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Skewing the Earnings Picture

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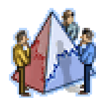

The spate of strong results from leading corporations has boosted optimism among investors, as the recent moves in the major indexes show. **Some analysts warn that the picture is being muddled**, however, because most of the strength comes from energy and financial firms, particularly the largest firms.

Through the end of last weeek, 769 companies in the Dow Jones universe had reported results, and net income, on a year-over-year basis, is up 3.96%. Vinny Catalano of Blue Marble Research notes that, excluding energy and financials, which are currently **sporting 64% and 15% gains**, respectively, year-over-year net income has fallen 3.59%. Furthermore, he points out that when Wall Street firms — defined as investment-services companies and asset managers **in the Dow Jones table** — are excluded, net income for the financial industry is up just 6.3%.

Bennet Sedacca sees a misinterpretation of the equity landscape as a result of financials also. The asset manager, writing on Minyanville.com, is suspicious of those who have noted the S&P 500's relative cheapness based on price-to-earnings ratios, **arguing that it's the powerhouse financial stocks making things look like a deal** – while the median stock in the S&P 500 has a P/E of 19.5, hardly a bargain.

"When we strip out financial stocks, which account for as much as 45% of earnings, we are kind of…well…stuck in the middle," he writes. "With stocks at 20 times earnings that are…well…not the highest quality earnings we have ever seen considering the financial engineering (stock buybacks, questionable options accounting, etc) and a yield barely above 1%, **I have to take issue with the 'cheapness' of the market**."

Similarly, Mr. Catalano says: "There are many reasons to explain why the equity markets around the world are making new highs, but an across-the-board strong 1Q07 earnings season is not one of them."