Stay focused on good companies that are cheap enough to buy back their own stock and see earnings rise, says *Forbes Magazine*'s Portfolio Strategy columnist and Fisher Investments chief executive Ken Fisher

Stocks are set to explode

I can't tell if 2006 is going to be a good one for stocks or a great one. Either is very possible. If investors remain dour, as they were in 2004 and 2005, the MSCI World index – the best way of measuring the whole world – may end up 9.5% like it was in 2005. If sentiment improves a little it would be easy to see it up 40%.

Stocks could explode. Ever since the bear market bottomed, something has happened that hasn't been true for a quarter of a century. The inverse of a country's price/earnings ratio or "P/E" – its earnings yield or "E/P" – became above the 10-year government bond rate.

That's true in all the largest markets and almost anywhere else of any significance. In the US today the spread is 1.5%, the earnings yield is 6% and the bond rate is 4.5%. In the UK and pretty much everywhere else big that counts, that spread is bigger – 3% to 4%.

Since corporate bond rates derive from government rates, the average company can borrow long-term money in its local market, buy back its stock and make earnings per share rise, all while pushing up the stock.

Remember – the earnings yield is an after-tax number while the bond yield is pre-tax. Depending on a country's tax rate, a firm can pull off this free-money grab with an earnings yield nicely lower than the bond rate. That's one of the big reasons why, for most of history, government bond rates were markedly higher than earnings yields.

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To return to more historical norms, where bond yields exceed earnings yields, what would have to happen? Take the US with its 6% earnings yield and 4.5% bond yield – stocks could rise 34%, the bond yield could rise 1.5%, the earnings could fall 25% or some combination of all three.

Since I don't think long rates will go up a lot in the US because they keep falling outside that country, then you either have a big up market or a recession.

In Europe right now, folks think it will be a recession and earnings will fall – but they are wrong.

Even if they aren't, recall the spread is twice as big outside the US. If sentiment returned to late-1970s' levels, non-US stocks would have to rise 70%, or interest rates would have to be up 3% or more, or earnings would have to decimate terribly.

OK, maybe none of that happens. Maybe we don't get back to more traditional relative valuations of earnings yields to bonds. That would be because sentiment would continue at dour 2004 and 2005 levels and then, maybe, this cheap stockmarket stays super cheap and just rises a little, like it did those years. It was still better then, after all the hand wringing, to be in stocks than bonds or cash. And it will be this year too, but maybe by a lot if sentiment improves.

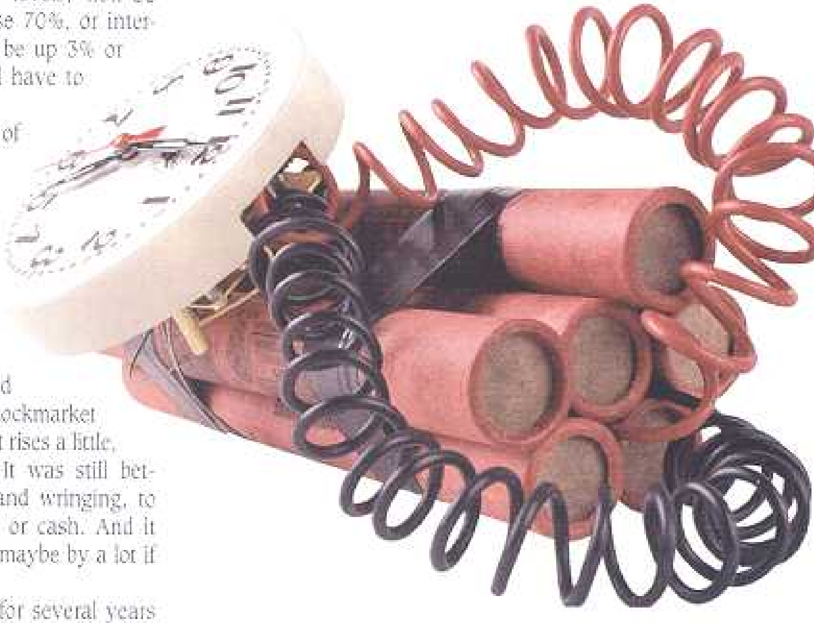
I've been too bullish for several years because valuations are so compelling. I would remain focused on good companies that are cheap enough to buy back their own stock and have earnings rise or else have someone take them over. Here are some examples:

French-based **Veolia Environnement** is the world's largest water utility and the second largest waste management firm. At 20 times earnings it is an easy takeover target.

While **Espirito Santo Financial Group** is Luxembourg-based, it is really a mid-sized Portuguese bank. Social trends toward deregulation are allowing it to grow rapidly and yet, at 15 times earnings, it too would be a juicy mouthful for any acquisition-oriented bank.

Dutch-based **Qiagen** distinguishes itself from the biotech world with real sales, rapid growth and actual profitability. As a vendor you obtain the growth without the risk because it sells gene separation and purification products across the industry. In this field a P/E of 22 is very cheap.

H&R Block in the US is morphing



from its traditional tax preparation business to being half a stock and mortgage broker. But, at 13 times earnings, what it should do is borrow money and buy back its own stock, pushing its earnings per share figure higher naturally. If it doesn't get the stock up, another broker is likely to borrow money and take it over.

ken@fisherinvestments.co.uk