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DECISION ECONOMICS, INC.
Information for Decisions™

Sinai's Economic and Market Perspectives

March 11, 2021

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Higher Interest Rates—Lower P/E Valuations? Economy Snapping Back Sooner, Stronger, So Higher Earnings

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"Bear" Fixed Income Market But Strong Economy and Strong Earnings Spell Bull Equity Market New Highs

DE has called a "Bear Market" for Fixed Income, i.e., on average, irregularly so, rising long-term interest rates and then later rising short-term rates when the Federal Reserve eventually moves to less Ultra-Easy Monetary Policy.

This marks a new stage in the Business Cycle and a different backdrop for trading and asset allocations than seen in a long, long time (see Chart 1) when the economy was mostly growing, Equity Bull Markets were-in-place and interest rates generally declining, although with interruptions from time-to-time.

At the same time, what is driving the rise of interest rates is yes, *massive fiscal stimulus* and a flood of U.S. Treasury securities now and coming in the future, but also *a much stronger economy*, sooner than had been thought and the potentially surprisingly high earnings that can go with a higher growth path for economic activity and Nominal GDP.

This is not new in the Business Cycle, appearing every time as the economy goes through a Recovery and approaches the Expansion, this latter stage most of the time the longest portion of a Business Cycle upturn.

For years, the U.S. has experienced a Bull Equity Market with stable or falling interest rates and transitory interruptions (Chart 1). But now, interest rates are rising as the result of the economy picking up, prices firming, and massive deficit-financed and fully-accommodated fiscal stimulus. This is now a stage of *rising stock prices and rising interest rates*, very different from what appeared from 1990 to 2021 Q1.

For equities, Earnings and Interest Rates are key fundamentals. Now, there is a tug-of-war between the potential reduction in valuations from rising interest rates—to the P/E ratios used against future cash flows or future earnings—and the earnings growth from a stronger economy.

Almost always, *at such a time, the gains in Earnings will end up far outweighing any reductions in valuations* on rising interest rates.

Strong Economy Means Strong Earnings

On what looks like an increasingly strong Q1 economy and elimination of a "Double-Dip" Recession possibility, a Macro Risk, *S&P500 Operating Earnings, DE model-driven, are being revised up yet again* on increased GDP forecasts (Table 1 for the latest forecasts).

Valuation Arithmetic

On rising interest rates, the P/E ratio of 21 (previous range 19-to-23) that has been used by DE for a long time in pricing Forward Earnings (on a 12-month ahead basis) *is in question*, given a 10-year Treasury yield at about 1.55%-to-1.6% and forecasted to move higher, on average, during the rest of this year.

The *move up in the 10-year Treasury yield of some 60 basis points* since December 31, if permanent, *suggests a reduction in the P/E ratio against Forward S&P500 Op. EPS to about 20.5* (from 21) and a reduction in the range for the P/E ratio that should be used against Forward Earnings to 18-to-22 from 19-to-23. *This is a result from sensitivity analysis with DE structural econometric models* of the P/E ratio for the S&P500.

On a new upward revised S&P500 Op. EPS for 2021, $185 (up from $180), the latter itself a previous upward revision on stunningly strong earnings results in Q3 and Q4, and *a new expectation of $205* for the S&P500 Op. EPS in 2022, based now on stronger forecasts for the economy, one-third into this year, taking account of a portion of next year's EPS estimate, *the Forward Earnings now being priced is $189*.

At a 21 multiple, still possible on the expected strong above-trend growth in the economy that is emerging, the point Fair Value for the S&P500 would be about 3,975, directionally pointing over 4,000. *At 20.5 times the S&P500 Op. EPS, the point Fair Value would be 3,875; at 20 times, 3,780*. The Upper Bound for the S&P500 is 4,100 to 4,200; lower, 3,500, a Correction level.

By Midyear, on current prospects the Forward Earnings that will be priced then is expected at $195. On a 20.5 P/E valuation and the now higher path of Nominal GDP that is expected, the Fair Value is 4,000. At 21 times this Forward S&P500 Op. EPS, it is 4,100. *At yearend 2021* if the $205 S&P500 Op. EPS estimate for 2022 holds up; at 20.5 times, Fair Value would be 4,200.

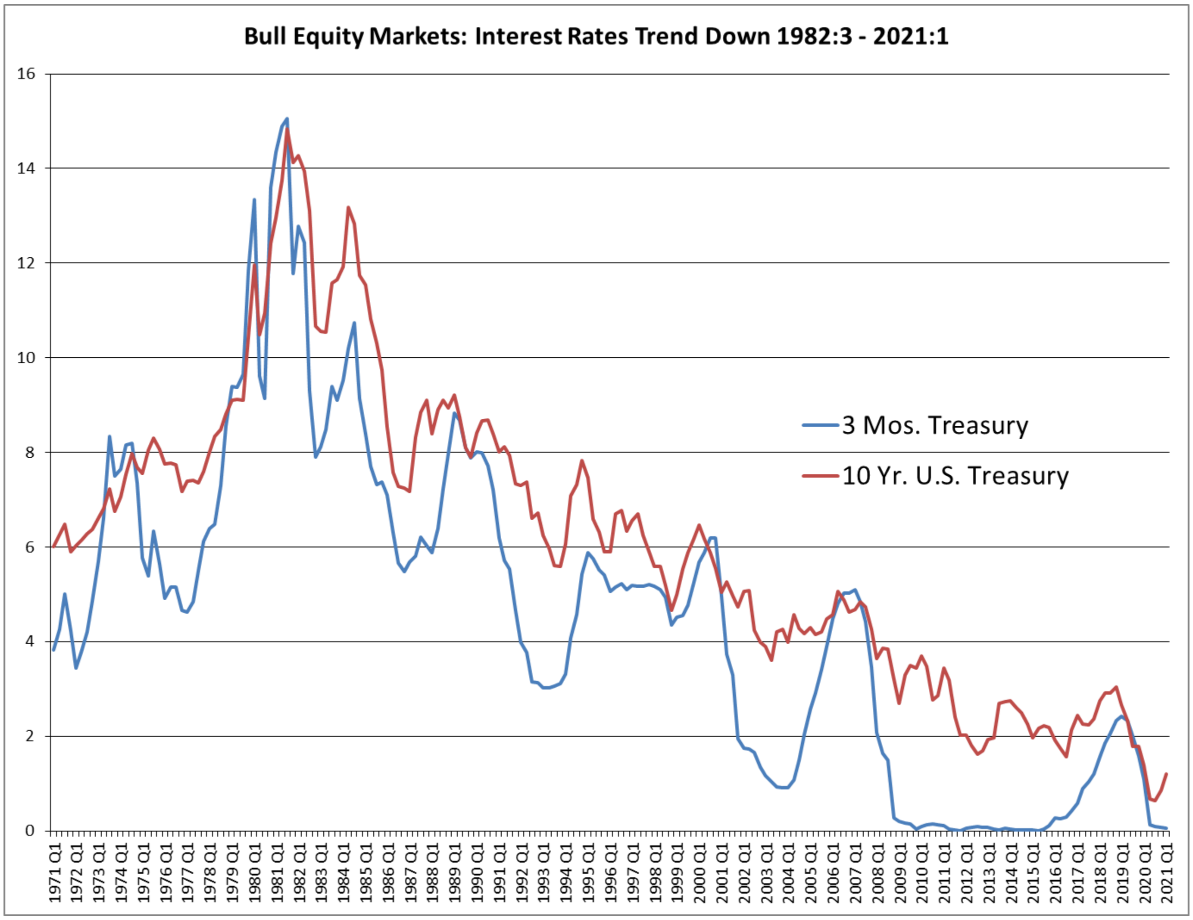
Upside and downside bounds on these point Fair Values range from 5%-to-10%. On the current DE Basic Prospect and its surrounding Macro Risks, now more up than down, the *strategic look at equities has to be Strongly Bullish*.

Concluding Perspectives

In a situation where rising interest rates can be expected, P/E ratios can be expected to come down.

But if what is causing the rise in interest rates is a strong economy driven by strong monetary and fiscal stimuli, the earnings growth and levels have historically outweighed the rises of interest rates in its initial stages and the Equity Bull Market has gone on… and on.

Chart 1



Sources: Bloomberg and Decision Economics, Inc. (DE)

Table 1
DE "Basic Prospect" Key Forecast Dimensions—
Growth, Inflation, Unemployment, Profits

	Quarterly					Annual				
	Q1 21F	**Q2 21F**	**Q3 21F**	**Q4 21F**	**Q1 22F**	**2019A**	**2020F**	**2021F**	**2022F**	**2023F**
Real GDP Growth										
(Pct. Chg., Qtrly., Ann.)	6.7	5.8	5.5	6.3	5.0	2.3	-2.4	6.1	5.0	3.5
Inflation—Consumption										
Price Deflator (Pct. Chg., YoY)	1.6	2.5	1.9	2.0	2.3	1.5	1.2	2.0	2.2	2.4
Unemployment Rate (%)	6.3	6.2	5.8	5.5	5.3	3.6	6.8	5.5	4.9	4.1
S&P500 Op. EPS										
(Level, $s)	43.80	44.89	47.15	48.80	47.40	166.32	144.49	184.64	205.45	221.97
(Pct. Chg., YoY)	30.5	58.5	19.4	13.1	8.2	1.0	-13.1	27.8	11.3	8.0

A-Actual; F-Forecast; Real GDP Annual, Q4-over-Q4; Inflation Annual, Q4-over-Q4; Unemployment Annual, Q4 Average
Source: Decision Economics, Inc. (DE) Basic Prospect March 10, 2021.