U.S. Equity Strategy Outlook

BI Equity Strategy, North America Dashboard


Gina Martin Adams
Team: Strategy
BI Chief Equity Strategist


Peter Chung
Team: Strategy
BI Equity Strategist

1. Stocks in 2H: Supported by Earnings, Bullied by Policymakers

(Bloomberg Intelligence) -- Stocks started 2017 backed by a solid earnings recovery and hopes for fiscal-policy support, but may be subject to growing political uncertainty in 2H. Economic fundamentals still support a steady profit outlook after a strong 1Q for the S&P 500 Index, and equity valuations are still low relative to other asset classes. But President Trump's agenda has stalled, and with budget battles and Fed balance-sheet changes looming, stocks may remain subject to the whims of policymakers as the second half unfolds.

Bloomberg Intelligence Equity Strategy's fair-value model shows that the S&P 500 is fundamentally supported to 2500. The sector scorecard shows a mix of cyclical and defensive sectors -- technology, utilities, industrials and materials -- have the strongest fundamental and technical supports. (06/06/17)

Key Points:

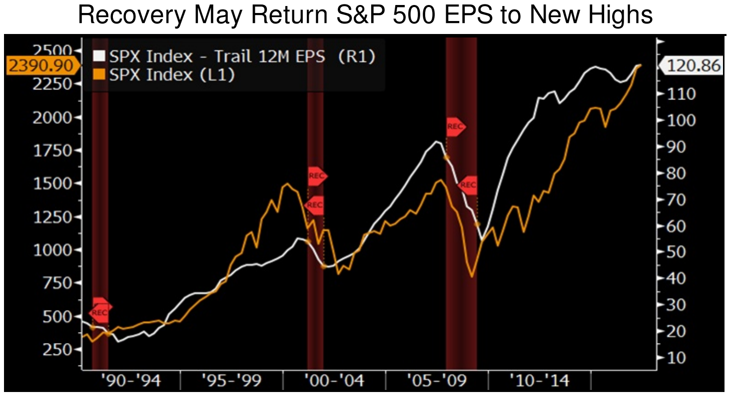
- Earnings Environment: Analysts May Be Getting Ahead of Themselves Based on Macro Signs

2. Stocks, S&P 500 EPS Happy Together for First Time Since 2015

The 1Q reporting season confirmed that earnings recovery is underway after a rare mid-cycle decline in 2015-16. Historically, earnings almost never fall unless the U.S. economy is in recession, yet trailing 12-month S&P 500 Index EPS dropped 4.7% from 1Q15 to 2Q16. Including 1Q, S&P 500 earnings have now increased 6% from the mid-2016 trough, offering a better backdrop. Analysts expect a strong but uneven recovery in EPS growth the next two years -- 12.3% in 2017 and 10.8% in 2018.

The difficult earnings environment of 2015-16 coincided with a 15% correction in the S&P 500's price. The profit turnaround of the last three quarters has helped stock prices to regain ground. Continued earnings momentum could extend the positive tone. (05/19/17)

Recovery May Return S&P 500 EPS to New Highs



3. Macro Indicators Suggest 12% S&P 500 EPS Growth Next 12 Months

Economic indicators suggest about 12% growth in S&P 500 EPS over the next 12 months, based on Bloomberg

Intelligence's top-down model. After strong 1Q earnings, analysts expect 13% growth in index EPS for the next 12 months. BI's model assumes 4% new-order growth, a 70-bp increase in the two-year Treasury yield, commodity prices 4% higher and a 10-bp decline in the unemployment rate.

Under a more-bullish economic scenario, BI's model suggests that EPS growth could approach 18%. A bearish macro case suggests slightly more than a 2% increase. The model is built on comparable EPS history going back to 2000 with a R-squared of 0.75. (05/19/17)

Base, Bull and Bear EPS Scenarios

Macro Model (Click to launch the model.)	Scenario Analysis		
	Base	Bull	Bear
TTM EPS	120.87	120.87	120.87
New Orders % Chg	4.00	8.00	0.00
Bps Chg in 2Y	0.70	1.50	0.00
Bps Chg in UR	(0.10)	0.40	1.00
CRB Commodity % Chg	4.00	8.00	(2.00)
NTM % Growth	12.25	17.88	2.43
NTM EPS	$135.68	$142.49	$123.81

4. Analysts May Be Getting Ahead of Themselves Based on Macro Signs

Macro indicators point to 12% EPS growth in the next 12 months for the S&P 500, shy of analysts' expectations for a 13% increase. Consensus bottom-up price targets also suggest that the index should rise 10% to 2,608, while macro indicators suggest a more-modest fair value of 2,500. Earnings momentum has helped stock prices regain ground and remains supportive, though based on macro models analysts' expectations may be getting a bit ahead of the trend.

History suggests that stocks with strong but not extreme upside to price targets have recorded the largest average returns, based on BI Strategy's factor analysis. The biggest upside potential based on targets hasn't always equated to the highest returns within the index. (05/19/17)

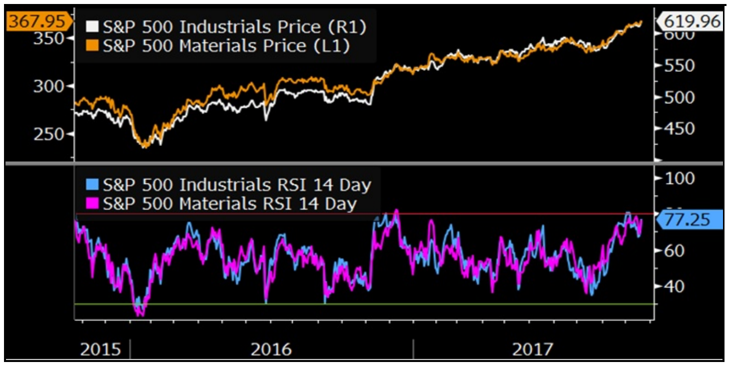
5. Overbought Condition Rooted in Industrials, Materials

Contributing Analysts Kevin Kelly (Strategy)

Much of the overbought condition for S&P 500 stocks appears to be rooted in industrials and materials, suggesting the market may be trading a bit too hot on the recovery in the commodity complex. The relative strength index for industrials topped 80 and materials neared that number earlier this month as the Bloomberg Industrial Metals index touched a level last seen in 2014. Yet momentum for both sectors has weakened in recent weeks, diverging from still-positive price action, likely a sign that they'll cool down.

The last time industrials and materials momentum reached such overheated levels was at the end of the post-election surge last December. Both sectors subsequently paused to relieve the overbought condition, and underperformed the S&P 500 until the turn of the calendar year. (10/24/17)

S&P 500 Industrials, Materials 14-Day RSI



6. Stocks Reach Rarely Seen Overbought Levels

On the heels of its longest daily streak of overbought records since 1996, the S&P 500 has traded to conditions that suggest a near-term pullback is increasingly likely. The index trades above the top of its trend channel, which last occurred just before the 2.8% market pullback in March through mid-April. Meanwhile, the index's 14-day relative strength index (RSI) is above 80, also a first since March and just the third instance since 1996.

A correction to the bottom of this year's channel for the S&P 500 implies about a 3% decline. Yet momentum has strengthened with price, confirming the underlying strength of the bull trend. (10/24/17)

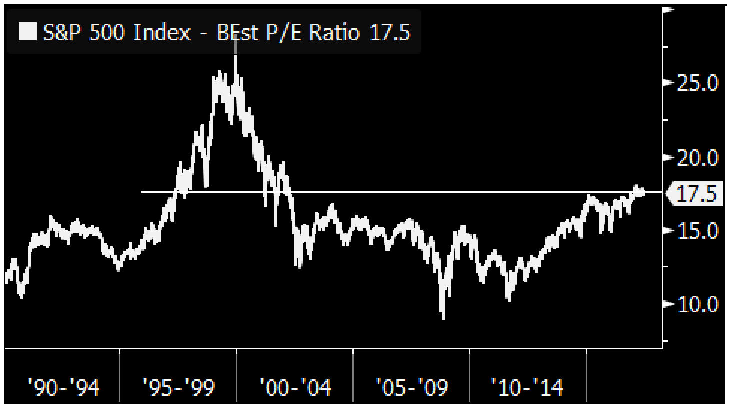
S&P 500 Candle Chart and 14-Day RSI

7. Earnings Catching Up, But S&P 500 P/E Still Near 15-Year High

With earnings set to grow by double digits for a second straight quarter and global bond yields still extremely low, investors are willing to pay up to own U.S. stocks. More than two-thirds of stock price gains so far this year have come from earnings expansion, but stocks still trade at 17.5x the index's forward 12-month earnings forecast, near the highest multiple since 2002. While lofty valuations historically suggest lower long-term average returns, this hasn't been the case in the short run.

Each equity bull market has ended at a different P/E level. Though equities are trading at a P/E multiple higher than 81% of history since 1990, in the words of John Maynard Keynes, "the market can stay irrational longer than you can stay solvent." (07/10/17)

Stocks in Late-1990s P/E Territory

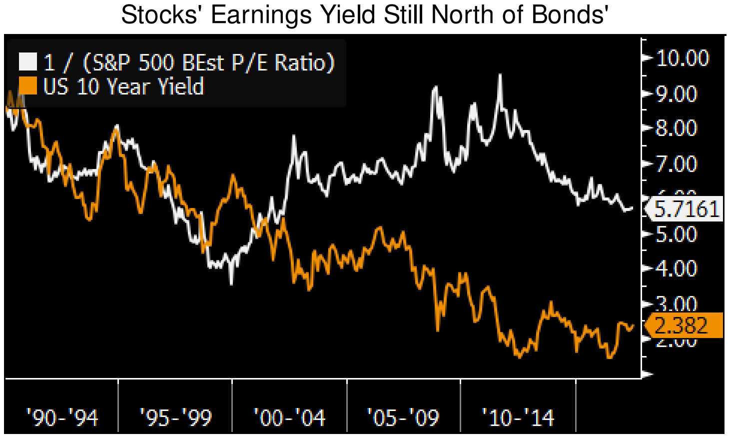


8. Bonds Close the Gap, But Stocks' Earnings Yield Still Higher

Investors frequently reference current price-to-earnings ratios as "too high," but relative to other asset classes, stocks are still trading at a considerable discount to both U.S. Treasury and corporate bonds. The current S&P 500 earnings yield of 5.7% is well-above 2.4% for the 10-year Treasury and the current high-grade corporate yield of 3.2%. The respective 330-bp and 250-bp risk premiums compare with long-term averages of 200 bps vs. Treasury bonds and 90 bps vs. corporates.

Though the recent Treasury sell-off has improved bonds' relative value a touch, it's not enough to eliminate the appeal of stocks. Equity risk premiums suggest that stocks are still highly discounted vs. bonds. (07/10/17)

Stocks' Earnings Yield Still North of Bonds'

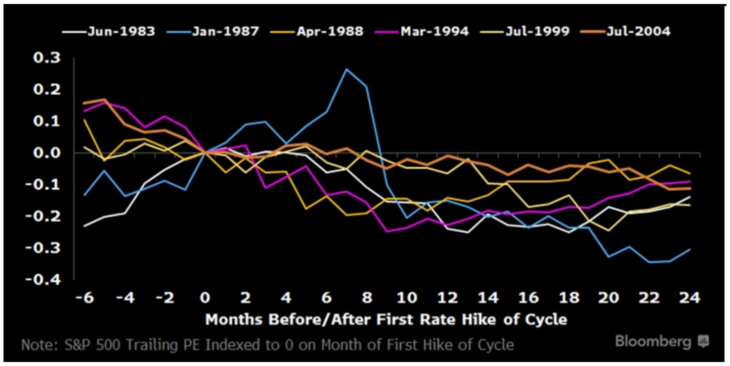


9. S&P 500 Equity Valuations Continue to Snub the Fed This Cycle

Stocks' price-to-earnings usually fall as the Federal Reserve tightens interest rates. EPS growth tends to drive price gains, yet equities are behaving in direct contrast to this usual pattern. The S&P 500 Index P/E has dropped by 2.3 turns, on average, in the six tightening cycles of the last 35 years, while EPS has grown from 2.2% (1987) to 46.4% (1994-95) in tightening cycles since 1990. Since the Fed started increasing rates in December 2015, the S&P 500 P/E is up 15% and EPS is up less than 2%.

Top-down forecasters appear to expect P/E to come under pressure with higher rates this year. The Bloomberg strategist consensus median EPS estimate is $128.56 and the median end-of-year price target is 2,400, implying a consensus P/E for year-end of about 18.7x, or 1.4x below its current level. (05/24/17)

S&P 500 P/E Usually Shrinks as Fed Tightens

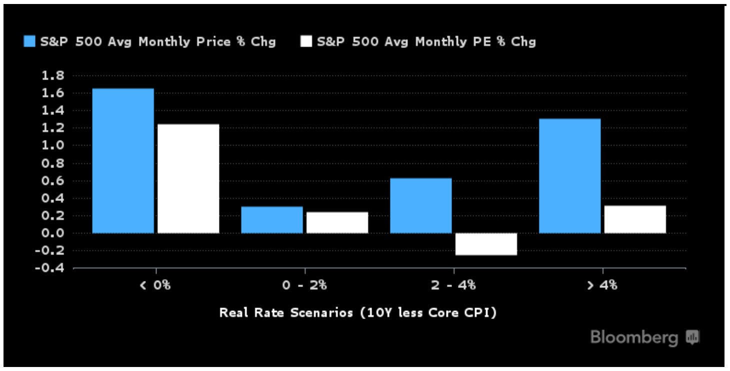


10. Real Interest Rates Are What Matter for S&P 500's P/E Ratio

Anomalously, price-to-earnings ratios have held up through the Federal Reserve's three interest-rate hikes this cycle. The S&P 500 Index P/E is up 15% since the Fed increases started in 2015, by contrast with the usual declines that accompany higher short-term rates. Very low real interest rates could be the reason. On average since 1962, the S&P 500 has recorded a monthly P/E change of up 1.2%, while real rates are below zero -- a state the market enjoyed for most of 2016.

Real rates, the interest rate minus the inflation rate, bumped above the zero bound in November yet remain very low at just 0.38%. If rates are the primary driver of P/E, history suggests that the S&P 500 Index P/E may continue to rise, but at a slower average pace than in the last 14 months. (05/24/17)

Valuation Likes Extremes

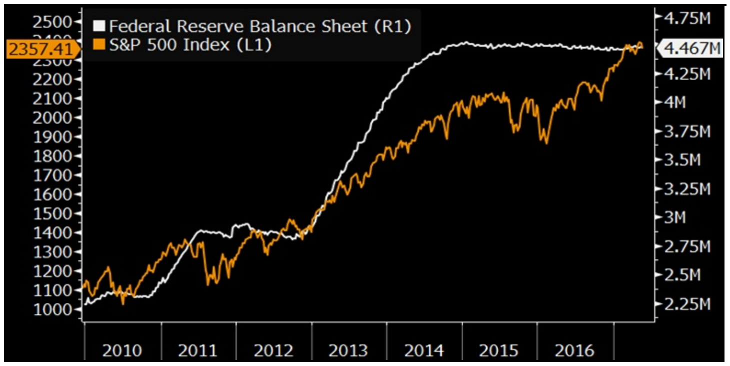


11. Federal Reserve Balance Sheet Becoming Topic Du Jour for Stocks

As real interest rates are the key to stock valuations, any change in the outlook for the Federal Reserve's balance sheet is becoming the topic du jour for equity investors keenly focused on monetary policy. Each time that the Fed has tried to stop expansion in recent years, stocks have corrected, as in 2010, 2011 and 2014-15. Stocks have been reinvigorated of late by improving economic indicators and hopes for fiscal stimulus. Low or negative real rates have allowed stocks to overcome concerns over policy change.

It remains to be seen how a shrinking balance sheet will affect the economy or investor sentiment. Anything beyond mere theoretical discussion could create volatility for equity investors comfortable with the giant balance-sheet cushion built up over the last few years. (05/24/17)

Fed Balance Sheet and Stocks



12. Flatter Yield Curve Is the Norm for This Stage of the Cycle

History suggests that stocks should generally do well, as long as the Federal Reserve doesn't tighten policy so much as to invert the yield curve. Over the last two cycles, a consistent pattern of yield-curve flattening and stock prices rising developed. Until the yield curve inverted, stocks generally advanced. The consensus expects that the yield-curve spread will remain positive, ending the year at 92 bps, very near its current level.

The yield curve is one of the best indicators of expansion or contraction for the economy and stocks. On average, the curve inverts 16 months prior to economic recession and 13 months before the accompanying stock-market correction. (07/26/17)

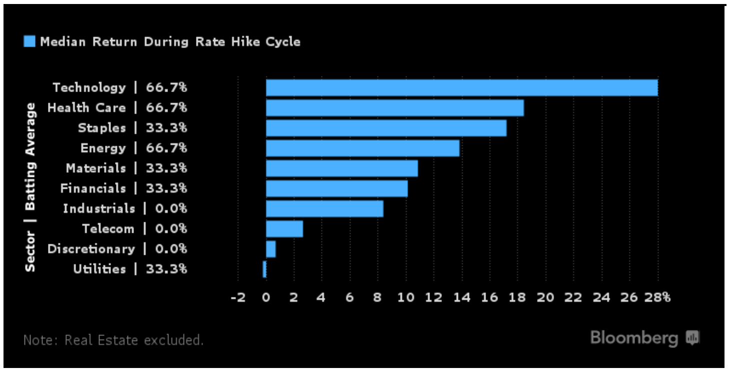
Yield Curve and Stocks

13. Tech, Health Care, Energy Best at Weathering Tighter Rate Policy

Stocks have largely shrugged off Federal Reserve tightening so far this cycle, though valuations usually feel the burn when the central bank raises interest rates. On average, the S&P 500 Index price-to-earnings ratio has declined 13.7% and during all six of the major Fed policy-tightening regimes since 1982. The later-cycle portion of the index, historically, has weathered tighter Fed policy the best. On average, the energy, technology and health care sectors outperform others.

The utilities, discretionary and telecom sectors have struggled the most with interest-rate hikes, underperforming in each tightening phase over the last 35 years. It should be no surprise that retail and auto segments of discretionary are underperforming as the Fed tightening cycle takes shape. (05/24/17)

Sector Performance During Rate-Hike Cycles



14. S&P 500 Earnings Abroad Could Come Home, Benefiting Shareholders

Companies with earnings abroad may experience a significant change to tax expenditures under federal reform plans. The corporate tax proposal of House Republicans includes a 100% exemption for dividends from foreign subsidiaries of domestic companies. It also features an 8.75% tax on accumulated foreign earnings brought back in cash, or a 3.5% tax if returned to the U.S. in another form. The Trump administration plan could change, but proposes repatriation at a 10% rate.

The S&P 500 rose more than 7% in the month after the U.S. last passed a repatriation holiday, in October 2004. S&P 500 prices were led by companies in industries sensitive to capital spending, such as materials, industrials and technology. (04/26/17)

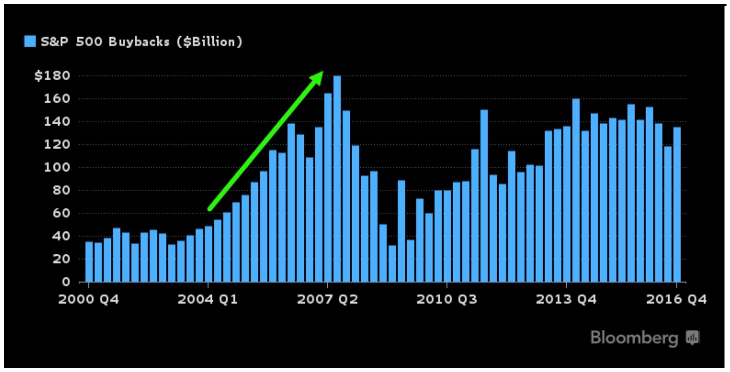
S&P 500 After Homeland Investment Act Passage

15. Buybacks Will Likely Be the Primary Beneficiary of Repatriation

Trump administration initiatives to entice U.S. corporations to bring home cash held overseas could be a boon to share buybacks. The Homeland Investment Act passed in late 2004 provided temporary repatriation of earnings held outside the U.S. The tax holiday coincided with 57% average year-over-year growth in share repurchases by S&P 500 companies in 4Q04-4Q05. That marked a significant increase from the 39% average annualized growth in buybacks recorded in the four quarters prior to the legislation (3Q03-3Q04).

The computer, electronic-equipment and pharmaceutical industries repatriated the most capital during the last tax holiday. All S&P 500 sectors recorded buyback growth after the legislation, led by energy, materials and defensives. (04/26/17)

Share-Buyback Growth Jumped on 2004 Tax Holiday

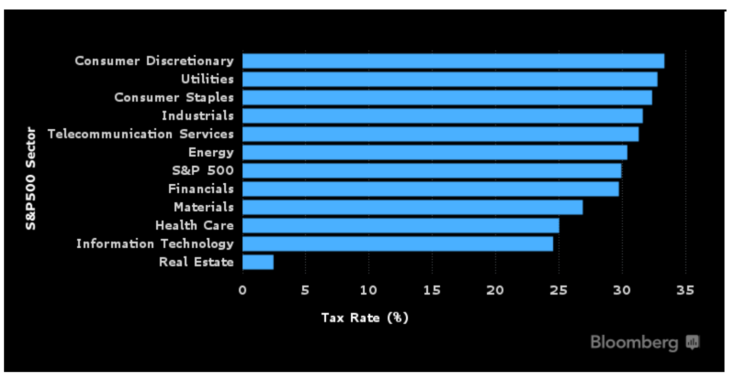


16. Trump's 15% Tax-Rate Plan Could Boost S&P 500 Index EPS by 13%

If President Donald Trump gets a 15% U.S. corporate tax rate passed into law, Bloomberg Intelligence calculates the after-tax 2018 EPS of S&P 500 Index companies could increase by $18.70, or 13.3%. A 20% rate laid out in Congress' plan would offer a 6.7% boost, or $9.34 a share. The current consensus estimate for 10.8% index EPS growth in 2018 could be closer to 25% if the Trump plan passes. The EPS increase would be about 18% if the congressional rate goes into effect.

Stocks in the consumer discretionary, utilities and consumer staples sectors, on average, pay the highest median effective tax rates, suggesting they may get the largest earnings increase from tax reform. Stocks in real estate, technology and health care pay the lowest. (08/15/17)

Median Effective Tax Rate for S&P 500 Sectors

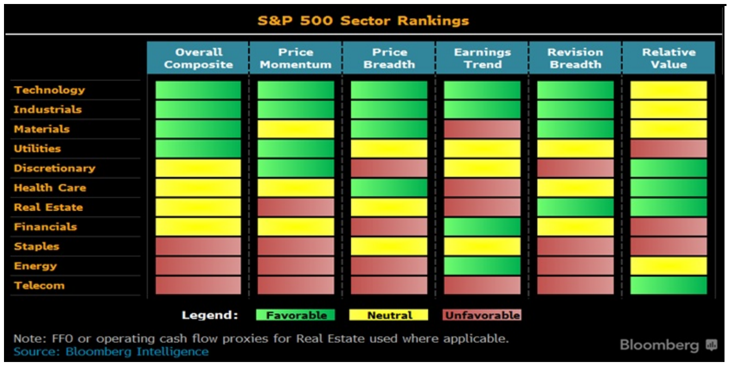


17. Cyclical Tilt in S&P 500 Sector Scores Favors Tech, Industrials

Summer volatility could create opportunities in cyclical sectors, such as technology, industrials and materials, yet prompt investors to hang on to defensive utilities to weather the season's usual storms. Based on BI Equity Strategy's multifactor assessment of the S&P 500 Index, tech remains the top ranked among sector peers. Earnings season improved the relative ranking of industrials and materials, and utilities is benefiting from the 10-year Treasury's range trade.

Methodology: BI's model scores relative trends between economic sectors of the S&P 500. Overall ranks are based on a blended score of 40% technicals (price momentum and breadth), 40% earnings (profit trend and revision breadth) and 20% valuation (volatility-adjusted relative forward P/E and discount breadth). (05/23/17)

BI Equity Strategy Sector Scorecard



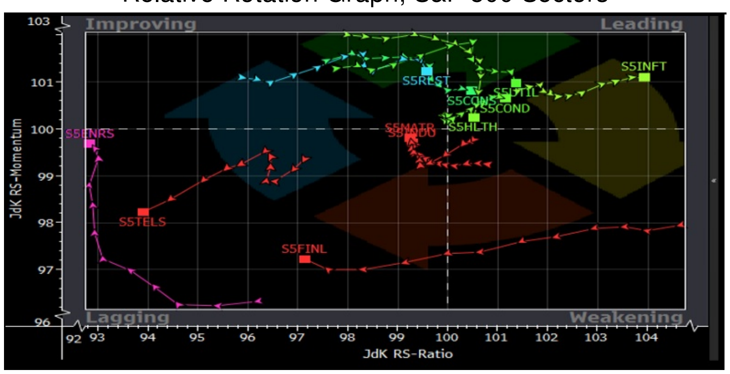
18. Without Inflation, Market Advance Depends on Tech and Defensives

Contributing Analysts Eliza Harkins

Though the market broke out to new highs at the end of May, sector-level leadership remains strongly in the hands of the technology sector. Utilities, discretionary, staples and health care have taken on a slightly weaker yet leading role over the last several weeks, as the financials and energy sectors' relative positions have lagged far behind. The loss of energy and financials participation has left the market moving higher on fewer names.

Nonetheless, distress is far from evident, with tech and defensives so far able to pick up the slack to carry the market to new highs. (05/31/17)

Relative Rotation Graph, S&P 500 Sectors

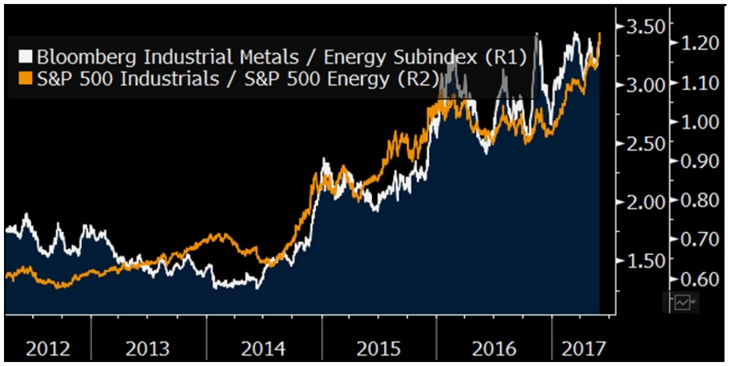


19. Metals Likely Aiding S&P 500 Industrials' Breakaway From Energy

Relative stability in metals prices should bode well for industrials' performance, particularly machinery and electrical equipment, relative to the broader S&P 500. So far this year, prices for industrial metals have outpaced those for energy. This divergence in the commodity complex has aided relative performance for industrials stocks. Over the long run, the sector's stock prices show a stronger correlation to metals prices than to those for energy.

Thus, periods where industrial-metals prices are holding up better than energy prices have closely coincided with industrials stocks outperforming energy stocks in the S&P 500. (06/05/17)

Metals/Energy Prices & Industrials/Energy Stocks

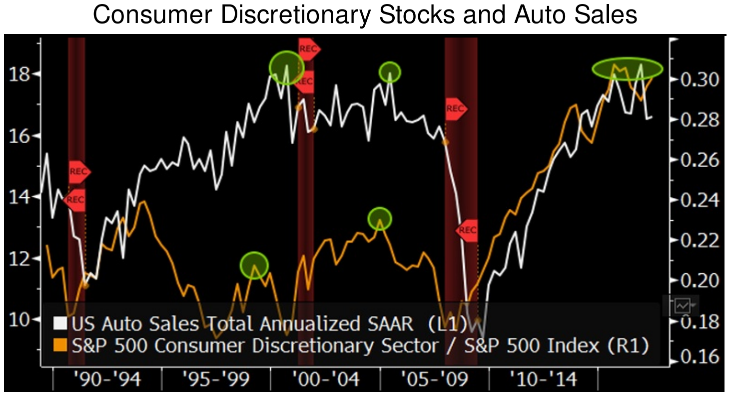


20. Auto Sales Slowdown Doesn't Bode Well for Consumer Stocks

U.S. consumers showed some weakness in 1Q, yet there's little reason to suspect that stocks will struggle as a result. Accounting for about two-thirds of U.S. economic growth, consumers spent at the slowest pace since 2009 in 1Q. Much of the sequential spending decline was tied to auto sales, which fell from a record December-quarter pace to a level last recorded in 2014. Auto sales peaked more than 29 months before stocks in 2007, and 14 months before the equities peak in 2001.

Slower auto sales don't usually bode well, however, for consumer-discretionary stocks relative to the S&P 500. Discretionary is one of the better-performing groups in the index so far this year, but in the last cycle underperformed following the apex in auto sales. (06/05/17)

Consumer Discretionary Stocks and Auto Sales



To contact the analyst for this research:
Gina Martin Adams at gmartinadam1@bloomberg.net