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Marketing Material

BUNKER DOWN: S&P MARGINS, BUYBACKS AND EPS QUALITY IN DECLINE

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IN A NUTSHELL

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HIGHER TARIFF RATES INTRODUCED TO THE FORECAST CALCULUS: 25% IS NOT THE MAX

Last week, President Trump announced, followed by a U.S. Trade Representative (USTR) statement, that all existing and scheduled tariffs on imports from China will be increased by 5% in response to China's latest retaliatory tariffs. The existing 25% tariff on about 250 billion U.S. dollar (USD) of mostly intermediate goods imported from China will be raised to 30% October 1. The 10% tariff on about 300 billion USD of mostly consumer goods imported from China – scheduled to take effect September 1 for half of these goods and December 15 for the other half – will now be 15%. This development changes the worst case scenario, well…within reason, of a 25% tariff on all imports from China to 30%. This prospect is the real "get out of China" message to corporate America.

BRINKMANSHIP WITH CHINA OR WARNING TO CORPORATE AMERICA TO BUNKER DOWN?

We appreciate game theory or "art of the deal" approaches to assessing this situation, but we think it is important to seriously consider this at face value. Every tariff on imports from China has taken effect as USTR scheduled with only small modifications from comment-period review. The looming September 1 effective date for the next tranche of tariffed goods will further confirm such follow through. We think a deal to reduce the tariffs in effect or stop those now scheduled is very unlikely by yearend. Any deal is likely to be next year and we are uncertain of even that, and we think any deal made will only lay out a framework and timeline for reducing the tariffs in effect over time. If investors, and, more importantly, corporate managers take the view that tariffs will be higher and longer lasting, damage to profits from costly supply-chain shifts will increase. Given the cost of such actions, they are unlikely to be reversed if tariffs are eventually rolled back. So it is a deal now or the profit damage to come will be hard to reverse. While some see this as raising the chance of a sudden deal, we see such chances as slipping away given heightened distrust, complicated matters beyond trade creeping into the negotiations, and the preparations both sides are now making to create an outcome more tolerable to their economies. We still expect the S&P 500 to revisit its early June lows prior to the G20 Summit's side meeting "truce."

FED LIKELY TO CUT AS TARIFFS INCREASE: PROVIDES CUSHION TO GDP, NONE TO S&P 500 EPS

Escalating trade war hitting global economic and corporate-profit-growth estimates. The China renminbi weakened to 7.15 per USD as more rate cuts from China are expected. This puts crude oil under more pressure. The U.S Federal Reserve (Fed) has opened the door to more rate cuts. We expect a federal-funds-rate cut at the September 18 Federal-Open-Market-Committee (FOMC) meeting and an outlook mostly tied to trade developments. The Fed itself warns this is a small cushion to the economy. We are convinced it will weigh on S&P 500 earnings per share (EPS) because lower interest rates hurt Financials. We doubt the Fed cuts weaken the dollar, as other central banks are likely to cut too and we believe investors will seek more safety in dollar-denominated assets.

THE DRIVERS OF THE 20+ YEAR ASCENT OF S&P 500 NET MARGINS ARE DISAPPEARING

Decades of globalization led to record high S&P 500 profit margins. S&P 500 net-margin expansion since the late 1990s is mostly attributed to: 1) higher pretax-margin industries gaining a larger share of S&P 500 profits as they expanded rapidly abroad, S&P 500 pretax profits from abroad doubled from about 15% in late 1990s to 30% in recent years; 2) lower effective tax rates as foreign profits taxed at lower offshore tax rates climbed, boosting net profits from abroad to about 40%; 3) lower interest expense from lower net debt and lower interest rates; 4) the U.S. corporate-tax-rate cut from 35% to 21% in 2018. We think these drivers have stalled and yet competitive pressures remain intense. The S&P 500 non-generally-accepted-accounting-principles (GAAP) net margin reached a record high of 13.0% in the third quarter of 2018 and 12.4% for full year 2018. The two-way tariffs implemented since July 2018, together with the byproducts of a stronger dollar and weaker oil, pressured S&P 500 net margins down to about 12% in the first half of 2019. More tariffs will pressure margins. Every 25 basis-point (bp) decline in net margins hits S&P 500 EPS by 2%. A significant headwind to S&P 500 EPS growth.

S&P 500 BUYBACK SLOW, BUT TOTAL DIVIDEND AND BUYBACK PAYOUT REMAINS HIGH

Buybacks have slowed a bit with net dollars spent on buybacks at 340 billion USD in the first half of 2019 vs. 395 billion USD in the second half of 2018. On a four-quarter-trailing basis, the dividend-payout ratio was 34% and 39% from buybacks for a combined 73%. We expect buybacks to slow further in favor of higher dividend payouts given valuations and as earnings growth slows.

EARNINGS QUALITY HAS BEEN SUB-PAR SINCE 2015, IT IS 84% IN THE SECOND QUARTER OF 2019

The S&P 500 GAAP EPS to non-GAAP EPS ratio has been below its norm since 2015. We consider this ratio healthy at 90%, when outside of recessions. We are bothered that rather than recovering this ratio drifted lower this year to 84% in the second quarter. We also compare non-GAAP earnings to an adjusted-cash-flow measure to assess how well non-GAAP EPS represents true earnings. Over the past few years, (non-GAAP net income plus depreciation and amortization (D&A)) was 10 to 15% higher than (operating cash flow - option expense) vs. about 5% prior. We advocate a 10% reduction to non-GAAP S&P 500 EPS to account for earnings quality.

GLOSSARY

Amortization
Amortization is an accounting term which refers to the periodical reduction of the book value of intangible assets (such as patents) or bank loans.

Basis point
One **basis point** equals 1/100 of a percentage point.

Central bank
A **central bank** manages a state's currency, money supply and interest rates.

Comment Period
U.S. citizens are entitled to comment on any proposed federal regulation. The time range during which this is possible is called **Comment Period**.

Depreciation
In relation to currencies, **depreciation** refers to a loss of value against another currency over time.

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

Earnings per share (EPS)
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.

Federal funds rate
The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Federal Open Market Committee (FOMC)
The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

G20
The **Group of 20** are the largest industrialized and emerging economies in the world.

Game Theory
Game Theory refers to a mathematical theory analyzing decision-making-situations in which multiple rational participants interact.

Generally accepted accounting principles (GAAP)
Generally accepted accounting principles, or **GAAP**, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

Gross domestic product (GDP)
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.

Operating Cash Flow
Operating Cash Flow is an accounting term that measures the amount of cash generated by a company through its usual business activities.

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

Renminbi (RMB)
Renminbi (RMB) is the currency of the People's Republic of China.

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

Share buybacks
A **share buyback** involves a company buying back its own shares.

U.S. dollar (USD)
The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

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

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