TOUGH TO BE BEARISH WHEN WALL STREET CONSENSUS HAS WHIFFED

1. How often do we hear “current market valuations” as a reason for caution?

“The S&P 500 now trades at an elevated P/E” or the “Equity Risk Premium (ERP) no longer allows for upside in stocks” are frequent comments we hear as reasons to be less optimistic regarding the equity markets. Makes sense.

However, there is one major “assumption” to reach those conclusions. That “assumption” is turning out to be colossally off-base this year.

What’s the correct “E” (earnings) in the P/E?

As we know, stocks are discounting mechanisms; they are the present value of future expectations. If you buy Pfizer, for example, you buy the stock because of your expectations of future product sales, not how well Pfizer has sold its products in the past.1 For that reason, when strategists/commentators/portfolio managers discuss market valuations they use either their own or the “consensus” analysts’ assumptions for future earnings.

2. And there is the rub.

What if they get the future earnings assumption wrong? What if they get that number really wrong? If they are wrong, then the P/Es are mis-stated, as is the perception of where the ERP is.

That is exactly what is happening now. Consensus has completely whiffed on the “E”.

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1 We do not hold Pfizer in our portfolios. This is not a recommendation to buy Pfizer, I am simply using this as an example.

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3. Here are the facts:

On December 31, 2020, Wall Street analysts’ bottom-up consensus estimate for 2021 S&P 500 earnings was $175.\(^2\) At the time, the S&P 500 was trading at a P/E of 21.5x. Lofty relative to history and certainly a reason to be cautious.

Guess where that consensus “E” for 2021 is now? $196.\(^3\) Year-to-date, Wall Street has been forced to revise upward their earnings estimate by 12%. Is it coincidental that the S&P 500’s return YTD is nearly the same as the revision change? I don’t think so.

4. These dramatic earnings revisions have come with only one quarter being reported!

What if $196 is still way too low, given we have three more quarters to go in the year? I do believe the operating leverage coming out of this recession is being underestimated, classic Wall Street post-recessionary caution. What if the actual earnings per share rises to $217 by the time we get to December 31st? After all, that is 8½ months to cause revisions to move as much as they already have after 4½ months.

Then the S&P 500 is only trading at 18.8x today and the ERP is not nearly as low as perceived.\(^4\)

5. At year-end, the SPX valuation will be priced on projected 2022 earnings, not 2021 earnings.

As 2021 estimates have been revised higher, so have those for 2022, moving from $195 at the beginning of the year to $210 today (+8%).\(^5\) I suspect the move for 2022 has not been of the same magnitude of 2021 estimates, given the likelihood of a corporate tax increase hitting next year. I do expect, however, we will begin 2022 with the street estimate around $230. That puts the current P/E at 17.8x the 2022 earnings number. Extremely reasonable, in my opinion.

6. Where could I be wrong?

Maybe the upward slope of revisions stops on a dime rather than progressing further. However analysts are notoriously slow to react, moving in measured steps to not foolishly look too optimistic. Not to mention, given the last big economic boom was over 15 years ago, most analysts have only experienced the post-Great Financial Crisis subpar economy, and certainly have not lived through an environment with this amount of stimulus.

7. The trend is your friend until proven otherwise.

I think it’s important to concede that earnings are doing better than what was expected. Anyone telling you “that’s over”, I find rather arrogant. To me, that’s similar to the ninth batter who has gone 0-5 asking to be moved up in the batting order. Let’s see some proof first.

To be clear, there are plenty of hurdles, other than fundamentals, that can influence the market on a short-term basis. However, longer-term, stocks have rarely gone down for long periods of time if companies exceed expectations. I simply do not believe it’s more complicated than that.

Finally, the real lesson is to be wary of valuation methodologies, because often there are imbedded assumptions by experts that can turn out to be inaccurate.

So far, 2021 looks to be a banner, yet bullish, year for inaccurate assumptions!

Andrew

\(^2\) Empirical Research. May 19th, 2021
\(^3\) Empirical Research. May 19th, 2021
\(^4\) May 19th, 2021
\(^5\) Factset.

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