Five reasons why S&P PE should be higher/ lower than history

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2019 S&P EPS growth likely 0-10%, but yearend S&P PE is more uncertain

The analysts' bottom-up and strategists' top-down estimates for 2019 S&P earnings per share (EPS) have been cut from 10% growth at September end to 5% now. A giant deceleration in S&P EPS growth from 22% in 2018, or 15% excluding the tax cut benefit, is now the widespread consensus view. However, there is a wide range in strategists' 2019 end S&P targets, i.e. strategists have very different views on what the price-to-earnings (PE) ratio should be.

Our 2019 S&P target of 2850 is 16.75x our $170 2019E S&P EPS forecast

We forecast 4% S&P EPS growth in 2019, but this includes a 15% decline in Energy sector profits. Excluding Energy, our S&P EPS growth estimate is 5.5%; which it has been for more than 6 months. Our intrinsic S&P 500 valuation model suggests a fair trailing S&P PE of 18, but our target is 16.75x our 2019E S&P EPS given uncertainty in several geopolitical issues; which include U.S.- China trade terms, Brexit and other issues that make it uncertain if enough caution is built into our EPS estimates.

There are good reasons to argue for a higher or lower S&P PE multiple from our 16.75 target, we list 5 of the top reasons on our mind for each. But we see upside from the current 16.0 PE and while we think 16.75 is a decently balanced S&P PE target, we think a climb to 17-18 is likely if the expansion shows more signs of lasting at least 2 or more years and 10 year real Treasury yields (TIPS) do not exceed 1.5%.

5 reasons why the S&P PE should be above its 16 average since 1960:

1. **Real long term interest rates are much lower than history**
   The real 10 year yield is below 1%. The U.S .Federal Reserve (Fed) will be patient and is quite close to the neutral rate in our opinion. We think real 10 year yields stay below 1.5% for the rest of this cycle. This is much lower than the 2-3% norm in 1960-2007.
2. **Low inflation and subdued inflation uncertainty, low ULCs**
   Since 1960, the average S&P PE is 18.0 when inflation and unit labor costs (ULCs) were below 4%. The average S&P PE was 14.0 from 1960-1984 and 17.7 since 1985. Today inflation and ULCs appear well contained at about 2%.
3. **Higher triple-net equity returns: Lower fees, tax rates, and inflation**
   Equity investment fees are lower, dividend and long-term capital gains tax rates are lower than history, and inflation is lower. Today, equity investors reap higher triple-net returns: 1) after fees, 2) after taxes, and 3) after inflation.
4. **The weight of typically higher PE sectors in the S&P is above history**
   Technology, Communication Services and Health Care are 40% of S&P by earnings weight now vs. 15% in 1985. These tend to be higher PE sectors.
5. **Higher S&P net margins are structurally sustainable**
   S&P 500 business mix has shifted to higher margin industries that have had success in replicating their business domestically and globally. Higher margins than history boost the ability of the index to absorb cost shocks.

5 reasons why the S&P PE should be lower than historic average:

1. **Robust late cycle EPS growth is often met with investor skepticism**
   The observed PE tends to be above average on cyclically depressed EPS and below average on cyclically peaked EPS. It is common for robust late cycle EPS growth and the resulting EPS to be questioned for its sustainability. S&P EPS must demonstrate its sustainability by delivering 5%+ EPS growth.
2. **S&P PE rarely expanded during Fed tightening, fear of policy mistake**
   It's rare for the S&P PE to expand while the Fed is hiking. However, the S&P PE at 16 right now is below recent levels and our 16.75 PE target is a level sustained and exceeded in prior hiking cycles. Post December, the Fed is now more conscious about over hiking risk and is expressing more patience.
3. **Global slowdown leads to greater fear of recession**
   The record long expansion and now global slowing raise recession fears. We acknowledge this "soft landing" uncertainty and will monitor the situation to adjust our PE accordingly. As of now, we consider our 16.75 S&P PE fair.
4. **S&P PE is rarely above 17 beyond 2 years after recession**
   S&P PE>17 beyond 2 years after a recession is rare. But it happened when the mid-cycle slowdown didn't turn into recession and the cycle proved to be long, such as late 1960s, late 1990s, and recently 2016-2018. It is also rare that long-term interest rates are this low after 10 years of expansion.
5. **Elevated geopolitical risks globally**
   Trade tension and Brexit are the two biggest known upcoming risks, but we think compromise solutions are still the most likely outcome for both.

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Definitions

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom from the European Union.

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

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

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

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A soft landing is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

Unit labor costs (ULC) measure the average cost of labor per unit of output. Such costs are calculated as the ratio of total labor costs to real output. In broad terms, unit labor costs show how much output an economy receives relative to wages, or labor cost per unit of output

The U.S. Federal Reserve (Fed) implements U.S. monetary policy.