EQUITIES ATTRACTIVE, BUT RISKS EXIST

By the end of 2020, the S&P 500 had already eclipsed its February 20, 2020, pre-pandemic peak of 3,380 index points by some 11%. During the first half of 2021, it tacked on an additional 14% worth of return to close at 4,352.

Investor optimism has obviously been in an updraft as developed economies continue to emerge from the pandemic, but one might wonder if advances made in the equities markets are appropriate to the economic progress that has been and will be made or, like a mid-week frat party, the celebration exceeds the occasion. Let's examine that.

CORPORATE EARNINGS ECLIPSE PRE-PANDEMIC LEVELS

Corporate earnings have long been the primary driver of equity valuations. As actual and/or expected earnings advance or decline, equity valuations have tended to follow suit. The following image shows Zack's Research's estimated aggregated earnings for the 500 companies that comprise the S&P 500 as of June. For the second quarter of 2021, Zack's expects aggregated earnings to total $394.8 billion. Not only is this figure 62% higher than the pandemic ravaged tally for the second quarter of 2020, it's also 10% higher than second quarter earnings were during pre-pandemic 2019.

At the close of the second quarter of 2019, the S&P 500 stood at 2,941. In essence, that $359.6 billion worth of corporate earnings "bought" an index level of 2,941 back then. As of the second quarter of 2021, $394.8 billion worth of corporate earnings now buys an index level of 4,352. **Stated differently, a 10% increase in corporate earnings since the second quarter of 2019 has somehow resulted in 48% more S&P 500 index points.**

That's obviously a welcomed outcome for investors who were brave enough to remain invested in equities throughout the pandemic. However, one might legitimately wonder whether the disproportionate surge we've experienced in equity valuations is built upon a sturdy foundation of economic rationality or, like that mid-week frat party, the enthusiasm we've been seeing for equities may prove to be a bit more ephemeral.

EXPECTED EARNINGS TRENDS ARE CRUCIALLY IMPORTANT

In addition to the actual level of corporate earnings at any given time, the rate at which earnings may *change* is of crucial consequence to investors. For a given level of corporate earnings, investors prefer future earnings environments in this precise order:

Q: WHICH EARNINGS ENVIRONMENT HAVE WE BEEN IN?

Corporate earnings expected to:

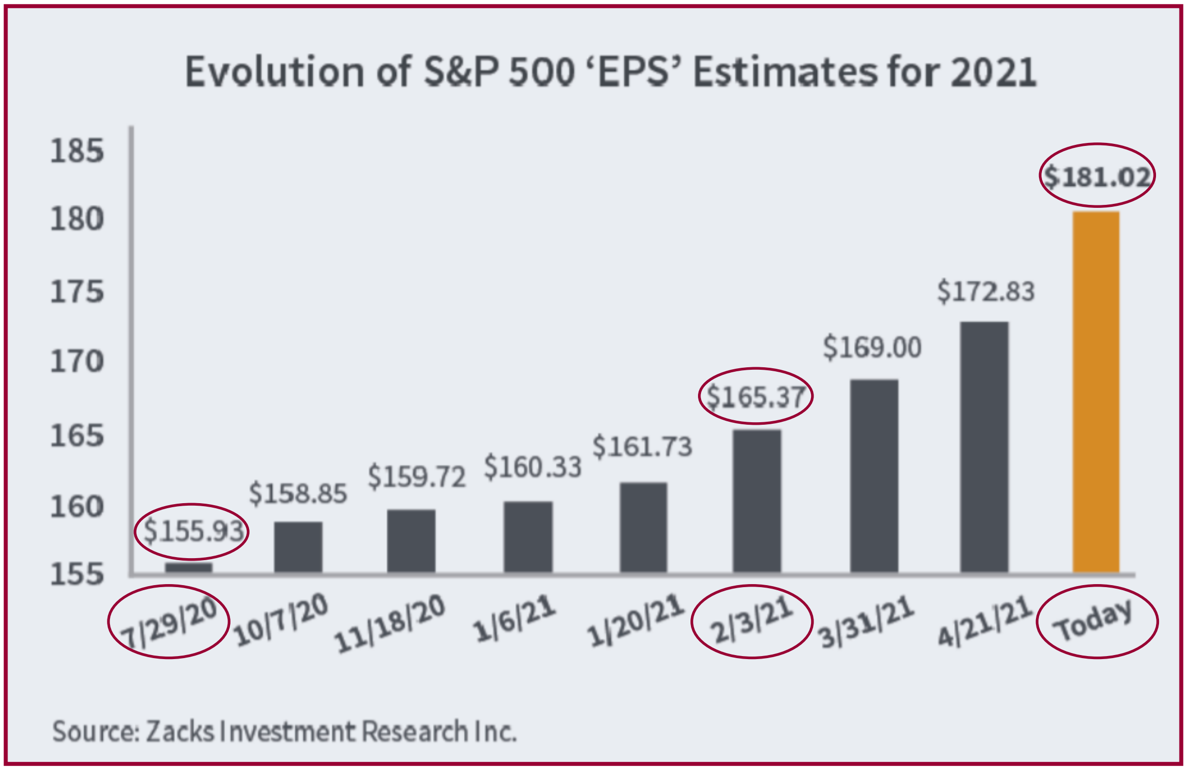
Best: 1 *Rise* at an *increasing* rate,
2 *Rise* at a *constant* rate,
3 *Rise* at a *declining* rate,
4 *Remain constant,*
5 *Fall* at a *declining* rate,
6 *Fall* at a *constant* rate, or
Worst:7 *Fall* at an *increasing* rate.

I doubt I'd receive too much resistance from securities analysts by declaring that the expected rate at which corporate earnings change influences equity valuations at least as heavily as does the absolute level of those earnings. Imagine how the value of a CD might increase if the issuer were to suddenly declare that it would regularly raise the yield of that CD throughout its remaining term. Investors would naturally gravitate toward longer-term CDs as they attempt to maximize the benefit from that suddenly increasing income stream.

Equities are not just long-term in nature, they actually represent *perpetual* claims on corporate earnings and assets, which means that equity investors will be disproportionately helped when they find themselves on the green end of that earnings continuum and disproportionately harmed when they're at the red end of it. And, unlike most CDs which are non-negotiable (i.e., they can't be sold to a third party), publicly-traded equities may be negotiated to a third party in an instant. Coupled with their perpetual nature, the negotiability of equities allows their owners to see the impact of the applicable earnings environment on the value of their portfolios in real time.

A: THE "BEST" ONE — EARNINGS RISING AT A RISING RATE

The earnings presentation for the S&P 500 that appears next is a bit different than the one that appears on page one. Rather than aggregating total, quarterly earnings of each of the 500 companies that comprise that index, this presentation aggregates the annual earnings an investor would be entitled to receive if that investor held exactly *one* share of *each* of those 500 companies. It's the same pizza as before, cut a bit differently.



Last July, during the depths of the pandemic, analysts tracked by Zacks Investment Research expected those 500 shares of stock to be entitled to about $156 worth of corporate earnings during 2021. Approximately half a year later, analysts had increased their 2021 earnings estimates by about 6% to approximately $165 worth of aggregated earnings. By mid-2021 (labeled, "Today"), they increased their aggregated 2021 earnings estimates by an additional 9%, to $181. Since analysts' estimates tend to become more accurate as the forecasted event draws near and because the rate at which earnings are expected to increase is, itself, increasing, we can assume we've been operating on the green edge of that Best/Worst earnings continuum for at least a year.

EARNINGS ENVIRONMENT #1 BUYS A LOT OF INDEX POINTS

When companies are operating from that "best" edge of the earnings continuum, a given level of corporate earnings is apt to "buy" tremendously more index points than when earnings are falling apart in the red zone, and substantially more index points than when the earnings environment is even slightly less favorable.

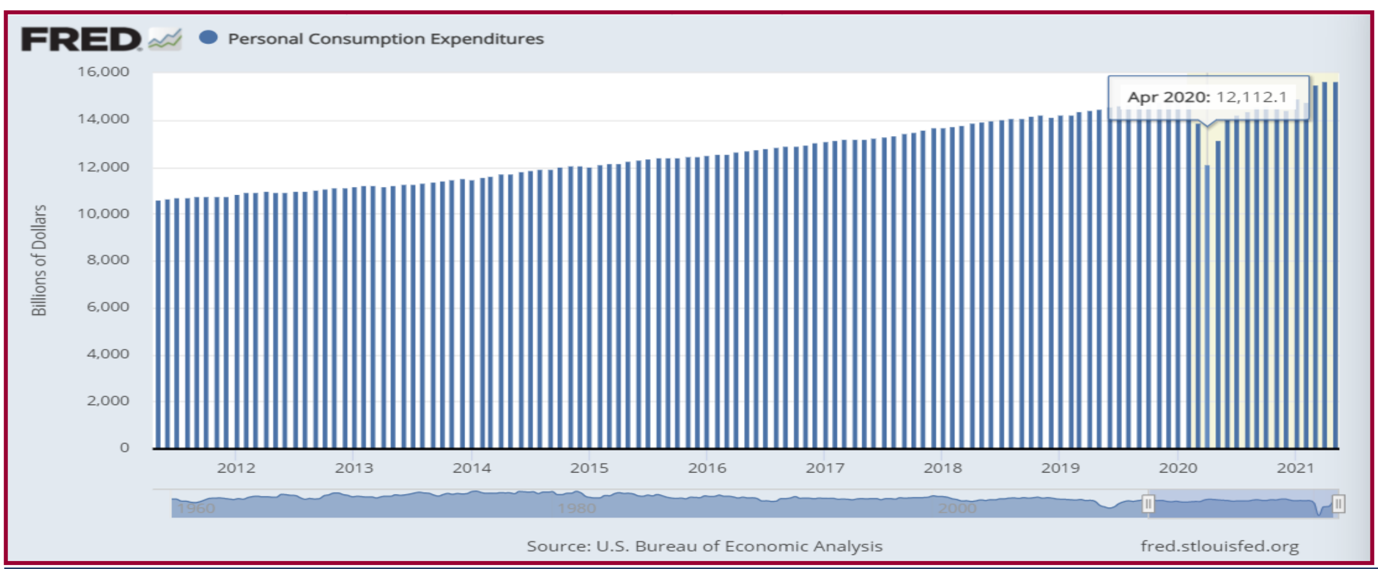
THE EARNINGS PICTURE WILL EVENTUALLY WORSEN

There's no precedent for a dramatic economic rebound such as the one we've been experiencing to last indefinitely. Therefore, it's really a matter of *when* the corporate earnings environment will begin to deteriorate rather than *if* it will.

In a June research note, the global market strategist for mutual fund giant, Invesco, opined that with $20 trillion of cash, bank deposits and other near money, "it is reasonable to expect that too much money chasing too few assets" could result in asset price inflation. I agree. As an example, national housing prices have surged 8% since last June, according to the St. Louis Federal Reserve District Bank, so asset inflation certainly appears to be a thing. Of course, this makes sense when one considers the fact that approximately $6 trillion of that $20 trillion total is comprised of stimulus money that had not existed prior to the onset of the pandemic. It's also worth noting that the Fed is continuing to add to that $6 trillion figure.

CARLIN KNEW THE U.S. CONSUMER

According to Fed data for March, consumer spending in the U.S. accounted for 68.3% of total economic output (GDP). In a rant about over-shopping (and over-eating), George Carlin groused about (semi-conscious) American consumers buying "[stuff] they don't need with money they don't have." He may have been exaggerating a bit for comedic effect, but there can be no doubt that consumer spending is the most vital component of the U.S. economy and the U.S. consumer is once again doing its part as shown here.



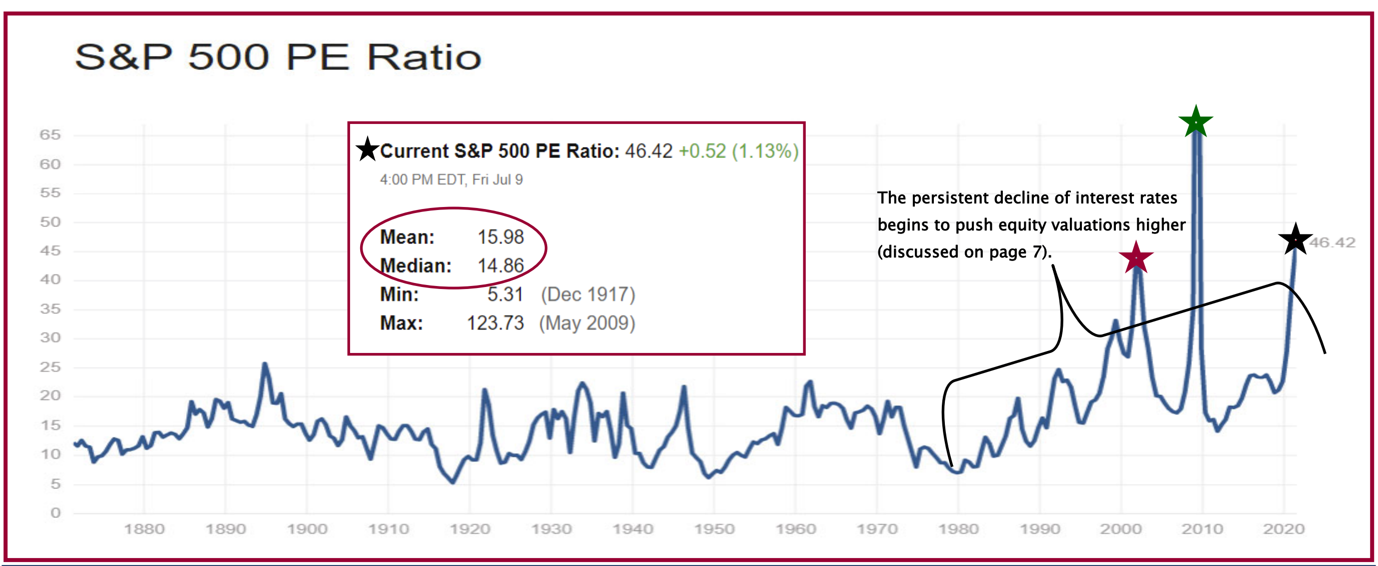
Prior to the pandemic, monthly consumer spending was on the order of $14.9 trillion per month. Last April, it contracted to $12.1 trillion, but spending has since rebounded to a run rate of about $15.7 trillion per month which is about $780 billion per month or 5.2% above the pre-pandemic spending level. **Since corporations make a lot of the stuff people like to buy, the return of the consumer bodes well for corporate earnings.**

WHAT IF THE EARNINGS ENVIRONMENT DETERIORATES RAPIDLY?

If the robust earnings growth analysts expect fails to materialize and the earnings environment abruptly shifts to a scenario closer to the red end of the earnings environment continuum, equity valuations could plunge as investors regain their bearings. The potential for this, however unlikely, argues for not recklessly chasing equities.

Recall how that 10% increase in corporate earnings since the second quarter of 2019 has somehow resulted in those 48% more S&P 500 index points having fluffed up portfolios. If earnings expectations were to deteriorate markedly, I would expect that 48% gain to reverse itself, and because investor psychology would be inflamed, a larger reversal could occur for the same reason a pendulum overshoots its equilibrium point when it reverses course.

The priciness of stocks and the stock market are often gauged by the relationship of the prices of stocks to a dollar's worth of earnings to which each share of stock may hypothetically be entitled. This ratio is referred to as the Price-Earnings (PE) Ratio. As you can see in the next image, the price of stocks in relation to their earnings have often traded around a ratio of 15 or 16 over the past 150 years, and almost never at 46.



MELTDOWN OF 2008/9 IS NOT PARALLEL TO TODAY

The PE ratio of the S&P was significantly higher during the meltdown of 2008/9 (green star, previous image), but instead of that spike *presaging* the pain that flowed to equity investors, it developed *as a result* of the corporate earnings collapse which coincided with equity investors seeing about half the value of their holdings disappear. Consequently, there's not much of a parallel between the meltdown of 2008/9 and the current environment.

TECH-WRECK OF EARLY 2000S MAY BE INSTRUCTIVE

To be clear, I'm not forecasting a market plunge. Rather, I'm laying out a framework to assess the losses that could be experienced by equity investors in the event the growth in corporate earnings expected by analysts do not materialize.

During the tech-related euphoria of the early 2000s, the PE ratio of the S&P 500 was almost as elevated as it is now (red star, previous page). As tech-related earnings failed to materialize as quickly as had been anticipated, equity valuations declined some 45% between June of 2000 and December of 2002.

As mentioned, the PE of the S&P 500 currently stands at 46 as shown on the previous page (black star). However, that ratio is based on the corporate earnings that have been reported over the *past* 12 months. **When the prices of stocks are viewed in relation to corporate earnings expected over the *next* 12 months, the price-earnings ratio of the S&P 500 declines from a stratospheric 46 to 22, a figure that is no longer dramatically out of line with historical norms.** The key for this happy ending will be for companies to deliver the earnings analysts expect.

ELEVATED VALUATIONS MAKES SENSE WHEN RATES ARE LOW

Although a forward-looking PE ratio of 22 is much more in line with historical norms than is the backward-looking figure of 46, it's still on the high side of history. But, context matters and in this case the context that matters is the general level of interest rates.

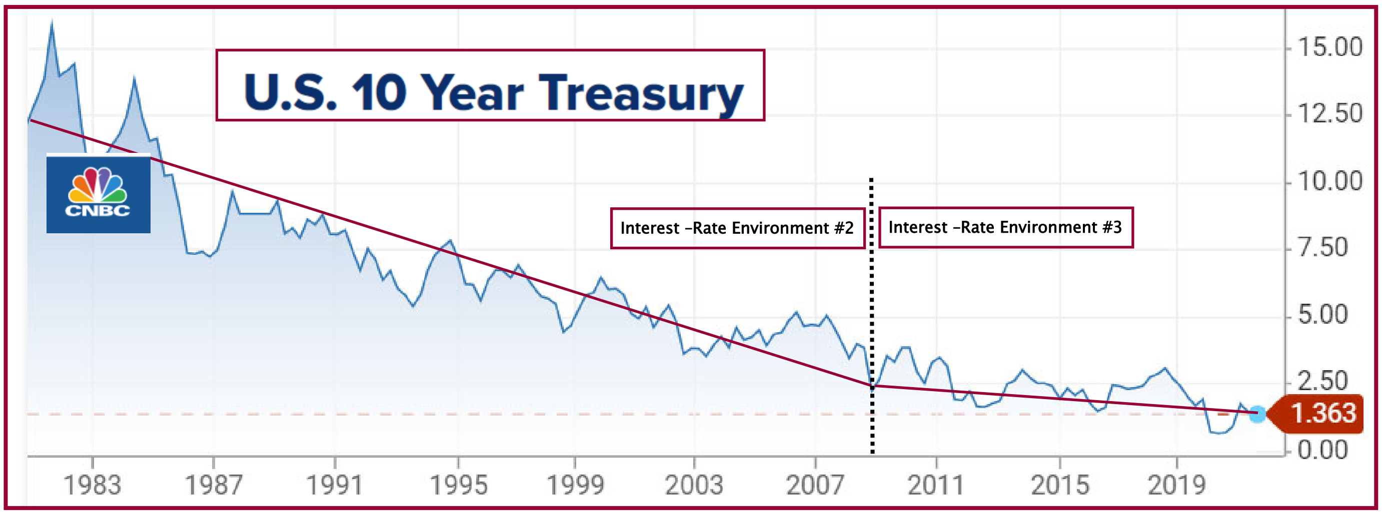
In general, the valuations ascribed to most asset classes are lowest when interest rates are high and rising and highest when interest rates are low and falling. By now you might sense a theme. As with the corporate earnings environment, investors prefer interest-rate environments in the precise order shown next:

Q: WHICH INTEREST-RATE ENVIRONMENT HAVE WE BEEN IN?

Interest rates expected to:

Best: 1 *Fall* at an *increasing* rate,
2 *Fall* at a *constant* rate,
3 *Fall* at a *declining* rate,
4 *Remain constant,*
5 *Rise* at a *declining* rate,
6 *Rise* at a *constant* rate, or
Worst: 7 *Rise* at an *increasing* rate.

To answer this question, note the discontinuous manner (dotted line) in which the yield on the 10-year Treasury Note has changed over time.



The U.S. was in a quite favorable interest-rate environment (Environment #2) from 1980 to about 2009 and in a somewhat less favorable rate environment (Environment #3) since then. **Much more importantly, the Federal Reserve's interest rate policy makers expect the interest rate environment to shift toward one of the rising-rate environments by at least 2023 and as soon as sometime next year.**

Now that you see that interest rates have been declining since 1980, refer back to the PE graph on page 5 to notice that the PE ratio of the S&P has generally risen over that same span of time. Correlation is not necessary causation, but **because there are sound reasons for lower interest rates to have forced equity valuations higher over the past four decades, those same sound reasons are apt to depress equity valuations when policy makers at the Federal Reserve finally begin their stated quest to hike rates again.**

BOTTOM LINE

The risk does exist that corporate earnings will not fulfill analysts' expectations, but unless the U.S. and/or the developed world in general suffers some type of systemic shock, I would expect corporate earnings to more or less meet the expectations analysts have set for them and for equity valuations to not suffer any dramatic downdraft as a result of pronounced earnings misses.

Analysts have tended to be overly optimistic when forecasting earnings, but they are not in the habit of routinely raising their earnings forecasts without good reason. Because analysts have been raising their corporate earnings forecasts with regularity, my sense is that corporations will deliver enough earnings growth to bring stock market PE ratios in better alignment with historical norms and that folks like us will be able to retain the gains we already have.

Even if analysts begin shaving their earnings estimates to better conform with earnings releases as they are about to be made, those last minute shaving exercises may be offset by corporate managers who tend to sandbag their earnings guidance by under-promising a bit so they can look like heroes to shareholders when they over-deliver.

Since a rise in the general level of interest rates seems to be an eventuality, I regard uncertainty around Fed policy to implement those rate increases without derailing the economy to present more risk than does the uncertainty around corporate earnings.

Invesco (that same mutual fund giant) reviewed the stock market returns associated with initial rate hikes that occurred in 1994, 2004 and 2015 (during several previous business cycles). **Encouragingly, Invesco found that stock market returns remained "robust" 12 months prior to and 36 months after the first rate hike, weakening only when short-term and long-term interest rates became relatively uniform. Equity investors would be relieved if they could know that this relationship would hold when the Fed begins raising rates in 2022 or 2023.** Unfortunately, no such assurance can be had.

Nonetheless, I remain confident that, over time, the returns to be had by investing directly in the capital markets will continue to dwarf the returns available through insured deposit products, savings bonds, fixed-rate annuities and other guaranteed offerings.

— Glenn Wessel