Pundit Prognostications

Measuring the Past, Viewing the Future

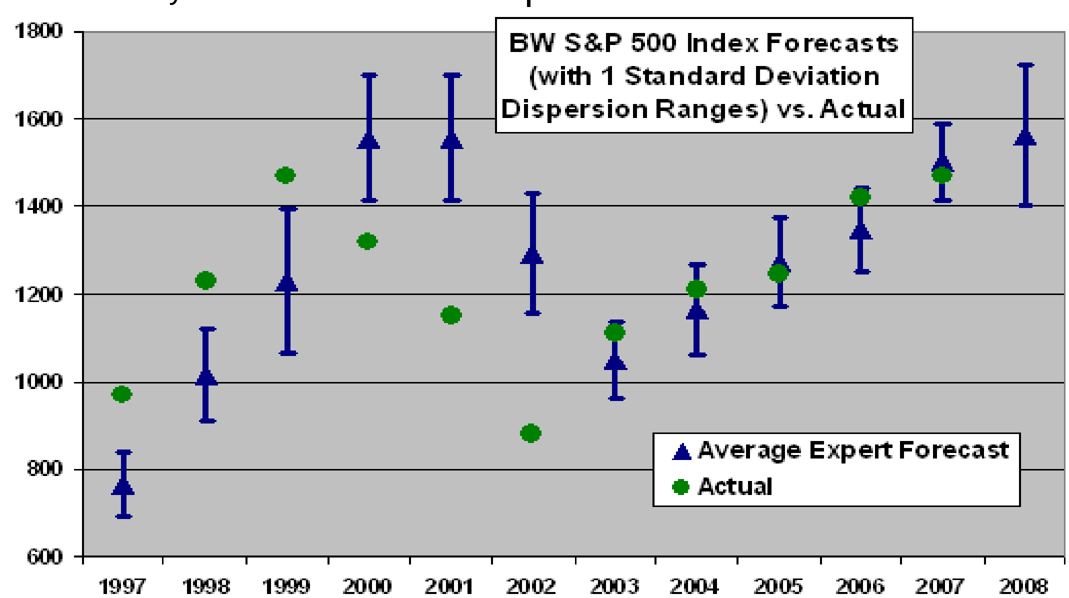
With New Year's resolutions firmly in place, we again roll over the calendar into January, the season when media and stock market gurus go on the record with their 2008 stock market predictions. So, as we did in 2006 and 2007 with our "Inside the Crystal Ball" and "Repolishing the Crystal Ball" newsletters, **we again return to the world of Carnack the Great to see what's in store for us in the coming 12 months.**

As a prologue to each year's prognostications, we normally post at least a partial scorecard from the previous year. However, rather than merely congratulating last year's winners and mocking the losers, we thought it would be more instructive to grade the gurus over a more meaningful timeframe. Fortunately, we have a ready resource since *Business Week (BW)* has performed its *Annual Business Week Stock Market Forecast* every year since 1997. During December of each year for more than a decade, *BW* has invited between 40-80 market experts (199 participants in total) to forecast the levels of major U.S. stock market indexes one year ahead.

The Past Decade of Star Gazing

So, how have the market masters done? The following chart, prepared by CXO Advisory Group, shows (blue triangles) the average year-end forecasts for the S&P 500 for all participating experts, with one standard deviation dispersion range. The green circles reflect the actual values of the index at the end of each year. As illustrated, actual values are higher than the forecast average six times and lower five times.

Clearly, the experts had a hard time predicting the pace of market inflation during the Internet Bubble between 1997-1999 and its equally speedy deflation between 2000-2002. Since 2003, the average of the experts has been below actual performance three times and above twice, though the "stair-step" increases of the S&P have been far more cooperative, allowing all five averages to stay within the dispersion range. **During the 11 years, a consensus forecast for a decline in the index has occurred only once.**



Putting numbers to the chart, we find that **the annual forecasts calculated by averaging across many experts were off by 5%-30% (too high or too low) over the past ten years.** Interestingly, CXO also compared the experts to a mechanically calculated forecast using the average annual S&P 500 index gain from 1951 through the year preceding the forecast year. This mechanical forecast beat the experts' average six times, tied twice and lost twice. Across all 11 years, the average absolute error for the mechanical approach was 12.1%, compared to 16.3% for the expert average.

As we shift our focus to this year's predictions, we should keep the results of the above study in mind because **when it comes to market forecasting, not only are the experts not right all of the time, they can't even claim to be right most of the time.** Still, it is worth listening to and evaluating their rationales in order to form a backdrop for our own decision making.

Bulls vs. Bears

Topping this year's list of bulls is Elaine Garzarelli, president of Garzarelli Capital, and still best known for advising her clients to sell just before the 1987 market crash. While in the camp of those seeing a sluggish start to '08, Garzarelli is counting on a major impact from the Federal Reserve's interest rate cuts. She sees lower borrowing costs and a weak dollar igniting export growth with a resulting 7% year-over-year increase in corporate earnings. **With her models showing the S&P 500 currently undervalued by 25%, it is no surprise that her 2008 year-end S&P target is an aggressive 1,780, a 21.25% advance.**

Also among the bulls are David Bianco of UBS AG, Kevin Gardiner at HSBC Holdings PLC and Jonathan Golub of Bear Stearns Cos., all of whom have targeted the S&P at 1700, or a 16% gain. Bianco, Chief U.S. Equity Strategist for UBS, is also looking for Fed rate cuts (to 3.5% by mid-year) to provide a capital rebuilding opportunity for banks and a stimulus for the economy. Citing strengthening exports and continued demand for high-tech products, he sees U.S. corporate earnings growth of 6%. **In support of his market optimism, Bianco also predicts an increase in the S&P 500 price-earnings ratio from 15.5 to 17, as bond investors shift back into stocks due to paltry interest rates.**

Rounding out our team of market optimists is Tobias Levkovich, chief U.S. equity strategist for Citigroup**. Even though Levkovich sees the S&P up 14% to 1,675 by year-end, his economic outlook proves that there are many roads to the same destination.** Unlike most of the commentators who are looking for the effects of the Fed rate cuts to kick in during the back half of '08, Levkovich expects the S&P index to spurt 18% during the first half of the year, driven by rebounds from the financial and retail sectors. **During the second six months, he sees a modest decline in the index caused by uncertainty over the Presidential election and a squeeze on corporate profits due to rising wages.**

Although clearly outnumbered, the survey of forecasters identified two experts whose outlook is far less rosy. Ben Inker, Director of Asset Allocation at Boston-based GMO, anticipates a market decline in 2008, although his 1,440 S&P target is off only 2%. Of particular concern to Inker is the prospect of a consumer retrenchment forced by the contracting real estate market. Even though he expects a marginal up-tick in 2008 profits, Inker also sees a "vulnerable market" if earnings fall short of expectations.

Finally, representing the "bear" viewpoint is Robert Arnott, Chairman of Research Affiliates. As a fairly lonely contrarian, **Arnott is looking for the S&P 500 to dip to 1,350, an 8% decline**. Unlike the optimists who are counting on Fed rate cuts to provide enough stimulus to avoid recession and reignite the economy**, Arnott sees corporate earnings,**

economic growth and stock prices all headed downhill. His obvious culprits are sliding home prices and soaring mortgage defaults, leading to sharply curtailed consumer spending, resulting in a mild recession. Additionally, Arnott cites the fact that corporate profits are at their highest level in 40 years while wages are at their lowest percent of GDP ever. **He poses an interesting question, "How likely is it that we will see earnings surge from current levels without a political backlash?"**

For those keeping score in 2008, we provide the following chart:

***Business Week* 2008 Forecasts**						
Name	**Firm**	**S&P 500**	**DJIA**	**Last Year's S&P Call**	**Call vs Actual**	**Stocks/Calls**
Elaine Garzarelli	Garzarelli Capital	1,780	16,000	1,640	11.11%	100% in Stocks
Laszlo Birinyi	Birinyi Associates	1,700	15,000	-	-	AIG
Bernie Schaeffer	Schaeffer's	1,700	15,300	1,580	7.05%	80% in Stocks
David Bianco	UBS	1,700	15,250	-	-	ORCL
Jason Trennert	Strategas	1,680	15,150	1,530	3.66%	Likes Tech
Tobias Levkovich	Citigroup	1,675	15,100	1,400	-5.15%	Likes Financials
Leo Grohowski	BNY Mellon	1,675	14,800	1,500	1.63%	FCSX
Thomas McManus	Banc of America	1,625	14,700	1,465	-0.75%	Likes TIPS
Stuart Freeman	AG Edwards	1,575	14,400	1,550	5.01%	PEP
Ralph Acampora	NY Institute of Finance	1,530	13,800	1,550	5.01%	Likes Tech
William Greiner	UMB Financial	1,520	14,400	1,525	3.32%	SBUX
Ben Inker	GMO	1,440	13,000	-	-	3% in Stocks
Robert Arnott	Research Affiliates	1,350	12,500	-	-	Likes TIPS
	Average	**1,612**	**14,569**			
	Current	**1,476**	**13,375**			
	% Gain in 2008	**9.18**	**8.93**			

As we stated last year**, "the measure of success is not one's expertise in forecasting but rather the ability to capture the unexpected opportunities and to minimize the unanticipated risks in order to reach each client's financial objectives."** We look forward to achieving your goals as we meet the challenges of the coming year.

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