



C A M B R I D G E A S S O C I A T E S L L C

INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Published Research Team

“Record S&P 500 EPS for 2011: 12-Month S&P Target Now 1,400” by David Bianco, Bank of America Merrill Lynch, December 2, 2010

Earnings per share (EPS) for the S&P 500 Index are set to reach a new all-time high in calendar year 2011 thanks primarily to strong sales at nonfinancial corporations and high net margins. Although some investors are concerned over the high level of current margins, their sharp rebound after the recession suggests that current margin levels are structural in nature. The combination of high margins and strong sales growth should drive the S&P 500 to 1,400 by year-end 2011.

EPS for the S&P 500 Index are set to reach \$93 in 2011, a new all-time high. Strong EPS growth, contrary to prevailing wisdom, has not been driven by aggressive cost-cutting; rather, sales at nonfinancial corporations rebounded strongly due to a number of factors, including foreign operations, business-to-business sales, commodity prices, exports, and consumer spending. Net margins (ex financials), meanwhile, have also recovered to pre-recession levels, suggesting that current margins, while higher than historic averages, are structural in nature.

S&P nonfinancial sales bounced back sharply from recessionary levels, despite slow domestic GDP growth. There are two main reasons for strong sales growth, which should continue into 2011 and 2012. First, emerging markets economies are likely to grow 6.4% in 2011, faster than global growth of 4.2%. S&P 500 corporations have strong direct (e.g., sales in areas like infrastructure spending) and indirect (e.g., profits of energy & materials sectors) linkages to emerging markets—

led growth. Indeed, there are more than 100 companies in the index that report Asia/emerging markets sales of at least 15%, up from just a handful of companies seven years earlier.

Second, a strong multiyear capital expenditure spending cycle is likely to unfold. Although business cut deeply into capital expenditure during the recession, the rebound to this point has been mostly maintenance-related. For instance, business spending (ex financials) relative to depreciation and amortization is at its lowest level since 1995. The strong profit recovery should encourage companies to upgrade existing infrastructure. Spending will also be supported by the fact that 40% of S&P 500 capital expenditure comes from three industries that are geared toward global growth: energy, industrials, and materials.

Similar to sales, S&P 500 nonfinancial margins have bounced back to pre-recession levels quickly. The sharp recovery in margins has triggered a debate regarding whether margins are sustainable at current levels. Indeed, many market participants point to the climbing share of corporate profits as a percentage of GDP as a cause for concern. This argument, however, ignores three structural factors supporting higher margins that are unlikely to fade in the near term.

First, nonfinancial firms have larger and more profitable foreign operations. Foreign sales have steadily increased from roughly 25% in 1995 to more than 30% in 2010. During the same period, however, the share of pre-tax profits from foreign sales has nearly doubled from 25% to 50%. Foreign profit margins are well above domestic equivalents; many overlook the fact that domestic pre-tax

margins are currently well below historical peaks. The big increase in contribution from foreign profits and margins is a result of a decade of significant investment in the 1990s. One reason that foreign margins are higher than domestic equivalents is that it was mostly higher margin businesses that expanded overseas.

The second factor supporting higher margins is lower interest expense, which owes to lower levels of leverage and interest rates. More specifically, the debt-to-market equity at S&P 500 nonfinancials is currently 17%, down from more than 20% in the 1990s, while interest rates (as measured by BBB corporate bond yields) have declined by about 100 basis points (bps) from the 1990s. Going forward, multinational firms are likely to capitalize on low borrowing rates and increase leverage to fund organic growth or increase share buybacks.

Third, lower effective corporate tax rates have mainly come from the rising share of foreign profits. Until profits are repatriated, foreign profits are taxed only at the international level, which are mostly lower than in the United States. Should domestic tax rates rise in the future, it would likely further shift hiring and capital expenditure abroad. Thus, there is limited risk to margins from higher domestic tax rates. On the other hand, there is a potential for further margin improvement if future tax legislation makes the U.S. corporate tax code more competitive.

High sustained margins, coupled with strong sales growth, should drive S&P 500 EPS from \$85 in 2010 to \$93 in 2011—a new all-time high. The positive earnings environment is likely to persist over the next couple of years, allowing EPS to climb to \$99 in 2012. Assuming a forward price-earnings multiple of 14, the S&P 500 Index should finish 2011 at the 1,400 level.

“The Coming Flattening in U.S. Profit Margins” by Richard Berner, Morgan Stanley, January 14, 2011

Earnings growth for U.S. companies is likely to slow in 2011 despite a moderate increase in U.S. economic output. The main reason for slower earnings growth is a flattening of corporate profit margins. Margins are likely to level out as a result of slower economic growth abroad, fading operating leverage, and an end to the decline in interest and labor-related expenses currently enjoyed by many U.S. companies.

Earnings growth for U.S. companies is likely to slow in 2011 despite a moderate increase in U.S. economic output. The main reason is a flattening in profit margins due to slower economic growth abroad, fading operating leverage, and an end to the decline in interest and labor related expenses currently enjoyed by many U.S. companies. The deceleration in profit growth initially will not be pronounced; after-tax profit growth will probably drop from 24% in 2010 to 17% this year. However, some of the earnings this year will be brought forward from 2012, when an outright decline is expected in after-tax economic profits.

To understand why profit margins are likely to flatten in 2011, it is worth revisiting why they have soared since their lows in 2008. Global growth increased 5% last year, and the 7.5% growth rate for emerging markets was near the blistering average growth between 2003 and 2008. As a result, overseas earnings for U.S. companies rose by an estimated 17%, and ratios such as profits as a percentage of domestic GDP got an extra boost. Second, during the most recent recession, companies showed a tremendous amount of discipline with respect to how they allocated capital: operating leverage was increased by reducing capital expenditures and cutting capacity. As a result, even the moderate economic recovery last year allowed for a huge increase

in factory operating rates. Finally, the recession forced companies to exert strong control over balances sheets. This was facilitated by interest expenses plunging to historical lows given record-low interest rates and limited demand for credit. Large layoffs also reduced compensation expenses and companies that showed hiring discipline during the downturn got a further boost from the corresponding reduction in health care benefits paid to employees.

In 2011, many of the dynamics that contributed to margin expansion over the last two years will start to reverse themselves. Global growth is expected to slow to 4% from 5% in 2010, with fast-growing emerging markets economies in Asia and Latin American adversely impacted by tighter monetary policies and stronger currencies. In Europe, fiscal restraint will slow growth in countries such as the United Kingdom, and peripheral economies will feel an especially acute impact. A weaker U.S. dollar may offset some of the effects on margins from lower growth abroad, but currency effects will ultimately not be enough to have an offsetting positive contribution to margins.

The boost to earnings from increased operating leverage is also likely to fade in 2011. U.S. capital expenditure outlays fell below depreciation for the first time in 50 years in 2010, suggesting that net capital stock in the United States declined for the second year in a row. In the 60 years prior to 2009, the capital stock had never declined. Companies cannot continue to hold off on replacing old equipment and delay new investment forever, and operating leverage will fade as depreciation and other fixed costs begin to rise and catch up with the growth rate of sales. This year should also see companies begin to hire again; job growth should be strong in areas within company operations that are best suited for growth. This will have the effect of increasing both fixed and variable costs associated with

compensation and health care, and will be perhaps the largest drag on margins in 2011.

Another challenge to margins in 2011 is rising commodity prices, which have been of particular concern to investors in recent months. There is concern that companies will not be able to pass on these higher prices to customers, and that margins will suffer as a result. Generally speaking, there is excess capacity and slack in the global economy, limiting the pricing power of companies. However, concerns about a commodity squeeze are probably overblown for two reasons. One is that the cost of materials is a relatively small 14% of gross industry output, so even a significant increase in input prices will have a small impact on overall margins. Second, the cost cutting and increased efficiencies honed during the recession should now help companies maintain margins as sales expand.

“Easy Money, Hard Market,” December 3, 2010, and “We Expect Margins Will Hit a New High,” January 18, 2011, by David J. Kostin, Goldman Sachs

Despite rising input costs and increased selling, general, and administrative spending, margins were expected to rise to peak levels in fourth quarter 2010. Margin expansion for the S&P 500 (excluding financial and utilities) will be heavily concentrated—85% of the rise from its 2009 trough will come from the consumer discretionary, energy, and information technology sectors.

U.S. GDP should grow 4% in 2011, leading to a 12% increase in S&P 500 operating earnings. The improved outlook for margins is the key reason why earnings have rebounded so quickly; the net margin on the S&P 500 ex financials should recover from 5.9% in 2009 to 9.0% by the end of next year. Although investors are skeptical of this improvement, it should be noted that trends in

margins vary significantly from sector to sector. For example, while information technology will reach 135% of its previous peak margin, sectors such as telecommunications, energy, and materials will see margins at only 70% to 85% of prior peaks. Further, within the industries expected to see the largest improvements in margins, gains will be highly concentrated among some of the heaviest-weighted stocks in the index.

One reason earnings are improving is the macro-economic environment, despite known risks such as European sovereign debts and emerging markets inflation. Economic growth in the United States is expected to accelerate over the next two years, as company sales improve. Inflationary pressures remain low, despite movement in some commodity prices, and liquidity is abundant. As a result, interest rates and debt servicing costs for corporate debt are currently at their lowest levels since 1965, boosting corporate margins.

No business metric is currently more hotly debated in client meetings than profit margins. Some investors believe that companies will be able to push margins even higher via investments in technology and productivity, lowering debt servicing costs, and expansion into emerging markets. Others question whether increased hiring and investment will eat into margins that are currently on the cusp of a new record. From a bottom-up perspective, S&P 500 (ex financials and utilities) margins should increase by 50 bps in 2011 to 9%. This will be a new record, achieved via improvement in a concentrated number of stocks and sectors. Just 16% of firms in the S&P 500 ex financials and utility will see margins reach new highs in 2011; the median firm will see a margin that is just 81% of its prior peak. Across sectors, information technology is expected to see

margins at 110% of previous peaks, while sectors such as energy and health care will be stuck at 70% to 80% of previous peak profitability.

Looking more closely at the data, it is clear that improvement in the margin outlook for a concentrated number of firms will be enough to reach record overall levels of profitability for the index. Just 25 firms in the S&P 500 (ex financials and energy) generate 45% of the overall 9% margin. This group is dominated by information technology firms (33% of group market cap), followed by energy and health care. These companies, on average, will see margins hit 105% of all-time highs in 2011. Looking at the stocks that will contribute the most to margin growth, information technology again figures in predominantly (41% of market cap), followed by health care and energy. Reasons for improvement in margin are varied and include noneconomic events. In information technology, Apple recently changed accounting methods to recognize revenue differently, resulting in stronger margins. In energy, margins have improved as the price of crude oil has leapt from below \$40 to \$90 per barrel, yet remain below previous peaks.

Risks to margin expansion do exist, as increases in selling, general, and administrative spending and rising input costs may depress margins. Companies have been increasing payrolls as the economic backdrop has been improving; a continuation of this trend may begin to suppress margin expansion. Additionally, commodity prices such as cocoa, copper, corn, and wheat have moved higher recently, suppressing margins. Furthermore, as growth is expected to be strong, any growth slowdown would become a risk to margin expansion, as investors may have to take note of any pro-longed period of sub-trend growth. ■

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