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Market Perspective
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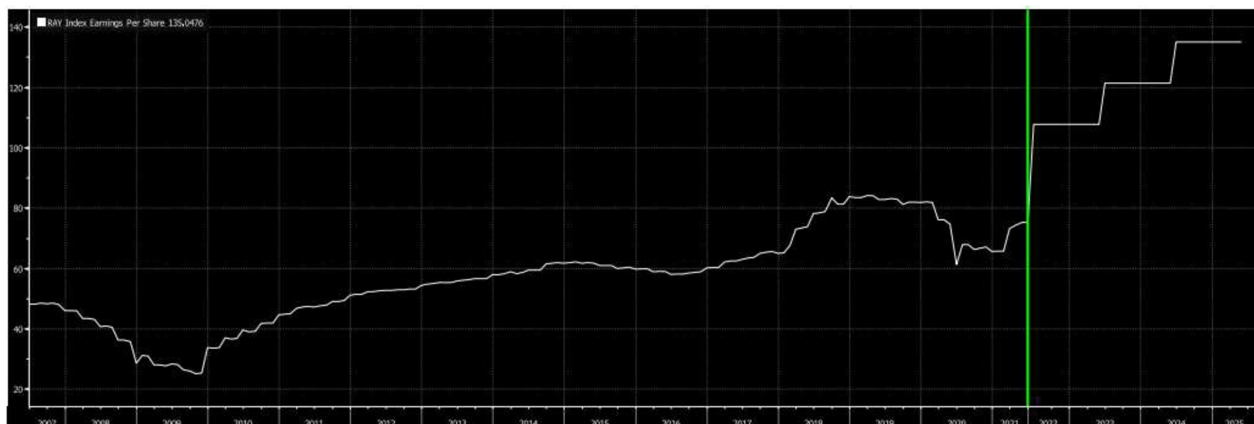
Earnings drive stock prices. Really, we should say that Expected Earnings drive stock prices. While the stock market's valuation (as a multiple of earnings) fluctuates over time, all else equal, if we expect much higher earnings in the future, then we should be willing to pay a higher multiple of today's earnings.

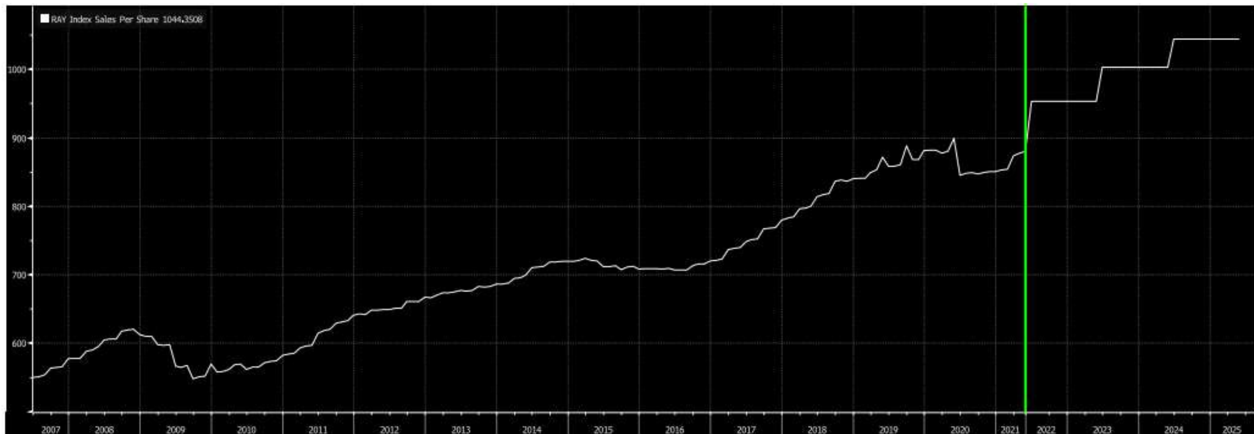
Many market observers have commented that the earnings increases projected over the next three years justify today's near-record multiples. My Market Perspective this quarter will examine the assumptions implied by these projections. The data that I will use is of the Russell 3000 index and its Growth and Value subcomponents. I believe this index is more representative of the entire US economy than the S&P 500, as it contains (on a capitalization weighted basis) the next 2,500 mid and small cap companies. My data source is Bloomberg, which compiles the forecasts of all sell-side analysts.

Let's start with the estimates themselves. Shown below is a graph of the actual earnings per share for the Russell 3000 dating back to 2007 and the consensus bottom-up analyst estimates for the next four years. Historical actuals are to the left of the green line, future estimates to the right. Just to the left of the green vertical line, we can see the dip that earnings took during the COVID "shutdown." Clearly, analysts are expecting much better bottom-line results from the index's constituents than has ever been produced in history. To provide some magnitude, next year's earnings are expected to rise 43% over the trailing 12 months (and a full 30% over pre-pandemic 2019), while the following two years are projected to increase 13% and 11%, respectively.



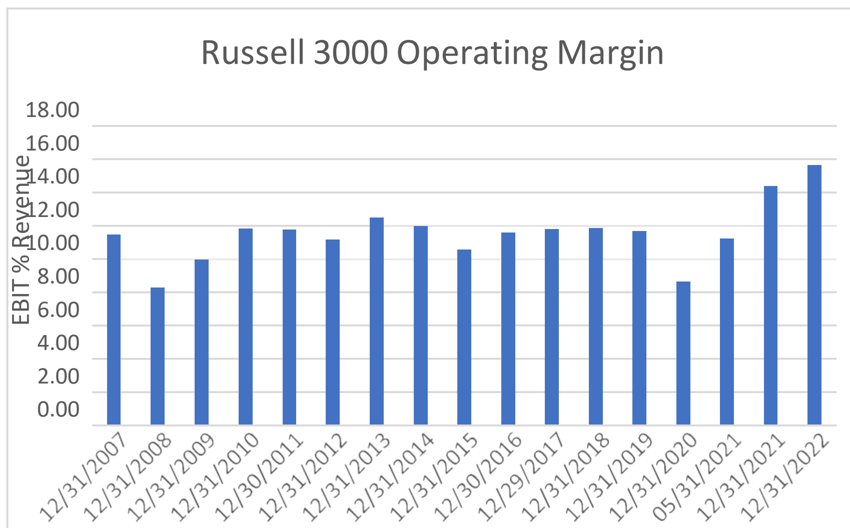
There are only three sources that affect the level of earnings. The first is Revenue. The second is the Operating Margin (% of Sales) and the third is the Tax Rate.

Let’s look at Revenues first:



This graph is constructed identically to the Earnings Graph. Note, however, that the increases for the next three years, while healthy, are a much more modest 8%, 5% and 4%, respectively (in comparison to the expected earnings increases). So, the big increases in earnings are not coming from sales growth. How about Margins?

This chart is instructive. I have gone into the Bloomberg database and extracted the line items for the analysts’ projected revenue and earnings (before interest and taxes). Dividing the latter into the former gives us the operating (or EBIT) margin. What we can see is that the high growth in bottom-line earnings that is being projected is predicated on Operating Margins being higher than any time in recent history.

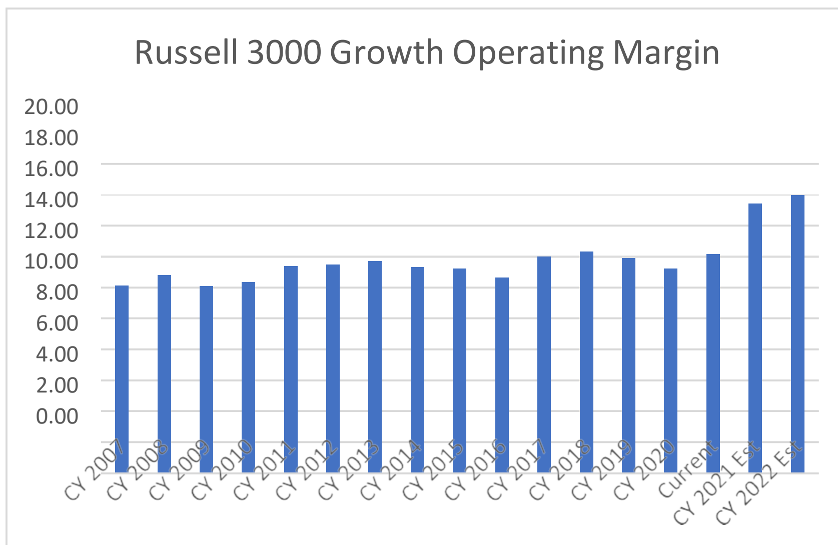


This data only goes out to 2022, but given the muted increases in revenue, it seems reasonable that analysts are projecting continued increases in margins for several more years.

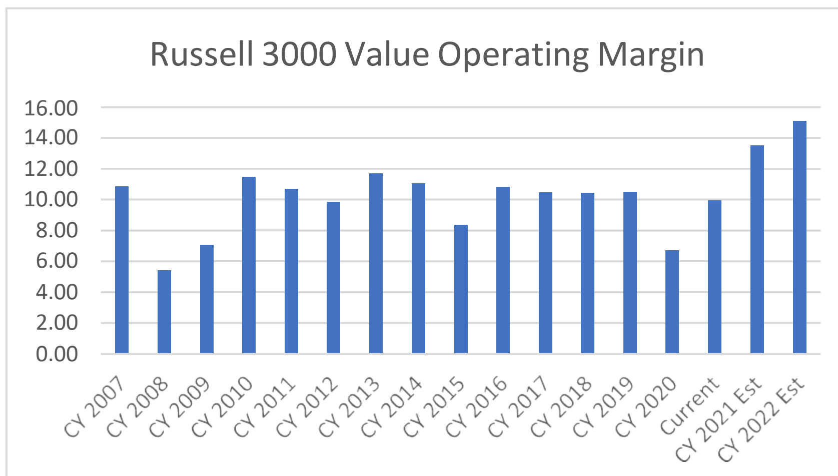
This may all come to pass. However, I think we need to consider the risks:

1. Modern-day Capitalism has a way of capping profit margins. If an activity is highly profitable, competition will develop. If it is a monopoly, regulators will cap returns.
2. This profile assumes that all inflationary forces will be borne by the end consumers. We have many historical examples of where inflation was borne partially by the producers through lower margins. We know that we are going to have more inflation than recent history; the only question is whether it is transitory or persistent.
3. This is all based on rosy top-line growth. If robust economic growth does not persist for multiple years, the bottom-line earnings are at risk.

Some argue that this margin increase is a function of large technology companies increasingly dominating the index. In other words, the index's composite margin is due to inherently higher margin companies making up a greater proportion of the capitalization. To examine that thesis, I looked at margins over time of both the Russell 3000 Growth Index and the Russell 3000 Value Index. Shown below is the Russell 3000 Growth Index on the same basis as the chart above. Clearly, this subindex is expected to have higher margins prospectively. Perhaps the technology behemoths will have ever-growing profit margins.



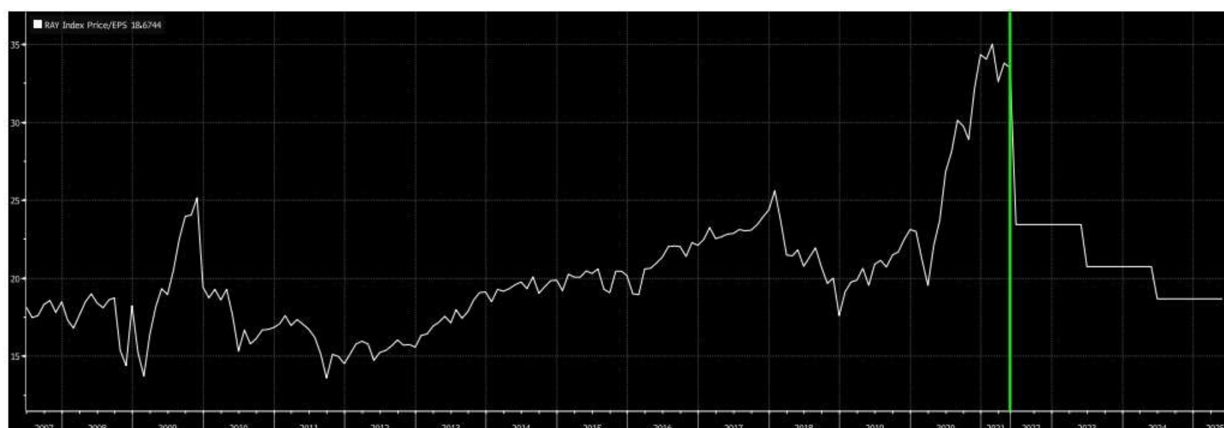
But the phenomenon is not isolated to growth. Look at the expectations for "value" constituent margins:



So virtually every company in the Russell 3000 is expected to have margins in the next two years that eclipse those that they have earned historically.

The final component is the corporate tax rate. The analysts' projections assume no change to those rates. Without getting into either a political debate or an analysis of tax policy, we need to realize that corporate tax rates were at 35% since the early '90s. Only in 2017 were they reduced to 21%. Given the build-up in debt the country has endured, and the burgeoning deficits we face, it would seem likely that corporate taxes will rise. Whether that involves all rates, or just a minimum rate for certain companies, this will be a direct offset to earnings per share.

Let me now conclude with an analysis of the claim that today's high multiples are justified by future earnings growth. Using the analysts' earnings projections that we have researched, here is a graph of the Price/Earnings valuation for the Russell 3000.



If revenues generate above-trend growth, margins hit levels never achieved before and tax rates remain at historic lows, then by 2025, the Price/Earnings multiple of the Russell 3000 will be back to average levels. I would suggest that this involves a lot going right. To say that US Equities are "priced for perfection" seems an understatement. There is certainly no rule that says that margins can't exceed historical levels or that asset prices must conform to historical metrics. However, history has shown us that when widely held expectations are not met, asset prices generally react.

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