Richard Bernstein Advisors

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Earnings-driven bull markets

Richard Bernstein, Chief Executive and Chief Investment Officer

One of the most frustrating statements we hear is that bull markets are impossible without price/earnings ratios expanding. History shows that this simply is not true. There have been interest rate-driven bull markets during which interest rates fall and PE multiples expand, but there have also been earnings-driven bull markets during which interest rates rise and PE multiples contract.

At RBA, our portfolios are positioned for an earnings-driven bull market and this positioning increasingly seems quite out of consensus on many levels. Whether it is our view on the overall equity market, our sector preferences, or our fixed-income strategy, a broad range of data currently seem to show we are swimming upstream.

TABLE 1:

S&P 500® Profits Recession Troughs (Dec. 1935 through Dec. 2015)					
	AT TROUGH		ONE YEAR AFTER TROUGH		
Date	Trailing 4 Qtr EPS Growth	Trailing P/E	Trailing 4 Qtr EPS Growth	Trailing P/E	S&P 500® Total Return
Sep-38	-49.2%	19.7	30.6%	16.1	11.5%
Sep-42	-21.0%	9.4	14.9%	11.2	44.2%
Sep-44	-16.7%	14.2	10.0%	16.3	32.4%
Jun-46	-16.0%	21.9	71.4%	10.6	-13.3%
Mar-52	-15.2%	10.2	1.3%	10.4	9.8%
Sep-58	-17.0%	17.4	19.1%	16.6	17.3%
Mar-61	-8.8%	21.1	9.1%	20.6	10.1%
Dec-67	-4.0%	18.1	8.1%	18.0	11.1%
Dec-70	-11.2%	18.0	11.1%	17.9	14.3%
Sep-75	-14.8%	10.8	23.1%	11.0	30.4%
Mar-81	-4.6%	9.3	1.6%	7.6	-13.1%
Dec-82	-17.7%	11.1	11.0%	11.8	22.6%
Dec-85	-12.2%	14.5	-0.9%	16.7	18.7%
Dec-91	-25.2%	26.1	19.5%	22.8	7.6%
Sep-98	-6.3%	26.7	15.4%	29.2	27.8%
Dec-01	-50.6%	45.8	11.7%	31.9	-22.1%
Mar-09	-88.6%	116.3	788.2%	19.2	49.8%
Mar-13	-0.9%	17.9	15.0%	18.6	21.9%
Dec-15	-15.4%	23.6	?	?	?
Avg ex- 2009	**-18.2%**	**18.4**	**16.1%**	**16.8**	**13.1%**

Source: Bloomberg Finance L.P. For Index descriptors, see "Index Descriptions" at end of document.

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an independent investment adviser focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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What is an earnings-driven market?

There are historically two types of bull markets: interest rate-driven and earnings-driven. Interest rate-driven markets are those characterized by falling interest rates and expanding PE multiples. Investors have become very familiar with this type of bull market because of the secular fall in interest rates since 1980. That familiarity has led investors to believe that falling interest rates and expanding multiples are the sole construction of a bull market.

However, there have been many periods of significant returns during rising interest rate environments. Bull markets during periods of rising interest rates are dependent on earnings growth to offset the PE multiple contraction associated with rising rates.

It is virtually a mathematical tautology that valuation multiples increase when longer-term interest rates fall because of present value theory. As interest rates fall, investors are more willing to expand the time horizon of their investments (i.e., PE multiples expand) because there are fewer shorter-duration investments that offer competitive returns. Portfolio construction during periods of falling interest rates typically focuses on making sure that PE multiples expand by "P" going up rather than by "E" going down. Stable growth companies tend to outperform cyclical companies during interest rate-driven markets because falling interest rates imply slower nominal growth, which hurts cyclical earnings. During interest rate-driven markets, "P" rises for stable growth, whereas "E" deteriorates for cyclicals.

Conversely, portfolio construction during an earnings driven-market needs to focus on PE contraction, ensuring that multiples contract by "E" going up rather than by "P" going down. Cyclicals tend to outperform stable growth during earnings driven-markets because cyclical companies' incremental earnings growth more than offsets the negative effect of rising rates. Stable growth companies, by definition, are stable and have little or no incremental growth. Stable companies' PEs usually contract by "P" going down because "E" is stable.

RBA thinks the next year or so will be an earnings-driven bull market

When RBA was formed almost seven years ago, we argued that the US was entering what could be the biggest bull market of our careers. So far, this bull market is the second longest of the post-war period, and we still believe it will ultimately be one for the record books. Our valuation, sentiment, liquidity, and profits research is certainly not as bullish as it was seven years ago, but that work continues to favor public equity investments over virtually any other asset class.

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The next leg of the bull market could be an earnings-driven phase. We repositioned our portfolios earlier this year to accentuate cyclical sectors because our proprietary research strongly suggested that 4q15 profits would be the trough of the profits cycle. That research suggests consistent improvement in earnings over the next year or so, and it is conceivable to us that S&P 500® reported GAAP profits toward the end of 2016 or early-2017 could be growing about 20%. The absolute growth forecast is somewhat immaterial because history suggests that if just the direction of that forecast proves correct and growth rates do improve meaningfully, then there is a good likelihood of an earnings-driven rally.

Table 1 on the cover page shows how the market typically performs during the year subsequent to a profits recession trough. Earnings-driven bull markets seem to be the norm during the year following a profits recession trough. We exclude 2009's data because it is so extreme, even though that cycle's experience strongly supports our views. Typically, the market advances about 13-15% and multiples contract about 1-2 multiple points.

Our earnings forecast for the four-quarter period ending June 2017 is roughly $115. The current S&P 500® PE multiple based on trailing reported GAAP earnings is about 24. If history were to repeat, then the multiple could compress by 2 multiple points during that period, which would give one an expected S&P 500® level of about 2500 (115 x 22 = 2530), or about 20% expected return.

This is clearly a rough estimate because one could make many assumptions about rising rates and lower multiples. However, to get a stock market return of zero based on our earnings forecast would require the PE multiple to contract six points from 24 to about 18. It's not impossible, but such a forecast seems to imply a very bearish scenario along the lines of 1946/7 or 2001/2. Although there is no sentiment data for the 1940s, our work seems to show that the current investing environment is nearly opposite of that in 2001/2. In 2001/2, investors were trying to anticipate the return of the Technology bubble, and were focused on capital appreciation. Today, investors are quite cautious and largely focused on income and downside protection.

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Earnings trough fueled by 2015's events not repeating

Extrapolating 2015's profits recession into 2016/7 might not be prudent given some of the extreme events during 2015 that led to the profits recession. By our reckoning, earnings growth could substantially improve during the remainder of 2016 and into 2017 if 2015's extreme events do not repeat. For example, the US dollar appreciated 25% from mid-2014 to late-2015, and that appreciation crimped the US dollar earnings of US companies (see Chart 1). If the USD stabilizes during 2016, then earnings comparisons will get easier as the year progresses.

CHART 1:

The US Dollar
(July 7, 2011- May 31, 2016)

Source: Bloomberg Finance L.P. For Index descriptors, see "Index Descriptions" at end of document.

Commodity prices collapsed by around 35-40% during 2014/5 (see Chart 2), but the odds seem reasonable that commodity prices might stabilize during 2016/7. If that happens, then the earnings growth of deep cyclical companies could demonstrably improve.

Analysts tend to downplay such earnings improvement as being attributable to "easy comparisons." However, every profits cycle, by definition, begins with a series of easy comparisons.
It is impossible to begin a cycle with difficult comparisons.

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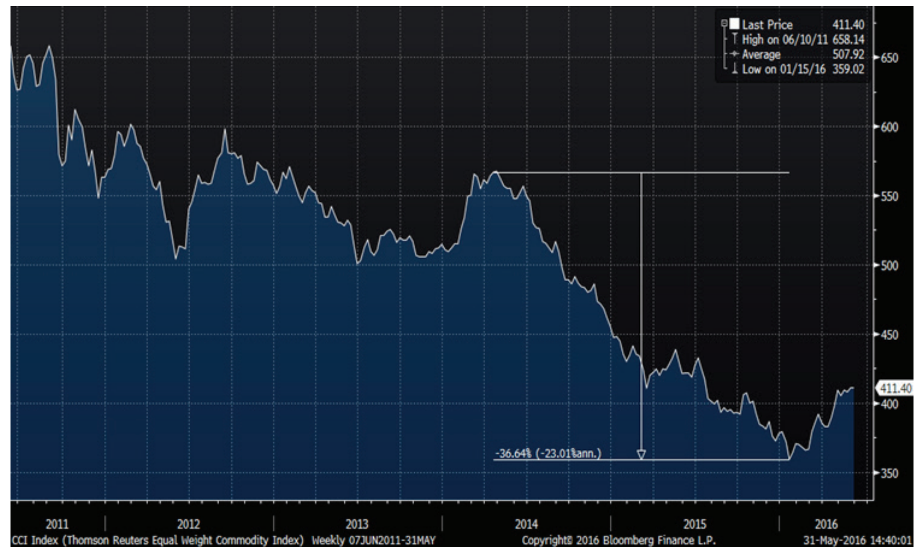
CHART 2:

The Thomson Reuters Equal Weight Commodity Index
(July 7, 2011- May 31, 2016)



Source: Bloomberg Finance L.P. For Index descriptors, see "Index Descriptions" at end of document.

It isn't about calamity

Some market observers have cautioned that overvaluation always leads to poor returns because multiples contract. There is indeed history to support such concerns. However, the key word is "always". As we have shown, there have been many periods in stock market history during which earnings growth improves, interest rates increase, PE multiples contract, and a bull market continues. They are called earnings-driven bull markets.

It is always headline-grabbing to predict a calamitous end to a bull market, and a broad range of sentiment data strongly suggests investors are quite scared. At RBA, however, we continue to swim against that fearful tide, and our portfolios are positioned for a cyclical rebound in earnings and an earnings-driven bull market.

If you would like to learn more about how RBA's portfolios are constructed, please contact your local RBA representative (http://www.rbadvisors.com/images/pdfs/Portfolio_Specialist_Map.pdf).

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INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. Indices are not actively managed and investors cannot invest directly in the indices.

S&P 500®: Standard & Poor's (S&P) 500® Index.
The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

US Dollar: IntercontinentalExchange (ICE) US Dollar Index (DXY).
The ICE US Dollar Index, indicating the general international value of the USD, averages the exchange rates between the USD and six major world currencies using rates supplied by some 500 banks.

Thomson Reuters Equal Weight Commodity Index:
The Thomson Reuters Equal Weight Commodity Index (Continuous Commodity Futures Price Index) is an equal-weighted geometric average of commodity price levels relative to the base year average price. This index is the old CRY Index. Disseminated by NYBOT.

RBA Investment Process:

- Quantitative indicators and macro-economic analysis are used to establish views on major secular and cyclical trends in the market.
- Investment themes focus on disparities between fundamentals and sentiment.
- Market mis-pricings are identified relative to changes in the global economy, geopolitics and corporate profits.

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About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an independent investment adviser. RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $3.1 billion collectively under management and advisement as of April 30th 2016. RBA acts as sub advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund and the Eaton Vance Richard Bernstein All Asset Strategy Fund and also offers income and unique theme oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF and the First Trust RBA Quality Income ETF. Additionally, RBA runs ETF asset allocation SMA portfolios at UBS, Merrill Lynch, Morgan Stanley Smith Barney and on select RIA platforms. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.

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