

# **Murphy Capital Management**

## **Mid-Year Update**

### **July 2007**

The first six months of 2007 have been an emotional rollercoaster for the stock market. Apathy early in the year was replaced by budding optimism as fears of recession were overshadowed by overall global expansion.

Given that the S&P 500 has risen this year and the 1-3 year bond index is essentially flat it would appear that the markets are running marginally ahead of fundamentals. The S&P multiple is currently 16.8 times which is higher than it was in the beginning of 2007.

An increase in P/E is normally associated with either a pickup in earnings growth or a decline in interest rates. Neither is present at this time. It can be argued that the P/E is low and a rise to 17 is totally justified. This is a reasonable argument. But it is equally arguable that the rise in the P/E occurred on excessive optimism fueled by a high level of stock buybacks, acquisitions and private equity which are beginning to moderate.

The key fundamentals for the stock market are always earnings growth expectations and interest rates. They define the future value of earnings and the current value of a stock. Unfortunately, neither are moving in a bullish direction.

Earnings growth is moderating. Second quarter earnings forecasts for the S&P 500 in aggregate call for about 5% - 6% growth. Third quarter estimates are for about 2% growth. Second quarter earnings will undoubtedly beat expectations as it happens every quarter. The final number may come in closer to 7%. But the difficult comparisons to last year's strong numbers and the sluggish economy in recent quarters will make blowout numbers difficult. The third quarter will be even more challenging.

Furthermore, longer-term earnings expectations will be kept in check by the general perception that central banks everywhere are raising rates to combat excessive liquidity. If global growth slows, U.S. earnings growth will as well.

The outlook for U.S. economic growth, which will also impact longer-term earnings expectations could be a little too aggressive. Second quarter real GDP growth could jump to 3 ¾% or even 4% however, that should be viewed as an offset to the weak 0.6% annual rate of growth posted in the second quarter. Underlying growth is moderating and consumer spending is steady. Business investment is picking up a bit, but housing still remains a real drag on the economy. Real Gross Domestic Product (GDP) growth in the second half of this year could remain below the long-term trend of 3%.

Another factor that is especially important to the future direction of the market is interest rates. In this area while we feel the interest rate outlook has become more clouded we still believe rates will be contained. We base this on inflation rates which have been

easing and should not rise above the Federal Reserve's forecast. In addition, the Fed is sensitive to the downturn in both the housing market and auto sector and does not want further erosion in these industries.

The Fed is not likely to tighten policy given the good inflation news and a mixed economic outlook. Moreover, the backup in long-term yields means the market has done some of the Fed's work for it.

In summary, we feel the stock market has come a long way very fast. A flat, or even slightly down trending market this summer would not be a surprise to us. However, we feel the market fundamentals are not bearish and we remain positive for the year. We base this on our benign view of inflation, reasonable P/E ratios, global economic expansion and significant market liquidity.

This year more than ever, keen stock selection coupled with proper sector and global representation will determine how well investors participate. Year to date stock portfolios have fared far better than portfolios with bonds and income oriented stocks. However, we would maintain these positions as a defensive play should the economy slow further or if an unexpected event were to occur.

On behalf of Murphy Capital Management we wish you an enjoyable summer and we look forward to a long and mutually beneficial association.