# Earnings Growth to Slow: Cyclical Bull for Stocks Intact

*From right to left:*

Rod Smyth
CHIEF INVESTMENT STRATEGIST

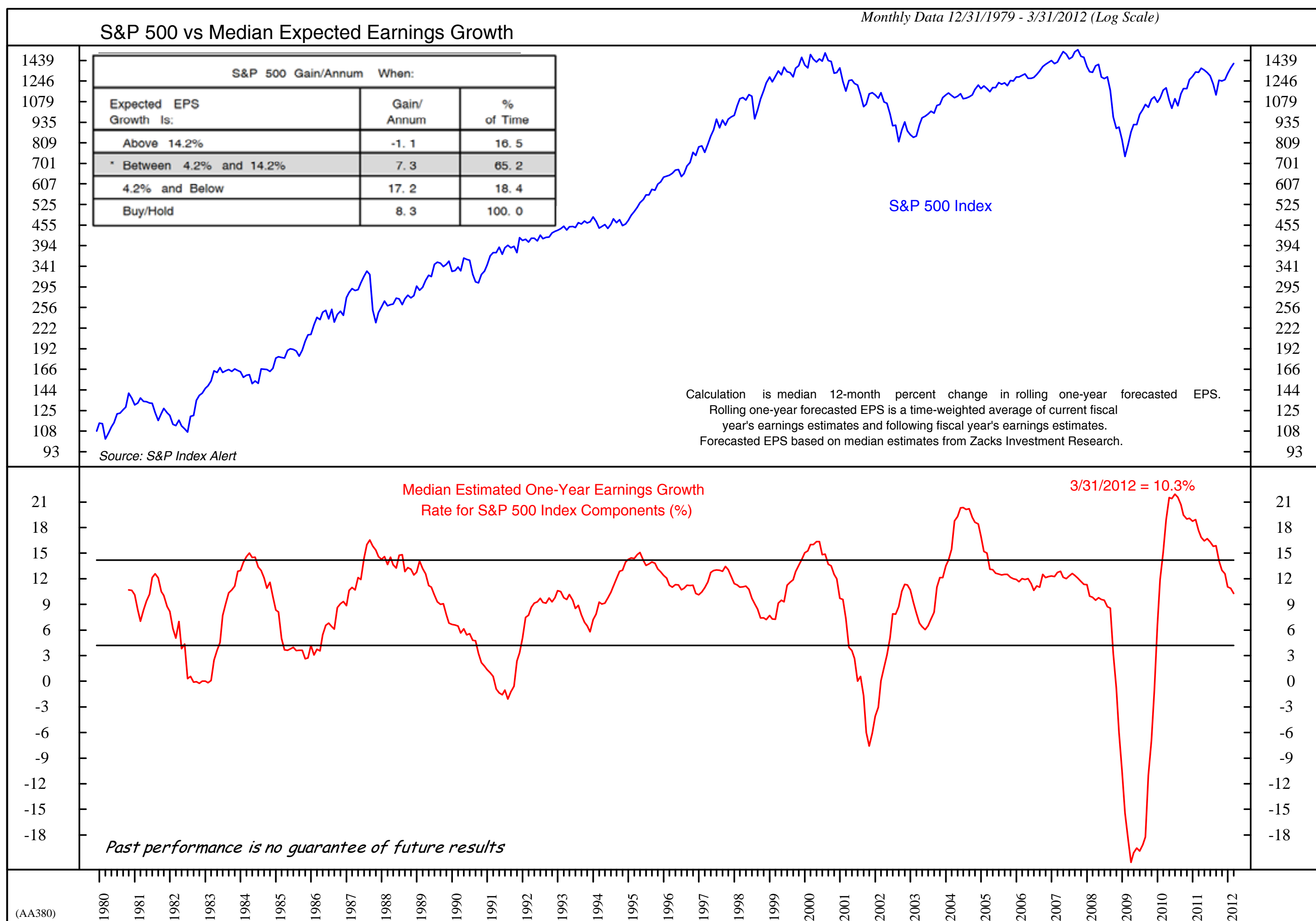
Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

- We expect corporations to maintain high profit margins and strong cash flows. However we recognize that earnings growth will likely decelerate to more sustainable levels. **Historically, when earnings growth is positive but the growth rate is decelerating stocks have continued to rise, albeit at a single-digit growth rate (see Weekly Chart).** We described this phase of the economic and market cycle from 2004 to 2006 as 'boring…but up,' and we would love a repeat. However with the outlook clouded by recessions in Europe, China's transition to slower growth and a looming 'fiscal cliff' in the US, we expect more volatility but an eventual upside breakout for the S&P 500.
- Despite last Friday's somewhat weaker jobs data, we think the economy will maintain its slow growth trajectory, and that the expansion is self sustaining as both business and households are taking advantage of low rates. We therefore believe the issue is not if but by how much 2012 S&P 500 operating earnings will exceed $100. Thus we think that the denominator (earnings) in the price to earnings ratio (PE) is less likely to cause volatility in 2012. Indeed, even if we adjust S&P 500 earnings by normalizing them to their 77-year trend, the number for 2013 trend earnings is a respectable $83.50. As the November election draws closer, we think market volatility will be driven by investors' confidence in the long-term trend of future earnings as opposed to fears of an imminent earnings decline. **Election years have generally seen a spring/summer market correction, and we expect this year to be no different, especially with conflicts that are likely to arise between the two parties on deficit reduction. That is why we have recently added to our 'quality equity' position and reduced cyclicality.**
- In our central case, a PE of 15 times current earnings and 18 times trend earnings (roughly 1500 on the S&P 500) will mark the upper end of the trading range for the remainder of the year. Rising above 1500 would require a degree of confidence about the future that has not been evident since the Great Recession. We think that the greater confidence in current earnings will limit any correction from current levels to 10% or less (see *The Strategic View* 4/2/12). We regard 1250 as fundamental and technical support for the S&P 500 and expect to raise both our floor and ceiling by about 100 points in 2013.
- **US corporate cash flows have exceeded capital expenditures by around $200 billion over the last year. This 'financing gap' is fueling dividends and stock buybacks as capital is returned to shareholders.** The buildup of cash is especially prevalent in the large-cap technology sector, where investor pressure to initiate and grow dividends has been rewarded.

- From present levels, we think dividend-growing companies are the best risk/reward alternative for growth and income investors. Investors should be wary of longer dated bonds. We expect dividend growth to continue at a double-digit pace, in contrast to single-digit earnings growth, because the dividend payout ratio (dividends as a percent of earnings) is close to record lows. If the Federal Reserve's strategy of keeping interest rates below inflation lasts for several more years, as we expect, we believe companies that are able to grow their dividends and deliver positive, inflation-adjusted total returns will significantly outperform investment grade bonds and will attract increased demand. **After overpaying for growth stocks in the 1990s and real estate in the early 2000s, baby boomers are now overpaying for the perceived safety of high quality bonds. We think it is only a matter of time before they overpay for dividend growth, and we believe our portfolios are positioned to benefit.**

## THE WEEKLY CHART: EARNINGS DECELERATION HISTORICALLY OK FOR STOCKS



| Expected EPS Growth Is: | Gain/ Annum | % of Time |
|---|---|---|
| Above 14.2% | -1. 1 | 16. 5 |
| * Between 4.2% and 14.2% | 7. 3 | 65. 2 |
| 4.2% and Below | 17. 2 | 18. 4 |
| Buy/Hold | 8. 3 | 100. 0 |



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Estimated S&P 500 median forward earnings growth has decelerated over the past year to 10.3%. While stocks have historically performed best when earnings growth is accelerating from low levels (after having discounted the slowdown), S&P 500 has tended to rise around 7% a year during periods of moderate earnings growth — about 4% to 14%. We expect earnings growth to remain within this range over the next couple years.

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