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Americas CIO View

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Marketing Material

COMPELLING EQUITY VALUATIONS ON LAST YEAR'S EARNINGS

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IN A NUTSHELL

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WHAT'S PRICED BY EQUITY MARKETS FOR 2021 RECOVERY EARNINGS?

The S&P 500 delivered a nearly 20% rally last week from prior week lows. We think the rally was driven by news of the two trillion dollar plus fiscal stimulus package in the works, which finally passed on Friday afternoon. We outline fiscal actions below, but we do not see last week's market action as indicative of investor's judgement on the package or the broad economic future, but rather this extreme volatility is just part of extreme uncertainty. We try to gauge investor expectations through observed valuations.

S&P 500 VERY ATTRACTIVE ON 2019 EPS, LOW TRAILING P/ES AT SECTORS MOST VULNERABLE

Our usual valuation charts are updated inside. Observed valuations based on last year's earnings are very attractive, but that's inane. We must contemplate when 2019 earnings are recovered by the S&P 500 and each of its sectors or industries. Robust ways to infer earnings expectations exist, but we can derive simple methods from the robust. By consulting our robust methods, we think an about 17 forward price-to-earnings ratio (P/Es) at 2021 start or about 18 trailing P/E at 2021 end is fair for the S&P 500. This will require far less volatility and risks than exists today, but we think this is a reasonable outlook.

Given the uncertainties investors currently face, we think they will demand a roughly 10% return from the S&P 500 for the rest of 2020. Thus, discounting a fair forward S&P 500 P/E at 2021 start of 17x by 10% equals 15.5x today. As such, the S&P 500 at 2,541 implies the market expects 164 dollars of S&P 500 earnings per shares (EPS) in 2021, or 100% of 2019 S&P 500 EPS.

Following a similar approach by sector, but with different fair forward 2021 start P/Es and 5% to 15% discounts for 2020 returns, we estimate the percentage of 2019 EPS that each sector is now priced to generate in 2021: Tech is 105% using a 19.5x forward PE at 2021 start, Comm. 95% at 18.5x, Health Care 80% at 18x, Staples 92% at 20x, Utilities 90% at 19.5x, Real Estate Investment Trusts (REITs) 95% at 18.3x, Consumer Discretionary 125% at 17.5x, Industrials 94% at 16x, Materials 100% at 15.5x, 90% Energy at 13.5x, Financials 75% at 14x.

OUR 2021E S&P 500 EPS IS 160 DOLLARS, BUT WITH RISING INDICATIONS OF DOWNSIDE RISK

As detailed last week, our 2021E (estimate) S&P 500 earnings per share (EPS) is 160 dollars. This implies normal 2020E S&P 500 EPS of 150 dollars; because S&P 500 EPS should rise 5% plus annually owing to reinvested earnings. Incorporating a long-term expected return on equity investment with consideration of dividend returns is the key concept underlying the Bianco P/E. This cyclically adjusted P/E method uses Equity Time Value Adjusted (ETVA) 10-year trailing average S&P 500 EPS, rather than Professor Shiller's inflation only adjusted past earnings. At 2019 end, 10-year trailing average ETVA S&P 500 EPS was 154 dollars. This happens to align well with our 2020E normal S&P 500 EPS estimate of 150 dollars, which we estimate using a different sector by sector fundamental process. At 2,541, the S&P 500 is trading at 17x our normal 2020E EPS or at a Bianco P/E of 16.5x vs. an average of 16x back to 1960 or

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18x to 1985. This would suggest that in a normal risk environment the S&P 500 is fairly valued if no lasting setback is suffered to its past 10-year average ETVA earnings.

FISCAL STIMULUS "PACKAGE #3": STRONG ON HOUSEHOLD SUPPORT

Key highlights of the two trillion dollars plus Coronavirus Aid, Relief & Economic Security Act:

1) **Checks to Americans (300 billion dollars):** 1,200 dollars single, 2,400 dollars joint file, 500 dollars plus per child.

2) **Pandemic Unemployment Insurance (250 billion dollars):** Boost by 600 dollars per week above the normal amount to July end, waive wait periods, extend coverage 13 weeks beyond usual 26 weeks, expand eligibility to self-employed, independent contractors, etc.

3) **Paycheck Protection Program (350 billion dollars):** Loans up to 10 million dollars for enterprises with under 500 employees through Small Business Administration programs. Loans eligible for forgiveness on eight weeks of payroll, rent or mortgage interest, and utilities.

4) **Emergency Loans, Treasury Funded Facilities at Federal Reserve (500 billion dollars):** Treasury loans to industries essential for defense and 454 billon dollars for facilities run by the U.S. Federal Reserve (Fed). Fed has established Primary and Secondary Market Corporate Credit Facilities. Facilities to support liquidity, orderly function of municipal bond, commercial paper and investment-grade credit markets. Asset-backed security purchases also renewed. Fed likely sets risk tolerances and allocates any capital loss budget provided by Treasury to the states, cities, public authorities and businesses critical to the nation.

5) **Many tax code changes and public / private regulatory directives (250 billion dollars):** Relief includes extension of net-operating-loss carrybacks (up to five years), payroll taxes paid by employer deferred to 2021, tax credits for paying sick employees, etc.

6) **Funds directed to States and Federal Agencies for crisis response (450 billion dollars).**

HOW BAD NEAR-TERM? WE DO NOT KNOW! FORECAST FREQUENTLY, LEARN ANDREVISE

Our 125 dollars 2020E S&P 500 EPS assumes a recession as large as or larger than 2008-09. This near 25% S&P 500 EPS decline compares to 45% in 2008/09 versus 2007 owing to a more resilient composition of S&P 500 earnings. We favor sectors with this resilience.

GLOSSARY

Commercial paper (CP) is issued by corporations and represents short-term unsecured promissory notes with a maturity of 270 days or less.

Cyclical is something that moves with the cycle.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

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

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

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

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

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

Real Estate Investment Trusts (REITs) are companies, mostly listed, that own and often operate various types of real estate. They are obliged to pay out a minimum of 90% of earnings.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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