What Happened to Earnings Growth: The Impact of the Rising U.S. Dollar

In this *MAInsights*, we take a look at some factors relevant to investors in the U.S. stock market.

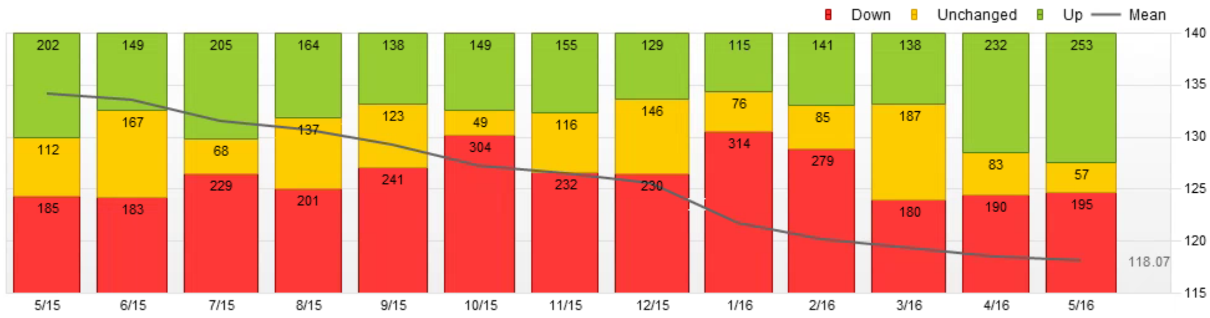
In any given period, equity returns are driven by a combination of the change in earnings, dividend payments, and the change in price-to-earnings multiples. For example, the total return of the S&P 500 in 2014 was 13.7%, which resulted from a 6.8% rise in earnings, 2.3% from dividends, and a 4.6% benefit from multiple expansion. The last 10 years results are displayed in the table below. The valuation level of the market is also a critical factor. It's much easier for the market to rise when multiples are low and conversely it can drop further when multiples are high. Over the long-term, returns are generally driven by earnings growth and dividends as valuation multiples tend to normalize.

S&P 500	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	10Y CAGR
Total Return	15.8%	5.5%	-37.0%	26.5%	15.1%	2.1%	16.0%	32.4%	13.7%	1.4%	5.7%
Earnings Change	13.7%	1.3%	-15.9%	-16.5%	39.0%	15.4%	6.8%	5.1%	6.8%	-0.4%	2.8%
Dividend Yield	2.2%	2.0%	1.5%	3.0%	2.3%	2.1%	2.6%	2.8%	2.3%	2.1%	2.3%
Multiple Impact	-0.1%	2.2%	-22.5%	40.0%	-26.2%	-15.4%	6.6%	24.5%	4.6%	-0.3%	0.7%
Price/Earnings*	16.6	17.0	12.4	18.4	14.9	12.9	13.7	16.9	17.6	17.6	

Source: Factset, *P/E based on year-end price and current year earnings.

This brings us to the strange environment we find ourselves in today, with minimal earnings growth. Over the past year, the 2016 consensus earnings estimate for the S&P 500 has declined from $133.4 to $118.1, a decline of 11.5%. With this revision, earnings are now forecast to rise by only 1.5% in 2016. For 2015, earnings were basically even with 2014. Furthermore, the 5-year compound annual growth rate for earnings will fall to 3.9% if estimates hold during 2016. That would be one of the worst non-recessionary 5-year growth rates on record.

On a positive note, April and May have posted improving earnings revisions as the U.S. dollar has weakened in recent months. The chart below shows how many S&P 500 companies are being revised up or down on a monthly basis over the past year.



Source: Factset

Why are U.S. companies struggling to increase profits?

Several factors are contributing, including weak productivity, rising labor costs, and deflationary pressure leading to weak sales growth. However, the biggest factor has been the rise in the U.S. dollar and that will be our focus in this piece.

The strength of the dollar has been a significant headwind for earnings. Over the last 2 years, the dollar has appreciated meaningfully compared to the currencies of our major trading partners. As the following table displays, the dollar is up 21% versus the euro and 17% versus the pound in the last 2 years. Emerging market currencies have fared even worse. The dollar has risen 41% compared to the Mexican peso and 60% relative to Brazilian real. As a result, U.S. based companies have reported lower than expected sales and profits from foreign subsidiaries.

U.S. Dollar vs.	Euro	Japan Yen	United Kingdom Pound	Canada Dollar	Mexico Peso	China Renminbi	Brazil Real	Australia Dollar
Last 6 Months	-2.8%	-10.2%	5.6%	-5.7%	4.9%	1.1%	-9.1%	-0.3%
Last 12 Months	0.9%	-8.9%	9.9%	8.0%	20.4%	5.3%	18.0%	11.2%
Last 2 years	21.3%	6.7%	16.8%	18.8%	40.9%	4.9%	60.4%	29.0%

Source: Factset, May 17, 2016.

Since the average S&P 500 company derives 31% of its sales from outside the U.S., currency fluctuations can meaningfully impact financial results. Reported sales from foreign subsidiaries are down across the board with the exception of China (see table below). S&P 500 companies have consistently missed sales expectations because of currency. In 2015, PepsiCo reported a sales decline of 5%, but excluding the impact of currency, *sales actually rose 5%*. Additionally, a stronger dollar also makes it more difficult for U.S. companies to compete on a global basis. For example, foreign auto makers such as Toyota or BMW can offer lower prices compared to U.S. based competitors as the dollar strengthens, since a majority of their costs are denominated in their home currency. U.S. competitors with costs in dollars are at a disadvantage when the dollar increases.

S&P 500 Geographic Sales Breakdown and Y/Y % Change*

	% of Tot. Rev.	% Chg (Y/Y)
United States	**68.8**	2.6
Mainland China	**4.9**	8.2
United Kingdom	**2.8**	-1.8
Japan	**2.2**	-10.9
Canada	**2.2**	-14.6
Germany	**2.0**	-8.3
Brazil	**1.3**	-19.2
France	**1.2**	-7.7

Source: Factset, May 17, 2016. *Includes currency impact

Taking currency fluctuations into account, history suggests the current weakness in earnings is normal. According to Ned Davis Research Group[1], over the past 30 years, the average growth rate for S&P 500 earnings is 12.4% per year when the dollar is declining and a mere 0.1% per year when the dollar is rising. Those numbers correspond almost exactly to where profits have plateaued in 2015 and 2016 in a strengthening dollar environment. The 12-month percentage gain in the trade-weighted dollar index hit a 30-year record during 2015, which just goes to show how unique this period has been from a historical perspective.

[1] Ned Davis Research Group BFC201412181B_C

Over the next 6 months, the market faces several risks, including: the United Kingdom's potential exit from the European Union, the U.S. election, the prospect for rising interest rates, and weakening economic conditions in emerging markets (most notably China). Given these risks and considering that the market is now trading at 16.5x forward earnings, a slight premium to its 25 year average of 15.9x, we believe multiple expansion is unlikely and future equity gains will primarily need to come from earnings growth. So until companies can begin to grow profits, the market will be challenged to deliver sustainable upside. The good news is that the dollar has weakened somewhat in the past 6 months and if this holds or weakens further, U.S. companies will anniversary difficult comparisons, which should boost profit growth. We believe the recent uptick in positive earnings revisions is related to the dollar finding stability in 2016, and that the profit picture for 2017 will improve if this stability continues.

Given MAI's expectation for minimal earnings growth in 2016 and thus a lower return environment, we generally shifted portfolios to a more defensive posture in late 2015/early 2016 by raising cash and reducing equity exposure where appropriate. Since bonds also offer low expected returns, we continue to investigate alternative investment options such as real estate, private equity, reinsurance, and structured notes. These alternatives can provide diversification benefits as well as an improved risk/reward profile relative to equities and bonds.

At MAI, we value the confidence you have placed in us. We are always available to discuss the markets and your portfolio in more detail, so please do not hesitate to reach out to us. Finally, please remember to contact us if there are any changes in your financial situation or investment objectives.

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