S&P 500 EPS Outlook: $131 / $140 for 2017 / 2018

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Reliable S&P EPS forecasts are crucial to fundamental investing

We base our S&P 500 price targets on a disciplined intrinsic valuation model based on a normalized S&P earnings per share (EPS) estimate framework. We use a “middle-up” approach to estimating S&P EPS. We examine macro profit drivers and sensitivities to forecast earnings for each S&P sector and sum them up to reach our aggregate S&P EPS estimate. We consider where we are in the economic/profit cycle and we also make an accounting quality adjustment to our normalized non-GAAP S&P EPS estimate. We then capitalize this adjusted normalized S&P EPS at our fair real cost on equity (CoE) estimate.

S&P is Global – Investment & Mfg. Oriented: Oil and FX also key

Our “middle-up” approach builds upon our sector-by-sector earnings forecasts and helps us determine the influence of various macro forces on S&P 500 EPS including global GDP, global capex, commodity prices, trade activity, FX rates, interest rates, loan growth, labor productivity, etc. Some rules of thumb are: Every $5/bbl higher crude oil price adds ~$1.50 to S&P EPS; every 10% stronger dollar vs. a basket of major currencies reduces S&P EPS by 2.5% or ~$3.00; every 25 basis point (bp) higher average Fed Funds rate raises S&P EPS by ~$0.50 via better Bank net interest margins, every 5 point reduction in the U.S. statutory corporate tax rate adds $5 to S&P EPS.

Raise 2017E S&P EPS from $130 to $131, 10.4% y/y, 7% ex Energy

Most sectors beat on 1Q17 EPS. However analysts continue to cut Energy earnings for the rest of the year despite beating the depressed estimates in 1Q. WTI oil showed renewed weakness in 1H as US shale production offset cuts implemented by OPEC, which suggests that the oil rebalance will likely take longer than many expect as we have long argued. We cut our 2017E Energy sector profits from $44bn to $42bn. Capex growth, especially Tech related, in the gross domestic product (GDP) account showed clear signs of acceleration even as 1Q U.S. GDP disappointed. Tech booked healthy top line growth and further margin expansion in 1Q. We raise our 2017 EPS estimate for Tech, and also for Financials as 2 more hikes from the Fed are likely this year.

Our 2018E S&P EPS remains $140. Up 7%, ex. corp. tax cut boost

Energy earnings are bouncing off cyclical lows in 2017 and in 2018 aiding S&P EPS growth. But ex. Energy, we expect S&P EPS to grow 6% y/y in 2018, slightly slower than 7% in 2017 ex. Energy, but in line with history. We think a corporate tax rate cut will happen in 2017, but it’s hard to forecast the exact benefit and timing of such until the details are known. We still think it’s reasonable for the U.S. to cut the corp. tax rate from 35% to ~25% to align with OECD average, rather than the proposed lower 15% rate with complex changes to the tax code. A 10% cut in the corporate tax rate reduces the S&P effective tax rate by 6%, which is an 8-9% boost to S&P EPS or ~$10.

Intrinsic valuation by sector: Most PE upside at HC & Fin. (Banks)

We assume an aggregate 5.5% real CoE for S&P 500 and apply intrinsic valuation by sector with sector specific real CoE estimates, non-GAAP EPS accounting quality adjs. and consideration of economic profit growth potential premiums. With our refined sector earnings estimates, Health Care and Financials still have the biggest price to earning (PE) upside and among the most attractive total return upside. The PE upside at domestic bond substitutes Utilities & Telecom’s could be delayed until long term yields get tested by more Fed hikes and asset sales. Tech’s PE upside is limited, but its superior EPS growth warrants outperformance. PE downside at Energy, Industrials and Materials and modestly at Consumer Staples and Discretionary.

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Definitions

One basis point (bp) equals 1/100 of a percentage point.

Capital expenditure (CapEx) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Consumer discretionary is a sector of the economy that consists of businesses selling nonessential goods and services.

Consumer staples is a sector of the economy selling essential products.

Cost of equity (COE) is the return a firm theoretically pays to it 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.

The federal funds rate is the interest rate at which banks actively trade balances held at the Federal Reserve.

FX or foreign exchange is the currency — literally foreign money — used in the settlement of international trade between countries.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Intrinsic value is the actual value of a company or an asset based on an underlying perception of its true value, including all aspects of the business in terms of both tangible and intangible factors. This value may or may not be the same as the current market value.

Net interest margin is a measure of the difference between the interest income generated by banks or other financial institutions and the amount of interest paid out to their lenders, relative to the amount of their interest earning assets.

Non-generally accepted accounting principles (Non-GAAP) earnings are an alternative method used to measure the earnings of a company. Companies may report both non-GAAP earnings in addition to earnings calculated through generally accepted account principles (GAAP).

The **Organization of the Petroleum Exporting Countries (OPEC)** is an international organization with the mandate to "coordinate and unify the petroleum policies" of its meanwhile 12 members.

The **Organization for Economic Co-operation and Development (OECD)** started in 1948 as the Organization for European Economic Co-operation (OEEC) and changed its name in 1960, now representing 34 countries with democratic governments and free economies.

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

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

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.
Index Definitions

The **S&P 500 Index** includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization. It is not possible to invest directly in an index.