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TRIVARIATE RESEARCH

US EQUITIES: TRICK OR TREAT?

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US EQUITIES: TRICK OR TREAT?

We think it is important for our clients to understand our framework for US stock-market appreciation over the longer-term. Our thought process is that **the US equity market offers around a 1.5% dividend, generally a 2% net buyback, and a call option on earnings growth**, (around 6-8% total return per annum in our judgment over the long-term). Compared to nearly every other major or liquid asset class, this looks compelling and has largely fueled our structural view to remain bullish on US equities for most of the last decade.

Since we launched our business a few months ago, we have been resolutely bullish on the US equity market, believing the combination of a healthy economy, strong corporate earnings, an accommodative FED, and a sustained fiscal stimulus would be a potent combination for equities. With the SP500 up 22.6% YTD, investors in our recent meetings have increasingly been questioning us on key risks to the market here, and what could potentially cause a double-digit pullback in the next few months. Essentially, they are asking, is this a trick or a treat?

Pushback from managers has mainly taken two main forms: **Risks to earnings and elevated valuation** given potential for rising rates.

RISK #1: EARNINGS

Our view since the Financial Crisis has been that in order to "call" a market top, we need to see rising risks that earnings will decline. Historically, that meant a combination of hubris and debt, meaning management arrogance and rising fears of debt burdens on the P&Ls of corporate America. We do not see a lot of either today. Capital spending is in check. There certainly is not excess inventory indicative of overconfident management teams. Hiring and operating expenses are not out of control. Debt burdens have largely been pushed out as CFOs have refinanced, so few companies appear to be facing challenging re-financings in the coming quarters. The risk is really around whether rising input costs (labor, materials, logistics) will ultimately not just impede, but damage earnings. While many companies have recently flagged that margin pressures are likely to remain through the first half of 2022, it seems likely that overall corporate earnings will grow in 2022 vs. 2021. **It is the absolute growth that matters, not whether the out-year estimates are too high.**

As evidence of this, forward earnings have existed since 1978, and in 41 of the 53 years since, the analyst bottom-up estimates in January of any given year proved to be too optimistic. Only in recession recoveries or the year after, did analysts estimates prove too low, as we saw this year when the analysts all collectively and typically got too bearish at the bottom. In an amazing coincidence (or perhaps not!), **earnings estimates for 2021 are now 22.6% from higher than they were on January 1st of this year** (S&P earnings have gone from ~168 to ~206), **matching the 22.6% YTD return of the SP500**. Currently, the S&P trades at just under 21x 2022 forecasted earnings, meaning **the multiple has actually CONTRACTED compared to Jan 1**, when it traded at nearly 22.5x 2021 forecasted earnings! However, in 2022 we are no longer in the recovery year – and if history is a guide it is likely that estimates in aggregate could be too high. Obviously, the market did not go down 41 of the last 53 years – so **what matters is NOT overly-optimistic estimates, but whether investors perceive that earnings will grow.**

FACTORS TO MONITOR

What should you monitor?

In our judgment, key items to monitor include book-to-bill and backlog for cyclical businesses like semiconductors and industrials. If book-to-bill ratios start approaching 1.0x and / or there is any sense that the 12-month (or extended) backlog at these businesses are at risk of cancellation, we would worry that stocks could sell-off, as it would be an indication that businesses are over-producing consumption, thus impacting earnings growth.

Our #1 recommended way to capitalize on this environment is to be **long / overweight energy and materials, and short / underweight industrials**. That, in our judgment, is a play on relative estimate achievability. The rising energy and materials costs will likely impede margin progress for industrials, yet the bottom-up estimates are for record profit margins.

RISK #2: VALUATION

On valuation, we loathe historical frameworks that presuppose margin and multiple mean-reversion. They have been and can be wrong for decades. Margins will remain elevated, as there is structurally less capital-intensity. Over 40% of US equities today have zero inventory dollars – their business models do not require it. Over 20% of the top 3000 US equities by market cap. are software or pharma/biotechnology, where growth typically lasts longer and current profitability is less relevant than high gross margin and sustainable growth. Eight of the biggest 10 market cap. stocks in 1985 were energy. **Obviously, the constitution of the market is different today, and this results in higher profitability and higher multiples.** The other key valuation point is real rates and the long-term non-linear relationship between real yields and multiples. Our view is that materially higher interest rates could and likely will cause some multiple contraction. However, **we think rising interest rates would be accompanied by stronger growth.** Experts have proven that forecasting the ten-year yield is challenging.

So, our view is status quo – we like US equities, we make industry bets playing the “relative estimate achievability” game, and **we think this is a treat, not a trick.**

Happy Halloween.

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