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In a nutshell

- S&P 500 pro-forma net margin has been declining for two quarters on trade tariffs
- Earnings quality back to normal at above 90% in the first quarter after an abnormal fourth quarter
- S&P 500 total (dividend and buyback) payout is at cyclical high of 76%
- Average S&P 500 EPS growth is 8.6% since 2012, buyback contributed 1.5%
- First quarter S&P 500 EPS finalizes at 39 USD or 1.6% y/y, supports 165 to 169 USD 2019 EPS

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Americas CIO View

S&P 500 margin hurt by trade tariffs, total payout at cycle high

S&P 500 pro-forma net margin has been declining for two quarters on trade tariffs

The S&P 500 non-generally accepted accounting principles (non-GAAP) net-income margin set a record high of 12.5% in 2018, up from 11.2% in 2017. All of the 125 basis-point (bp) margin expansion is from the U.S. corporate tax-rate-cut boost. Non-GAAP net margin reached a record high of 13.0% in the third quarter of 2018, but dropped to 12.0% in the fourth quarter of 2018 and further to 11.6% in the first quarter of 2019 due to the newly imposed trade tariffs. The pressure on S&P 500 net margins will persist in the second quarter of 2019 as the tariffs on 200 billion U.S. dollars (USD) of Chinese goods raised from 10% to 25% go into effect. Large U.S. multinational companies showed strong capacity to divide the additional cost of tariffs among their overseas suppliers, consumers and themselves. But a 25% tariff on a wide range of products is much harder to stomach without either losing some buying capacity from consumers or survival chances of some suppliers. We see the S&P 500 non-GAAP margin to hold above 11.0% in 2019 if the United States will not impose additional tariffs or dial back on existing tariffs. Any further escalation could cause S&P 500 profits to decline in 2019 and offset all the tax-cut benefit.

Earnings quality back to normal at above 90% in the first quarter after an abnormal fourth quarter

S&P 500 GAAP net margin recovered to 10.5% in the first quarter after dipping to 7.9% in the fourth quarter of 2018. GAAP/non-GAAP earnings-per-share (EPS) ratio rose to 91%, higher than the 86% average out of recessions since 1990. S&P 500 GAAP net margin also made a record in 2018, but the fourth quarter in 2018 saw significant widening between GAAP and non-GAAP metrics: fourth-quarter 2018 GAAP net margin was down year-over-year (y/y) as GAAP earnings were 66% of non-GAAP EPS, owing to several large idiosyncratic charges that did not reflect then economic conditions. GAAP EPS includes all items but discontinued operations and the cumulative effect of accounting changes. Non-GAAP EPS generally excludes asset impairments and usually gains/losses on asset sales (at non-financials) and often other lumpy items like large restructuring, tax or litigation charges. We think true EPS sits in-between GAAP and non-GAAP EPS; and we make adjustments for such in our valuation process.

S&P 500 total (dividend and buyback) payout is at cyclical high of 76%

On a trailing four-quarter basis, S&P 500 total yield is 4.4%, 1.9% dividend yield and 2.4% buyback yield. The total payout is 76%, 34% dividend payout and 42% buyback payout. We estimate buyback yield as: (net USD spent on buybacks - stock option expenses) /

market capitalization. Buyback-yield estimates should reflect the continuous issuance of stock to employees at option exercise prices that are well below the market price at which shares are repurchased. This 76% total payout is the highest of this cycle and compares to the 85% cyclical high in early 2008 during last cycle. Companies boosted their buybacks significantly in 2018 with repatriated cash prompted by the new corporate tax law, and lack of profitable investment opportunities as the cycle matures and uncertainties build upon trade tension. S&P 500 companies spent 764 billion net dollars (gross buybacks less stock issuance) on buybacks in 2018. This is 300 billion USD more than the roughly 450 billion USD net buybacks in each year during 2014 to 2017. We think this new trend in buybacks will continue in 2019 and then gradually dial back as companies depend more on their free cash flow for buybacks.

Average S&P 500 EPS growth is 8.6% since 2012, buyback contributed 1.5%

It is easy to misunderstand cash-flow-statement accounting of buybacks and some investors misuse them in estimating EPS growth, true payout or total yield figures, and also some valuation metrics. Companies repurchase shares at market prices, but issue them at lower prices through employee-stock-option programs. Thus, cash-flow-statement-reported net dollars spent on share repurchases as a percent of market cap overstates likely share count shrink and its contribution to EPS growth. We compare S&P 500 EPS growth to its net income growth for the actual impact of buybacks. Since 2012, the average S&P 500 EPS growth is 8.6%, 7.0% of which is from revenue growth and margin expansion, and 1.5% from share buybacks. Buybacks contributed to less than 20% of the total EPS growth. We expect strong buybacks to contribute 2% to S&P 500 EPS growth this year.

First quarter S&P 500 EPS finalizes at 39 USD or 1.6% y/y, supports 165 to 169 USD 2019 EPS

First quarter results showed S&P 500 companies' earnings resilience when faced with 10% tariffs. It is supportive of our 2019 estimated EPS of 169 USD or 4.3% y/y if the newly raised 25% tariffs are dialed back to 10% to 15% and some agreement is reached in June. Otherwise 2019 S&P 500 EPS is likely to be 165 USD if the 25% tariffs last through this year.

Appendix: performance over the past 5 years (12-month periods)

	04/14 - 04/15	04/15 - 04/16	04/16 - 04/17	04/17 - 04/18	04/18 - 04/19
S&P 500	10.7%	-1.0%	15.4%	11.1%	11.2%

Past performance is not indicative of future returns.

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 5/23/19

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Glossary

Basis point

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

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.

Free Cash Flow (FCF)

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

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.

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Idiosyncratic risk

Idiosyncratic risk is a risk which is related solely to the individual company and has no correlation with the general market risk.

Market capitalization

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

Option

An **option** is a contract which gives the buyer the option – but not the obligation – to buy or sell an asset in the future at a specified price.

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.

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U.S. dollar (USD)

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

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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by the Financial Conduct Authority and Prudential Regulation Authority. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority, and regulation by the Financial Conduct Authority are available from us on request.

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