to corporate profits for the 1999-2000 period were unusually large and negative. The unexpected surge in the value of stock options during both years played the major role. See "Recent Revisions To Corporate Profits: What We Know, And When We Knew It," *Current Issues In Economics And Finance*, Federal Reserve Bank of New York, March 2004.

NIPA vs S&P 500 Profits

NIPA after-tax profits based on tax returns soared to a new high last year despite the jump in depreciation expense related to tax law changes in 2002 and 2003. This measure of profits excludes write-offs so it is similar to S&P 500 operating net income rather than to S&P 500 reported net income.

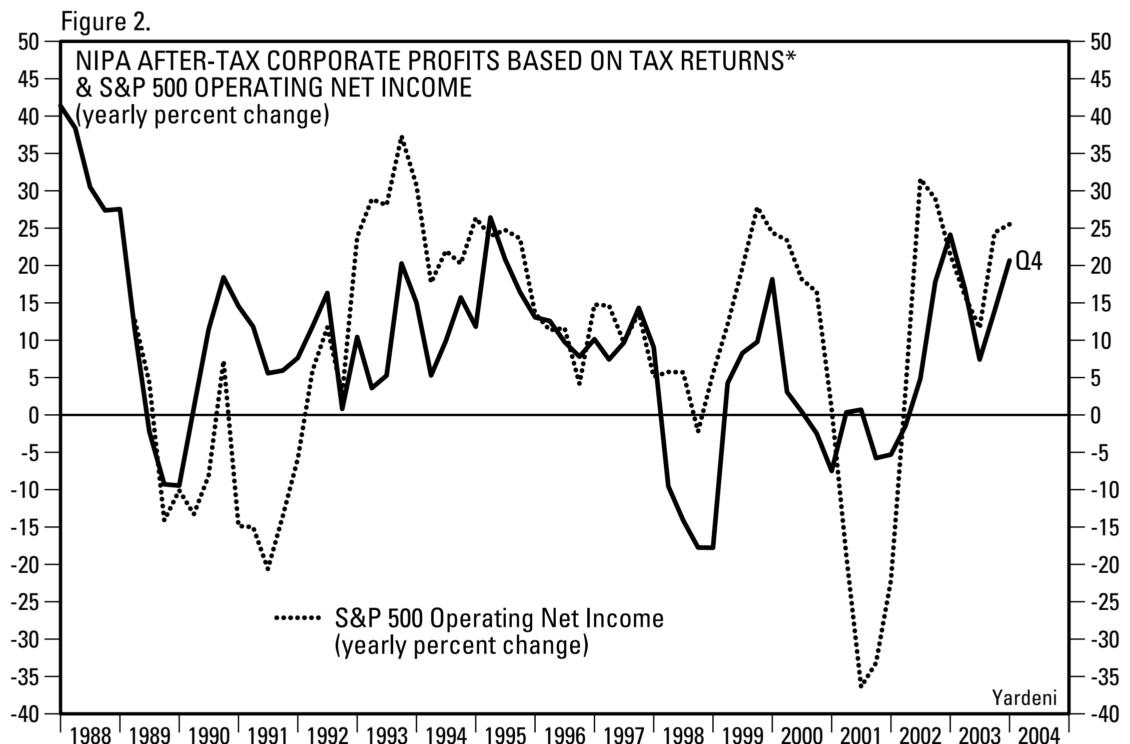
Figure 1.



* Excluding IVA & CCadj. These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
Source: U.S. Department of Commerce, Bureau of Economic Analysis, and Standard & Poor's Corporation.

Last year, NIPA after-tax profits based on tax returns and S&P 500 operating net income rose 21% and 26%, respectively.

Figure 2.

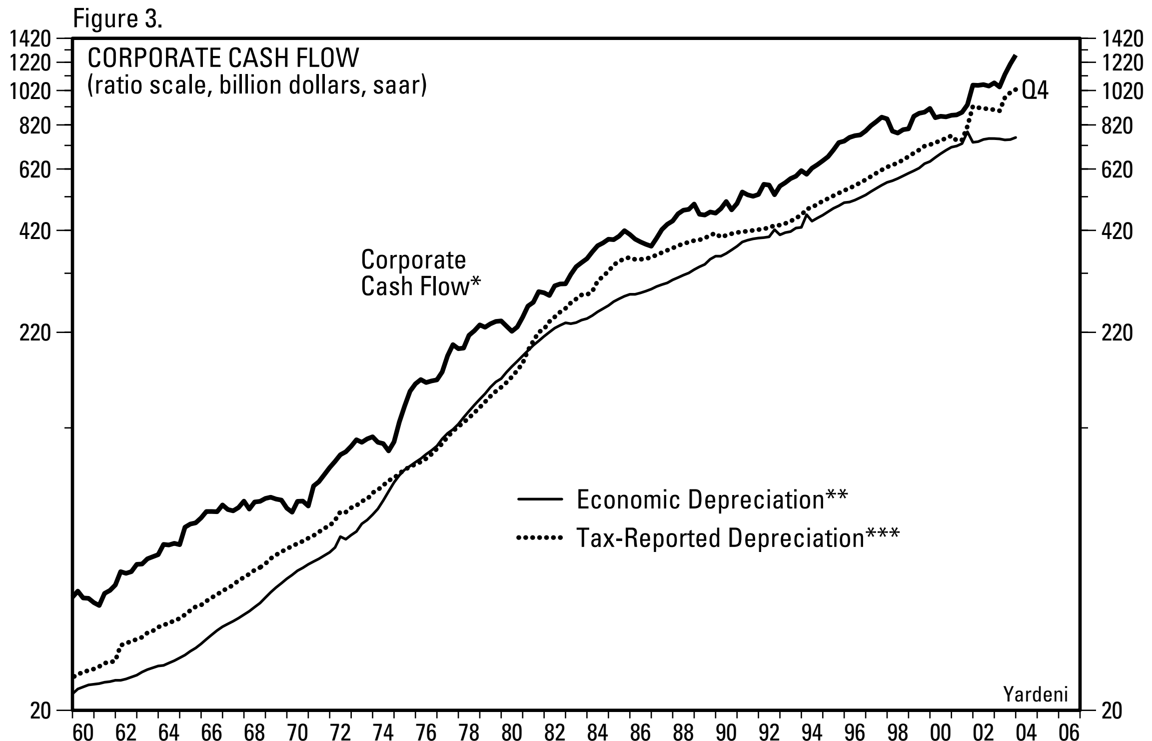


* Excluding IVA & CCadj. These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Depreciation & Cash Flow

Corporate cash flow at a record high, boosted by higher retained earnings and jump in tax-reported depreciation attributable to 2002 and 2003 tax law changes.

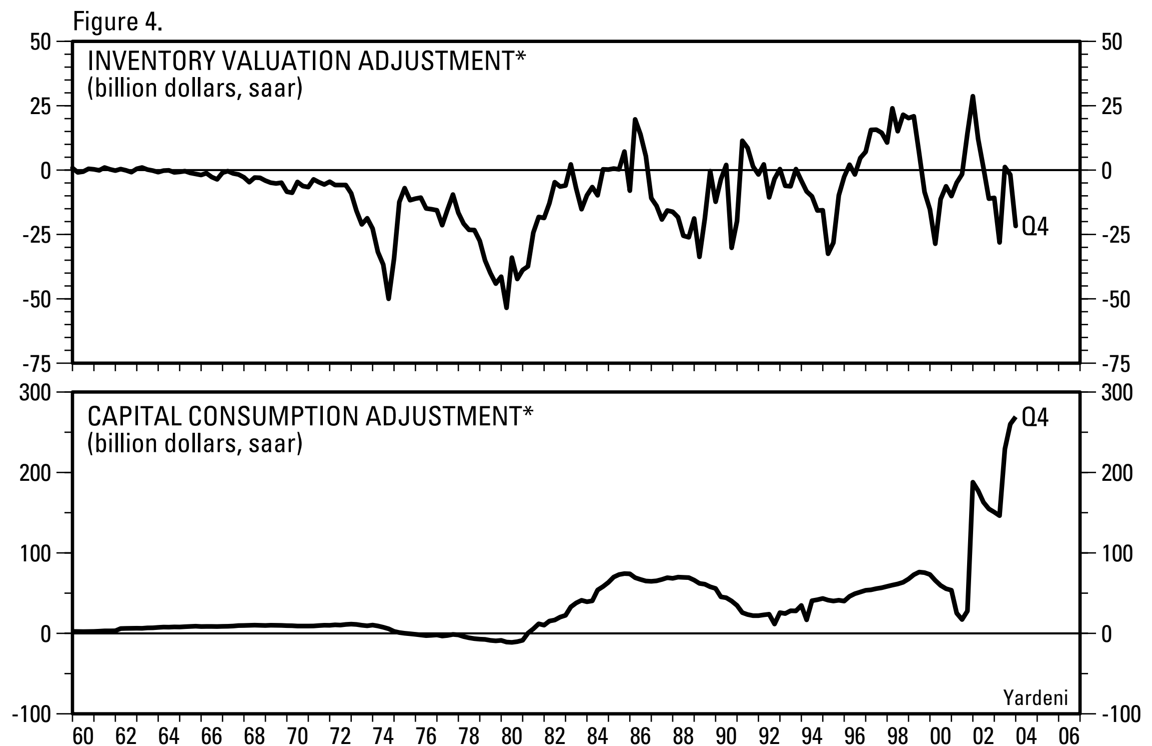
Figure 3.



* After-tax retained earnings plus tax-reported depreciation.
** Corporate capital consumption allowances.
*** Corporate capital consumption allowances with capital consumption adjustment.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The Capital Consumption Adjustment was a major contributor to corporate cash flow in 2002 and 2003 by boosting tax-reported depreciation expenses.

Figure 4.

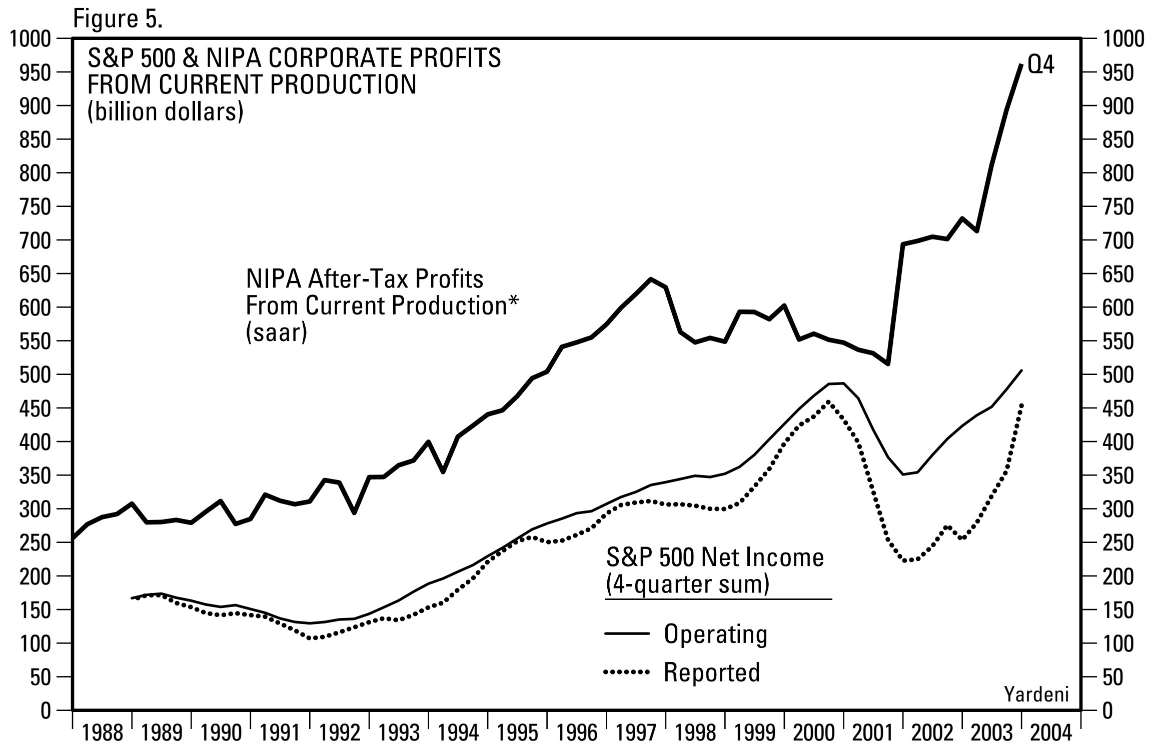


* These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

NIPA vs S&P 500 Profits

Corporate profits on a cash flow basis soared in 2002 and 2003 along with depreciation allowances. However, this didn't have much impact on S&P 500 measures of profits, which are based on financial accounting and less volatile depreciation expense.

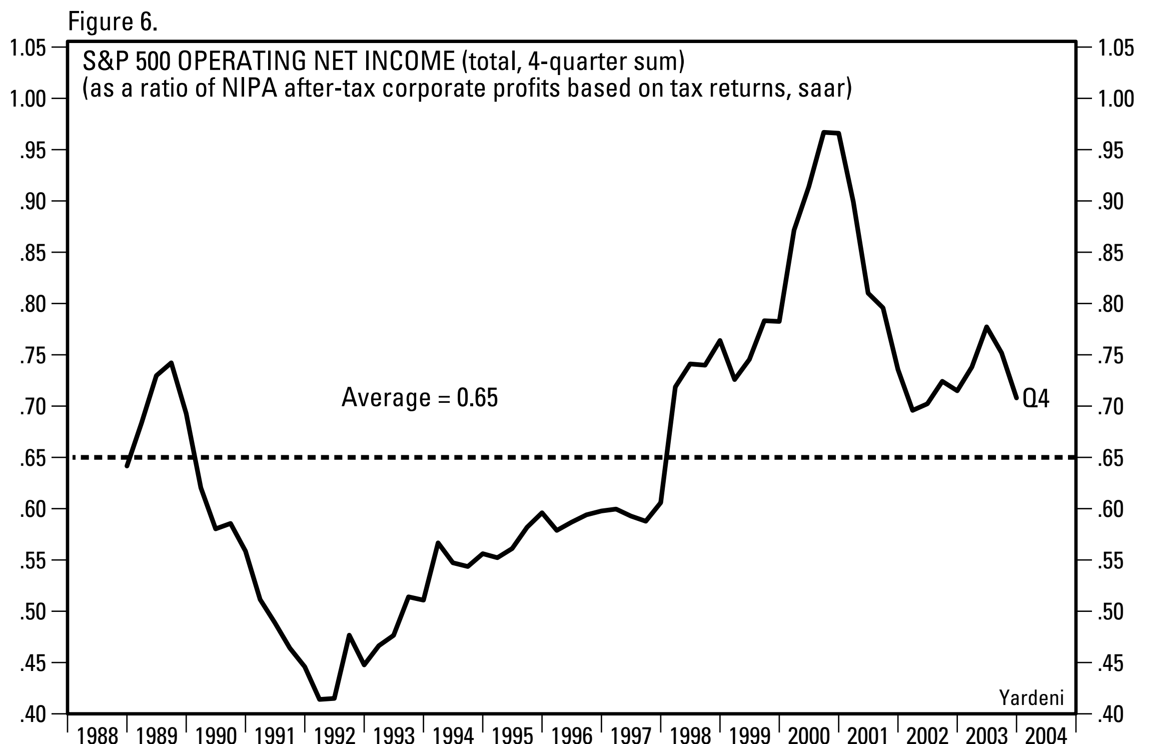
Figure 5.



* Including IVA & CCadj. These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
Source: U.S. Department of Commerce, Bureau of Economic Analysis, and Standard & Poor's Corporation.

When this ratio is above (below) average, S&P 500 earnings may overstate (understate) actual profits.

Figure 6.

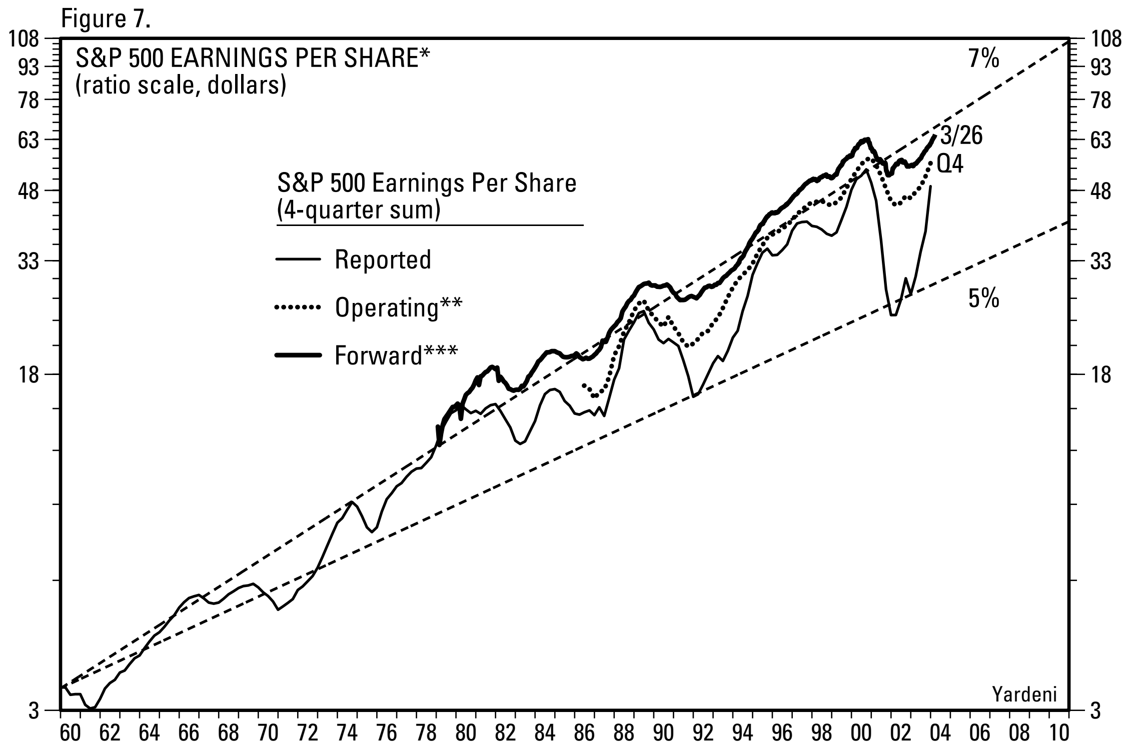


* Excluding IVA & CCadj. These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
Source: U.S. Department of Commerce, Bureau of Economic Analysis, and Standard & Poor's Corporation.

S&P 500 Earnings

The stock market tends to discount forward earnings, which has been fluctuating around a 7% uptrend. If it continues to do so, then S&P 500 earnings could rise to $110 per share by 2010, a 72% increase.

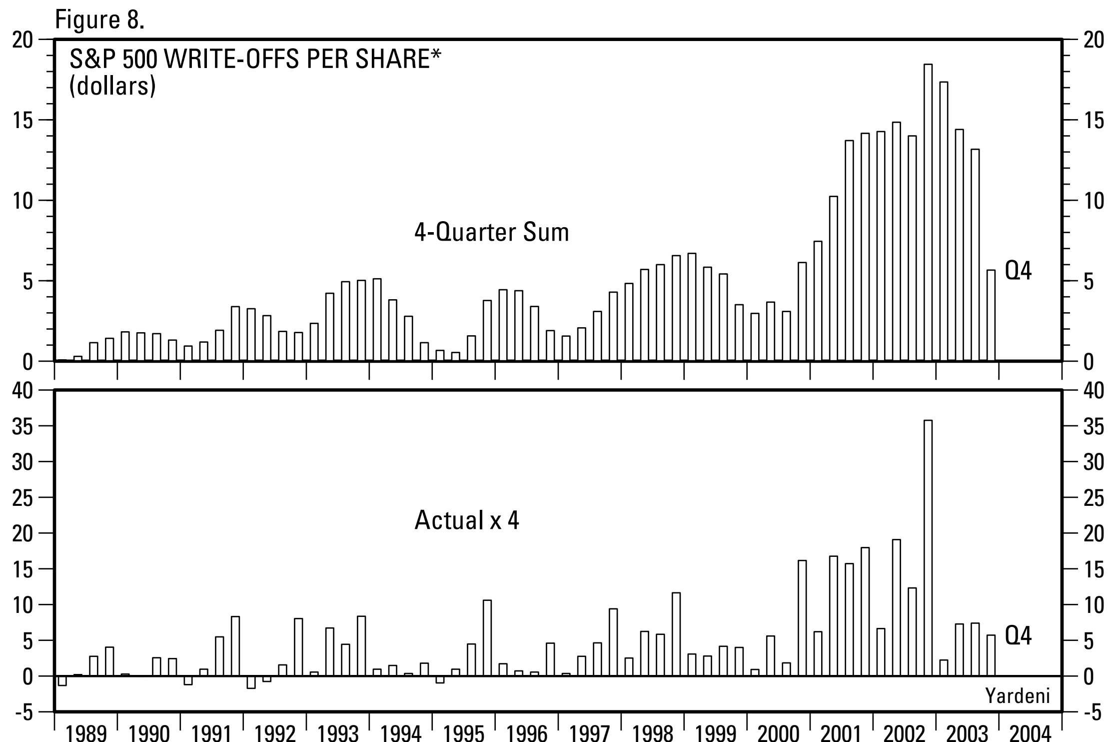
Figure 7.



* Growth paths are compounded monthly to yield 5% and 7% annually.
** Excludes write-offs.
*** 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through April 1994; weekly thereafter.
Source: Standard & Poor's Corporation and Thomson Financial.

Write-offs dropped sharply last year.

Figure 8.

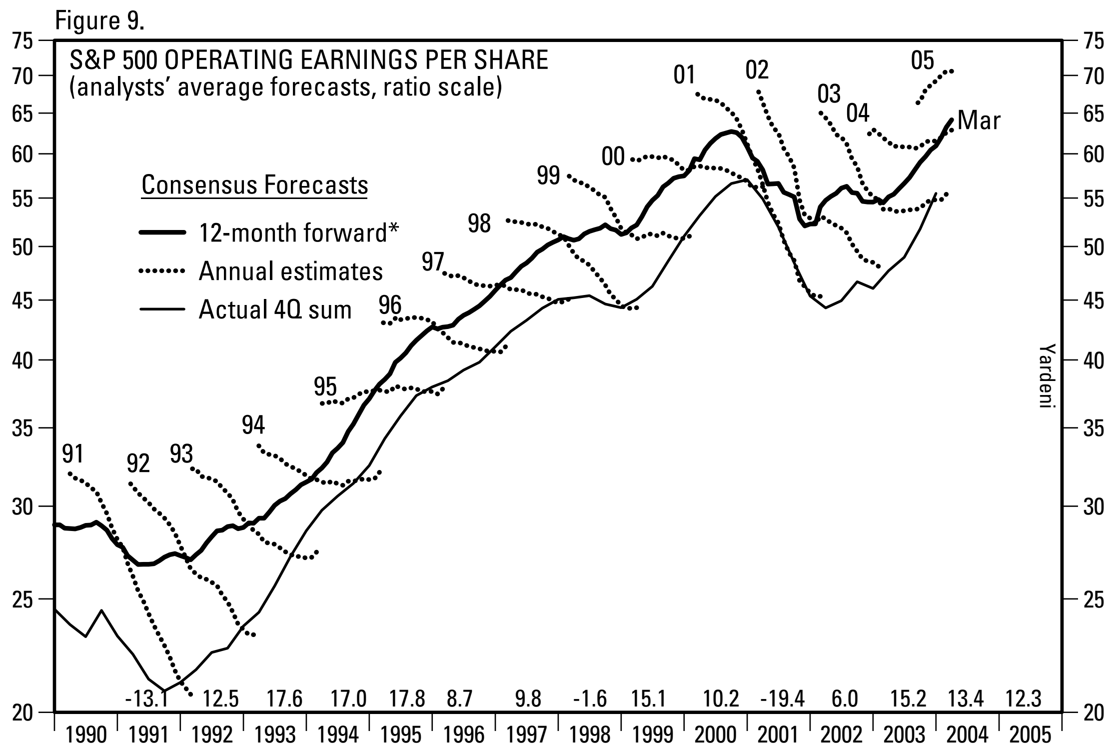


* Operating less reported earnings per share.
Source: Standard & Poor's Corporation.

S&P 500 Earnings

Earnings Squiggles show that analysts are usually overly optimistic about the earnings outlook for each year. However, they seem to be more confident about their estimates for 2004 and 2005. They haven't lowered their 2004 estimates recently. They've raised their 2005 estimates. They expect gains of 13.4% in 2004 and 12.3% in 2005.

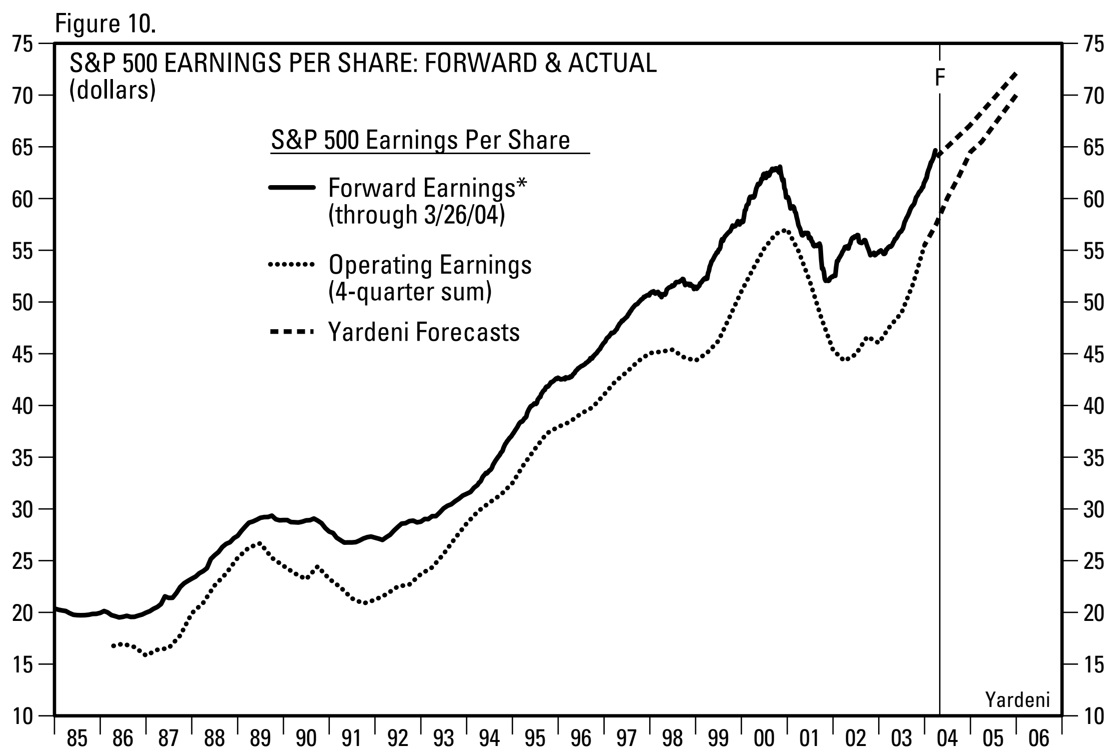
Figure 9.



* Time-weighted average of current and next years' consensus earnings estimates. Numbers above time line are annual growth rates.
Source: Thomson Financial.

Forward earnings are a good leading indicator for operating earnings. Both should rise into record territory in 2004. The market tends to discount forward earnings, which should rise to $67 per share and $72 per share by the end of 2004 and 2005, respectively. Actual earnings should be $64.50 and $70 in 2004 and 2005, respectively.

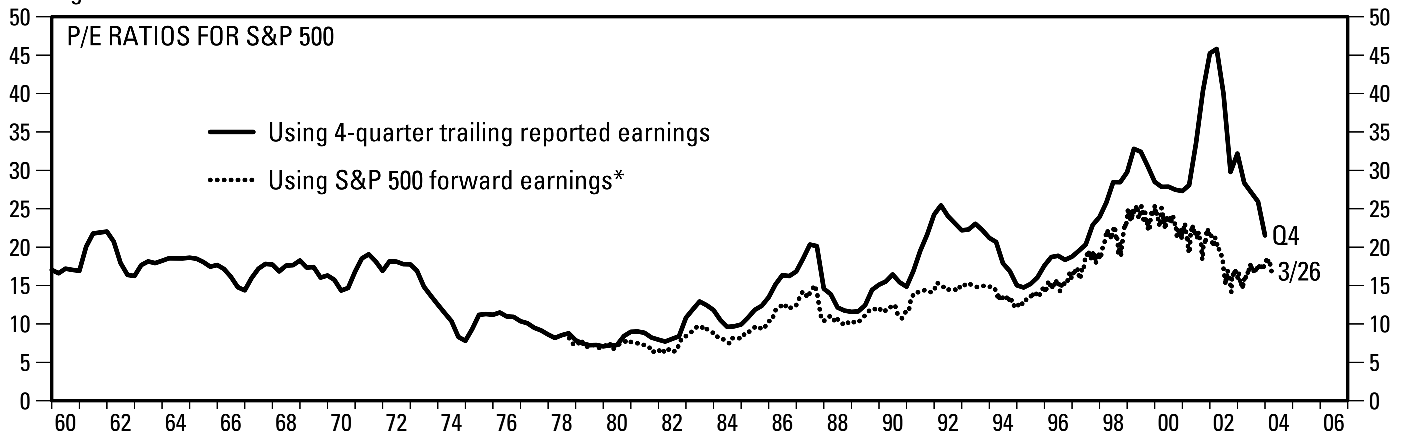
Figure 10.



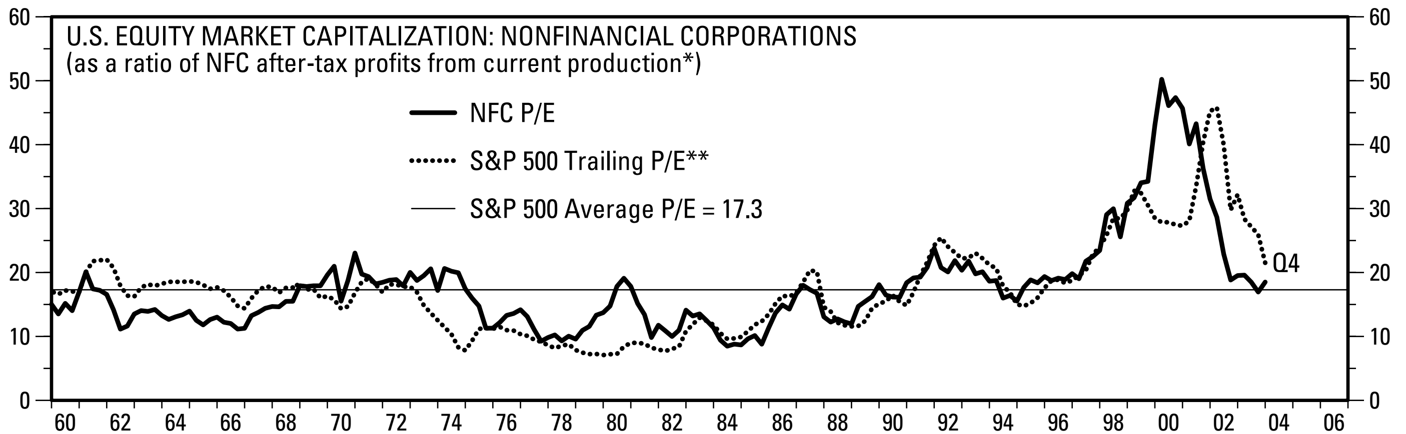
* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly thereafter.
F = Ed Yardeni's forecasts as of January 6, 2004.
Source: Thomson Financial.

Valuation: P/E Ratios

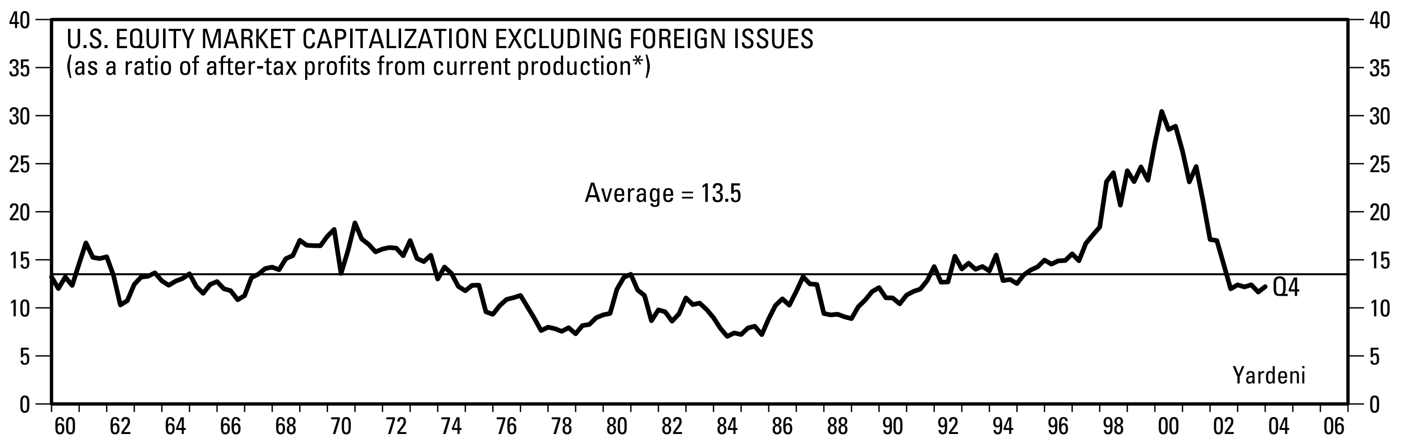
Figure 11.



* Price divided by 12-month forward consensus expected operating earnings per share using mid-month data. Monthly data through April 1994, weekly thereafter.



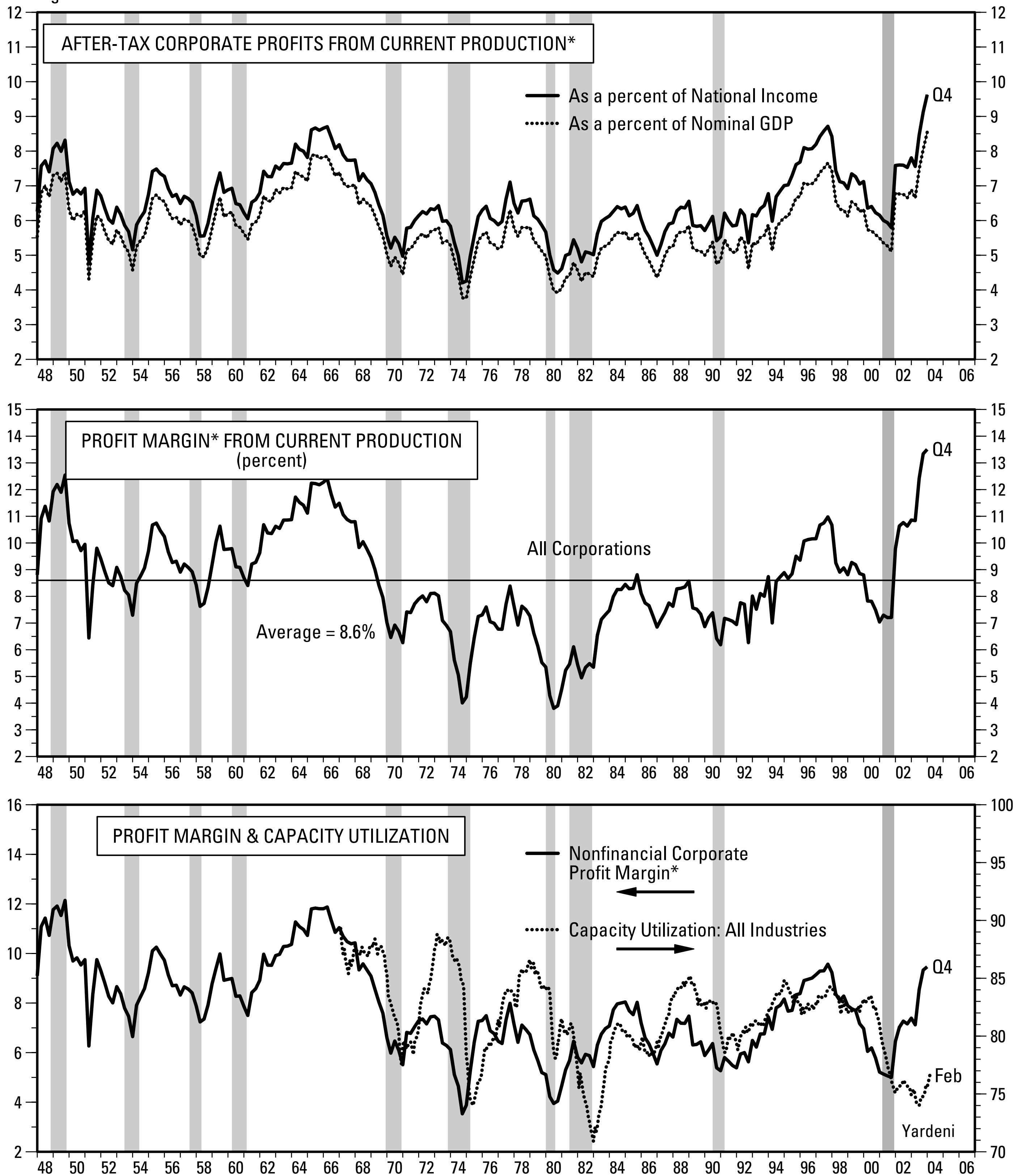
* Including IVA and CCadj. These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
** Using four-quarter trailing reported earnings.



* Including IVA and CCadj. These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
Source: Thomson Financial, U.S. Department of Commerce, Bureau of Economic Analysis, Federal Reserve Board Flow of Funds Accounts, and Standard & Poor's Corporation.

Corporate Profit Margins

Figure 12.



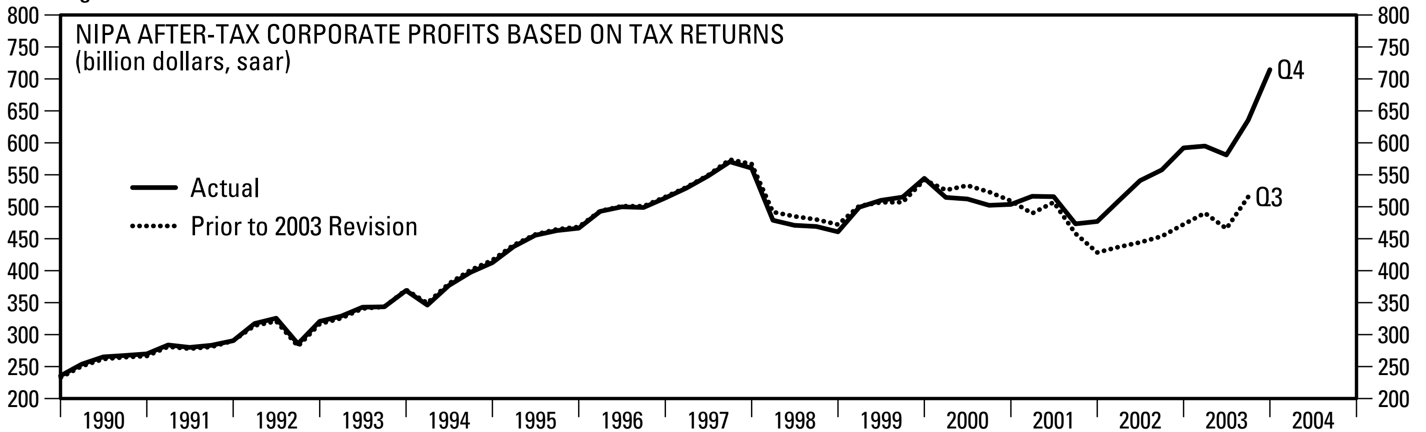
* Including IVA & CCadj. These two adjustments restate the historical-cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current-cost measures used in GDP.

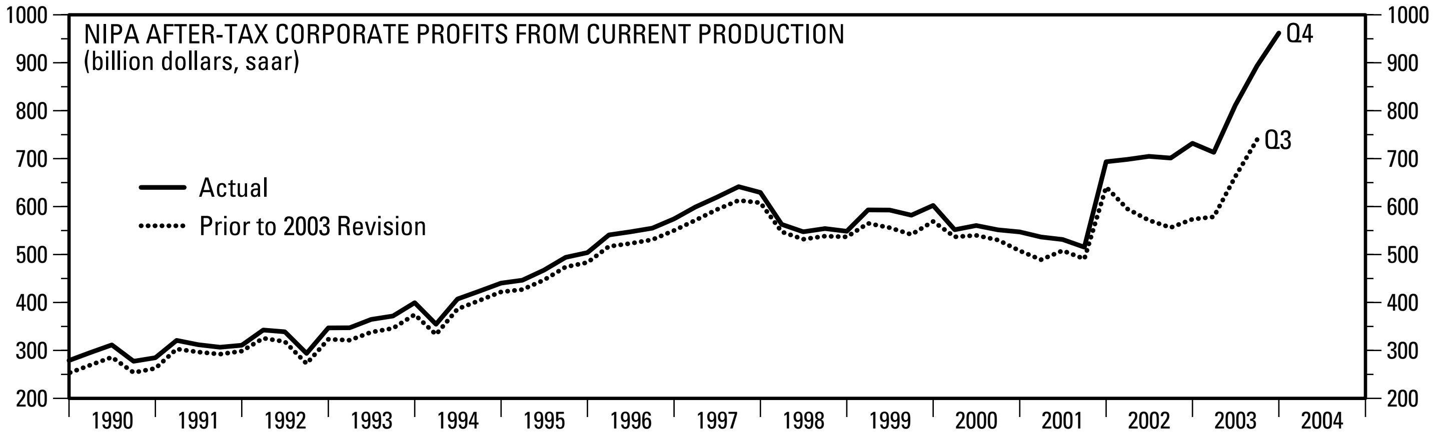
Note: Shaded areas are recessions according to the National Bureau of Economic Research.

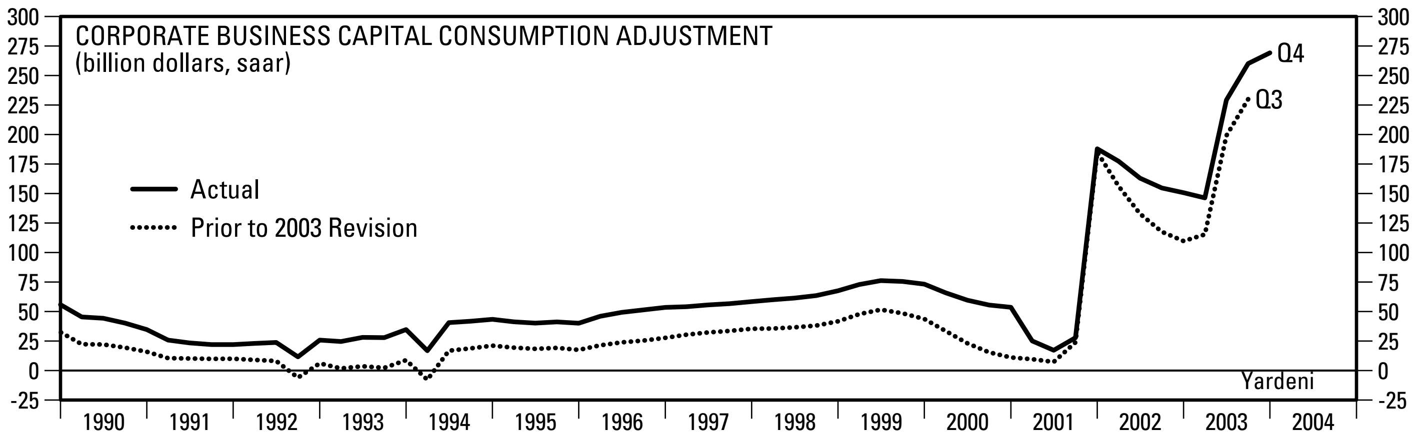
Source: U.S. Bureau of Labor Statistics and Standard & Poor's Corporation.

NIPA After-Tax Profits

Figure 13.







Source: Haver Analytics.

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Underweight(Sell)*	21.00%	1.00%
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Underweight(Sell)*	24.00%	1.00%
Excludes Closed End Funds		
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Neutral Weight(Hold)*	41.00%	3.00%
Underweight(Sell)*	26.00%	1.00%
Excludes Closed End Funds		

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