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WRAPPING UP THE EARNINGS SEASON

QUICK POINTS

Market watchers have claimed that this summer's selloff is a long overdue correction in US equities.

We believe that in the long run, market movements tend to align with earnings and revenue growth.

Based on second-quarter reports, the S&P 500 Index has actually been moving with fundamentals.

Earlier this year, pundits in the financial media lamented when the stock market hit new highs — as if that was a bad thing. Then the summer selloff came, and these authorities on the market asserted that US equities had been due for a correction all along.

Whatever these commentators choose to think, we believe that market movements tend to align with earnings and revenue growth over long periods of time. Accordingly, this year's highs are not surprising but rather, actually in line with history. From June 2009, when the recession ended, through 8 August 2014, the price-only S&P 500 Index (before dividends) and operating earnings on this benchmark both rose about 180%.

When we examine 2014, we find that the pattern of strong earnings and modest but upward revenue growth has continued, almost as if disconnected from the overall economy. In the first quarter, for example, the US government reported that GDP contracted –2.1% in real terms (adjusted for inflation). The S&P 500 told a different story for the same quarter, however, with both revenues and earnings growing and net profits and cash flow hitting new records.

For years now, market watchers have been calling for S&P 500 earnings to flatten and net profit margins to revert to a level more consistent with the long-term average of 4.5%. Yet during the second quarter, net margins climbed above 10% — very close to an all-time high.

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About 90% of S&P 500 companies have reported for the second quarter as of this writing. Revenues have risen nearly 4% year over year and earnings, at 5.5%, have expanded even faster, with the result that margins have increased again.

In short, earnings and revenues for the companies in the S&P 500 continue to grow and profitability remains high.

As for valuations, there is no suggestion at this point that the market is cheap, but neither is there evidence of a bubble. The forward price-to-earnings (P/E) ratio of the S&P 500 is around 15 times, and the trailing P/E multiple is 17 times earnings.

Could it be that the US equity market has actually been moving with fundamentals and is not — as the press likes to speculate — a bubble after all?

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