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CONTENTS

A Recapitulation: The S&P 500 and Corporate Profit 1

Disclaimer & Contacts 5

Weekly Commentary

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Macro View

By Hubert Marleau

A Recapitulation: The S&P 500 and Corporate Profit

I don't believe that anyone can predict what the stock market will do over the very short term. It's just too difficult to time it. On occasion it slumps or crashes, but in the fullness of time it goes up. In fact, calamities are rare, and the upside vastly outweighs the downside. Since the end of World War ll, 50% crashes have occurred only 3 times. That's one out of every 26 years. In this connection, having a negative bias against the market is not only a costly affair, but also a very low-probability bet because there is a long-term tendency for the US economy to generate a lot of free-cash-flow for US large-cap corporations. According to Julius Baer, corporate free-cash-flow as a percentage of N-GDP rose from 5% in 1982 to 20% in 2020. Aside from the pandemic experience, this phenomenon has been going on for a very long time, which may explain why the stock market tends to produce positive returns.

According to “A Wealth of Common Sense,” since 1926 the U.S. stock market has experienced positive returns:

- 56% of the time on a daily basis
- 63% of the time on a monthly basis
- 75% of the time on a yearly basis
- 88% of the time on a 5-year basis
- 95% of the time on a 10-year basis, and
- 100% of the time on a 20-year basis

Now that the earnings season is over, we can see that there is no evidence that any of the aforementioned profit-trends have been broken. Indeed, first-quarter earnings reported by the bulk of the large companies were far better than Wall Street analysts had expected. The S&P 500 average earnings-per-share fell only 1.4% versus the 5.9% that had been expected at the start of the quarter. Aside from commodity producers, big industrial and commercial companies have been able to shift the burden of higher input costs like wage rates and cost of goods to consumers because of their strong pricing power. Interestingly, positive guidance by corporate executives has been encouraging and has started to feed into forward earnings forecasts as margins are edging north. According to Citi, about 57% of all earnings revisions for S&P 500 companies were raised in May. That's higher than they were in April.

Macro View cont.

By Hubert Marleau

Faced with many moving parts, companies still face risks to earnings. Nevertheless, Yardeni Research made the astute observation that forward earnings had bottomed during the February 9 week and were up 1.8% since then through the May18 week. Yardeni's weekly series for forward earnings is currently $230 per share, converging toward the analysts' consensus earnings estimate for 2024 of $246.

When it comes to standard metrics, however, like price-to-sales, price-to-earnings and price-to-book, valuations don't look cheap. The Shiller cyclically adjusted p/e ratio (CAPE) is very near a record high. The only place where valuations are bang on historical averages is the equity risk premium - the extra return that the stock market gives over supposedly risk-free 10-year government bonds. Ethan Wu of the Financial Times pointed out that, using BCA Research's various methodologies for calculating the ERP, that valuation may be near a decade low, but still represents fair value. According to my numbers, at 250 bps the US equity risk premium is offering an excess return in nominal terms of 300 bps and 450 bps in real terms. These estimates err on the conservative side because they are backward-looking and do not consider growth expectations.

In my judgement profit margins should be the focus. I've just finished reading Andrew Smithers' excellent new book, entitled "The Economics of the Stock Market," in which he argues that pre-tax corporate profit margins as a share of output are both mean reverting across history. While the analysis is compelling, not everybody agrees with his conclusion that this mean-reversion is imminent. The oligopoly structure of industry has given big public companies tremendous pricing power.

According to Yves Bonzon, chief investment officer at Julius Baer, he disagrees with the consensus among private investors that US equities are overvalued. In his opinion, the earnings-based measures to judge their valuation may be flawed and that US equities might be trading around fair value. I list his points below:

- The Shiller CAPE measure has lost significance because the composition of the S&P 500 index has changed from financials and transport companies to information technology and healthcare whose higher growth prospects justify higher valuation levels.

- Free cash flow is a superior indicator of gauging a company's superior health than reported earnings. From this standpoint the markets are rewarding companies in accordance with long- term averages.

- Professor Aswath Damodaran of NYU Stern School of Business, who includes 5-year forward earnings growth expectations, arrives at an implied equity risk premium of 5.9% at the start of 2023, suggesting an expected long-term
- average annual return of 9.8% on the S&P 500. In this connection, the S&P 500 is trading around fair value, pricing in a normalization of both growth and inflation, which is my base case scenario.

Macro View cont.

By Hubert Marleau

- The amount of equity capital circulating in the public markets has been trending down for 20 years due to a secular decline in initial public offerings, the expanding number of companies that are delisting and an increasing trend in share buy-backs.

- The S&P 500 is relatively insensitive to interest rates, as the average maturity of outstanding debt is around 7 years, 80% of it at fixed rates, with less than 5% maturing each year.

Thus, the idea that the S&P 500 is overvalued is based on the notion that the market is discounting a mean reversion of p/e multiples. That may indeed be wrong because it has morphed from a cash-raising to a cash-returning mechanism. I rest my case on the belief that buy-backs will not stop, corporate taxes are not going back to 40% and globalization is not dead - just altering.

The S&P 500 crossed the first red line of resistance on Friday, to close decisively above the 4200 level, suggesting that the profit-decline of the last 3 quarters may have ended, as Yardeni Research alluded to in its latest note to investors. Citi, meanwhile, upgraded its rating for equities to neutral from sell, citing that a mild recession, one last hike and weak sentiment are already baked in. According to Vanda Research's analysis of trade flows, retail investors have not yet stepped in. US-focused funds have now shed more than 68 billion year-to-date. Last week's outflow was the sixth one in a row. Many blame the resilience of the market on the AI-frenzy. I say that is an excuse for missing out. Given the huge amount of publicity surrounding AI, they may start to chase the market as soon as the various market metrics like the Vix, Skew and Fear-Greed indices take a turn for the better.

What About the Recent Commodity Bust?

There is a tendency among investors to eyeball the S&P 500 and make an assessment about what the recession probabilities are. That is a bad way to look at them. The broad benchmark is composed mainly of mega-cap growth shares, which are long-duration investments. Recession trades are found in the commodity and bond markets. The market for commodities is a better barometer, because it's more about economic activity, whereas bonds are more about inflation. However, investors should be aware that there can be a huge disconnect between the physical and paper market. This is not what has been going on.

Copper prices are down 18% from the 2013 peak and oil is down 15%. Goldman Sachs' Jeff Currie puts the blame on an unprecedented physical destocking and an equally large financial de-stock. On the physical side, it does not appear to be related to recessionary conditions, but to a reduction in government stockpiles of oil: a discerning approach to sanctioning supply of commodities and the healing in global goods supply chains. On the financial side, the paper selling is clearly related to the cost of holding positions, the US debt ceiling issue, and the want of insurance policies.

Macro View cont.

By Hubert Marleau

Jeff Currie wrote: “On the net, this leaves the entire complex exposed to upside should the anticipated recession not materialize or turns out to be just a soft one.” Goldman Sachs is now forecasting the S&P GSCI to return 30% over the next 12 months.

Huber Marleau's 'Macro View'

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