# Investors wrestle with S&P earnings outlook

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There is no shortage of bulls on Wall Street forecasting record company earnings this year. It is a consensus that has proved resilient even as US equities have tumbled from post-crisis highs, falling for six weeks in a row.

A stuttering US recovery, disruption to the global supply chain from Japan's March earthquake and tsunami, renewed sovereign debt fears in Europe and the looming end to the Federal Reserve's $600bn bond-buying programme – QE2 – have all hit sentiment in equities.

The question is whether the slide in stocks since the end of April is the start of a bigger correction or a short-term retreat, a pause for breath in the impressive bull run that began in March 2009 and which represents a buying opportunity.

Backing the bulls' case is that lower share prices have not been accompanied by any dilution of the forecast record earnings per share of $99.97 for companies in the S&P.

That targeted earnings level sits well above the current record of $88.18 earnings per share in 2007.

Moreover, the S&P's dividend yield of 1.96 per cent looks more attractive than the five-year US Treasuries return of 1.60 per cent. No wonder, then, that many on Wall Street say equities are better assets to hold than bonds right now.

However, while those comparisons make equities tempting at current levels, much rides on whether the economy pulls clear from its soft patch.

One risk facing investors is that a prolonged period of lacklustre job creation and growth could compel companies to start cutting their earnings estimates, which would knock shares lower. It is those earnings expectations that are underpinning the S&P.

"The next big question for the markets is whether the turnround in the second half that people are banking on actually materialises," says Anthony Chan, chief economist at JPMorgan Private Wealth Management.

For some investors, such as Jim Paulsen, chief investment strategist at Wells Capital Management, the drop in stock prices is ultimately bullish.

"We could well see a 10 per cent correction, but I expect the economy will pop in the second half of the year," he says.

## Rally required

The forward S&P 12-month price/earnings ratio of 12.2 is well below the average of 15.2 for the past 10 years. This reflects the expected rise in earnings during the next three quarters.

John Butters, of data provider FactSet, says: “On a per share basis, forward 12-month earnings are expected to be over $105.”

A reversion to the long-term p/e ratio requires a drop in future earnings, a rally in shares, or a combination of both.

Hard evidence of how companies are performing will start to emerge next month when second-quarter company results are due. More than usual, investors will focus on guidance from companies for the rest of the year. And not everyone is as confident.

“Second-quarter earnings are going to be fine, but the guidance is going to be awful and it is going to cause analysts to lower their expectations for the year,” says Burt White, managing director and chief investment officer of LPL Financial. Others are warier still.

David Levy, of the Jerome Levy Forecasting Centre, says: “US corporate profits are undergoing a peaking process that will mean falling profits by the end of 2011.

“Tightening federal fiscal policy, state and local cutbacks, home prices falling to one new low after another, and growing strains on household budgets from higher food and energy prices all presage downward pressures on profits during the second half and, especially, in 2012.”

Steven Ricchiuto, chief economist at Mizuho Securities, says the consensus forecast for second-half economic growth of 3 to 3.5 per cent will probably be revised down towards a 2 to 2.5 per cent range.

“This disappointing macro scenario is even more unsettling for the growth bulls in light of all the fiscal and monetary policy stimulus that has been provided over the past few years to try and get the economy moving and bring the jobless rate back to a more acceptable level.”

Not only is US government spending set to tighten, the Fed will no longer be pumping liquidity, via QE2, into the financial system. Concern about Chinese demand and global growth have intensified.

Those who think companies will prosper cite the beneficial effects of the dollar’s fall.

“A weaker dollar without higher interest rates or higher oil prices will help to cushion the economy,” says David Bianco, chief US equity strategist at Bank of America Merrill Lynch.

He expects the bank’s estimate of $97 earnings per share for the S&P in 2011 will hold despite weaker growth. Falling commodity prices could also fuel a rebound in the second half.

Even so, at current levels and without the adrenalin shot of Fed liquidity, meeting lofty earnings targets is likely to be challenging.

Indeed, some analysts warn that the bulls' reading of the pullback as a "mid-cycle correction" may be too optimistic. The retracement could well last longer than a few weeks.

"We don't want to pay a higher multiple for today's earnings, given stagflation has a higher probability than disinflation in the US, and the probability of a China slowdown is not immaterial," says Morgan Stanley.

Brett Hammond, senior economist at TIAA-CREF, the asset manager, says: "The stiff wind that has been supporting earnings and profit growth in the last few years has turned into a soft breeze, and there is a risk that we are going to find ourselves in the doldrums."