CORPORATE EARNINGS: FURTHER UPSIDE SURPRISES

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Summary and Major Conclusions:

Traditional valuation measures strongly suggest that the equity market is overvalued by an estimated 15%. The S&P 500 is priced at a P/E ratio of 23, which compares with a justifiable P/E ratio of 20 based upon current interest rates. Equity investors appear to grasp and fully appreciate the excellent outlook for corporate earnings and have therefore bid stock prices to lofty levels. There are two important implications for equity investors: First, the equity market may continue to ignore current rich valuations in the short term; but long-term equity returns could prove disappointing when measured from the current starting point of overvaluation.

- The level and direction of the equity market in the long term is determined by two variables: Corporate earnings and interest rates. The latter is a proxy for equity valuations and shows a strong negative correlation with price-to-earnings (P/E) ratios.
- One of the major themes in my outlook for the next two years is the potential for explosive growth in company earnings. Reported profits during the past several quarters have exceeded Wall Street estimates by an unusually wide margin and I believe that this trend will continue into 2022.
- Nearly 75% of companies in the S&P 500 have reported fourth quarter earnings and more than 80% have beat prior Wall Street estimates. Rather than a 10% decline as previously expected, actual reported earnings are showing an increase of 3% versus the year-ago quarter. Analysts continue to raise estimates for 2021 and 2022.
- The primary factor at work is a significant expansion in profit margins. Revenue growth remains weak but relentless cost containment measures have contributed to profit margin expansion. These cost control initiatives are expected to continue in the foreseeable future.
- The most notable of these cost controls involves worker compensation, which accounts for more than two-thirds of total business expenses. Managements have been slow to hire and have been successful at capping wage increases. These trends are likely to continue until the economy approaches full employment.
- Operating leverage will be the key driving force for earnings reported over the next two years. Leverage occurs when revenues increase at a faster pace than fixed operating expenses, producing a much larger gain in earnings relative to that of sales.
- In principle, operating leverage is most pronounced during the early years of an economic recovery, as a combination of aggressive cost-cutting and a rapid rebound in revenues results in profit margin expansion.
- Operating leverage is likely to be even more pronounced in the current cycle. In a typical cycle, earnings rise by a factor of 2 to 2.5 times revenue growth. During the next two years, the multiplier could be 3 to 3.5.

- My forecast for this year assumes revenue growth of 8% to 10% and earnings growth of 25% to 35%. I am assuming slightly slower but still robust growth in 2022. An increase in the corporate tax rate would detract moderately from growth.

- Equity investors appear to fully appreciate and grasp the excellent outlook for corporate earnings and have therefore bid stock prices to lofty levels in anticipation of strong future earnings growth.

- Traditional measures of valuation indicate that the equity market is overvalued. On the basis of 12-month forward analyst estimates for earnings per share (EPS), the S&P 500 is priced at a P/E ratio of 23, which compares with a justifiable P/E ratio of approximately 20 based upon the level of interest rates and inflation.

- Changes in stock prices are driven by the differential between actual reported earnings and estimated earnings. In other words, earnings surprises — both on the upside and the downside — dictate the direction of stock prices in the short term.

- Relative stock price performance in the medium term is predicated upon relative earnings growth. This means that shares of companies with EPS growth surpassing that of the S&P 500 tend to register superior investment returns.

- Relative earnings growth strongly suggests a rotation in market leadership this year in favor of cyclical stocks, predicated upon the belief that EPS growth in cyclical sectors should grow at a faster pace relative to that of the overall market.

One of the major themes in my outlook for the next two years is the potential for explosive growth in company earnings. Reported profits during the past several quarters have exceeded Wall Street estimates by a very wide margin and I believe that this trend will continue into 2022. This week's *Economic Perspective* answers questions regarding the current trend in company earnings and provides an analysis of investment implications.

COULD YOU BEGIN WITH A SUMMARY OF CURRENT EARNINGS TRENDS?

Corporate earnings are in a rapidly rising trend, exhibiting exceptionally strong momentum on a quarterly basis. Reported earnings are exceeding Wall Street analyst expectations to an unprecedented degree, acting as a strong propellant for common stock prices.

More than 75% of companies within the S&P 500 have reported financial results for the fourth quarter, and a near-record 80% of firms have exceeded analyst estimates. Compared with ***estimates of a 10% decline*** in Q4, actual earnings per share (EPS) were 3% ***higher*** than in Q4 of 2019. If +3% is the actual number for Q4, it will mark the first quarter of year-over-year growth since Q4 of 2019.

Moreover, the magnitude of upside surprises is nearly unprecedented: Compared with the five-year average of 74%, the current percentage of upside surprises is an impressive 80%. Three sectors within the S&P 500 were responsible for the majority of upside surprises: Information technology, communication services, and financials.

HOW DO FOURTH QUARTER RESULTS COMPARE WITH PREVIOUS QUARTERS?

Strong earnings momentum has been apparent in the past three quarters. Reported EPS beat analyst estimates by more than 20% in the third quarter and 18% in the second quarter. *These three quarters of double-digit upside surprises are the largest since the 1990s*. The key point is that the ***current earnings cycle*** is on track to be the most spectacular since those of the 1980s and 1990s.

IS THE CURRENT MOMENTUM CARRYING OVER TO THE FIRST QUARTER?

Yes, analysts are frantically lifting estimates for the current quarter and for all of 2021. *In only four weeks' time, Wall Street has raised EPS estimates for Q1 by more than 18%, an unprecedented development*. Compared with reported EPS of $33.32 in Q1 of 2020, my forecast assumes Q1 EPS will approach $43, an increase of 30%, and the largest year-over-year gain since 2018. My projections for quarterly EPS growth in Q2, Q3, and Q4 of this year are +55%, +25%, and +30%, respectively.

HAVE MORE COMPANIES RETURNED TO THEIR PRACTICE OF ISSUING FORWARD GUIDANCE?

Virtually all companies in the S&P 500 Index suspended earnings guidance immediately following the outbreak of the coronavirus pandemic last winter because of a complete lack of visibility. An increasing number of firms have resumed guidance in recent months, as managements have begun to feel more confident regarding the outlook for both revenue and expense trends.

For the current quarter, 46 companies have issued positive EPS guidance, versus only 26 firms issuing negative guidance. I expect an increasing number of company managements to continue to guide analysts higher in their EPS estimates as public health conditions improve and as the economy strengthens, implying higher stock prices in coming months.

WHAT EXPLAINS THE STRONG CURRENT TRENDS IN PROFITABILITY?

There are several powerful macroeconomic trends benefitting company profitability, the most important of which are as follows:

- **Weak Labor Market:** Depressed employment conditions allow businesses to keep tight control over labor expenses in terms of both staffing and wages.

- **Economic Recovery:** Rapid growth in GDP will boost company revenues. Assuming nominal GDP growth of 8% this year — consisting of real GDP of 6% and inflation of 2% — company revenues could expand by 10%.

- **Operating Leverage:** The combination of rapid revenue growth and slow growth in operating expenses should result in a significant widening in profit margins. This phenomenon can be best represented in the relationship between corporate earnings and manufacturing production.

- **Industry Consolidation:** The pandemic has accelerated the pace of industry consolidation, which began in the 1990s. As small businesses fail, industry giants will increase revenues through both market share gains and selling price increases.

CAN YOU EXPLAIN HOW OPERATING LEVERAGE WORKS?

Operating leverage is a mathematical concept that captures the tendency for changes in bottom-line earnings to exceed changes in top-line revenues, both on the upside and on the downside. Compared with revenues, earnings exhibit far greater volatility. *Leverage is derived from the fact that earnings tend to grow faster or slower than sales growth because of the existence of fixed costs*.

Historically, earnings growth in the early years of a typical cycle have consistently exceeded revenue growth by a factor of 2 to 2.5. Under normal circumstances, my assumption of a 10% rise in revenue this year would imply earnings growth of 20% to 25%. However, as explained below, I believe that a larger earnings factor is justified in the current economic environment, perhaps on the order of ***3 to 3.5***. This suggests that earnings could increase by at least 30% this year consistent with a 10% rise in sales.

WHY IS THIS PHENOMENON OF OPERATING LEVERAGE SO PRONOUNCED IN THE CURRENT CYCLE?

There are two factors at work: (1) Both GDP and company revenues are unusually depressed, which means that the rebound over the next two years could be unusually pronounced; and (2) The business sector has been exceptionally aggressive in cutting costs, which means that a larger portion of the growth in sales will fall to the bottom line. In addition to labor expenses, the current environment has enabled firms to reduce costs pertaining to business travel and office leasing.

HOW FAST CAN EARNINGS INCREASE THIS YEAR AND IN 2022?

I expect EPS for the companies in the S&P 500 to increase by nearly 30% this year, from $140 to $180, while the yield on long-term Treasury bonds could climb from 1.15% to 1.85% at yearend. If so, stock prices could rise by 10% over the course of the year, as the sharp increase in EPS is partially offset by a decline in price-to-earnings (P/E) ratios. After-tax earnings could grow at a slower pace in 2022 because of a likely increase in the corporate tax rate.

COULD YOU QUANTIFY THE IMPACT OF HIGHER TAXES ON 2022 EARNINGS?

Corporate tax rates are expected to increase under the Biden tax plan, although possibly not until 2022. Under President Trump, the statutory US corporate tax rate was lowered from 35% to 21%. President Biden wants to increase the rate to 28%, although a compromise rate of 25% is possible. The negative impact on after-tax profits could range from 5% to 10%. Therefore, my forecast for 2022 assumes a 25% to 30% increase in ***pretax*** operating earnings and a 20% to 25% increase in ***after-tax*** EPS.

DOES THE EQUITY MARKET ADEQUATELY DISCOUNT THIS FAVORABLE OUTLOOK FOR COMPANY EARNINGS?

Yes, in fact traditional measures of valuations strongly suggest that the equity market is overvalued by an estimated 15%. On the basis of 12-month forward analyst estimates for EPS, the S&P 500 is priced at a P/E ratio of 23, which compares with a justifiable P/E ratio of approximately 20 based upon current interest rates.

In other words, equity investors appear to grasp and fully appreciate the excellent outlook for corporate earnings and have therefore bid stock prices to lofty levels. As I have discussed in the past, *valuation is a poor indicator of short-term market behavior but is a significant determinant of long-term equity market returns*.

There are two important implications for equity investors: (1) The equity market may continue to ignore current rich valuations in the short term; but (2) Long-term equity returns could prove disappointing when measured from the current starting point of overvaluation.

CAN YOU DISCUSS THE IMPLICATIONS FOR THE EQUITY MARKET IN THE CONTEXT OF THE OUTLOOK FOR EARNINGS?

There are a variety of factors that drive stock prices. However, in principle, the level and direction of stock prices are driven primarily by prospects for corporate earnings. More specifically, stock prices are driven by the differential between actual earnings and estimated earnings. In other words, ***earnings surprises*** — both on the upside and the downside — dictate the direction of stock prices in the medium term.

The direction of stock prices is also dependent upon interest rates. *In practice, trends in EPS and market interest rates often move in opposite directions over the course of an economic cycle*. This phenomenon is particularly true in the middle years of an expansion cycle when company profits are still improving while interest rates are in a cyclical uptrend. Conversely, the so-called sweet spot of the cycle typically occurs during the early years of economic recovery, when EPS are growing rapidly and interest rates are still stable.

My investment outlook assumes that the equity market will remain in this sweet spot for all of this year and at least a portion of 2022. Interest rates are likely to grind higher over the next 12 months, but at a slower pace relative to the rise in corporate earnings. The implication is that *equity returns will be positive in 2021 but will lag earnings growth*. The result should be a moderate rise in stock prices of approximately 10% during the year.

WHAT DOES THE EARNINGS OUTLOOK IMPLY WITH RESPECT TO SECTOR PERFORMANCE?

I continue to believe that 2021 will be remembered as a year of significant rotation in equity market leadership versus recent years. Relative stock price performance in the medium term is predicated upon ***relative earnings growth***. This means that shares of companies with EPS growth surpassing that of the S&P 500 tend to register superior investment returns.

Technology, telecommunications services, and media performed best during 2020 because earnings growth in those sectors massively exceeded that of the overall market. Relatively faster growth among cyclical sectors — industrials, materials, financials, and energy — strongly suggests that equity market leadership could shift decisively to these economically sensitive sectors.

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Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

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Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

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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.

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