Profits: The Mother's Milk of Stocks

With equity markets at or near all-time highs, we thought it would be helpful to place the market's gains in the context of S&P 500 aggregate sales, earnings per share (EPS), and operating margin growth per FactSet data. In our view, the data actually demonstrates that equities are not yet quite in hyper-extended territory, and likely still have some room to run. Having said that, we also expect to see higher near-term volatility as monetary policy support is withdrawn, and the fundamental economic growth outlook moderates.

Earnings Growth is *Real*

There has been much talk about how the earnings growth that has supported the market's appreciation is largely the result of base effects, (i.e. growing off depressed 2020 numbers). In order to smooth for that effect we compared the S&P 500's sales and earnings performance to 2019 figures. Based on the 91% of S&P 500 companies that have reported earnings thus far, Q3 2021 sales growth is 16.1% over 2019, not far off from the Q3 2021 year-over-year (yoy) comparison of 17.1%. Similarly, Q3 2021 EPS growth over 2019 currently stands at 32.0%, which is only about ~10.0% below the yoy EPS growth rate of 42.2%.

More importantly, on a full-year basis (which includes actuals for the first three quarters and estimates for Q4) 2021 sales growth over 2019 is expected to be 14.6%, which is also not far off from the 16.0% yoy growth rate. The difference between the two metrics is greater on an EPS basis (31.6% growth over 2019 vs. 48.7% growth yoy), but nonetheless tells the same story: the majority of S&P 500 earnings growth is real growth above and beyond simple base effects. Furthermore, the 45% appreciation in the S&P 500 since the end of 2019, though fast and aggressive is, in our view, entirely reasonable in the context of the more than 30% earnings growth since 2019.

The Thinking Man's Approach

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Ignacio Pakciarz | CEO & Founder
Rene J. Negron | Senior Analyst

- Equities still have room to grind higher albeit with higher near-term volatility
- The 45% appreciation in the S&P 500 since the end of 2019, has been supported by more than 30% earnings growth since 2019
- Profit margins have increased by 230bps which partially explains the market's acceptance of higher earnings multiples
- The equity risk premium is right around its long-term average and its 2019 level indicating there is still adequate compensation for assuming the risk of owning equities over Treasuries
- Over the medium-term, earnings will continue to be the primary determinant of equity prices

For more on how we are positioning our portfolios, please contact your investment advisor or: ideas@bigsurpartners.com

Figure 1: S&P 500 Aggregate Sales Growth

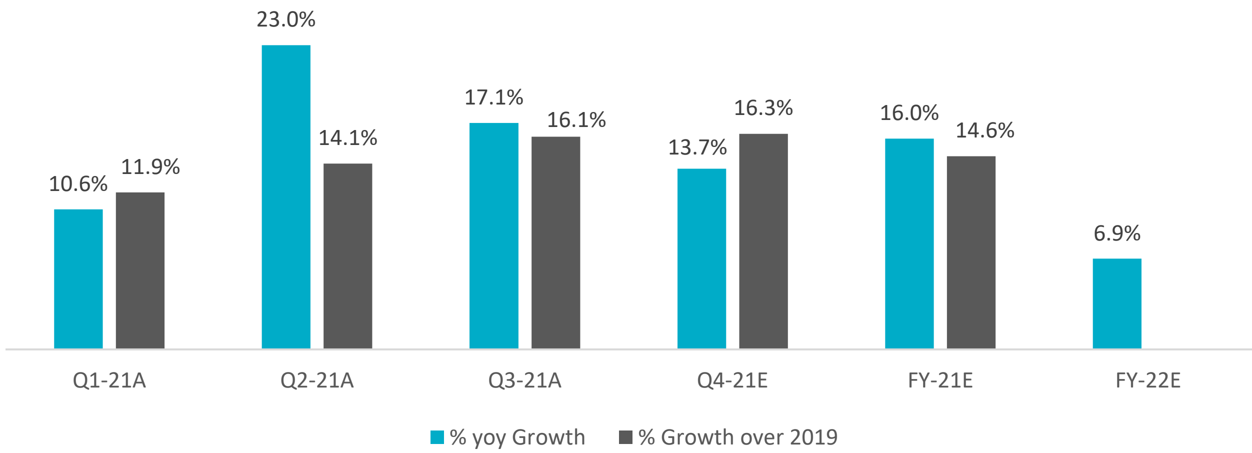


Figure 2: S&P 500 Aggregate EPS Growth

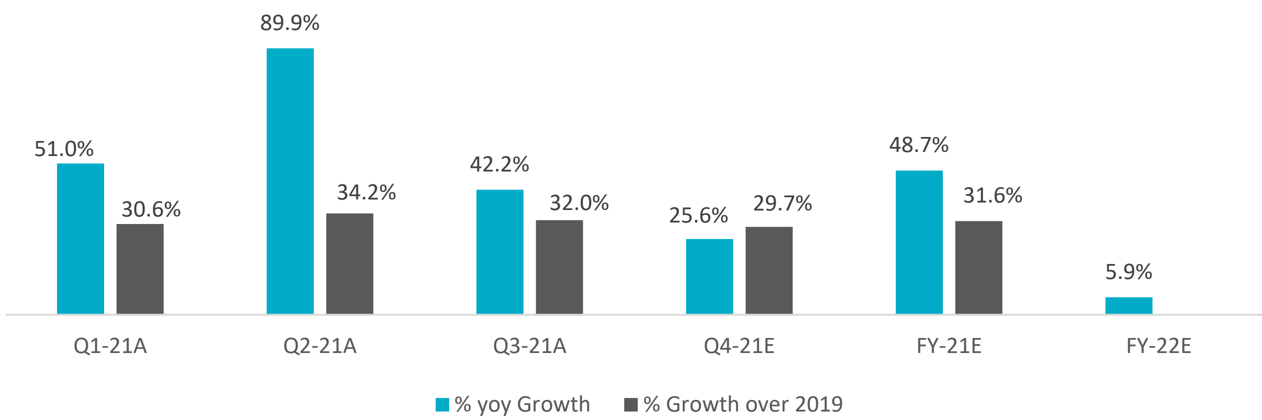
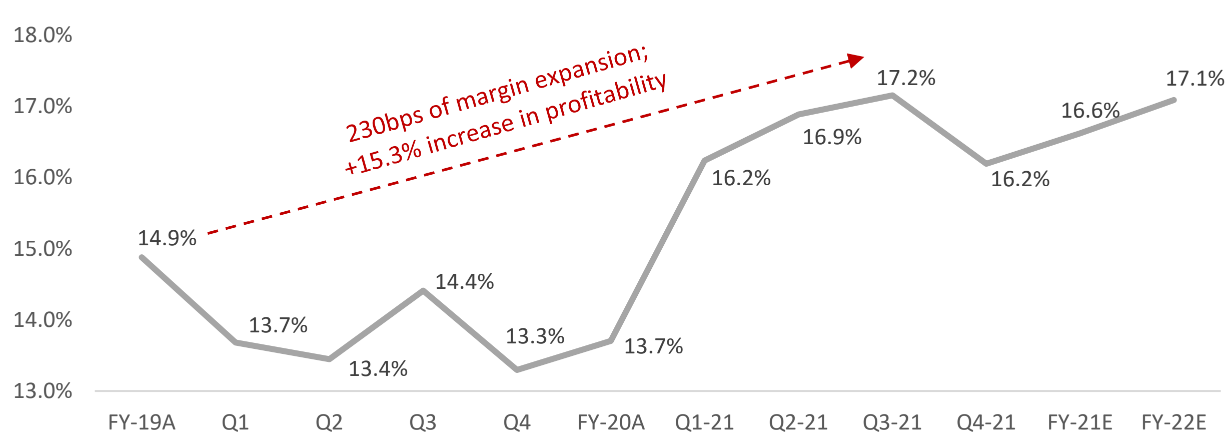


Figure 3: S&P 500 % Operating (EBIT) Margins



Operating Margins Have Also Improved

Over the last two years % EBIT margins (or earnings before interest expense and taxes) have also increased. Though margin expansion can have many reasons, in the Covid era, the explanation has been fairly straightforward: with labor and product shortages, companies have been forced to do more with less, driving efficiency and passing on cost inflation to customers. This, in our view, partly explains the market's acceptance of slightly higher multiples: cash flow from higher-margin businesses is generally credited with a higher multiple.

Q3 2021 EBIT margins currently stand at 17.2%, which is 230bps higher than 2019 EBIT margins of 14.9%, which roughly translates to a 15.3% increase in profitability (Figure 3). In our view, it is this 15.3% increase which partially explains the 15.2% increase in the S&P 500 one year forward earnings multiple (23.1x today vs. 20.2x at the end of 2019). Investors currently are paying more per dollar of earnings than they were at the end of 2019, but they are also getting companies that are more profitable in return.

Equity Risk Premium Still Supportive

The last piece of the market valuation puzzle is to place equity returns in the context of the opportunity cost of holding riskless assets, (i.e. Treasuries). This opportunity cost can be interpreted as the excess return that equity holders receive for assuming the risk of investing in equities, or what is popularly known as the equity risk premium (ERP). To arrive at the ERP, we take the inverse of the one-year forward earnings multiple to arrive at the market's earnings yield. We then subtract the 10Y Treasury yield, and compare this number to its longer-term average (i.e. the average spread between the earnings yield and the 10Y Treasury yield since the year 2000).

The S&P 500 ERP currently sits at 280bps, which is slightly above its long-term average of 270bps, and right around its year-end 2019 level (Figure 5, *on the following page*). The main conclusion here is that even if earnings estimates were flat in the near-term we could still see equity markets rally to at least the point where the ERP would fall below its long-term average, likely something closer to 200bps. Assuming a 2.0% yield on the 10Y and an ERP of 200bps, implies a market multiple of 25.0x, or roughly 8.1% of upside to current markets levels, and that's assuming there is no incremental upside to forward earnings estimates.

BSP View: We Continue to Be Cautiously Optimistic

In our view, the fundamental data paints a clear picture: earnings growth and margin expansion has justifiably supported equity prices, while low yields and only moderately higher earnings multiples still offer adequate compensation for assuming the marginal risk of holding risk assets. Putting the more speculative pockets of the market aside (e.g. electric vehicles, meme stocks, and certain cryptocurrencies) we see equity markets continuing to grind higher, either through continued growth in earnings (albeit at a more moderate pace), multiple expansion, or a combination of both.

Figure 4: S&P 500 1-Yr Forward Price / Earnings Multiple

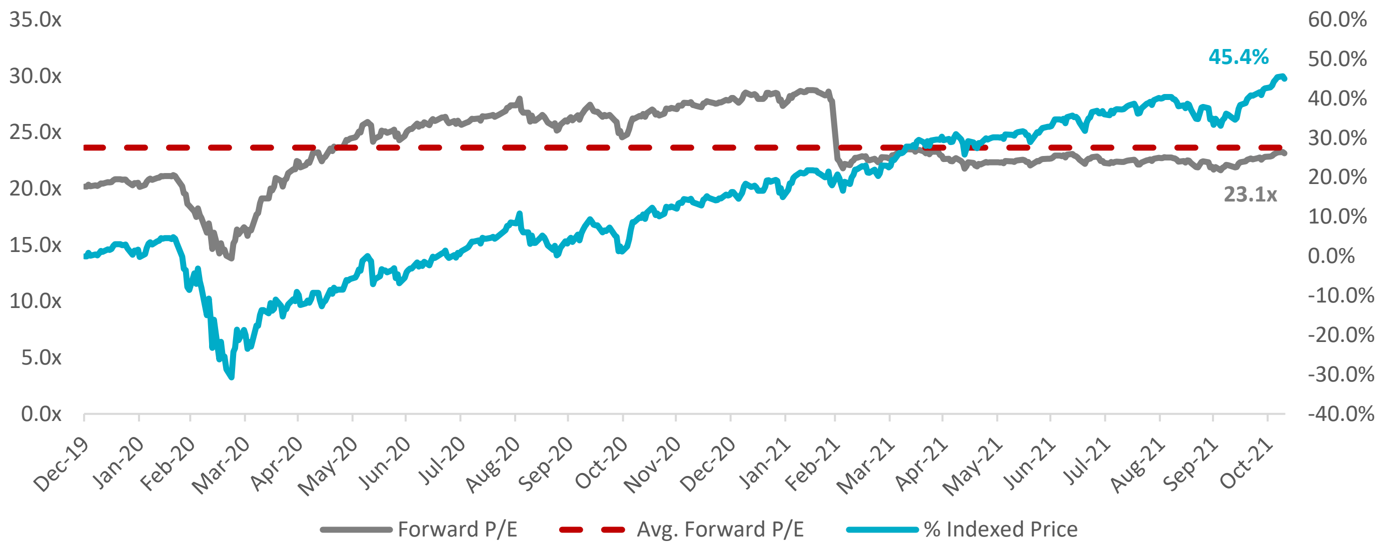
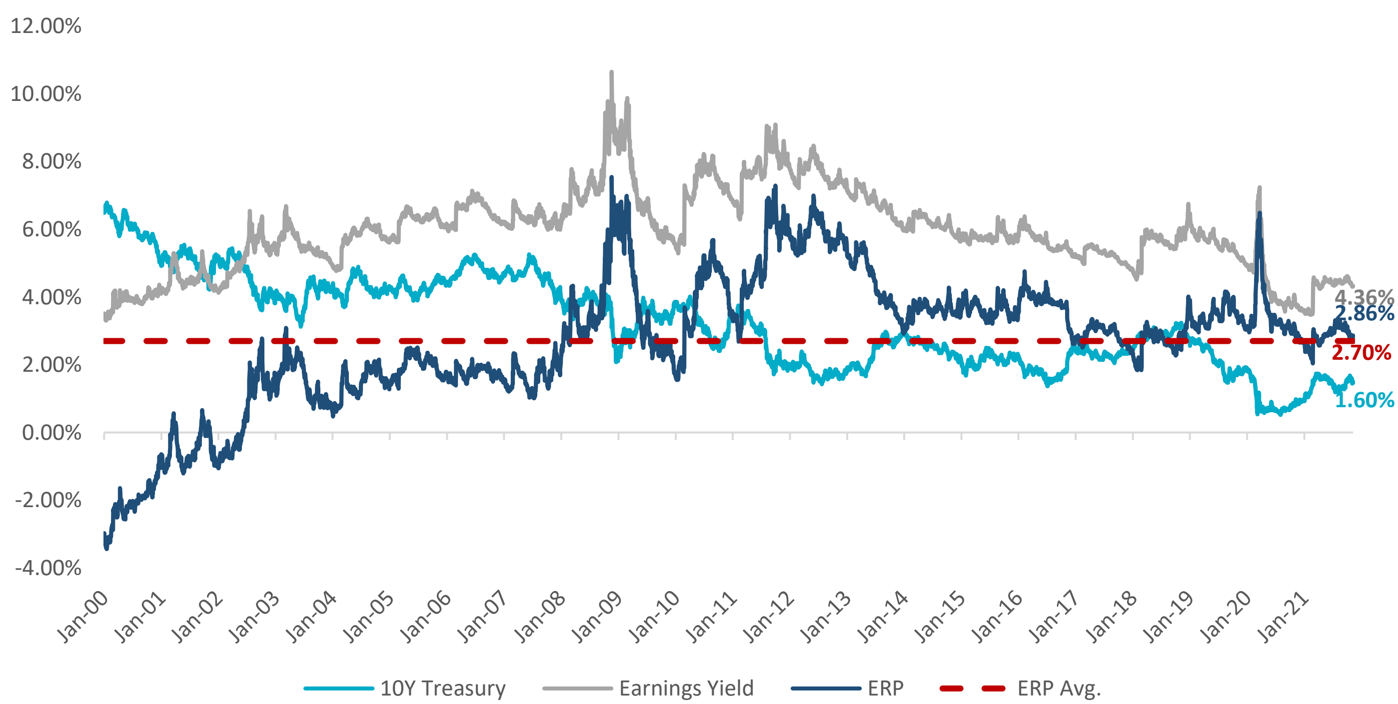


Figure 5: S&P 500 Equity Risk Premium



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BigSur Wealth Management, LLC
1441 Brickell Avenue, Suite 1410
Miami, FL 33131
Office (Main): 305-740-6777 ext. 8006
Fax: 305-350-9998
http://www.bigsurpartners.com