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MACROCOSM

Snapple, not Kool-Aid

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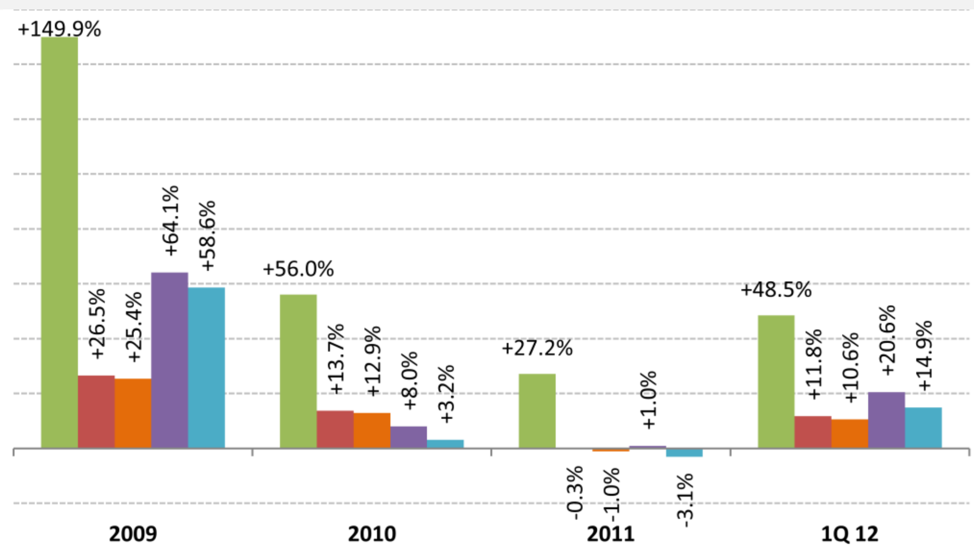
Donald Luskin

Apple mattered to Q1 performance -- but it says nothing about valuation, or faster growth.

We were perhaps the first to point out the extraordinary role that Apple was playing in 2012's first quarter -- and the need to draw a distinction between Apple and the S&P 500 ex-Apple. It was back in January, when we noted how this single company was responsible for 70% of earnings season's aggregate upside surprise (see "On Q4 2011 GDP" January 27, 2012). Two weeks ago we pointed out that Apple's forward earnings surge was masking a *decline* for the S&P 500 ex-Apple (see "We Love Our New iPhone, But..." March 22, 2012). Now it seems it's a fad -- there's even a brand-name making the rounds for ex-Apple analyses: "Snapple," for "S&P no Apple."

- A number of clients have commented on how critical owning Apple was to first quarter performance. Snapple underperformed the full S&P 500 by about 1%. Leaving Apple out of the S&P 500 Info Tech sector cost about 6%.
- But it's not just this quarter. The same thing has been going on now for more than three years (please see the chart below).

Apple S&P 500 Snapple S&P 500 IT sector IT ex-Apple
Price change only; dividend not included



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO: Analyzing Apple's outsized impact has become a fad on Wall Street. Yes, its astonishing gain of $183 billion in market cap in the first quarter made it one of the keys to performance. But far more important was the risk-on decision to own undervalued stocks -- Apple or not -- instead of overvalued bonds. The equity risk premium told us that at year-end, and Apple had no effect on that at all, and still doesn't. Now the equity risk premium is near its mean, so further relative gains for stocks will have to come from momentum, not value. That could yet carry stocks to new highs, after an inevitable correction. But without Apple, the reality is that forward earnings are still in decline -- the economy is weaker than most now believe, and significant political threats still loom for year-end.

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- Apple's relentless cumulative outperformance has made it a very large-cap stock -- so even though it wasn't the best-performing stock in the first quarter, its sheer dollar gains in market cap are astonishing.
- Apple's 48% gain only made it the tenth best-performing stock in the S&P 500 in the first quarter. Sears Holdings was the best, up 108%. What made Apple so important was that it added $183 billion to its market cap in the first quarter, almost 50 times Sears' $3.7 billion gain -- and 3.5 times Microsoft's second-ranked gain of $52 billion.

So no other *single stock* mattered as much as Apple did in terms of performance. But it wasn't the only decision that mattered in the first quarter.

- Sector decisions that had nothing to do with Apple mattered, too. Omitting Financial sector exposure cost just as much in relative performance as omitting Apple -- about 1%.
- What *really* counted was the high-level stock/bond asset allocation decision. Starting the year with an extremely elevated equity risk premium (see "2011: A Lost Year" December 29, 2011), it isn't a surprise to us to see the S&P 500 up 12.5% and 30-year Treasuries off 8.2%, on a total return basis.
- Asset class-level valuation decisions are not affected by Apple's outsized influence. Omitting Apple has almost no effect whatsoever on the level of the equity risk premium, or its relation to its crisis era mean.
- That's because as Apple has risen to dominance in the S&P 500, its forward earnings multiple has perfectly converged on the market multiple (please see the chart below). Several years ago when Apple's multiple was more than twice that of the market, the company wasn't a large enough component in the index to matter. Now that it's the largest single component, it has the same multiple

Forward earnings multiple — Apple — S&P 500

Source: Zacks, TrendMacro calculations

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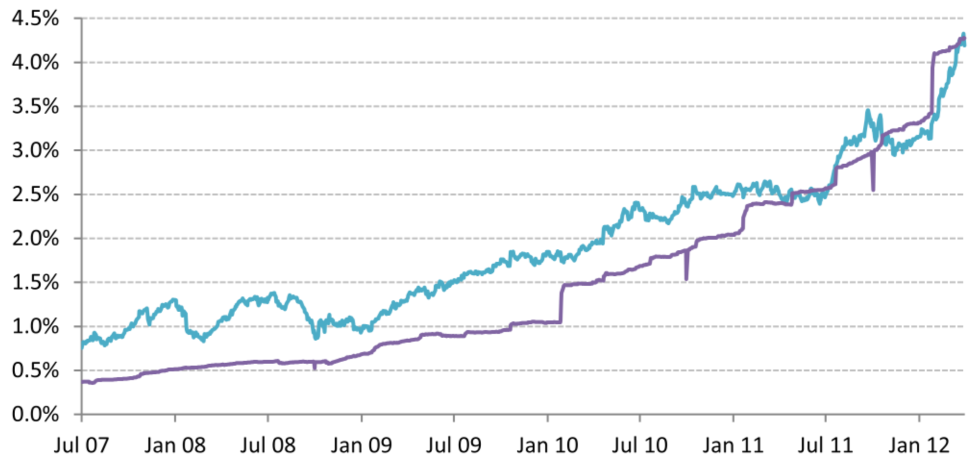
as the market -- so again, it doesn't matter.

- To say the same thing another way, Apple's capitalization is the same percentage of the market's capitalization as Apple's forward earnings are of the market's forward earnings (please see the chart below). So in the index or omitted from it, Apple has no impact on aggregate valuation.

Apple as percentage of S&P 500 — Capitalization — Forward earnings



Source: Zacks, TrendMacro calculations

- With or without Apple, the equity risk premium is still somewhat elevated versus its crisis era mean, which is itself elevated versus historical norms. But the equity risk premium is hardly at the generational extremes that moved us to call the bottom in October 2011 (see the chart below, and ["Europe Fails, US Stocks Flail"]() October 4, 2011).

— S&P 500 equity risk premium   Recession
Forward earnings yield minus 30-year Treasury yield

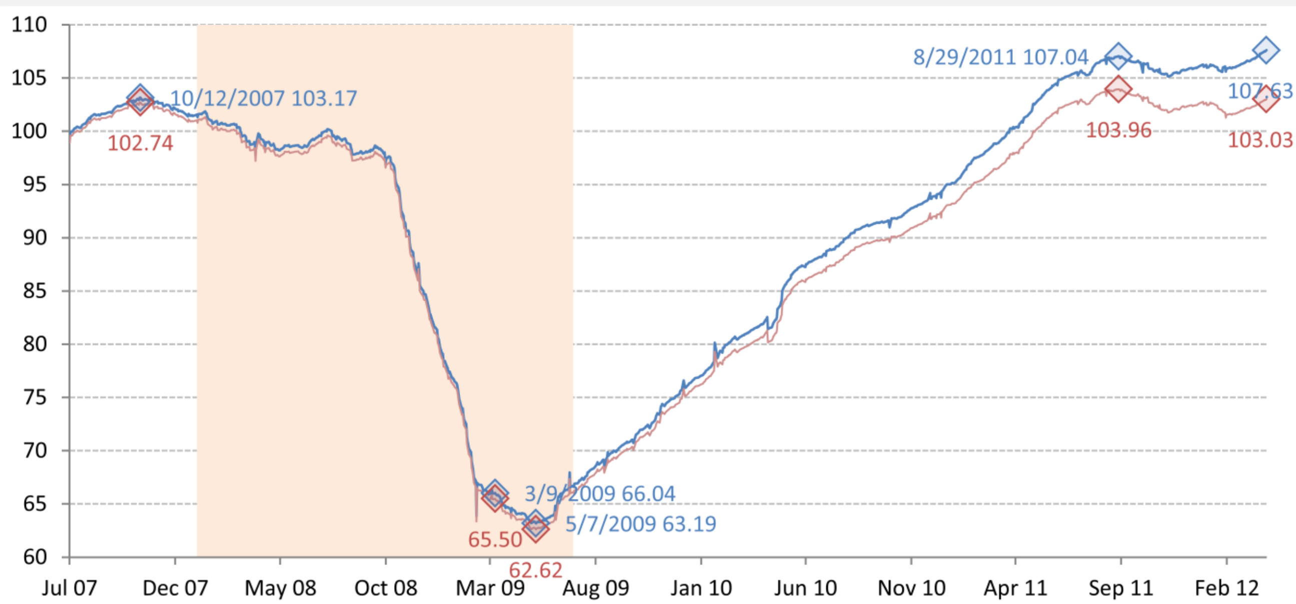
Source: Zacks, Bloomberg, TrendMacro calculations

- From here, further relative gains for stocks will come from momentum carrying the equity risk premium -- a mean-revering series -- *below* the crisis era mean. This would be sufficient to carry the S&P 500 to new all-time highs.
- But along the way to that, with the present slow-motion melt-up now having gone for 80 weekdays without so much as a 3% correction, we have to be ripe for more of a reaction than last week's pause.

A necessary technical correction aside, once the momentum of the mean-reverting equity risk premium has run its course, we are still not willing to enthusiastically drink the Kool-Aid on what seems, on the surface, to be an upswing in growth (see "On the February Jobs Report" March 9, 2012). And we are attentive to approaching political risks that will cluster at year-end after the election (see "What Could Possibly Go Worng?" March 8, 2012).

These concerns connect, again, with Apple. We still think the most salient strategic element around Apple is the fact that it has masked the decline in forward earnings among the 499 stocks in Snapple (see the chart below, and again "We Love Our New iPhone, But...").

Forward earnings per share — S&P 500 — Snapple — Recession



Source: Zacks, TrendMacro calculations

- In August 2011, forward earnings for the S&P 500 with and without Apple made new highs, besting their prior highs from October 2007. For the S&P 500, there was then a six-month pause, with a break to all-time highs two weeks ago. But this has been due to the extraordinary surge in Apple's forward earnings. For Snapple, it's been a six-month *decline* -- we're still waiting for a break to an all-time high that so far hasn't materialized.

- We don't like to tinker with our single most trusty business cycle indicator this way -- but breadth has to count for a lot. So until proven otherwise, this key metric of economy-wide strength remains a negative in our macro outlook.
- And if we say it's not kosher to take Apple out of our appraisal of the economy's earnings power, then don't we have to ask some tough questions about Apple itself? Truly, how long can this go on? *Just how many gadgets can one hardware company sell?*

Bottom line

Analyzing Apple's outsized impact has become a fad on Wall Street. Yes, its astonishing gain of $183 billion in market cap in the first quarter made it one of the keys to performance. But far more important was the risk-on decision to own undervalued stocks -- Apple or not -- instead of overvalued bonds. The equity risk premium told us that at year-end, and Apple had no effect on that at all, and still doesn't. Now the equity risk premium is near its mean, so further relative gains for stocks will have to come from momentum, not value. That could yet carry stocks to new highs, after an inevitable correction. But without Apple, the reality is that forward earnings are still in decline -- the economy is weaker than most now believe, and significant political threats still loom for year-end.