Back To The Horizon: EPS Cycles Again

By Ed Easterling
December 31, 2008 (update)
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Earnings had been increasing at double-digit growth rates for five consecutive years from 2002 through 2006—although many agreed that earnings growth might be slowing, it was beyond almost everyone's foreseeable horizon that earnings might actually experience a decline.

Yet, before anyone knew it, the end of the cycle was in the rear-view mirror rather than beyond the distant horizon.

As discussed in detail in the previous article at *CrestmontResearch.com* titled "Beyond The Horizon: The EPS Cycle," earnings typically grow handsomely for three to five years, and then decline for a year or two before again growing (*this article expands on material from the previous piece*). That's usually all that it takes to restore the balance.

Earnings in 2007 were significantly lower than they were in 2006….and now 2008 is expected to show a further decline. History again repeats itself—this time was not different. The most recent five-year surge in earnings is again followed by a couple years or so of declines.

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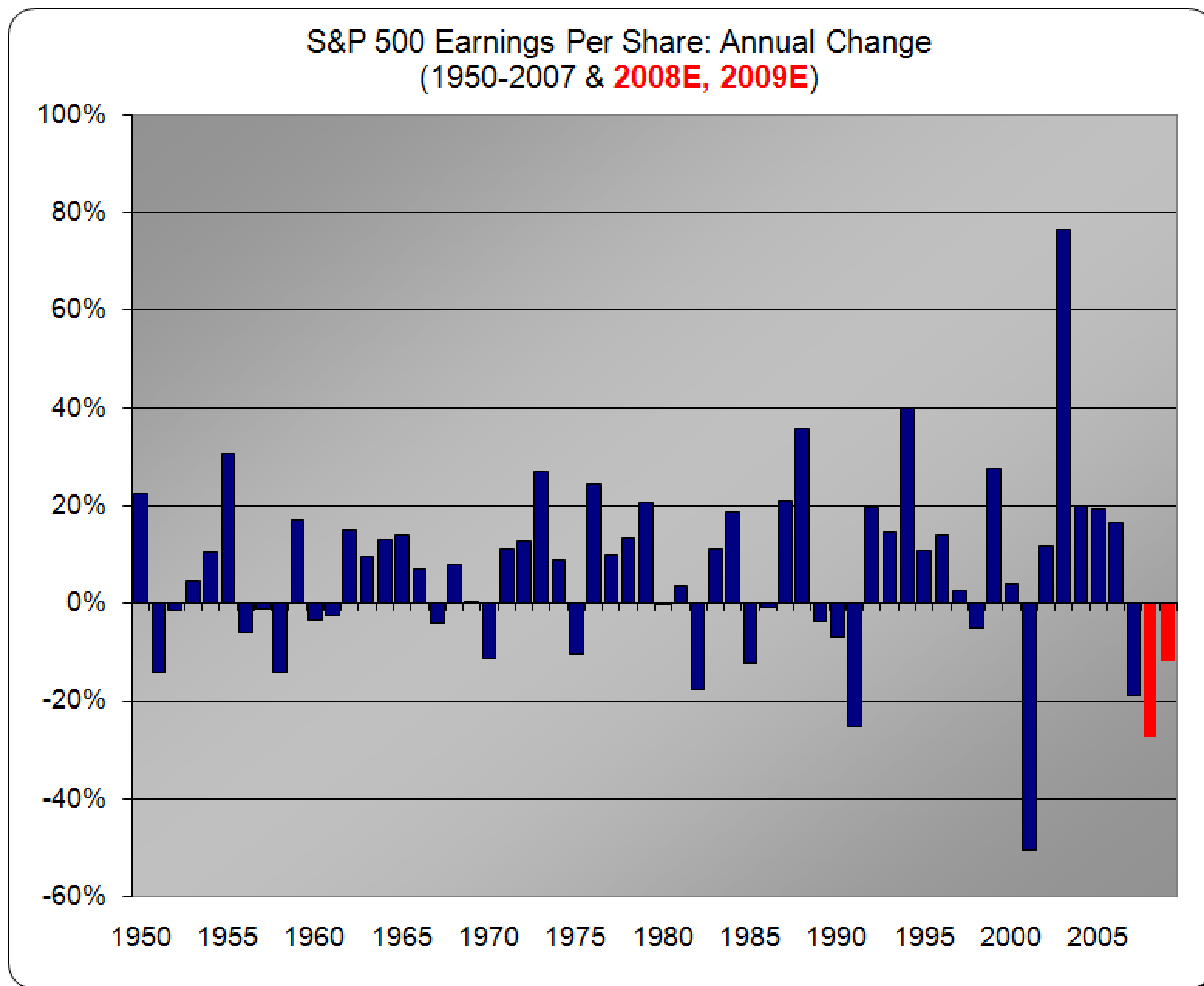
A couple or SO?

Standard & Poor's provides periodic updates to historical and estimated future 'as reported' earnings per share ("EPS"). The 'as reported' figures are the actual numbers reported by the companies and follow the required accounting standards. Earnings peaked in 2006 at $81.51 per share following a strong five-year run. In 2007, EPS declined 19% to $66.18. As of December 23, 2008, the EPS estimate for 2008 was $48.05, down 27% from 2007. For 2009, another decline is forecast—to $42.24—yet the pace of decline appears to be slowing (down 12%).

Although six months ago a quick rebound in EPS was expected, a more extended period of decline is now likely to follow the recent extremely-strong period of earnings growth. For many that have not studied history, this may be news. For many economists and business cycle analysts, this is very consistent with the analysis described in "Beyond The Horizon" (see CrestmontResearch.com).

Let’s take a look at Figure 1 for a view of EPS history and currently forecast estimates. The graph presents the annual change in reported earnings per share for the S&P 500 companies from 1950 through the estimate for 2009.

Figure 1. S&P 500 Earnings Per Share Growth: 1950—2007 & 2008E, 2009E



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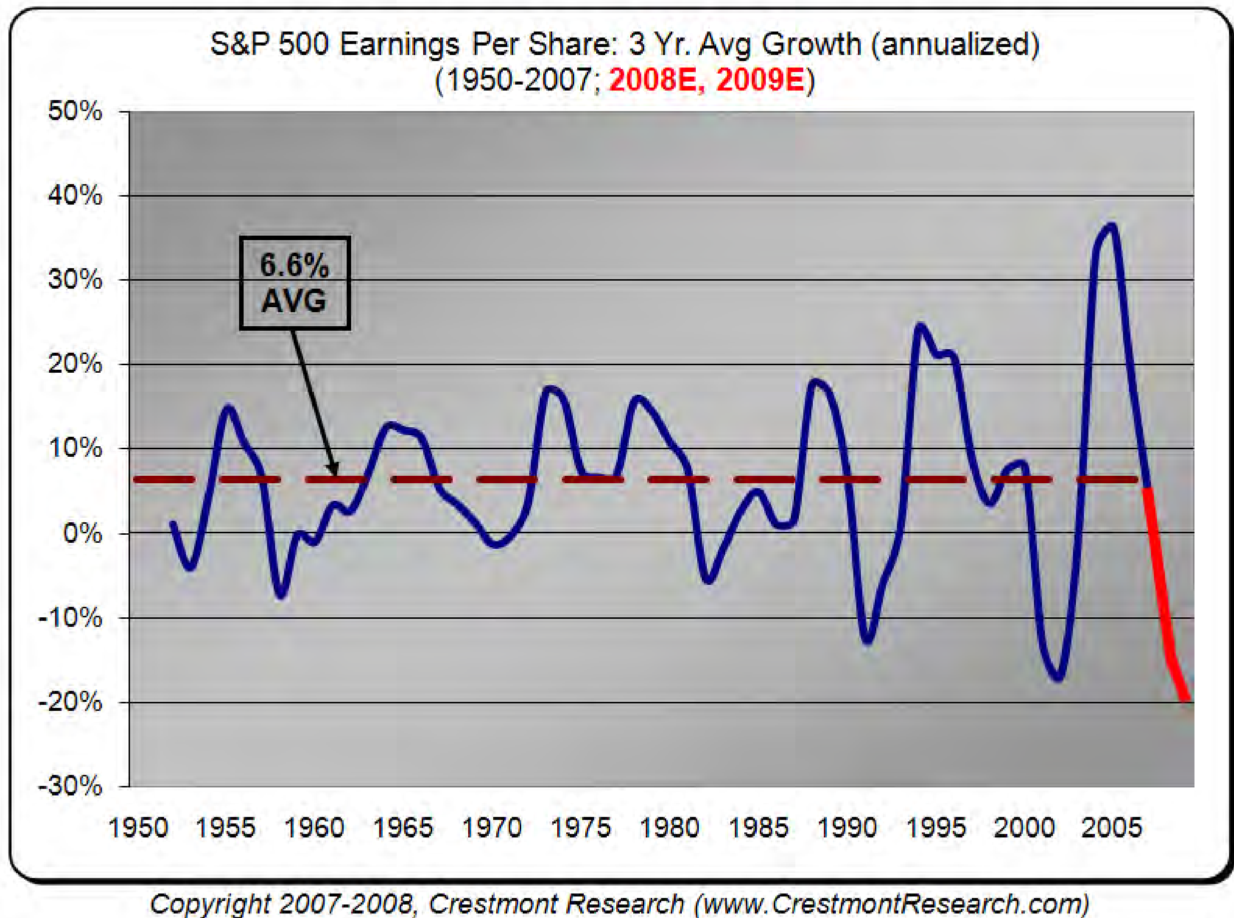
Over the past six decades, there was a fairly consistent pattern of three to five years of strong profit growth followed by a year or two of profit declines. Only one period in the 1990s extended into a sixth year of gains. The recent era of growth appeared to be destined to tie or exceed that record. Yet, economics and capitalism are powerful forces—the relatively high profit surge during the recent five-year period likely led to the abrupt and unexpected reversal. It now appears that we’re set for two or three years of declines in earnings…not at all uncommon, as history illustrates.

To more accurately see the trends, we can combine a few years into a moving average. A multi-year average smoothes the short-term swings and presents an insightful view into the earnings cycle.

Given the historical duration of profit surges and retreats, three years is probably a reasonable period to use. Figure 2 presents the three-year average growth rate for earnings, where the earnings cycle begins to show its more cyclical nature.

Figure 2. S&P 500 EPS 3-Yr. Average Growth: 1950—2008E, 2009E



As you can see in the graph above, the recent periods and projected next two years reflect a potentially increasing variability in the EPS cycle. Nonetheless, the pattern is very consistent with the historical cycle of the past six decades.

WHAT'S THIS TELLING US

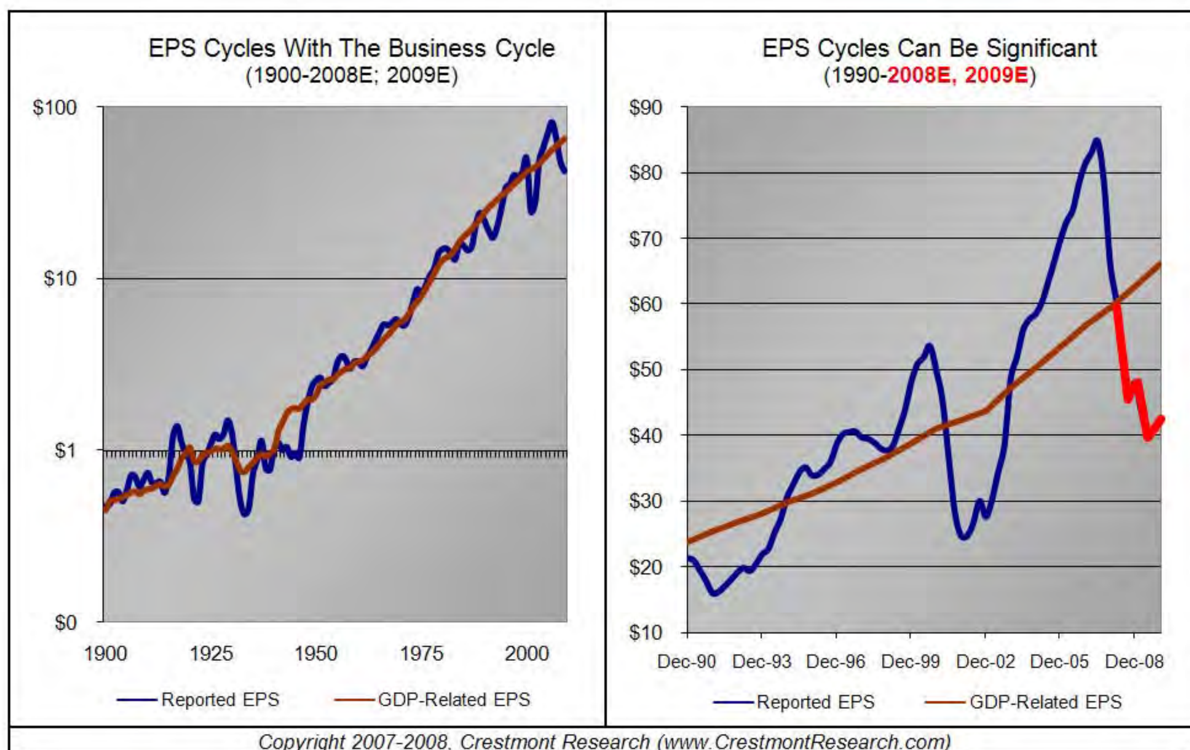
Figure 3, titled "The Business Cycle And The Impact On EPS", presents the historical relationship between reported EPS and EPS adjusted for the business cycle. Adjusted EPS is based upon the long-term and highly-correlated relationship between EPS and the overall economy. The relationship and methodology were explored in layman's terms in *Unexpected Returns: Understanding Secular Stock Market Cycles.*

As reflected in the graph on the left side of Figure 3, reported earnings per share (EPS) for the S&P 500 companies over the past century has cycled actively and repeatedly in relation to the underlying economic cycle—reflecting the business cycle.

In the graph on the right side of the figure, the cycle is more apparent when viewed since 1990. EPS exceeded, then regressed, as it cycled around the baseline.

Well if the analysts at Standard & Poor's are correct, we'll headed right back to the long-term trend line in earnings over the next few years. Again we are reminded that history repeats itself, using the same lyrics for what initially sounds like a different tune.

Figure 3. The Business Cycle And The Impact On EPS



So let's translate this to terms that every investor wants to know…what does this mean for the stock market? Where might we be in ten years?

As discussed extensively in *Unexpected Returns*, we only need two factors to determine the future level of the stock market (S&P 500) in the future: (1) EPS—earnings per share, and (2) P/E—price/earnings ratio. To forecast EPS, we can look to its relationship with the economy and develop fairly good estimates into the future. For the P/E, it's main driver is inflation. A more detailed description of the analysis is developed in "Beyond The Horizon" (see CrestmontResearch.com).

In summary, EPS is likely to be near $105 per share in 2018. P/E is likely to be in the range of 20-25 if inflation remains low and stable. Higher inflation or deflation would drive P/E ratios back to the average of 15 or toward historical secular bear cycle lows below 10. Since the June 30, 2008 update to this report, the stock market has

experienced significant declines and normalized P/E ratios have fallen below 15 (see "The P/E Report" at CrestmontResearch.com). If P/Es return to 20 or more, total annual returns over the next decade would be more than 10%. If P/Es decline, investors could still see the current level of the stock market in 2016. If P/Es remain at current levels, total annual returns would be near 8%.

THE SOLUTION

As described in chapters 9 and 10 of *Unexpected Returns*, the goal is to use absolute return-oriented "rowing" investments, rather than more passive relative return "sailing" strategies. Although the stock market will likely provide shorter-term periods of solid returns over the next decade, it will likely also have offsetting periods of declines. Unlike secular bull markets where the upswings far outweigh the downdrafts, the current environment is set for a much more modest (and likely disappointing) result. Rather than acquiesce to the uncertain returns forecast by the analysis above, investors can take action and develop their portfolios to profit regardless of the overall market direction. Although market timing may be an option for some, it is generally not a good option for most investors.

CONCLUSIONS

There is a business cycle that has endured for more than a century. It generally delivers three to five years of above-average growth before experiencing one to three years of pull-back. We had a solid run over the five years from 2002-2006 that left profits well above its historical relationship to the economy.

Several factors indicate that a period of decline may be upon us. This is confirmed by recent forecasts by Standard and Poor's, economists at the Congressional Budget Office, and others. It does not necessarily portend a decline in the market over the next five to ten years, although several plausible scenarios do include that possibility. More likely, we're set for the typical period that follows super-charged eras like the 1980s and 1990s—when returns are roughly breakeven for a decade or two.

As an analogy, winter is not a time for farmers to hibernate; rather it's a period to approach crops differently. Today's investors have so many tools and techniques available to them to actively "row" and invest like institutions, thereby seeking relatively consistent returns with a lot less disappointment risk.

Ed Easterling is the president and founder of Crestmont Holdings, LLC, an Oregon-based investment management and research firm that manages a fund of hedge funds and publishes provocative research on the financial markets at www.CrestmontResearch.com. In addition, he is a Senior Fellow at the Alternative Investment Center, and previous member of the adjunct faculty, at SMU's Cox School of Business. Mr. Easterling is the author of Unexpected Returns: Understanding Secular Stock Market Cycles.