

# Can Stocks Earn Their Keep?

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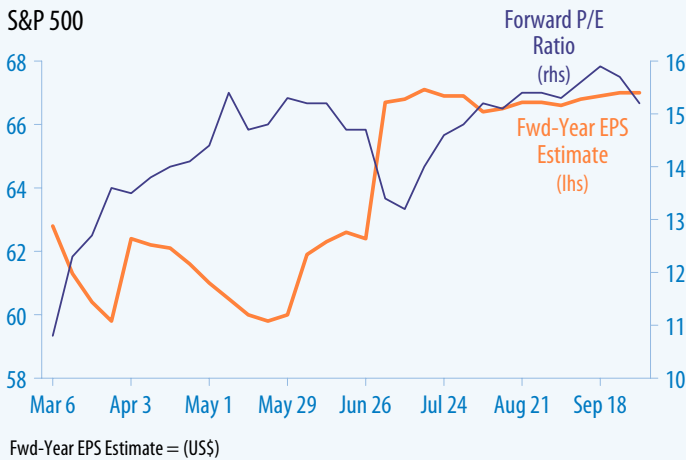
Following the blistering 7-month rally of nearly 60%, stocks now appear to require some solid earnings gains to keep up the momentum. Yet, the consensus view is that we're in for a tepid economic recovery, leaving the recent run-up in stocks with what many view as an unjustifiably high valuation. However, equity market valuations are hardly stretched, and as we head into the Q3 earnings season, the recovery in corporate profits has the potential to surprise to the upside.

Since the S&P 500 bottomed in March, both forward-year earnings expectations and the p/e multiple have expanded, with the multiple doing most of the work. Forward-year earnings expectations were \$62.8 on March 6<sup>th</sup>, and have since risen about 7% to \$67. Meantime, the p/e multiple on these earnings was 10.8 at the market bottom, and has since expanded to 15.2 today (Chart 1). However, almost all of the multiple expansion took place in the two months immediately following the market bottom, likely a re-normalizing of depression-risk valuations. Since that point, underlying earnings have taken over, with forward-year expectations rising about \$7 while the p/e multiple has been little-changed. So, the equity market story in recent months isn't so much one of stretched valuations, but rather one of an expected earnings recovery—and there are a number of factors that suggest it could be solid.

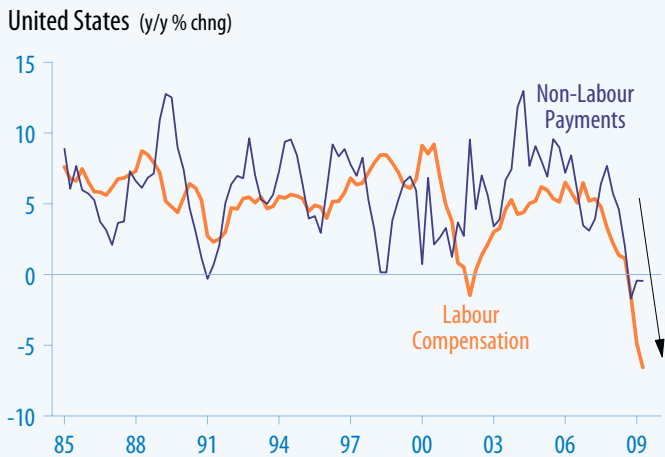
**Cost cuts:** Cost cutting in the corporate sector has been rampant in recent quarters. Total labour compensation in the U.S. business sector was down 6.6% y/y in Q2, the steepest decline in the postwar era (Chart 2). However, payrolls aren't the only thing that have been slashed as non-labour payments have registered the steepest one-year decline since the early-1980s. This has helped to boost earnings in recent quarters, and sets the stage for a levered recovery once demand revives—this operating leverage will allow a bigger portion of revenues to flow directly to the bottom line. IBM might have said it best in their Q2 earnings report: *"When revenue growth becomes a tailwind, the operating leverage we've created will really come through"*.

**Pricing power:** There is still plenty of slack in the global economy, and with U.S. consumers repairing their

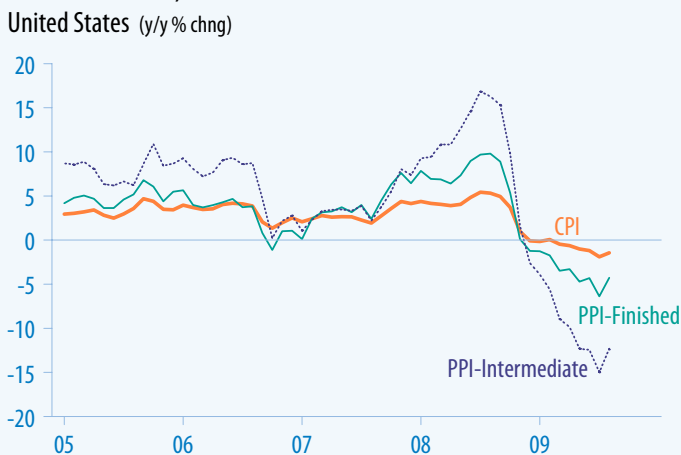
**CHART 1  
DISSECTING THE RALLY**



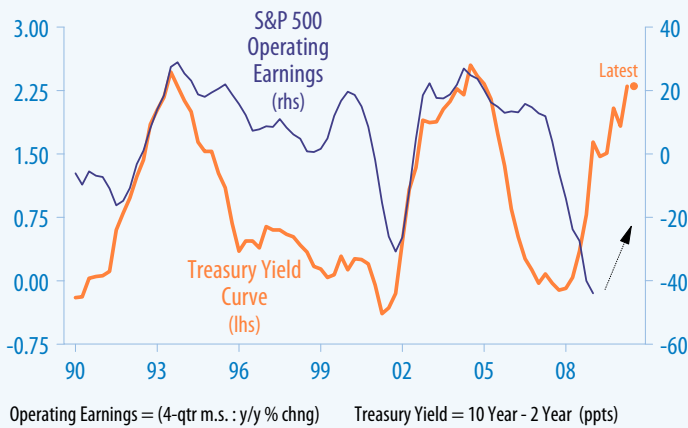
**CHART 2  
COST CUTS GONE WILD**



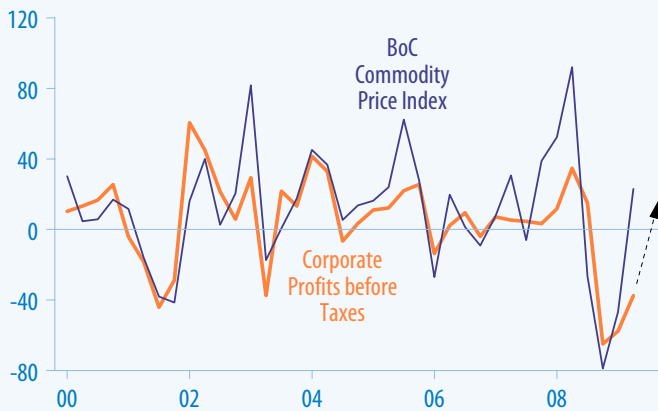
**CHART 3  
PRICING WEAK, COSTS WEAKER**



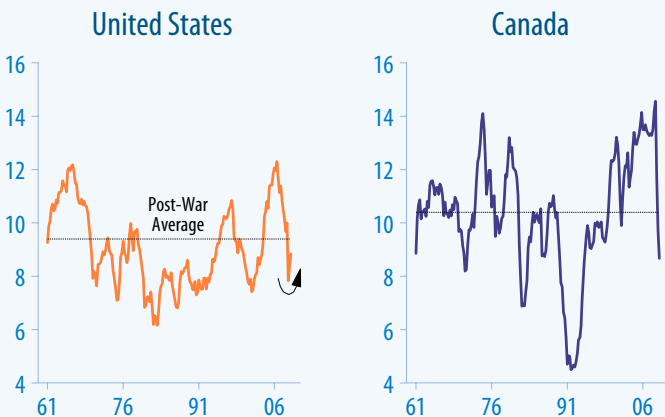
**CHART 4**  
**JUICY YIELD CURVE**



**CHART 5**  
**COMMODITY PRICES INCREASE CANADIAN PROFITS**  
Canada (q/q % chng : a.r.)



**CHART 6**  
**MARGINS EXPANDING AGAIN?**  
(profit share of GDP)



finances, corporations face the risk of deteriorating pricing power. However, while top-line consumer prices are down year-over-year for the first time since the 1950s, prices have fallen even faster along the production pipeline (Chart 3). At the same time, the weak U.S. dollar has improved the pricing power of U.S. companies operating abroad, particularly in the industrial and technology sectors, which the upcoming Q3 earnings reports are likely to highlight. All told, weak input cost pressure and the depreciating U.S. dollar should help to offset weak pricing power, and support U.S. profit margins.

**Yield curve:** The spread between 10- and 2-year Treasuries widened to as high as 2.7 ppts, marking the steepest yield curve since at least 1980. A steep curve not only hints at economic recovery, but also juices profits in the financial sector (banks can borrow at the short end and lend at the long end). Indeed, a steep yield curve was a precursor to the last two strong post-recession profit recoveries in 1991 and 2002 (Chart 4), and currently hints at a similar rebound.

**Commodity prices:** From a Canadian perspective, commodity prices are a key driver of corporate profits, particularly on the TSX where energy and materials make up nearly half the index. The sharp rebound in commodity prices from the lows earlier this year should help drive a profit recovery (Chart 5).

**Profit margins:** Combining these factors suggests that profit margins might have bottomed in the first half of this year. In both Canada and the U.S., the profit share of GDP has fallen below the post-war average, leaving room for margin expansion (Chart 6)—we already saw the first sign of improvement in the U.S. in the second quarter. Importantly, even if the recovery in GDP is weak-to-average, as most expect, an expanding profit share could make the recovery in corporate earnings average-to-strong.

**The Bottom Line:** The recent rally in equity markets has been built largely on expectations of a recovery in corporate profits. While the consensus view on the economy seemingly argues otherwise, there are mounting signs that the earnings recovery could be on the strong side.

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