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How Do We Have 18.4% Earnings Growth In A 2.58% GDP Economy?

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Summary

- Growth rate of a stock equals dividend plus earnings growth.
- There are short-term factors that have boosted earnings.
- International growth makes up the largest portion of earnings growth.

Growing earnings have propelled the overall markets to new highs the last few years. With first-quarter earnings expected to grow at an 18.4% annual rate, it raises the question of how is this possible when GDP is only 2.58%? I researched this issue and found that many reputable sources have attacked this issue from different angles. My aim is to try and break down and simplify this issue and discuss why there is such a large discrepancy. There are many factors driving the discrepancy between earnings growth and GDP growth, but the primary factor is international earnings growth.

Going Over The Basics

Just in case some readers have forgotten, the growth rate of a stock should equal its dividend rate plus its earnings growth, assuming the PE ratio stays constant. A company late in its growth stage will usually pay a larger dividend than a younger company that is rapidly growing. The rapidly growing company has ample opportunity to re-invest earnings, which will allow it to grow its earnings at a faster rate than a company paying a large dividend.

The PE ratio is a little beyond the scope of this article, but it is worth noting the current S&P 500 trailing PE of 24.24 is high based on historical standards. A major reason this ratio is high is because analysts predict rapidly growing earnings and the forward PE ratio is 17.12. The question still remains, how do we have such rapidly growing earnings in a slow growth economic environment?

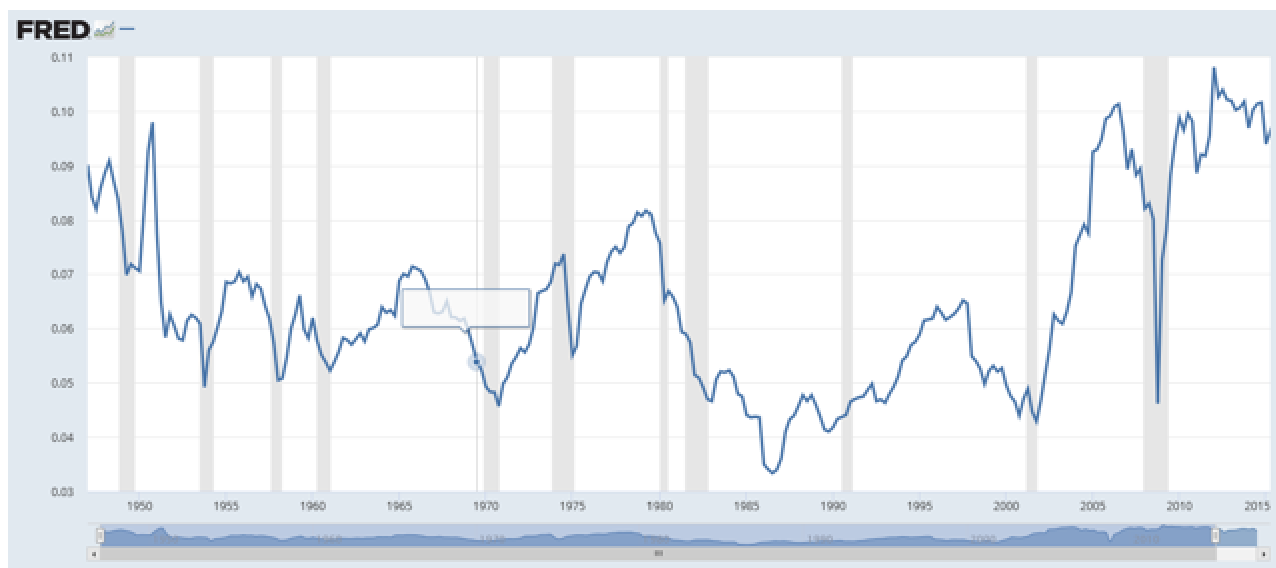
S&P Revenue is Not the Same as GDP but Should be Close in a Closed Economy

S&P revenue does not equal GDP and is calculated in a much different way. Gross domestic products and services are the total value of goods produced and services provided in a country during one year. Services make up a much larger portion of GDP, and manufacturing makes up a much larger portion of S&P 500 earnings. Consumer spending has a much larger impact on GDP and business spending impacts S&P 500 revenue more. There are other differences, but the biggest difference is obviously that GDP growth does not include the international sales of S&P 500 companies. With GDP, globalization has a negative impact since exports are subtracted from imports.

Despite the differences in how GDP growth and the S&P 500 earnings growth are calculated, historically, these numbers have been very close. We will discuss the impact of increasing globalization in another section, but in a closed economy, these two numbers are similar over an extended period of time. Over the short term, there are factors that can cause GDP and S&P earnings to differ in a closed economy.

There are Short-Term Factors Impacting Earnings

What if profit margins rise in a closed economy and earnings make up a greater percentage of revenue? Due to lower labor cost, a weak dollar, and low interest rates, that is exactly what have been occurring with the S&P 500. The following chart shows corporate profits as a percentage of GDP.



As the chart shows, corporate profits currently make up a much larger percentage than they have historically. With the labor market tightening, interest rates rising, and the dollar gaining strength, the portion of this trend related to U.S. earnings is likely to reverse. Over the long term, corporate profits as a percentage of GDP should drop to historical norms in a closed economy.

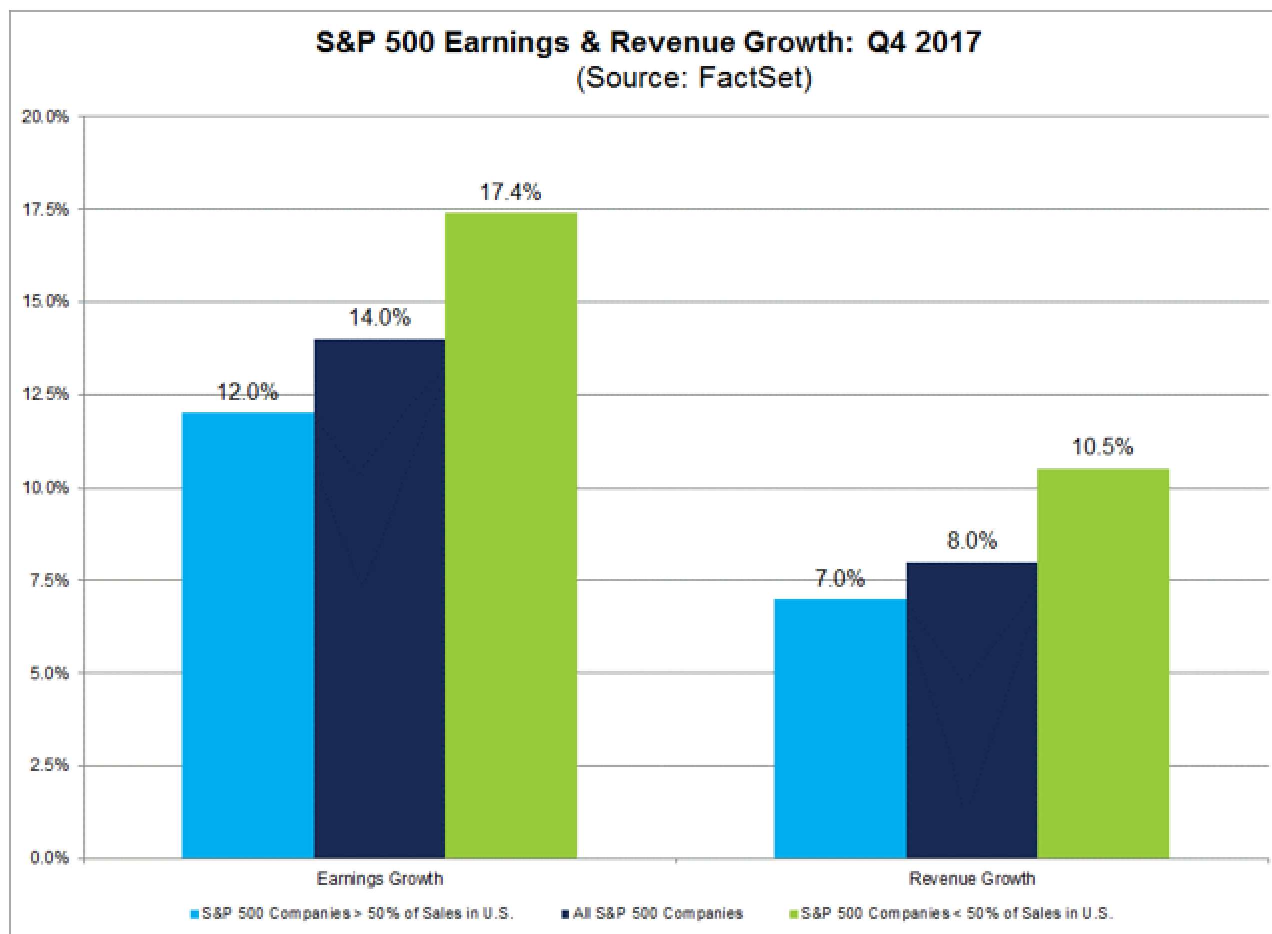
This is Not a Closed Economy

The most obvious difference between GDP growth and S&P 500 earnings growth is international earnings growth. GDP growth equals population growth plus productivity growth. With emerging economies like China and India rapidly increasing production as their population expands, it is no secret that their GDP growth rates are higher than developed countries like the U.S. This of course means if General Motors (GM) manufactures and sells cars in China, their growth rate for their Chinese business should roughly match China's relatively higher GDP growth rate. With China's GDP growth exceeding U.S. GDP growth, it is easy to see how a company with business in China might have an earnings growth rate that exceeds U.S. GDP.

I think varying GDP growth rates in different countries is well understood, but what about growth attributed to companies rapidly gaining market share within emerging market countries? For example, there is very little room for Walmart (WMT) to grow in the United States, as the market is clearly saturated with their stores. However, with far fewer stores in Mexico, Walmart's growing market share in Mexico could cause its growth rate to far exceed Mexico's GDP rate. Walmart could add stores in new cities and rapidly grow throughout Mexico, just as they did years ago in the United States. Earnings growth should roughly equal GDP growth in a closed market, but an established and dominant company like Walmart can far exceed the GDP growth rate when rapidly acquiring market share in a new market.

Understanding how international growth could impact S&P earnings is easier than quantifying it. This is because not all companies in the S&P 500 offer sales and earnings data for each region they do business in. Analysts have tried to organize data by either assuming all companies which didn't separate international sales had no international sales, or by only using companies which did offer complete international sales data. Both of these methods are imperfect, but it is certain that international sales make up an increasing amount of total S&P 500 revenue.

In the fourth quarter of 2017, companies with over 50 percent of international exposure reported higher earnings growth than companies with less than 50% international sales exposure. The following chart shows the earnings growth and revenue growth for S&P 500 companies based on their exposure to international business. This analysis assumes companies which didn't report international earnings had no international earnings.



As the chart shows, earnings growth for companies with over half of their sales in foreign countries was 5.4% greater than companies with less international exposure. The chart also shows international earnings growth exceeded international sales growth. These charts certainly show a direct correlation between international growth and earnings growth, but it is tough to tell the exact nature of this growth. We still don't know how much earnings growth was attributed to emerging markets such as China and developed international markets such as the UK and most of Europe. We also don't know how much of this growth can be attributed to normal GDP growth, and how much is attributed to the market share increases companies experience when they enter a new market.

Conclusion

Earnings growth has far exceeded GDP growth recently and it is difficult to understand exactly why. Short-term factors such as a weak dollar, low labor cost, and low interest rates should cause future earnings to decrease as they become aligned with historic levels. International growth's long-term impact on earnings is more difficult to determine. International growth is clearly the primary factor driving earnings growth, but it is difficult to analyze the international earnings data.

As international sales make up a greater and greater portion of S&P 500 sales, earnings growth and GDP growth will become increasingly disconnected. There are not a lot of books or articles written on international earnings growth of the S&P 500, because of the incomplete reporting by companies. Precise public data is simply not available, which leaves some guesswork for index fund investors.

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