Beyond The Horizon: REDUX 2011
By Ed Easterling
May 17, 2011
Copyright 2011, Crestmont Research (www.CrestmontResearch.com)

In April 2007, while forecasters predicted at least two more years of increases, the first “Beyond The Horizon” article stated:

“Earnings have increased at double-digit growth rates for five consecutive years—although many agree that earnings growth may be slowing, it’s beyond almost everyone’s foreseeable horizon that earnings might actually experience a decline.”

By the end of 2007, earnings per share (EPS) for the S&P 500 declined versus 2006.

By the end of 2008, after an 80%+ decline in reported earnings, it was beyond almost everyone’s horizon that reported net earnings would recover to more than $90 per share over the subsequent several years…yet this year’s forecast is now $95 and next year may break $100.

Rather than rehash old ground, this article will provide a speed-round of charts and limited commentary to explain the current conditions and the expectation for an earnings decline within the next few years. Once again, since the fundamental principles of the business cycle cause history to repeat itself, a decline in EPS should not be beyond your horizon!

For the full explanation of the concepts relating to the first four figures, please see “Beyond The Horizon: The EPS Cycle”; the original version dated April 23, 2007 is located at www.CrestmontResearch.com. That article is the first posting in the Earnings & Economy section on the Stock Market page.

The second posting in the Earnings & Economy section on the Stock Market page is an article titled “Back To The Horizon: EPS Cycles Again,” dated December 31, 2008. This article provides updated charts and further discussions about the topic.

Additional charts are included toward the end of this piece reflecting additional perspective about why this cycle is unlikely to endure a few more years.

Currently, profit margins are cyclically high, near historical highs, and already at unsustainable levels with projected further increases over the next two years. Beware.
Figure 1. S&P 500 Earnings Per Share Growth: 1950–2010

Note: This is an updated version of Figure 1 from Beyond The Horizon: The EPS Cycle. EPS has been unusually volatile over the past decade.

Figure 2. S&P 500 EPS 3-Yr. Average Growth: 1950–2010

Note: This updated version of Figure 2 reflects that EPS has quickly returned to the baseline trend. Once 2008 rolls out of the average, watch for the line to soar!
NOTE: This updated version of Figure 3 reflects that profit margins pulled-back somewhat during the recent recession, but have surged back. We should not have expected that profit margins would move directly below the mean from recent highs, yet the resurgence toward an even higher high is surprising.

NOTE: This updated version of Figure 4 reflects the recent return of profit margins to lofty levels, but it does not reflect the forecast by most analysts for even higher margins—ironically, the hump at the end may be a sign of what is to come!
Figure 5. The Analysts’ Forecast: S&P’s Outlook—Percentages

NOTE: This is Figure 1 with S&P’s forecast for the next two years…

Figure 6. The Analysts’ Forecast: S&P’s Outlook—Dollars

NOTE: The blue line is actual reported EPS; the red line extension is S&P’s forecast. The orange and purple lines are baseline normalized EPS using Crestmont’s & Shiller’s methodologies (the latter one is adjusted as described in Probable Outcomes).
Figure 7. Magnitude of EPS Over/Under Baseline Trend

NOTE: This graph reflects the percentage variance of reported EPS over and under the baseline trend EPS based upon Crestmont's methodology. Current forecasts imply record profit margins.

Figure 8. Comparable Profit Margin Analysis

NOTE: This is Figure 3 with the implicit levels for national profit margins based upon the forecast changes for S&P 500 profit margins. Not only do the current forecasts represent records for the past six decades, but also they are near the levels achieved after the extreme declines during the Great Depression of the 1930s.
NOTE: So if you are convinced that a reversion of profit margins is imminent, how soon could it happen? Past EPS cycles have lasted one to six years. Over the past six decades, there have been twelve up-cycles. Six lasted one or two years (2010 was year two for the current cycle). We’re in the second half of the game! As each next year passes with an increase in EPS, the likelihood rises for the next decline…

IMPLICATION
The market does not expect a decline in EPS over the next few years…

It’s hard to deny that EPS is vulnerable to decline over the next few years…

When the decline occurs, it will not be minimal…expect 30% to 50%…

The stock market reacts to surprises quite negatively. But there is no reason that investors need to walk blindly into this storm…“Who Knew?” will not a reasonable explanation.

Active portfolio management can position portfolios to participate in further upside until the downturn occurs, then it can provide protection from the full brunt of the ensuing losses. If losses are reduced during downturns, then an investor only needs a portion of the upside when the market ultimately recovers to achieve success over the long-term.
NOTE: So is the implication that a downturn in EPS will coincide with a recession? Does this portend a double-dip? NO! The business cycle is distinct from the economic cycle. Over one-third of the past sixty-one years have experienced EPS declines despite growth in the economy...therefore, don’t be surprised that EPS might decline in spite of continued growth in the economy.

THE SOLUTION

As described in chapter 10 of *Probable Outcomes* and 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 provide shorter-term periods of solid returns over the next decade, it will 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 mediocre returns on the horizon, 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

The business cycle has endured for well more than a century. It generally delivers two to five years of above-average EPS growth before experiencing a year or two of pull-
back. We have had a dramatic run over the past two years and the forecast for the next two years now positions profits well above its historical relationship to the economy.

Several factors now indicate that a period of EPS decline may be upon us. It does not necessarily portend a decline in the market, although that vulnerability clearly exists. Beware nonetheless! For investors, this means that portfolios should be positioned with diversification and active risk and return management.

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 author of recently-released* Probable Outcomes: Secular Stock Market Insights and award-winning Unexpected Returns: Understanding Secular Stock Market Cycles. *Further, he is President of an investment management and research firm, and a Senior Fellow with the Alternative Investment Center at SMU’s Cox School of Business where he previously served on the adjunct faculty and taught the course on alternative investments and hedge funds for MBA students. Mr. Easterling publishes provocative research and graphical analyses on the financial markets at www.CrestmontResearch.com.*