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Economic EPS growth: Does any region have it this cycle?

David Bianco
Americas Chief Investment Officer
DWS

Economic profit growth is very difficult to achieve at regional index levels

A business that generates economic profit is a business that makes better use of the capital it employs than other similar risk businesses. Companies that generate economic profit under free market conditions tend to boost economic productivity and societal prosperity. Investors tend to prefer such companies and award them higher valuations versus their broad regional index.

Economic EPS growth is a simplified proxy for proper economic profit growth

While many individual companies generate economic profits, it's very difficult for the full set of companies in a regional index to generate economic profits and especially to increase their economic profits. In this note, we introduce economic earnings-per-share (EPS) growth as a proxy for proper economic profit growth metrics and see if any of the major global regions are achieving such growth this cycle. It appears that only the U.S. and EM (emerging markets) Asia are doing so on a secular basis, or setting cyclical EPS bounce aside. These two regions both have high Tech sector representation. Japan has turned the corner on its poor capital allocation of the past, but it will take more time to tell if it can sustain secular economic EPS growth.

Economic EPS growth = Real EPS growth – (EPS retention ratio * Real CoE)

It is well understood that inflation doesn't represent value added EPS growth. Only real EPS growth raises a company's real value. What is less understood is that real EPS growth only represents economic profit growth when that EPS growth exceeds a threshold that accounts for the portion of earnings retained rather than paid out to shareholders as dividends. If real EPS growth is less than the retention ratio times a fair real cost of equity (CoE), then investors would be better off if earnings were paid as dividends instead. As then, the dividend yield should exceed the prior real EPS growth rate.

Shiller vs. Bianco PE: Inflation only vs. reinvestment adjusted 10yr trailing EPS

The concept that EPS growth should exceed inflation whenever companies reinvest part of their earnings is the principle underlying the calculation of our Bianco price-to-earnings (PE) and why we have long argued that Shiller PE misleads; because it fails to account for changes in S&P 500 dividend payout ratios across time. Because payout ratios also differ across global regions and sectors, we consider Shiller PE unreliable for valuation comparisons across such global equity market segments. Inside are updated Bianco PEs across regions. Europe remains cheap on Bianco PE, but this requires a continued recovery in the earnings power of Europe versus its last cycle. We believe this will happen, albeit slowly and probably not to the fullness of prior cycle earnings peaks. EM is cheap on Bianco PE, but we prefer EM Asia as its low Bianco PE being truly attractive is less dependent on a return to high commodity prices of the last cycle.

Using trailing vs. forward EPS is the main debate right now on the S&P PE

Shiller PE continues to point to an overvalued S&P 500, as it has for many years. But Bianco PE also points to a somehwat expensive market on 10 -yr trailing average S&P EPS adjusted for both inflation and fair return on reinvestment. It is only on a forward PE that the S&P is attractive at about 17x 2018E EPS vs. its 30yr average PE. This is why this earnings season is so important. If this earnings season, which will include benefits of the U.S. corporate tax rate cut, supports our 2018E S&P EPS of $155 or higher, we expect stocks to rally strongly.

What economic profits are to businesses, alpha is to investment managers

Just as measuring economic profits requires a risk adjusted cost of capital, measuring true alpha requires analysis that incorporates all the risks taken to generate any outperformance vs. a benchmark. It's well understood that beating a benchmark from a persistent tilt toward securities with a beta to the benchmark above one is not true alpha. Similarly, any persistent tilt toward other risk factors, like size and value,per Fama & French, is also not true alpha.

Contributor - Ju Wang, Investment Strategist & Portfolio Analyst

Contact Information

David Bianco 212 250-8169, david.bianco@dws.com

Ju Wang 212 250-7911, ju.wang@dws.com

Jamie A. Serio 212 454-0554, jamie-a.serio@dws.com

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Definitions:

Alpha is a measure of the active return on an investment. An investment's alpha is the excess return relative to the beta-adjusted market return.

The cyclically adjusted price-to-earnings ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the U.S. S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

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.

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