HAVE CORPORATE EARNINGS PEAKED FOR THE CURRENT CYCLE?

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Summary and Major Conclusions:

There are several reasons why world equity markets climbed to record highs in November, despite zero earnings growth. First, actual third quarter earnings exceeded analyst expectations. Investors were prepared for the worst, and most companies delivered decent Q3 operating results. The second reason is that company earnings have performed quite well relative to a weak economy. Stock prices respond to earnings, not GDP. Finally, financial markets are forward-looking and anticipate future economic and policy trends. Recession fears have eased in recent weeks, as investors now expect economic growth to improve in 2020.

- US corporate earnings have not yet peaked for the current business expansion. Following a period of weakness that began one year ago, company earnings should begin to grow at an accelerating pace during 2020 and early 2021.
- Along with monetary policy and long-term interest rates, the direction of corporate earnings is a critical variable in the outlook for equity markets. Stock prices and company profits have risen steadily over the past decade.
- As measured by the S&P 500, stock prices have risen by a cumulative 350% over the past decade, compared with a 200% increase in earnings per share (EPS). The differential between stock prices and EPS is attributable to the steady rise in equity valuations over this period.
- There are two historical series for measuring corporate profitability: Operating EPS for the companies in the S&P 500 Index (SPX) and another series for operating earnings derived from the National Income and Product Accounts (NIPA).
- The calculations for these two measures differ in several respects, including accounting standards, universe of firms, company size, geographic exposure, and sector orientation.
- NIPA is a companion series to GDP. This economy-wide measure of business income is based upon reports from hundreds of thousands of firms, and is therefore representative of the average company.
- S&P 500 operating EPS have become the standard for equity investors. While both measures of US corporate earnings are fundamentally sound, analysts and investors tend to focus on the SPX index of large company earnings.
- Earnings for the S&P are based upon reports of only 500 companies. Moreover, SPX earnings are dominated by a relatively small number of very large companies and have a much larger exposure to international markets. Manufacturing firms account for 40% of SPX earnings, compared with only 25% for NIPA profits.
- There has been a strong correlation between growth rates in SPX and NIPA earnings when measured over very long time periods. However, this correlation has declined sharply in recent years. Over the past decade, annual growth in SPX EPS of 10% has significantly outperformed the 3.5% growth in NIPA profits.
- The principal reason for this growing differential is company size. Because of the steady consolidation of many domestic industries over the past two decades, the largest companies have become increasingly more dominant, and therefore more profitable, at the expense of smaller firms.

- Earnings per share for the companies in the S&P 500 have also benefited from a systematic reduction in shares outstanding. As a rough approximation, EPS growth has been augmented by two percentage points annually as reported earnings are spread over a smaller number of shares outstanding.

- A final factor responsible for this gap in growth rates involves the surge in technology sector profits. Technology company earnings comprise more than 20% of total SPX earnings and have increased at a 15% annual rate over the past decade. This compares to only 8.5% for non-tech earnings.

- Following a surge in 2018, company earnings have been on a plateau since the end of last year. Another two quarters of flat profits are likely. The slump in company earnings can be attributed to the sharp slowdown in world economic growth.

- The recent slump in business profits is also attributable to trade policy. Sales growth has slowed because of weakness in world manufacturing and export trade. Profit margins have eroded because of rising input costs and incremental expenses resulting from a disruption to global supply chains.

- While the US earnings cycle is in its late stages, another spurt in growth seems likely in 2020, prior to a cyclical peak in 2021 or early 2022. An acceleration in world GDP growth should act a catalyst for faster profit growth. A declining US dollar, as I expect, would reinforce the positive trend.

- There are three explanations for the advance in stock prices to all-time highs despite zero growth in earnings. The first is that actual Q3 earnings exceeded Wall Street analyst expectations by nearly 5%. Investors were prepared for the worst, and most companies delivered decent Q3 operating results.

- The second is that company earnings have performed quite well relative to what would typically be expected based upon normal macroeconomic variables. Stated differently, corporate profits have outperformed the broad economy. Stock prices are driven by EPS, not GDP.

- Finally, financial markets are forward-looking in principle and anticipate future changes in fundamental trends. Recession fears have eased in recent weeks, as investors now expect economic growth to improve during 2020.

- The conclusion is that equity market returns in 2020 should closely track increases in EPS, with valuation measures remaining constant. Under the most likely scenario, EPS growth will average 7% next year, implying equity market returns of 5% to 10% over the next six to nine months.

Along with monetary policy and long-term interest rates, the direction of corporate earnings is a key variable in the outlook for equity markets. Stock prices and company profits have risen steadily over the past decade, although profit growth has stalled in recent quarters, lagging the uptrend in stock prices. This week's *Economic Perspective* provides a review of recent profitability trends along with a forecast of earnings growth in 2020.

DEFINITION OF US COMPANY PROFITS

There are two historical data series for evaluating US company profit trends: (1) Operating earnings for the companies in the S&P 500 Index (SPX), produced by FactSet; and (2) A measure of operating earnings derived from the National Income and Product Accounts (NIPA), a companion series to the GDP data produced by the Bureau of Economic Analysis. These two series differ in several important respects:

- **Accounting Standards**: Whereas the companies within the S&P 500 use financial accounting standards, the calculation of NIPA economic profits is based upon tax accounting standards, utilizing tax returns filed with the IRS.

- **Universe of Companies**: Whereas SPX earnings are based upon a relatively small -- 500 firms - universe, economy-wide profits are derived from hundreds of thousands of small, medium, and large companies. NIPA profits encompass both incorporated and unincorporated firms, including partnerships, proprietorships, limited liability corporations (LLCs), and S corporations.

- **Company Size and Concentration**: As such, NIPA earnings are more representative of small- and medium-sized firms. Moreover, concentration within the SPX is accentuated by the dominance of a small number of mega companies in the technology, internet, healthcare, financial, and consumer brands sectors. *The largest 15 companies within the S&P 500 — or only **3%** of firms — comprise more than **25%** of the total profits of the index*.

- **Sector Orientation**: Economy-wide earnings are dominated by small- and medium-sized *service, consumer, and financial* companies, while the SPX has a heavy *manufacturing* orientation. Approximately **40%** of companies in the S&P 500 are in various manufacturing industries.

- **Geographic Orientation**: NIPA profits are heavily *domestic* whereas SPX earnings have a large exposure to *international* markets. More than **40%** of SPX earnings are foreign sourced, compared to only 25% for economic profits.

In conclusion, while both measures of US corporate earnings are fundamentally sound, most analysts and investors tend to focus on operating earnings for the companies in the S&P 500. The simple reason is this earnings source is most closely linked to the component stocks within the S&P 500 Index.

HISTORICAL GROWTH RATES

Historical analysis shows that earnings growth for the SPX has exceeded that of NIPA in most recent years. Earnings per share (EPS) for the companies in the S&P 500 have increased at an annual rate of **10%** over the past ten years and **6.5%** over the past five years. By comparison, NIPA profits have lagged over both ten (+3.5%) and five (+4.8%) years. *However, growth rates are comparable when measured over a very long timeframe*. Both measures of profits have increased at a **6%** annual rate over the past 25 years.

- **Industry Concentration**: One of the primary reasons for this differential in growth is the superior performance of large companies versus small- and mid-sized companies. My research has revealed a distinct trend in industry concentration over the past two decades that has allowed the leading firms in many industries to achieve an even more dominant position, mainly through acquisitions and the operating advantages derived from scale.

- **Oligopolies and Profit Margins**: As industries have become more oligopolistic over the years, profit margins of the dominant firms have steadily increased, resulting in a faster rate of growth in EPS. For a comprehensive analysis of these trends, please see my September 3 *Economic Perspective,* "US Industry Concentration and Corporate Profitability."

- **Technology Sector**: Stronger growth in SPX EPS versus NIPA profits can also be attributed to rapid growth in technology sector earnings, which account for more than 20% of total SPX earnings. Technology sector EPS have increased at a 15% annual rate over the past decade and 13.5% over the past five years, both well in excess of that of the overall S&P 500 Index.

Profitability Ratios: The largest companies within the domestic economy have been able to attain higher profitability ratios relative to small- and mid-sized firms. Operating profit margins of 13% and return on shareholders' equity (ROE) of 16% for companies in the S&P 500 exceed margins (9%) and ROE (10%) for the companies in the S&P 400 Mid-Cap Index. These data are consistent with industry concentration ratios and an increasingly dominant market position of the largest firms in an industry.

CORPORATE EARNINGS AND THE ECONOMY

There are several macroeconomic indicators that are linked to the direction and rate of change in corporate earnings.

Earnings and GDP: As a broad generalization, business revenues and nominal (current dollar) GDP are highly correlated. The strong relationship between US GDP and profits is especially true for economy-wide profits as measured in NIPA. *However, because of its large international exposure, S&P 500 EPS are more sensitive to changes in **world** GDP*.

- **Leading Indicators**: However, there are several lead/lag relationships to consider. Because profit margins are a leading indicator of the overall economy, *the absolute level of company earnings tends to peak prior to the peak in GDP*. In addition, *the cyclical peak in economy-wide (NIPA) profits tends to lead that of S&P 500 profits*. NIPA is dominated by smaller companies, which are more susceptible to a weakening economy; as such, their profits do not have the staying power of the larger companies in the SPX.

- **Sector Influences**: Changes in overall company earnings respond differently to broad economic leadership. *For example, overall company profits are strongest when GDP is propelled by strength in the manufacturing, export, and capital goods sectors*. Conversely, strong growth rates in consumer spending and services have a much lesser positive impact on corporate profits. The anticipated rebound in company earnings in 2020 could be especially pronounced if led by the US industrial economy and by world trade, as I expect.

Price/Cost Relationship: Trends in labor compensation and business pricing are also important determinants of company profit trends. The most reliable indicator of profit margin trends is the ratio of selling prices to unit labor costs (ULC). Over the past decade, corporate selling prices have increased at an annual rate of **2%**, compared with an annual rate of only **1.2%** in ULC. This gap is an important contributor to the widening of profit margins over this period. Looking ahead, my forecast assumes 2% growth in both selling prices and ULC, suggesting that this ratio will be a neutral factor.

Operating Leverage: Another important driver of profitability is operating leverage, defined as changes in profit margins attributed to changing growth rates in company revenues. When revenues increase at a faster rate than overhead expenses — which tend to increase at a rate slightly in excess of general inflation — profit margins tend to expand. The converse is true when sales growth falls below that of overhead expenses.

- **Revenues and Overhead**: Profit margins widened over the past decade, partially because average annualized growth in sales of 5% exceeded the average 3% increase in overhead expenses. I expect the trend in company revenues to increase at a rate slightly in excess of the trend growth in overhead expenses, resulting in slightly wider margins in 2020.

The US Dollar: The direction of the US dollar (USD) has a significant impact on company revenues and profit margins, with a lead time of one year. *Large multinational companies in the S&P 500 are heavily impacted by large currency swings*. The correlation between the US dollar and business profits is negative: *A rising USD penalizes company profitability while dollar weakness boosts company profits*. A strong dollar reduces the competitive position of firms in global markets and reduces reported foreign-based revenues and earnings when translated back to dollars when company earnings are consolidated.

CORPORATE EARNINGS OUTLOOK

Third quarter earnings were slightly better than prior expectations. More than 75% of the companies in the S&P 500 exceeded analyst expectations, averaging nearly five percentage points. In absolute terms, Q3 revenue and EPS increased by 3% and 2%, respectively. Sluggish growth in revenues is attributable to the ongoing slump in world GDP and decline in world trade. The utility, healthcare, and real estate sectors increased EPS by 5% to 10% in the quarter, while energy (-40%) and materials (-10%) suffered the largest declines.

- **Margin Pressures**: *Profit margins narrowed because of increased costs related to tariffs on imported goods, which had the effect of raising business input costs*. Tariff-related *disruptions to global supply chains* also triggered a rise in operating costs. Current quarter sales and earnings growth is expected to approximate those of Q3. For all of 2019, EPS for the companies in the S&P 500 are expected to increase by only 1%, from $161 to $163.

2020 Earnings Outlook: Investors should expect an improving trend in company earnings over the next 12 to 18 months. Company sales should benefit from a faster pace of US and global GDP growth, led by a recovery in manufacturing. Faster growth in industrial production should boost productivity growth, thereby pushing unit labor costs lower.

- **Widening Profit Margins**: Continued weakness in raw material costs should also support a modest increase in profit margins. Accelerating growth in revenues should also lower unit costs, as overhead expenses are spread over a larger base of revenues. Finally, an expected reversal in the US dollar should benefit reported earnings, albeit with a lag of roughly nine months.

INVESTMENT SUMMARY

World equity markets rose to record highs in November, even as company earnings growth has flattened. There are three explanations for the advance in stock prices despite a quarter of flat earnings. The first is that actual Q3 earnings exceeded Wall Street analyst expectations. Investors were prepared for the worst, and most companies delivered decent Q3 operating results.

The second is that company earnings have performed quite well relative to what would typically be expected based upon current economic trends. Stated differently, corporate profits have outperformed the broad economy. Stock prices respond to EPS, not GDP. The third is that financial markets are *forward looking* in principle and anticipate ***future*** changes in fundamental trends. Recession fears have eased in recent weeks, as more investors now expect economic growth to improve in 2020.

Manufacturing sector data also suggest that the global manufacturing cycle may be close to a bottom, implying at least a partial recovery in 2020. Faster economic growth is normally accompanied by accelerating growth in company earnings. My profit forecast assumes that EPS will rise from $163 in 2019 to $175 in 2020, an increase of 7%. Over the four quarters of 2020, EPS could increase by more than 10%.

Aside from earnings, other key fundamental factors appear positive for stock investors: Inflation is under excellent control; the Federal Reserve is unlikely to tighten monetary policy until 2021; a breakout in bond yields is unlikely until later next year; and the yield curve is upwardly sloped and likely to steepen further as 2020 unfolds. There are also preliminary signs that the US dollar may be in a peaking process.

Finally, common stock returns are predicated upon changes in equity market valuations. Although the price-to-earnings (P/E) ratio for the S&P 500 of 18x is near the upper end of a normal historical range of 14x to 18x, valuations do not appear excessive. *My forecast assumes that equity market returns in 2020 will closely track EPS growth, with valuations remaining constant*. Under this most likely scenario, EPS growth in 2020 is likely to average 7% on revenue growth of 3% to 4%, implying equity market returns of 5% to 10% over the next six to nine months.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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