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AMP capital INVESTORS

Sharemarket earnings and dividends

Oliver's insights

Key points

- Long term valuation measures and earnings comparisons tell us nothing about the short term outlook for shares but they are useful in assessing long term potential returns from shares.
- While its likely company earnings have more downside ahead of them, the trend level of earnings implies that shares at current levels are cheap.
- Dividends are also likely to fall further, but dividend yields are attractive relative to cash and bond yields and are at levels associated with above average long term returns from shares.

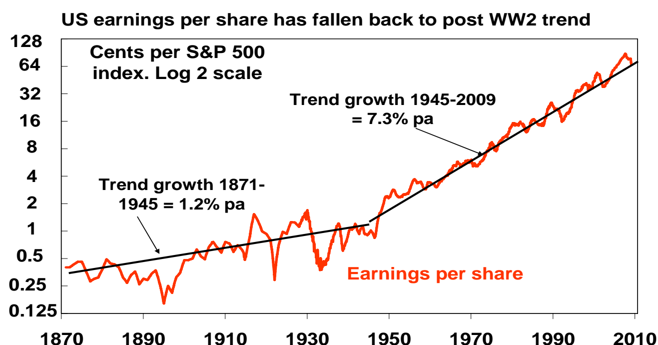
Introduction

Profits, and the dividend payments they fund, are the key long term fundamental driver for sharemarkets. Right now earnings are falling sharply. The deteriorating economic outlook points to further sharp falls ahead. Given the obvious uncertainty regarding the earnings outlook it would be useful to get a handle on what is a reasonable assumption regarding the trend level for earnings.

The long term trend in earnings

A key factor underpinning the 2003-2007 bull market in shares was a sharp rise in earnings. This was driven by a combination of reasonable productivity growth and benign wages growth. Some would argue though that it was all just an earnings bubble fuelled by easy credit conditions. The next chart shows the level of nominal earnings per share for US S&P 500 companies since 1870. The vertical axis is a log scale whereby each tick mark higher corresponds to a doubling in earnings per share.

US earnings per share has fallen back to post WW2 trend

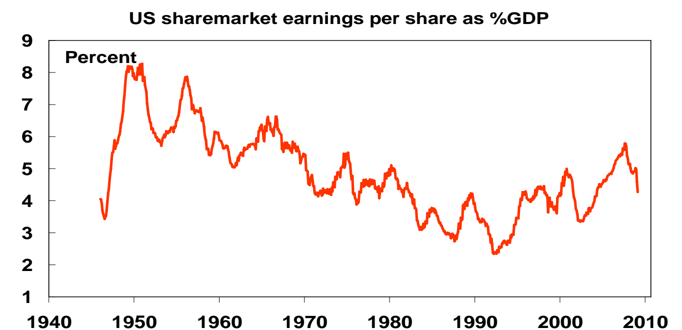


Source: Global Financial Data, Thomson Financial, AMP Capital Investors

There are several points to note. Firstly, it can be seen that during the boom-bust period up to World War II earnings were extremely volatile around a more constrained growth rate (just 1.2% pa over the 1871 to 1945 period). From 1950 the trend has been more decisively upwards.

Secondly, **profit growth over the 2003-07 period was well above trend, but was not widely out of line with previous cyclical rises in earnings**. In other words, while profits rose to a level above trend this seems to be normal cyclical behaviour rather than being indicative of a massive profit bubble that has to be unwound. A similar conclusion can be reached by comparing the value of US earnings per share to the level of US GDP. While this ratio rose to its highest level since the late 1960s, it only reached the low end of the range seen in the 1950s and 1960s.

US sharemarket earnings per share as %GDP



Source: Global Financial Data, Thomson Financial, AMP Capital Investors

Thirdly, **after the 26% fall in profits since 2007 the level of earnings are now back in line with their post 1945 trend**, which translates to 65 cents per share at present. However, if the recessions of the mid-1970s, early 1980s and early 1990s are any guide earnings could fall 30% or so below trend before bottoming. This would imply that S&P 500 earnings per share could fall to around 46 cents.

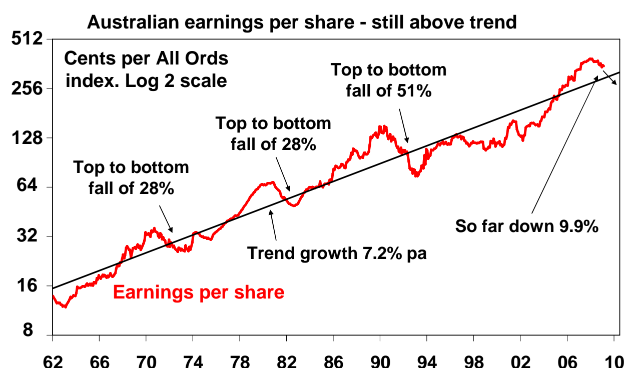
There is much debate about an appropriate price to earnings multiple to value shares, but a simple approach is to take the average of the last 138 years which is 15 times. (Note that this is a conservative approach given the low level of interest rates and greater market liquidity today would suggest the PE should be higher.) If earnings do fall to 46 cents per share then a PE of 15 would imply fair value for the US S&P 500 share price index should be around 690, which is roughly where it is right now. But given the volatility in earnings, focusing on trend earnings is a more appropriate way to value shares and this would suggest that fair value is around 975 for the S&P 500 (ie 15 x 65 cents per share). In other words, shares are cheap.

Of course, if the US economy is on its way into a depression then such earnings and valuation calculations are meaningless. In the Great Depression US earnings per share fell by a whopping 78%. But given the stimulus being provided by the US government along with assistance to the banking system a depression is unlikely. More likely

though is that the trend rate of growth in earnings will slow from the post war rate of 7.3% pa to something more like 4 or 5% pa. This of course would mean a lower rate of return from shares over the next decade or so, but wouldn't change the conclusion that shares are now cheap.

Australian earnings

Australian aggregate earnings data is only available from 1962. The chart below shows nominal earnings per share for the Australian All Ords index. Like US earnings, local profits over the last few years have risen well above trend, but no more than occurred in the early 1970s, early 1980s and early 1990s. There is nothing here to suggest that we have seen a massive earnings bubble. Right now earnings are still well above trend. A further fall of 15% is required to take earnings back to their post 1962 trend. A typical overshoot would see earnings fall by a total of 30% over the next year. Taking trend earnings (currently 300 cents per share) as fair value and applying a PE multiple of 15 times would suggest that fair value for the All Ords index is around 4500, which is well above the current level of 3200 suggesting the market is cheap. Even applying a PE of 15 times to a 30% fall in earnings would suggest fair value of around 3680.

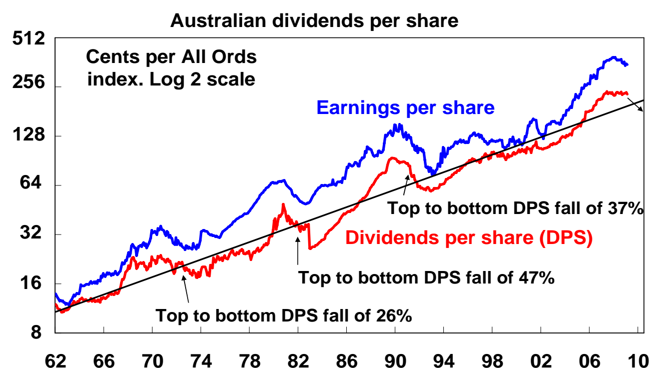


Source: Global Financial Data, Thomson Financial, AMP Capital Investors

Of course if we go into a depression a further big slump in earnings is on the cards and any valuation support will vanish. And earnings growth going forward is likely to slow from the post 1962 trend pace of 7.2%, maybe to around 5% pa, suggesting a lower rate of average return from shares over the next decade.

Dividends

As can be seen in the chart below, dividends move roughly in line with earnings.

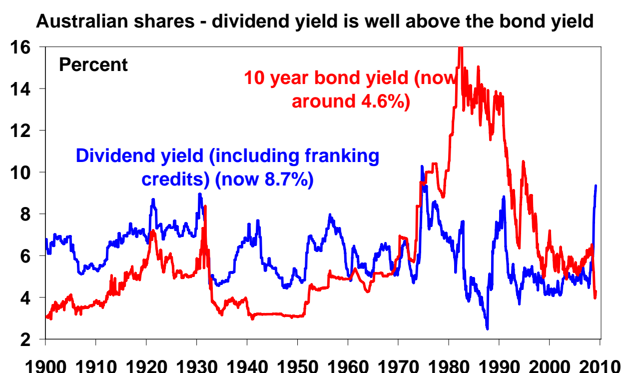


Source: Global Financial Data, Thomson Financial, AMP Capital Investors

Normally dividends are a bit more stable than earnings, reflecting the desire of companies to smooth them over time. Right now they are falling more rapidly as companies are seeking to reduce debt and conserve capital given the uncertain economic outlook. 40% of Australian companies announced a cut in the dividend payment or their elimination in the reporting season last month. The fall in dividends is also a global phenomenon – GE has cut its dividend (by 68%) for the first time since 1938 and Dow Chemical has cut its dividend for the first time since 1912.

If, as we expect, profits fall by another 30% going forward, dividends are likely to be cut further. This is clearly bad news for investors, particularly those relying on the cash flow from dividends (whether they own shares directly or via managed funds).

Right now the grossed up for franking credits dividend yield on Australian shares is a very high 9.2%. This is well above the bond yield of 4.3% and bank term deposit rates which are around 4.2% and set to fall even further. The 9.2% level compares to past peaks in the dividend yield in 1930, 1974 and 1990. See the chart below.



Source: Global Financial Data, Thomson Financial, AMP Capital Investors

If an investor had bought shares at the peak of the dividend yield in each of those years (and assuming their return was in line with the market) their ten year average return would have been 14.2% pa (or 14.3% pa in real terms) after 1930, 22.6% pa (or 11.9% pa in real terms) after 1974 and 13.6% pa (or 10.9% pa in real terms) after 1990. These returns are well above the average return from Australian shares of 11.9% pa since 1900 (or 7.7% pa after inflation). So if history is any guide shares, are now very attractive from a long term perspective. It is also worth noting that dividends payments were cut after each of these peaks in the dividend yield. In fact, after the 1930 peak they were cut by 45% and after the 1990 peak they were cut by 34%, yet a long term investor would still have done well.

Even if current dividend payments are cut by another 30% this will take the dividend yield from 7.2% now to 5%. After grossing up for franking credits this is still 6.5%, which is well above the yields now available from bonds and cash.

Concluding comments

Looking at trend profits and valuation measures will be completely useless if, in the unlikely event, we are sliding into a depression. But plausible estimates of the trend level of company profits suggest that shares are cheap. Similarly, notwithstanding likely cuts in dividends, the dividend yield is now at a level suggesting above average returns from shares over the next decade. Of course this provides no guide as to whether shares have bottomed.

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