Chart of the Month

October 2015

There is a strong correlation between earnings growth and the performance of stocks. Rising earnings typically lead to rising share prices and falling earnings to falling prices. This relationship is in stark contrast to those who believe that the stock market is nothing more than a casino.

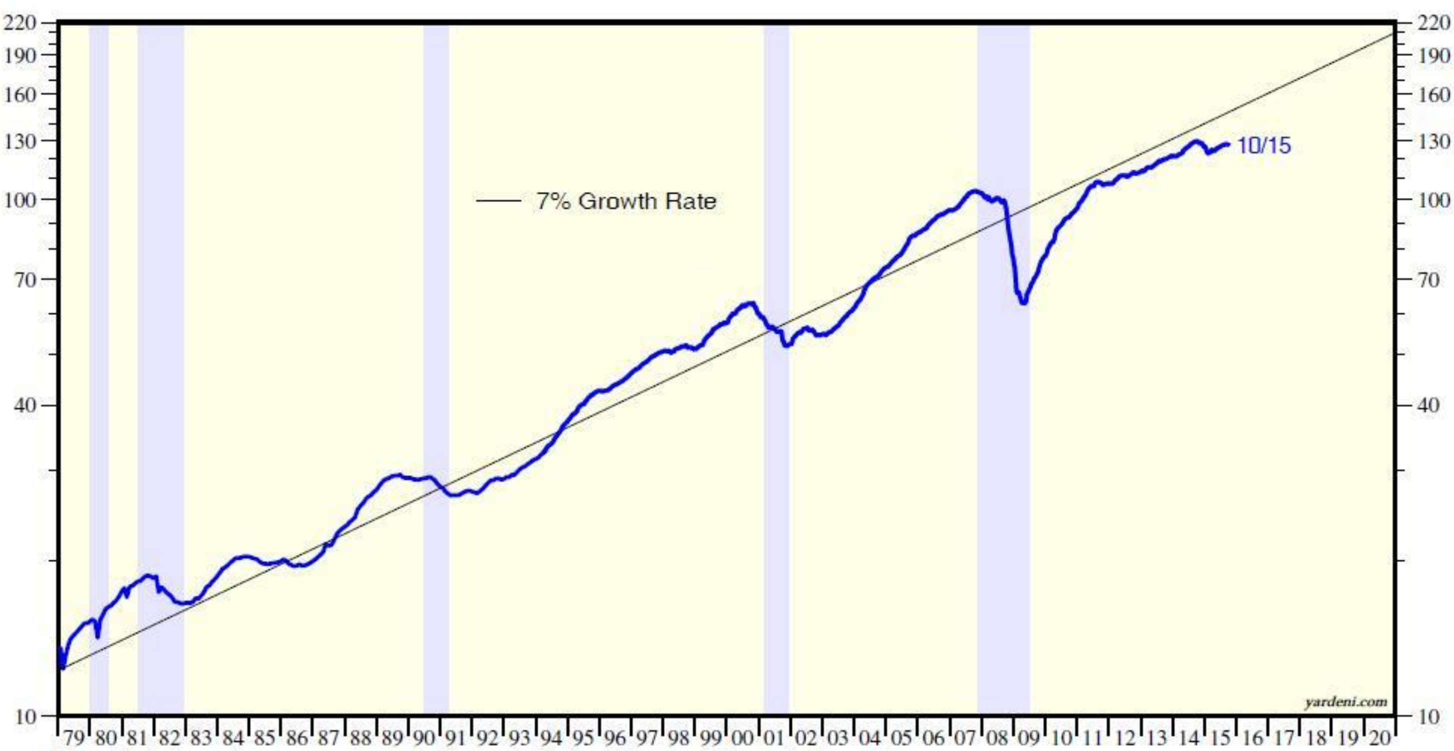
Importantly, stocks represent a claim on the stream of future corporate earnings, discounted back to the present using an appropriate rate of return (such as the cost of capital). As a result, it follows that stock prices and profits would be highly linked. While day-to-day swings may be as much emotional as fundamental, the connection between stocks and earnings is powerful over all but the shortest periods.

As shown in the graph below, the Standard & Poor's 500 Index has increased its earnings at an average annual rate of nearly 7% since the late 1970s. During this time, the S&P 500 has appreciated at an average annual rate of 8.6%. While imperfect, the association has been significant. The difference is due to the fact that stock prices have also benefited from an expansion in price-earnings ratios over the past four decades, which has amplified the effect of the growth in profits.

Over the past century, stocks have generated a total return of roughly 10% annually with 3% to 4% coming from dividends and 6% to 7% from price appreciation. Going forward, we estimate that stocks will generate a total return of approximately 6% to 8%. Our assessment is based on the S&P 500's current dividend yield of 2% plus the likely continuation of 6-7% EPS growth minus 1-2% owing to a contraction of the P/E as valuations regress from 16.5x forward earnings to their historical norm of 15.0x. Although the prospective returns are lower than their long-term results, we believe stocks remain attractive relative to interest rates and alternative investments.

As we witnessed this past summer, stock prices do not go up in a straight line. Instead, they will fluctuate due to changes in earnings expectations as well as short-term "noise" that should be disregarded by investors with a longer-term horizon.

S&P 500 FORWARD EARNINGS



Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
Source: Thomson Reuters I/B/E/S.

Lederer & Associates
Investment Counsel
5305 East 2nd Street, Suite 201, Long Beach, California 90803
Tel: (562) 434-5305 ▲ Fax: (562) 434-5306
www.lederer-associates.com