In recent weeks, the nation’s financial media have been puzzled – obsessed, almost – with the stock market’s resilience in the face of rising inflation. How can investors be so blithely complacent? Isn’t a correction, or even a bear market, just around the corner?

We’ve been in similar situations in recent years, with buoyant stock prices despite some perceived threat on the horizon. I hate to repeat myself – say something once, why say it again?1 – but sometimes I suppose it’s necessary. So I will say it again, just as I’ve said it whenever investors have been jittery at market highs: Stock prices are driven by earnings expectations, tempered by interest rates and sentiment. And while I’m at it, I’ll also repeat another eternal truth, one that’s especially relevant today: Stocks provide investors with inflation protection.

A correction is always possible, of course, from any price point; markets go up and down for all sorts of reasons in the short term, and a 10% dip typically occurs about once a year anyway. But random market movements aside, the evidence suggests that stock prices are quite reasonable today; there’s no reason to anticipate a sudden bear market.

But wait, the bears say, stocks aren’t just high. They are trading at euphoric P/E ratios not seen since the peak of the dot-com era (and not since the Roaring Twenties before that). As Chart 1 shows, the bears don’t have their facts wrong: It’s true that a dollar of earnings costs more today than it has in decades, regardless of whether we’re looking backward at trailing earnings or forward to future earnings.

---

1 I also hate repeating musical references, so please forgive me for quoting Talking Heads’ “Psycho Killer” just a year after I mentioned their “Life During Wartime” in my June 11, 2020, On Our Minds commentary.
But the bears do have the interpretation of this simple relationship wrong, in two ways. First, interest rates remain at historically low levels. The 10-year Treasury note currently yields less than 1.6%, compared with an average of 5.76% over the 66 years from 1953 to year-end 2019. When bond yields are low, it usually follows that earnings yields are also low – and the P/E ratio is simply the inverse of the earnings yield (E/P). Unless interest rates and bond yields suddenly jump higher, the higher P/E ratios as shown in Chart 1 are not *per se* reason for concern; they just reflect a low-rate environment.

Second, the P/E multiple is a function of two distinct numbers – price and earnings. Coming out of a deep recession, the denominator of the P/E ratio is at a trough, which naturally inflates the ratio. It may seem counterintuтив, but disciplined investors recognize that P/E ratios are often at their highest when the stock market is cheap and about to emerge from recession, and conversely P/E ratios are often at their lowest at the top of a business cycle, when earnings peak. Looking at today’s high P/E ratio without considering the economic cycle could easily lead an unsuspecting investor astray.

*Aha!,* the bears may counter. They will point out here that P/E ratios have been rising sharply even as reported earnings have recovered from their trough a year ago. Today, they complain, we’re paying high P/Es on higher earnings – *and that way lies madness!* On this point, alas, the bears are simply wrong on the facts, as shown in Chart 2. On a trailing 12-month basis, S&P 500 earnings per share (purple line) fell about 22% from peak to trough through the pandemic, and although they are past their trough, they are still well below their pre-pandemic peak. The high P/E ratios are still based on depressed earnings.

---

2 There’s nothing special about this particular time period; it’s just as far back as I was able to get good monthly data. If you prefer a shorter time period, the 10-year note averaged 4.50% from 1990 through year-end 2019. Indeed, compared with *any* historical period before the onset of the pandemic, bond yields are at least two percentage points lower today.
The bears are also blind to the sheer potential of earnings growth in corporate America. Companies coped exceptionally well through the pandemic, cutting expenses sharply in response to lower demand; that’s why the country is still about seven million jobs shy of its pre-pandemic peak, even as the economy is on the cusp of its unfettered reopening. Investors now expect companies to retain their newfound efficiency even as output recovers and revenues grow. Chart 3 summarizes this powerful earnings leverage.

![Chart 3: S&P 500 Trailing vs. Forward Profitability](source: FactSet, Eastern Bank Wealth Management)

In this chart, the blue columns show aggregated actual results for S&P 500 companies for the twelve months ended May 31, 2021. The orange columns show consensus investor expectations for the next twelve months, to May 31, 2022. In the left pairing, investors expect S&P 500 companies to post an 11% gain in revenues per share in the coming year versus the prior year; in the center pairing, the corresponding expected gain in earnings per share is four times greater, a 44% gain. The right pairing shows that the net profit margin (earnings divided into revenues) is expected to jump from about 10% to about 13% in the course of just this one year.

Bears can be relentless, of course. Their natural response to Chart 3 is to doubt that a small 11% sales improvement can lead to a large 44% profit gain. What they miss is the tremendous improvement in efficiency seen in the past year. Capacity utilization remains well below its pre-pandemic peak (Chart 4), so companies have plenty of slack capacity to put to work as demand improves.

![Chart 4: Capacity Utilization](source: Federal Reserve)
Despite recent reports of worker shortages and higher raw materials prices, companies still have enormous favorable operating leverage. Their fixed costs remain fixed, so even if companies pay higher variable costs for increases in output, the overall average unit cost falls because those fixed costs are spread over a larger production base. In other words, the overall profit margin still expands. The result is that incremental profit margin on incremental sales revenues is expected to be about 39% in the coming year versus the prior year – vastly better than the overall 10% profit margin in the past twelve months.

This assessment is based on FactSet’s “consensus” average of Wall Street estimates. I believe that these estimates are too low, for two reasons. First-quarter S&P 500 EPS was $50.20, for an annualized rate of $200.80. Yet the consensus 2021 EPS expectation is only $198, implying that investors think earnings have already peaked. Since the U.S. economy is clearly growing rapidly, S&P 500 revenues and profits should be rising from that annual rate, not shrinking. Second, the U.S. has led the global recovery from Covid-19; as other major economies – especially Europe – also reopen, global multinationals could gain yet another source of revenue acceleration. Putting all this together, I wouldn’t be surprised to see final S&P 500 EPS between $210 and $220, a 5% to 10% boost from current estimates that is not reflected in today’s market prices.

There is one more reason that investors should take comfort in anticipating a dramatic increase in earnings growth. Stocks – it bears repeating yet again – protect investors from inflation. Earlier this year, I argued that we should expect sharply higher inflation and that it would be temporary. That’s still my base case hypothesis, and for the same reasons I discussed at the time. But let’s assume I’m wrong about inflation, and that it persists at higher levels. As consumers become inured to higher inflation, they willingly pay higher prices, which more than offset higher input costs for companies. Consumer price inflation leads to higher corporate profits and dividends: Equity investors are thus insulated, while fixed income investors see the “real” (net of inflation) value of their bonds diminish.

Since David Byrne felt justified in repeating the chorus of “Psycho Killer” four times after his proclamation about saying something just once, perhaps I can repeating my chorus one more time: Stock prices follow earnings, and earnings are looking very promising. Despite the ever-present possibility of a short-term correction, the U.S. stock markets are not unduly expensive.

Eastern Bank Wealth Management is a division of Eastern Bank. The opinions expressed herein are those of the author, and do not necessarily reflect those of Eastern Bank, Eastern Bank Wealth Management, or any affiliated entities.

Views and opinions expressed are current as of the date appearing on this material; all views and opinions herein are subject to change without notice based on market conditions and other factors. These views and opinions should not be construed as a recommendation for any specific security or sector. This material is for your private information and we are not soliciting any action based on it.

The information in this report has been obtained from sources believed to be reliable but its accuracy is not guaranteed. There is neither representation nor warranty as to the accuracy of, nor liability for any decisions made based on such information. Past performance does not guarantee future performance.

**Investment Products:** Not insured by FDIC or any federal government agency. Not deposits of or guaranteed by any bank. May lose value.

---

3 Both of these factors are, to use Fed Chair Jerome Powell’s favorite word, transitory. Input price inflation is mostly due to disrupted supply chains still recovering from the pandemic, and worker shortages may be partly due to government stimulus and unemployment payments. Both factors are likely to diminish substantially later this year.

4 See my On Our Minds commentary, “Inflation: Menace or Mirage?”, published April 1, 2021.