DWS

Americas CIO View

Five reasons why the S&P 500 P/E should be higher or lower than historical values

2019 S&P 500 EPS growth is likely zero to 10%, but year-end S&P 500 P/E is more uncertain

The analysts' bottom-up and strategists' top-down estimates for 2019 S&P 500 earnings per share (EPS) have been cut from 10% growth at September end to 5% now. A giant deceleration in S&P 500 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 500 targets, i.e. strategists have very different views on what the price-to-earnings (P/E) ratio should be.

Our 2019 S&P 500 target of 2850 is 16.75x our 170 U.S. dollar 2019E S&P 500 EPS forecast

We forecast 4% S&P 500 EPS growth in 2019, but this includes a 15% decline in the Energy sector profits. Excluding Energy, our S&P 500 EPS growth estimate is 5.5%; which it has been for more than six months. Our intrinsic S&P 500 valuation model suggests a fair trailing S&P 500 P/E of 18, but our target is 16.75x our 2019E S&P 500 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 500 P/E multiple from our 16.75 target, we list five of the top reasons on our mind for each. But we see upside from the current 16.0 P/E and while we think 16.75 is a decently balanced S&P 500 P/E target, we think a climb to 17 to 18 is likely if the expansion shows more signs of lasting at least two or more years and 10-year real U.S. Treasury yields (TIPS) do not exceed 1.5%.

Five reasons why the S&P 500 P/E should be above its 16 average since 1960:

1. Real long-term interest rates are much lower than historical values

The real 10-year yield is below 1%. The U.S. Federal Reserve Board (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 500 P/E is 18.0 when inflation and unit labor costs (ULCs) were below 4%. The average S&P 500 P/E was 14.0 from 1960-1984 and 17.7 since 1985. Today inflation and ULCs appear well contained at about 2%.

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In a nutshell

- 2019 S&P 500 EPS growth is likely zero to 10%, but year-end S&P 500 P/E is more uncertain
- Our 2019 S&P 500 target of 2850 is 16.75x our 170 U.S. dollar 2019E S&P 500 EPS forecast
- Five reasons why the S&P 500 P/E should be above or below its 16 average since 1960

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 historical values, 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 P/E sectors in the S&P 500 is above history

Technology, Communication Services and Health Care are 40% of the S&P 500 by earnings weight now vs. 15% in 1985. These tend to be higher P/E sectors.

5. Higher S&P 500 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 historical values boost the ability of the index to absorb cost shocks.

Five reasons why the S&P 500 P/E should be lower than the historical average:

1. Robust late-cycle EPS growth is often met with investor skepticism

The observed P/E 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 500 EPS must demonstrate its sustainability by delivering 5% plus EPS growth.

2. S&P 500 P/E rarely expanded during Fed tightening, fear of policy mistake

It is rare for the S&P 500 P/E to expand while the Fed is hiking. However, the S&P 500 P/E at 16 right now is below recent levels and our 16.75 P/E target is a level sustained and exceeded in prior hiking cycles. Post December, the Fed is now more conscious about over-hiking risks 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 P/E accordingly. As of now, we consider our 16.75 S&P 500 P/E fair.

4. S&P 500 P/E is rarely above 17 beyond two years after recession

S&P 500 P/E bigger than 17 beyond two years after a recession is rare. But it happened when the mid-cycle slowdown did not turn into a recession and the cycle proved to be long, such as late 1960s, late 1990s, and recently 2016 to 2018. It is also rare that long-term interest rates are this low after 10 years of expansion.

5. Elevated-geopolitical risks globally

Trade tensions and Brexit are the two biggest known upcoming risks, but we think that in either case a compromise is still the most likely outcome for both.

Performance over the past 5 years (12-month periods)

	01/14 - 01/15	01/15 - 01/16	01/16 - 01/17	01/17 - 01/18	01/18 - 01/19
S&P 500	11.9%	-2.7%	17.5%	23.9%	-4.2%

Glossary

Bottom-Up

Buttom-up is an approach which focuses on approaching a problem through the smallest elements (e.g. individual corporate results).

Brexit

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

Consensus estimate

A **consensus estimate** is a figure that depicts the average of different analysts' estimates about the performance of a particular asset.

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.

Inflation

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

Intrinsic value

The **intrinsic value** is the one that comes closest to the value that an objective fundamental analysis would ascribe to an asset.

Multiple

A **multiple** is a ratio that is used to measure aspects of a company's well-being by setting various of the company's metrics against each other and thereby building indicative ratios.

Price-to-earnings (P/E) ratio or multiple

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

Real

In economics, a **real** value is adjusted for inflation.

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.

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.

Top-Down

Top-Down, in the contrast to "Bottom-Up", is an approach which moves down from a broad analysis of the economic or investment environment to more specific issues.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

U.S. Federal Reserve Board (the Fed)

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

Unit labor costs (ULC)

Unit labor costs (ULC) measure the average cost of labor per unit of output.

Valuation

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

Yield

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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