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Marketing material

PE Risks: Rising rates, falling margins. How normal is 2022 S&P EPS?

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IN A NUTSHELL

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20yr S&P EPS growth super-cycle on Global & Digital. Can Healthcare extend it?

A two-part S&P earnings per share (EPS) super cycle in 2000s and then 2010s. Strong China growth and related strength in commodity prices, US capital expenditure (capex) and exports drove double-digit S&P EPS growth for non-financials in 2000s. Continued globalization with a surge in digitalization further boosted S&P profitability in the 2010s and through the pandemic. The average rolling 10yr and 20yr real S&P 500 EPS rate shifted up after the mid-1990s. The average 10yr rolling real S&P EPS growth was 1.9% during 1960-1993, but jumped to 5.3% during 1994-2022. Unfortunately, the drivers of such superb real growth are slowing. The question today is will any economic trends and sectors pick up the baton to keep EPS growth strong or even just healthy in the 2020s. We think demographic demand trends against a rising supply of innovation in medicine, medical devices/equipment and diagnostics have the best chance of aiding healthy S&P EPS growth. Ongoing digitalization, virtualization, electric vehicles and utilities should also help push healthy EPS growth. Many consumer, commodity and manufacturing industries are likely to divert earnings from reinvestment to distributions.

Equity time value properly estimates normal EPS growth from retained earnings

Using annual EPS averages over a full economic cycle is a classic value investing tool. Graham & Dodd suggested 5-7 year trailing EPS averages to capture cyclical peaks and troughs in earnings power. Making such full cycle observation on EPS is the conceptual basis of Shiller's PE. Cycles were shorter in Graham & Dodd's time, so Shiller used 10yr averages to span recent cycles. However, time value must be properly accounted for if using EPS from 10 or more years ago to calculate averages indicative of normal EPS today.

The Shiller PE uses inflation to adjust past EPS for time value, but this is not sufficient. Unless the dividend payout is 100% of earnings, companies should generate EPS growth above inflation. To compensate for forgone dividends, EPS growth must exceed inflation by the retention ratio multiplied by the real cost of equity. Real EPS growth equal to this amount is merely a dividend substitute. The Shiller PE doesn't adjust for EPS growth that should come from retained earnings. This is a major pitfall because dividend payout ratios declined tremendously since 1900-1950, from over two-thirds to less than a third in recent decades. Thus, EPS underlying Shiller's PE notably underestimates today's normal EPS.

We modify Shiller's method by making an equity time value adjustment (ETVA) to historical EPS. We raise historical EPS observations by inflation plus the retention ratio that year multiplied by a real cost of equity estimate compounded for all years past. Our ETVA properly accounts for the opportunity cost of retained earnings, beyond inflation adjusting.

2022E S&P EPS is higher than inflation and fair return reinvestment would support

In 2022, 10yr trailing ETVA S&P EPS is $198; inflation only adjusted 10yr trailing S&P EPS is $167; and Shiller inflation only adjusted 10yr GAAP S&P EPS is $141. 2022 S&P non-GAAP (Generally Accepted Accounting Principles) EPS is likely to be $225-230, about 15% higher than 10yr trailing ETVA S&P EPS. Most of 2022 S&P EPS above ETVA trend is from 2018-2022. We expect some of that digital surge to reverse in the coming years, but also some of the globalization benefits at other sectors from the years before. We think real S&P EPS growth will be 3% or less.

S&P EPS quality deteriorating, quality metrics suggest unsustainable cash flow

Another concern we have is deteriorating S&P earnings quality. The GAAP to non-GAAP EPS ratio averages 86% out of recessions, usually above 90% for healthy mid-cycle quarters. However, it fell toward 80% in the last couple of quarters. Another metric we monitor is: (Net income + D&A) / (CFO – Stock Option Expense). Free Cash Flow vs. Net Income is more an indication of investment activity than earnings quality. But comparing Cash Flow from Operations (CFO) to Net Income + Depreciation & Amortization (D&A) over several years helps reveal earnings quality. This measure is 10% higher than usual, both non-GAAP and GAAP based, suggesting earnings overstate steady-state cash flow.

Bigger Bear risk rising: S&P EPS risk still ahead and interest rates still climbing

If 2yr Treasury yields stay over 4% and 10yr Treasury Inflation-Protected Securities (TIPS) yield over 1% at 2023 end, then the trailing S&P price-to-earnings (P/E) ratio should not be above 18x on 2023E S&P EPS of $225-235. Because rates are at these levels today and likely to persist through 2023 given U.S. Federal Reserve (Fed) resolve, unless a worse than expected recession hits, we lower our 2023 end S&P target to 4200 from 4400. No change to our 4200 12-month target. But less upside through 2023 means that this small bear is justified and the risk of a bigger bear is rising. We maintain our next 5%+ S&P price move signal as Down, but daily/weekly volatility likely stays high upward and down.

Glossary

Amortization is an accounting term which refers to the periodical reduction of the book value of intangible assets (such as patents) or bank loans.

Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

In relation to currencies, depreciation refers to a loss of value against another currency over time.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

Operating Cash Flow is an accounting term that measures the amount of cash generated by a company through its usual business activities.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

The cyclically adjusted price-to-earnings ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the U.S. S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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