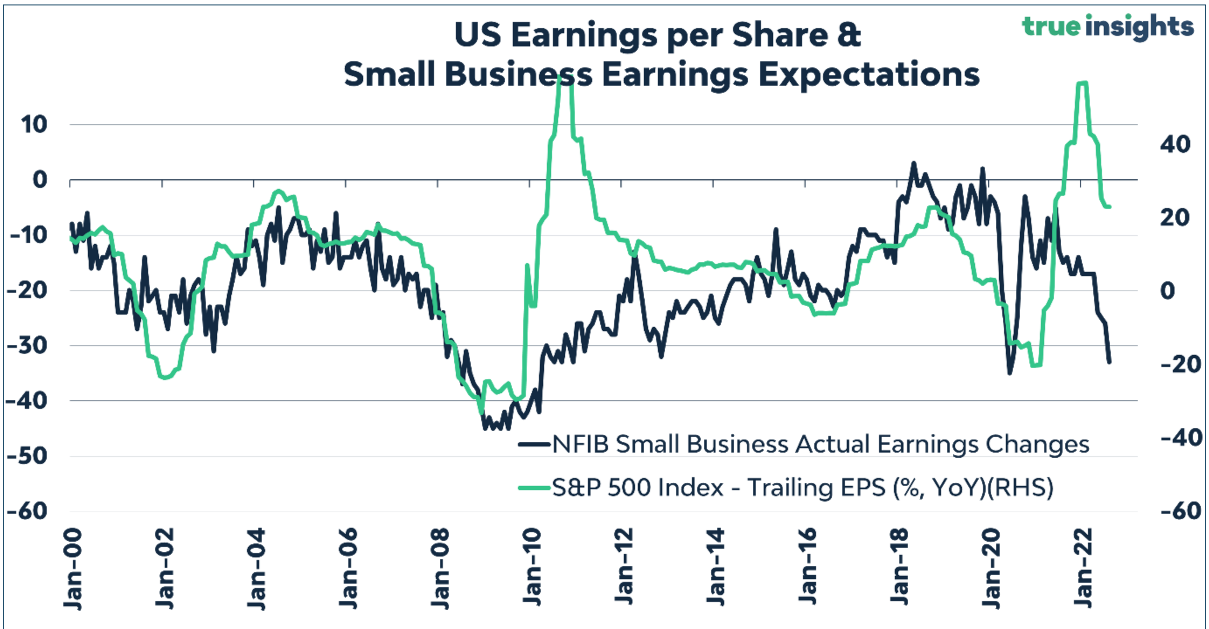
true insights

Equity Valuation and Earnings: where's the upside?

Daily Insight September 2022

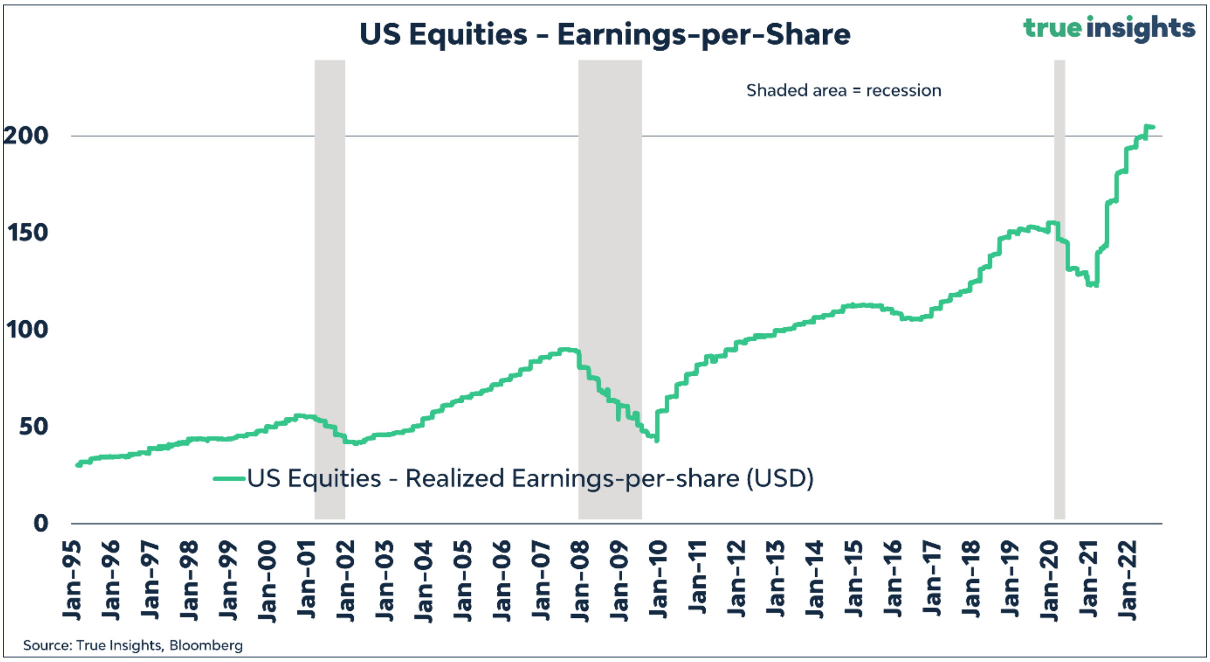
The higher-than-expected US inflation numbers reported on Tuesday made equities crumble. But there was more equity-unfriendly macro data that did not make the headlines. While the NFIB Small Business Optimism Index rose marginally in August, the outlook for earnings worsened and is not far away from the levels seen during the COVID crisis. It's one of several indicators that suggest earnings expectations are too upbeat.



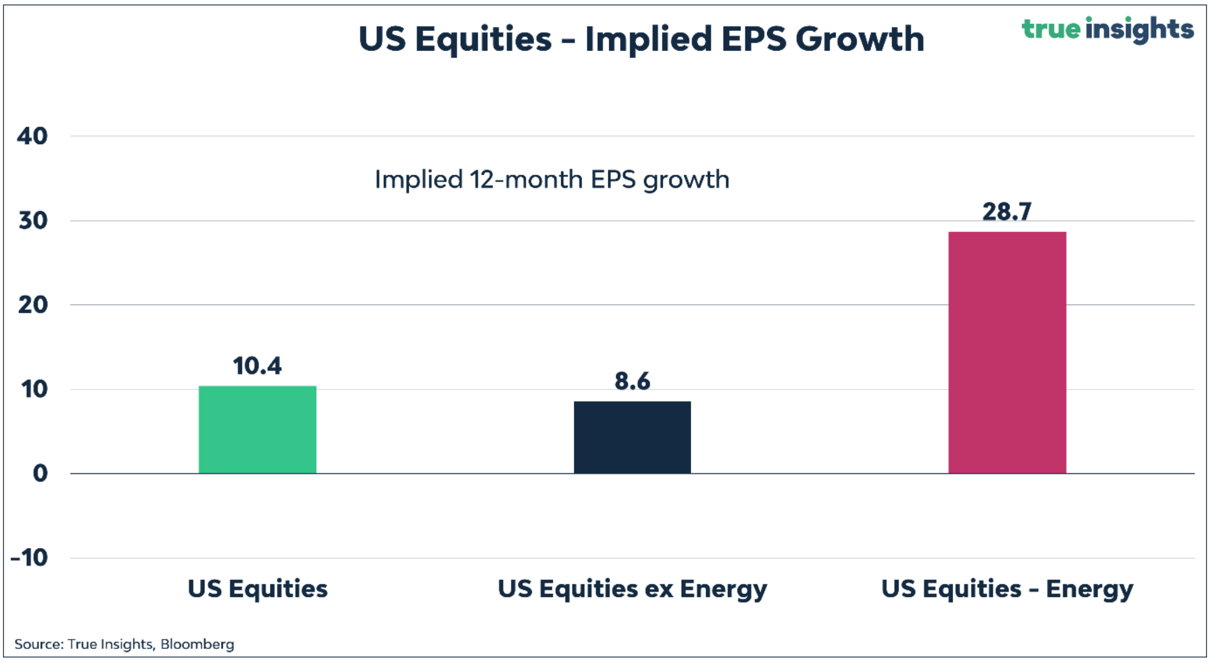
Source: True Insights, Investing.com, Bloomberg

Too much earnings growth

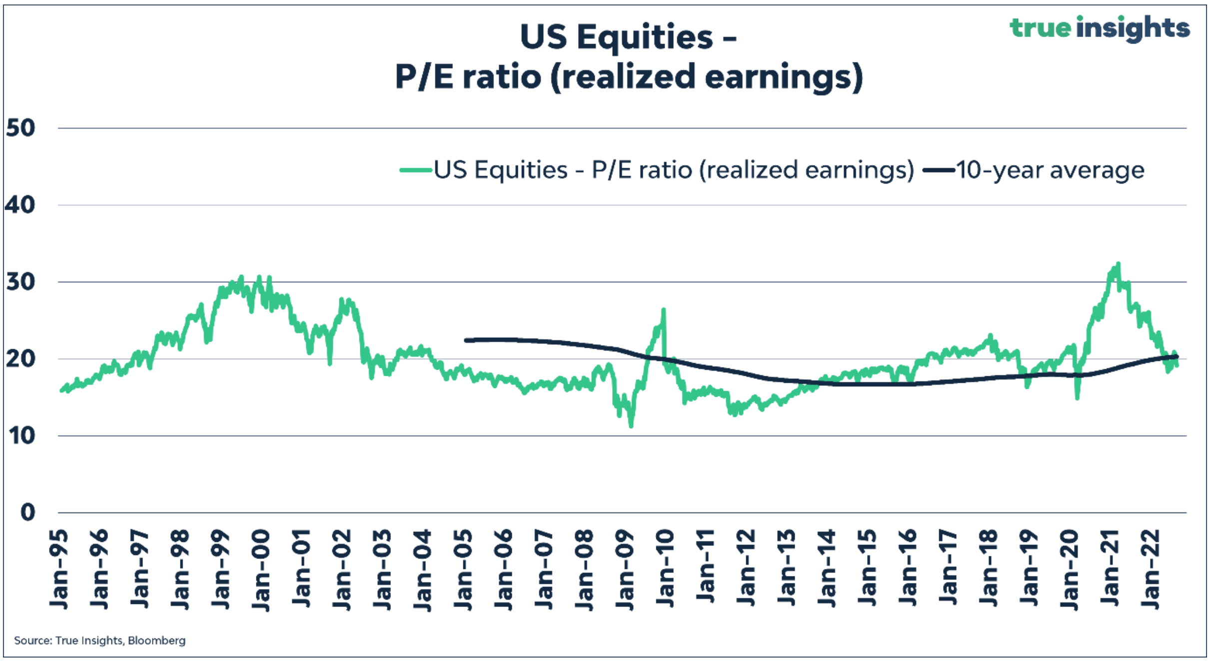
Earnings-per-share growth turned negative during every recession but also during every major economic slowdown, like the one in 2015/2016. Yet, the expected 12-month earnings growth for the S&P 500 Index remains above 10%.



As we have highlighted in earlier research notes, the 10% expected earnings growth for the S&P 500 Index is not masking a less-demanding outlook for earnings once the expected earnings growth of the energy sector is taken out. Excluding energy, investors expect S&P 500 Index earnings-per-share to grow by 8.6% in the next 12 months. That number does not match an environment of and slowing economy with elevated odds of a recession.



Demanding valuation
Things get more awkward when valuation is added to the mix. The current P/E ratio of the S&P 500 Index based on realized earnings is 19.2. This is marginally below the rolling 10-year average P/E ratio. But as the chart below shows, this is largely explained by the massive spike in the P/E ratio after COVID. The valuation of the S&P 500 index skyrocketed because investors wrongfully extrapolated the technology trends that 'benefited' from the lockdown measures. This is what we call the 'Zoom' effect, with the Zoom stock rising more than 600% between February and October 2020 before crashing 85%(!). At its peak, the P/E ratio of Zoom topped 700!



But even if we forget about this investor delusion, the P/E ratio bottomed at significantly lower levels during previous recessions and slowdowns. For example, during the Great Financial Crisis, the P/E crashed to 11.3, and in the aftermath of the dot-com bubble, the S&P 500 Index P/E ratio bottomed at 17.5.

Connecting the dots
The table below combines several scenarios for EPS growth and different valuation levels. It reveals that for the S&P 500 Index to have any meaningful upside, a combination of positive EPS growth and a P/E ratio of at least 19 is required. However, we think the odds of flat to negative EPS growth with lower P/E ratios are significantly higher. Hence, the earnings-valuation outlook – one of the key parts of our Valuation pillar in the Macro, Sentiment, and Valuation framework – brings downside for equities. Should EPS growth turn negative, as we witnessed in previous episodes of strong

downturns or recessions, the June low of 3667 in the S&P 500 Index is at risk.

S&P 500 Index - EPS vs. P/E Scenarios

EPS Scenarios	P/E Scenarios - Current					Current PE: 19.2
Current EPS (USD 204.50)	20	19	18	17	16	Average
10.4%	4,526	4,299	4,073	3,847	3,620	4,073
+5%	4,304	4,089	3,874	3,659	3,443	3,874
0%	4,099	3,894	3,689	3,484	3,279	3,689
-5%	3,894	3,700	3,505	3,310	3,115	3,505
-10%	3,689	3,505	3,320	3,136	2,951	3,320
Average	4,102	3,897	3,692	3,487	3,282	3,692
Current S&P 500: 3946						

Source: True Insights

Conclusion and Positioning

Equity market valuation remains elevated even though the outlook for earnings-per-share growth is deteriorating. The latest NFIB Small Business data confirm this. However, earnings expectations remain too upbeat. As a result, the combination of the current P/E ratio and slower earnings growth than markets expect brings substantial downside for the S&P 500 Index.