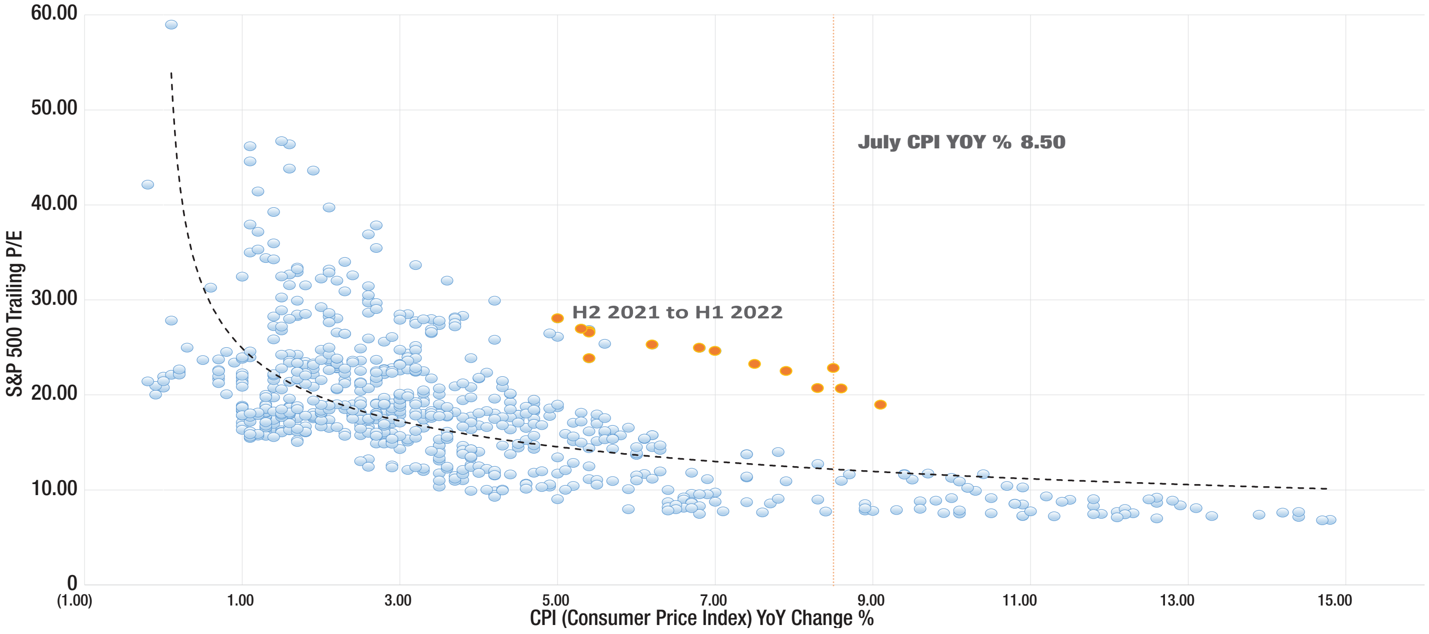
From Equity Valuation to Earnings Growth

– Danke Wang, Portfolio Manager

In the most recent Pacer perspective, we highlighted the inverse relationship between inflation and the S&P 500's P/E ratio.

With Consumer Price Index (CPI) readings jumping to the highest level in 40 years, equity valuations face downward pressure. As of 7/29/2022, the S&P 500 trades at 20.18x on the last 12 months' (LTM) earnings and 18.21x on forward earnings.

S&P 500 P/E vs CPI YoY Change
January 1960 - July 2022



Source: Pacer Advisors, Bloomberg

So, how low can the S&P 500's P/E ratio go?
The recently announced 8.5% inflation rate indicates the S&P 500 P/E ratio can reach as low as 12.17 (as indicated on the chart above), a P/E level investors haven't seen since the 1980s. Such a contraction would be an extreme case.

Most people believe the worst inflation scenario is behind us and the Fed will be able to control inflation moving forward. However, the market still expects the CPI numbers to stay relatively high, so stock valuations may not stay where they are now. Below are some potential scenarios of the S&P 500's P/E ratio based on hypothetical CPI numbers.

Implied S&P 500 P/E on CPI YoY Change

CPI YoY%	Implied S&P 500 P/E
8.0	12.42
7.0	12.98
6.0	13.67
5.0	14.53
4.0	15.66
3.0	17.25

If we step outside of CPI-based speculation, the historical average for the S&P 500's P/E is 17.47, and the average Shiller P/E ratio is 16.96.

By those measures, from a historical perspective, the S&P 500's current P/E suggests it is still trading too high on a price-to-earnings basis.

Source: Pacer Advisors

Earnings and P/E Contraction

There are two ways for a P/E ratio to come down: the stock price drops, or the company's earnings grow. Hypothetically, if earnings growth is fast enough, a stock's P/E ratio can still go lower without triggering significant price depreciation.

The S&P 500 next 12-month (NTM) earnings' estimate is 238.68, which means S&P 500 companies are expected to grow their earnings by 16.47% (the LTM EPS 204.93). Assuming earnings grow at this rate and the price stays flat for the next 12 months, we could see the S&P 500's P/E ratio move down to 17.30 next year, right around the historical average. But the question is, can such growth be realized?

Hypothetical S&P 500 P/E based on Earnings Growth Scenarios

Hypothetical S&P 500 Earnings Growth NTM	P/E (assuming S&P 500 Price being flat)
5%	19.19
10%	18.32
15%	17.53
20%	16.80
30%	15.50
40%	14.40
50%	13.44
60%	12.60

The table to the left shows different P/E levels of the S&P 500 in different NTM earnings growth scenarios.

For example, in the extreme case that the S&P 500 trades around 12X (implied by the CPI number), earnings need to grow more than 60%.

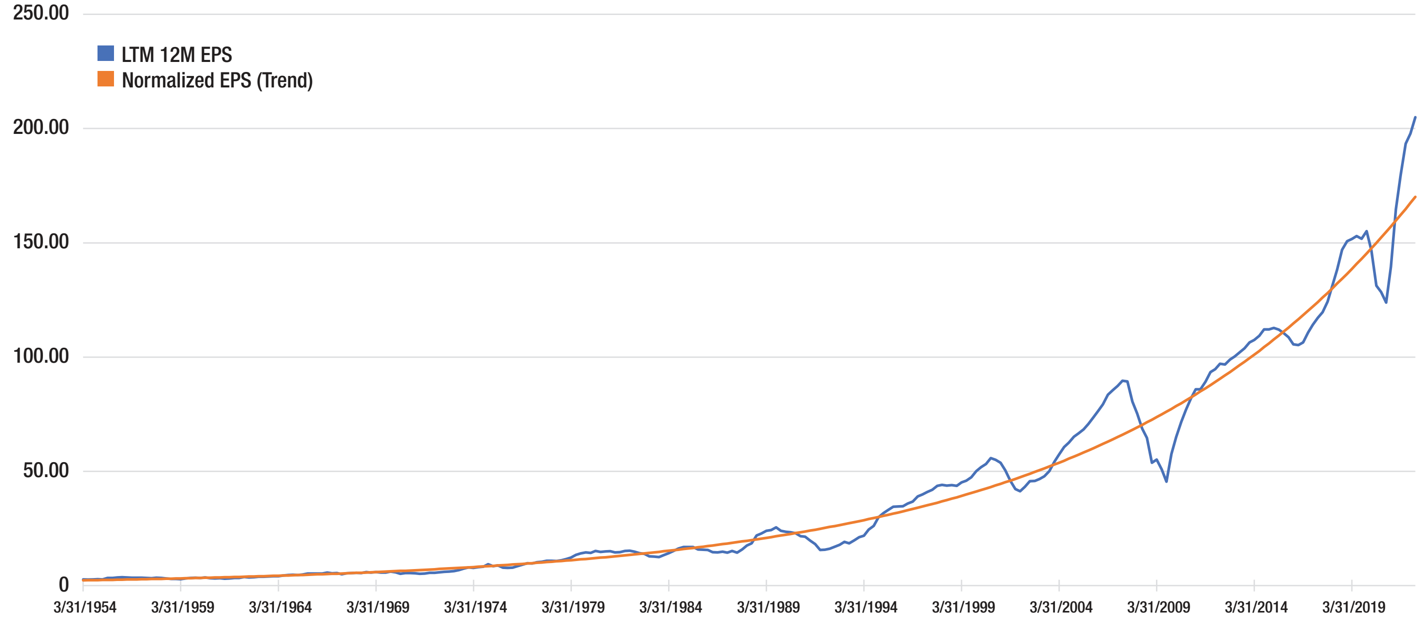
Source: Pacer Advisors

Since Q2 2021, we have seen consecutive 20%+ year-over-year growth (average 37%) from the S&P 500 based on LTM earnings. This growth has come under the backdrop of the Fed's easing monetary policy and an economic recovery post COVID. This backdrop has also contributed to the above trend earnings growth of the S&P 500 (seen in the next chart).

The earnings growth trend refers to the normalized earnings per share or earnings adjusted for economic cycles. The temporary and sometimes extreme fluctuations in the business cycle will cause the actual earnings to deviate above or below the normalized earnings. This is why we see corporate earnings recovery, expansion, slowdown, and contraction over time. Using normalized earnings allows investors to assess the long-term earnings growth trend of a company or index.

S&P LTM 500 EPS vs Normalized EPS

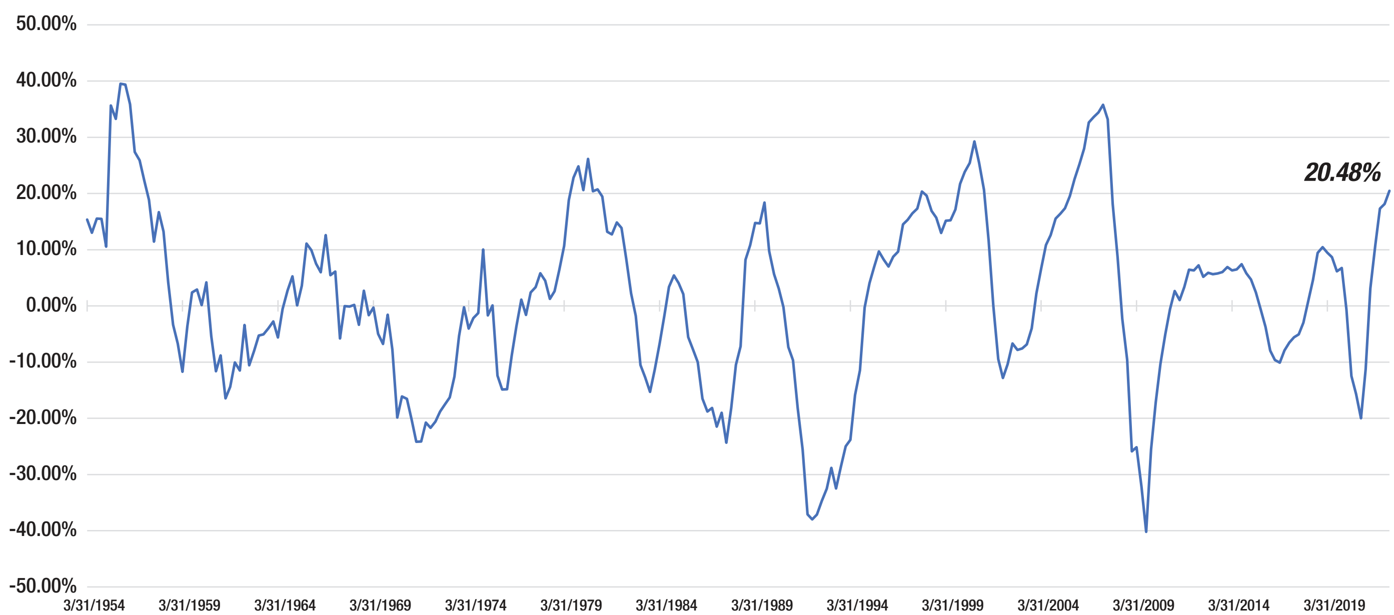
March 1954 to June 2022



Source: Pacer Advisors, Bloomberg

% Spread Between S&P 500 LTM EPS vs. Normalized EPS

March 1954 to June 2022



Source: Pacer Advisors, Bloomberg

As of Q2 2022, the S&P 500 LTM EPS is 20.48% above the normalized EPS, which is the highest post-08 spread. For context, the record high for the spread occurred in 1955, when it reached 39.52%.

Going forward, the S&P 500 normalized EPS is projected to be 181.18 for the next 12 months (NTM). The table below shows the percentage spread between LTM EPS vs. normalized EPS based on hypothetical NTM earnings growth. This includes the current S&P 500 NTM earnings growth estimate.

NTM Earning Growth		NTM EPS	% Spread between trailing EPS vs normalized EPS	Percentile
20.00%		245.92	35.73%	98.7
16.47%	**Expected Growth**	**238.68**	**31.74%**	**96.6**
15.00%		235.67	30.08%	96.4
10.00%		225.42	24.42%	93.2
5.00%		215.18	18.77%	87.5
0.00%		204.93	13.11%	77.8
-5.00%		194.68	7.46%	67.5
0.00%		204.93	13.11%	77.8

Source: Pacer Advisors, Bloomberg

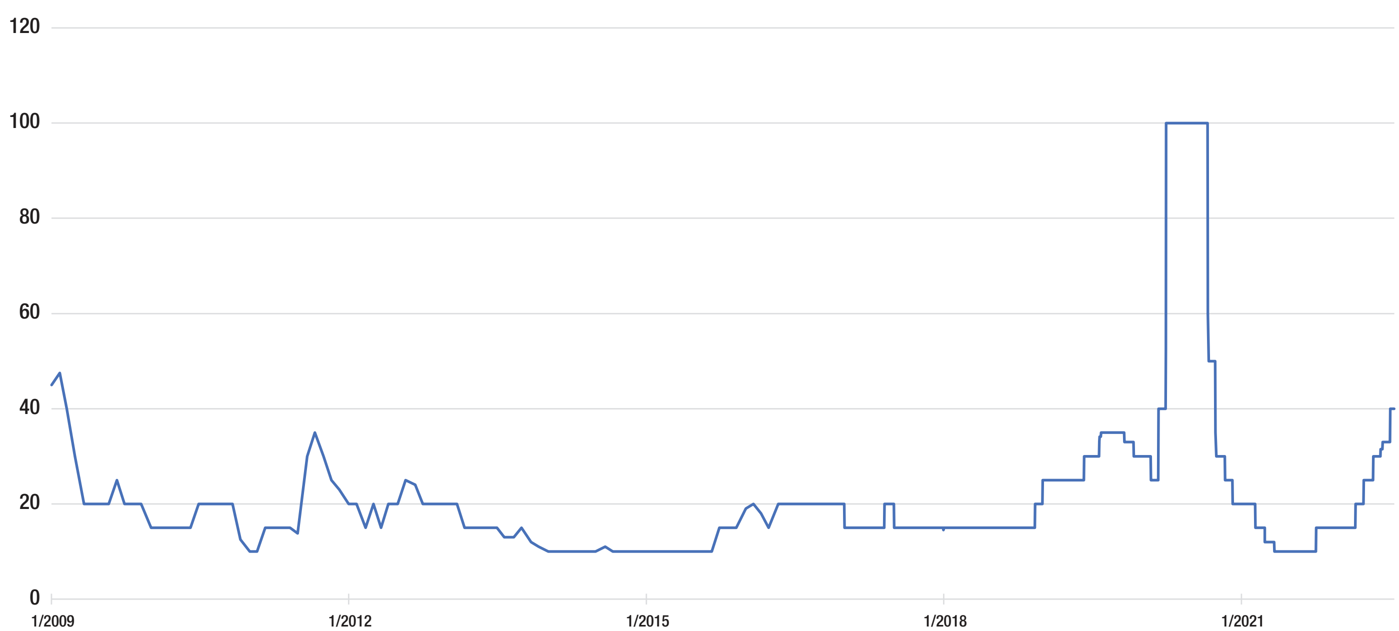
As indicated in the table above, the market's forecasted 16.47% NTM earnings growth (EPS 238.68) will put the S&P 500's earnings even further above the normalized EPS trend line (31.74% vs current 20.48% spread). This suggests an extended economic expansion beyond what we have seen in the past two years.

This is certainly, one of the best scenarios we can expect, considering the fed is raising rates more aggressively than they have in decades and the US' GDP contracted for two consecutive quarters in 2022.

However, the risk of recession is getting higher. According to Bloomberg[1], "there's a roughly one-in-three risk of a US recession over the next year."

(1)https://www.bloomberg.com/news/newsletters/2022-07-05/what-s-happening-in-the-world-economy-the-38-risk-of-a-us-recession?sref=fBP8AbSM

Probability of a US Recession Within 12 Months
January 2009 to July 2022



Source: Pacer Advisors, Bloomberg

The projected NTM earnings growth might be tough to achieve, considering the current market environment based on the fed, recession threats and market valuations. These factors may put downward pressure on the S&P 500's price level, which explains why many people are so pessimistic about where the market will go in the future.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

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PTLC

The Pacer Trendpilot US Large Cap ETF applies a trend following strategy based on the 200-day simple moving average. It aims to help investors avoid negative trends and participate in positive ones.

Pacer Swan Structured Outcome Strategy
SOS

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