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How Bad An Earnings Hit?

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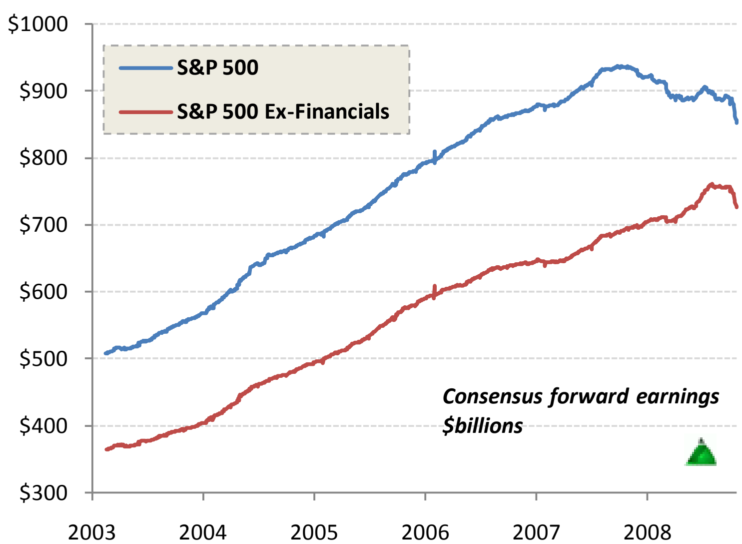
Forward earnings are falling -- but stocks have already fallen far more.

S&P 500 consensus forward earnings hit their all-time highs at $937 billion -- or 102.8 in index point terms -- in late September, 2007. They've been falling ever since, and are now off 9.0% from the highs, to 93.8. Over the years we've found that the topping out of forward earnings is an infallible recession predictor, with about a one-year lead, and so it proved to be again this time around. We would have been smart to heed it, but we didn't because so much of the earnings drop-off was explained solely by the financial sector. In fact, forward earnings for the S&P 500 *ex-financials* were still at all-time highs as recently as late August, capturing correctly the fact that the overall economy had remained quite robust to a long-simmering banking crisis. But with the recent sudden boiling over of the crisis, ex-financial forward earnings have headed decisively lower, off 4.7% in less than two months. And the economy is now surely in recession (see "Fear Itself, Volume 2" September 23, 2008).

Update to strategic view

US STOCKS: With massive interventions in place to halt the vicious cycle of the banking crisis, but with the economy certainly in recession, the issue now is how badly earnings will be hit. They're already off considerably, but we think widespread extremely pessimistic expectations are overdone, or at least premature. Even if they are correct, stocks have already discounted a historic earnings hit.

[see Investment Strategy Dashboard]



As we've traveled around the country talking to investors over the last two weeks, we've heard a near-universal consensus that earnings are now headed a lot lower. We have heard 60 often cited as a virtually inevitable downside target for S&P 500 earnings, representing a 36% further drop from the present consensus of 93.8, itself already off 9% from the 2007 all-time high -- making an overall drop of 41%. Considering that the economy has only

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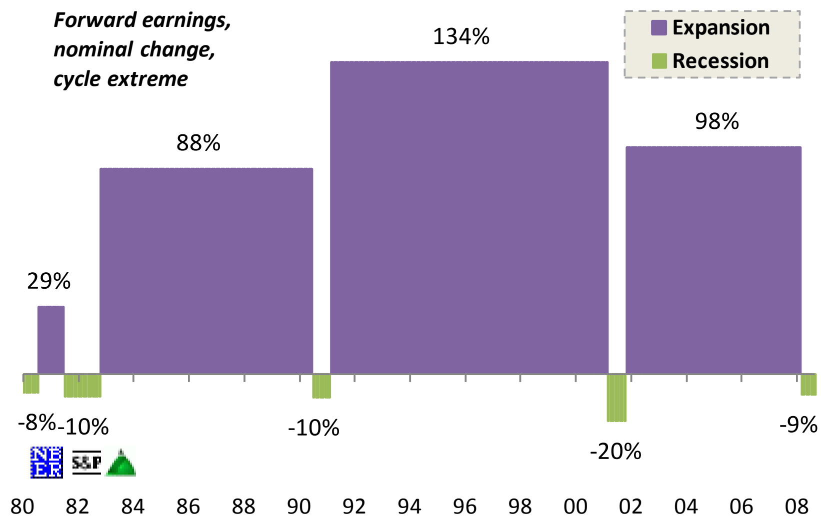
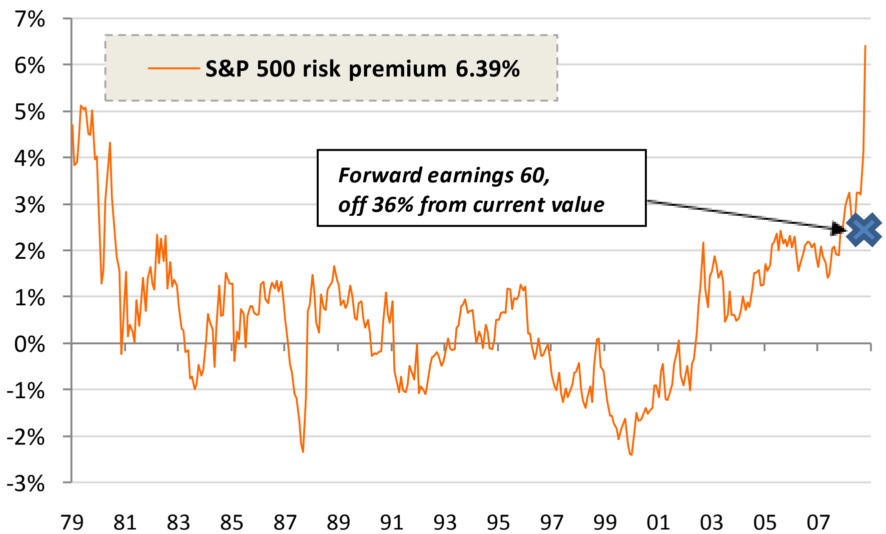
just now fallen into recession, this strikes us leaping to a rather heroic expectation. A 41% drop would be more than twice the largest in the 28-year history of forward earnings, and a third larger than the largest drop in over 50 years of as-reported earnings. Furthermore, among the same investors who expect S&P 500 earnings of 60, there seems to be a general -- if still tentative -- belief that the worst of the credit crisis is over, thanks to the credible promise of unbounded capital and guarantees from the Treasury, the Fed, the FDIC and financial authorities around the world (see "At Last: A Bail-out That's a Bail-out" October 14, 2008). The recent acceleration of the crisis has been a costly blow to the economy -- and even if the worst is over, it will take time for the appetite for risk-bearing to be restored, and for growth to recover. But if the crisis stops getting worse, then it's worth questioning whether the widely expected earnings cataclysm will materialize to the full extent now anticipated.



Either way, stocks have already discounted an enormous blow to earnings. Since the top a year ago, forward earnings have fallen 9%, but the S&P 500 is off 42.7% -- more than discounting the 41% forward earnings drop required to get to the target of 60. So if forward earnings do in fact fall that much, the bad news is already in prices. If they don't, then stocks stand to earn a considerable upside.



Using today's consensus forward earnings -- already off 9% from the highs -- the S&P 500 risk premium now stands at a record level for the 30-year period over which data is available. The difference between the forward earnings yield of the S&P 500 and the 30-year Treasury yield -- the reward for bearing equity risk -- is even higher today than it was in 1979 and 1980, when the economy was in chaos, hyper-inflation was rampant, and the Iranian revolution was delivering a brutal oil supply-shock (and, we must note, there was a Democratic president and Democratic majorities in both houses of Congress). If we reduce forward earnings to the target of 60, the risk premium narrows significantly -- to the level indicated by the blue "x" in the chart above. That's still the highest level seen since 1980, which means that stock prices wouldn't have to fall very much, if at all, to provide investors with a powerful incentive to take equity risk even given sharply lowered earnings expectations.

BOTTOM LINE: With massive interventions in place to halt the vicious cycle of the banking crisis, but with the economy certainly in recession, the issue now is how badly earnings will be hit. They're already off considerably, but we think widespread extremely pessimistic expectations are overdone, or at least premature. Even if they are correct, stocks have already discounted a historic earnings hit.