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Stocks Cheapest in 26 Years as S&P 500 Falls, Earnings Rise 18%

By Alexis Xydias - Jun 20, 2011

For the second time since the bull market began, profits are surging and stocks are falling.

Standard & Poor's 500 Index companies will earn 18 percent more this year than in 2010, according to the average estimate of more than 9,000 analysts compiled by Bloomberg. Higher profits haven't stopped the gauge from falling 6.8 percent since April 29, pushing valuations to the cheapest levels in 26 years. Even if companies posted no growth, price-earnings ratios would be lower than on 96 percent of days in the past two decades.

The combination of China raising interest rates, concerns about a Greek default and the end of the Federal Reserve's $600 billion stimulus program have almost wiped out this year's gains. The divergence between profit forecasts and economic indicators shows the challenge to investors after the S&P 500 gained 88 percent from a 12-year low in March 2009.

"The market is not willing to pay for future growth," said Nigel Holland, who helps oversee $516 billion at Legal & General Group Plc in London. "Provided there is better data, it will stabilize," he said. "The market probably has room to rise 10 percent by year-end."

The S&P 500 climbed less than 0.1 percent to 1,271.50 last week, snapping its longest retreat since 2008, after reports on jobless claims, retail sales and Chinese industrial production exceeded economists' forecasts and German Chancellor Angela Merkel retreated from demands that bondholders be forced to swallow losses in a Greek rescue.

The S&P 500 advanced 0.5 percent to 1,278.36 at 4 p.m. in New York today.

Longest Streaks

Equities also got a boost as retailers Best Buy Co. and Kroger Co. (KR) said they would match or exceed predictions for 2011 income. The advance pared the S&P 500's loss from its 2011 peak of 1,363.61 on April 29 to 92.11 points.

At 34 days, the decrease is the second longest since the bull market began. The 16 percent tumble from April to July 2010 lasted 49 days, Bloomberg data show. This year's retreat has coincided with a decline in predictions for 2011 gross domestic product growth to 2.6 percent from 3.2 percent, according to the median estimate of 83 economists surveyed by Bloomberg.

Losses since April have pushed the price of the S&P 500 to 14.5 times the past year's earnings, compared with the average of 20.5 since June 1991, according to Bloomberg data. The gauge is valued at 8.7 times cash flow, cheaper than in 81 percent of occasions since 1998. The gauge is priced at 2.1 times book value, or assets minus liabilities, lower than it has traded 90 percent of the time since 1995.

Not Excessive

"Even in the assumption that earnings growth is zero, valuations would not be excessively high," said Patrick Moonen, who helps manage $537 billion at ING Investment Management in The Hague, Netherlands. "We are below consensus in the estimated earnings growth, and still think the corporate momentum is very strong."

Disappointing reports since May on housing, employment and manufacturing have heightened concerns that $600 billion in Treasury purchases by the Fed have failed to bolster growth. The S&P 500 posted its biggest weekly decline since August in the period that ended June 3 after the U.S. jobless rate unexpectedly climbed to 9.1 percent and payrolls expanded at the slowest pace in eight months. A report from the Institute for Supply Management on June 1 showed that manufacturing expanded at the lowest rate in more than a year.

Greek Swaps Soar

The cost of insuring against defaults on Greek, Irish and Portuguese government debt surged to records last week on concern governments will fail to impose spending cuts needed for a European Union debt restructuring.

Credit-default swaps on Greece soared as much as 459 basis points to 2,237 on June 16, according to CMA prices, meaning it cost more than 2 million euros ($2.9 million) a year to insure 10 million euros worth of the nation's debt.

They traded at 1,932.75 basis points as of 4:30 p.m. in London on June 17 as Merkel backed down from her demands and said she'd work with the European Central Bank to avoid market disruptions.

Investors are concerned about slowing growth in the U.S. and Europe's sovereign debt crisis at the same time policy makers in China, the world's second-largest economy, are trying to cool expansion. The country's central bank has raised the reserve-requirement ratio for lenders 11 times and boosted interest rates four times since the start of 2010 to keep inflation in check.

Lehman, 1980s

Analysts are boosting profit forecasts even with the global economy showing signs of weakness. S&P 500 earnings may rise to $99.61 a share in 2011 from $84.58 last year and $61.52 in 2009, according to data compiled by Bloomberg. That's an increase from the forecast of $95.37 on Jan. 3 and $98.70 on April 29, the data show.

Should stocks stay at current prices and the analyst prediction come true, the S&P 500 would trade at 12.8 times income on Dec. 31, the lowest level since 1985 except for the six months after Lehman Brothers Holdings Inc.'s bankruptcy in September 2008 and nine months in the late 1980s, according to Bloomberg data. Companies in the S&P 500 are forecast to earn $24.31 this quarter, up from $24.16 at the start of April.

Concern the slowdown will lead to another recession will weigh on stocks even as companies report higher income, said Doug Cliggott, Boston-based equity strategist at Credit Suisse Group AG. He said the S&P 500 will be little changed through year-end.

Not Extreme

"We wouldn't put the market now as extremely rich or in a sense extremely attractively valued," Cliggott said in an interview on Bloomberg Television's

“InsideTrack” with Deirdre Bolton on June 13. “Price-earnings multiples will be at or below their historical averages because of all the uncertainties on future growth.”

Stocks may also have to do without more stimulus from the Fed, which will complete its second round of Treasury purchases this month. While Fed Chairman Ben S. Bernanke said during a June 7 speech in Atlanta that record monetary stimulus is still needed to boost the “frustratingly slow” U.S. economic recovery, he gave no indication that the central bank will start a third round of so-called quantitative easing.

Retreats in the S&P 500 that exceed 5 percent are common during bull markets, according to data from Birinyi Associates Inc., the Westport, Connecticut-based money manager and research firm. During the nine rallies between 1962 and 2007, the S&P 500 fell that much an average of seven times, the data show. The index has posted nine such retreats during the current advance.

‘Strong Backbone’

Global investors increased their cash holdings to the highest level in a year this month as hedge funds slashed the amount of borrowed money invested in stocks, a survey from Bank of America Corp. (BAC)’s Merrill Lynch unit showed on June 14.

“Valuation is a strong backbone,” ABN Amro Private Banking Chief Investment Officer Didier Duret, who manages about $200 billion in Geneva, said in a telephone interview. “It’s more or less a reflection of how reluctant investors have been to get back into the equity market.”

Kroger in Cincinnati rose 4.5 percent, the most since October 2009, to $23.99 on June 16. The largest U.S. grocery chain increased its fiscal 2012 earnings forecast to as much as $1.95 a share from $1.92. Analysts, on average, estimated $1.90.

Best Buy, the world’s biggest consumer-electronics retailer, rallied 4.6 percent two days earlier after reporting profit that exceeded analysts’ forecasts, helped by rising demand for smartphones. The Richfield, Minnesota-based company reiterated its full-year projection for earnings per share of $3.30 to $3.55, excluding restructuring costs. Analysts predicted $3.47.

To Alison Porter at Ignis Asset Management, stocks have priced in prospects for a Greek default and the end of the Fed’s bond-buying program.

“We are seeing stable growth, but it is not a strong cyclical recovery,” said Porter, who as U.S. equities fund manager in Glasgow helps oversee $123 billion. Still, “valuations in the market should provide some support,” she said. “Equities are reasonably well positioned from here.”

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