



2016 S&P EPS growth to surge to 5%!

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Falling standards of excellence this cycle: Is there an objective passing grade? We reduce 2016E S&P EPS from \$128 to \$125. We're unsure of the tone of language appropriate to describe this reduction. Slashing or even cutting is too harsh as our new estimate is merely 2.5% lower. This trimming shouldn't surprise investors given recent commodity and currency markets. So is \$125 good S&P EPS in 2016? Is it bullish or bearish? It's only 5% growth, subnormal mid-cycle real EPS growth, but 10x better than 2015. Thus, S&P EPS growth is set to surge in 2016! But is there an objectively healthy S&P EPS growth rate? In this note we present our new 2016E S&P EPS and we explain why a healthy S&P EPS growth rate is the nominal cost of equity less the dividend yield.

2016 S&P EPS cut from \$128 to \$125 on stronger dollar, lower oil assumptions. We have long cautioned that every 10% appreciation in the dollar vs. mature currencies drags on S&P EPS growth by 2.5%. Every dime the Euro declines vs. USD hits S&P EPS by \$1. Every \$5/bbl oil price decline hits S&P EPS by \$1, net of small benefits outside of Energy, Industrial Capital Goods & Materials; which all suffer. Airlines, Consumer Staples & Discretionary firms benefit from lower oil prices, but most of the cost savings is passed forward to customers. We lower our average 2016 Euro assumption from about \$1.10 to \$1.05. We raise our 2016 avg. DXY assumption from about 95 to 100. We lower our 2016 avg. oil price assumption from \$60/bbl to \$55/bbl and natural gas to \$2.75. We also tempered our growth assumptions at US Retailers, Housing and Banks.

2015 did not have healthy underlying revenue or EPS growth ex oil and dollar. S&P sales and operating EPS growth was broadly weak in 2015. Weakness extended beyond commodity producers and FX drags at multinationals. A surge in airline profits masked a significant Industrial Cap Goods profit decline. Revenue was flat at Financials with EPS growth from less litigation than 2014. No growth at Consumer Staples despite lower input costs. Good growth at Retailers, but disappointing given the macro tailwinds owing to fierce price competition. Strong at auto, but home builders disappointed. The strongest growth was at Health Care and consumer oriented Tech firms. Corporate tech spending on equip. and software remains very sluggish and chip makers were flattish on earnings given slow PC, handset and weak industrial end markets. Ex. Energy, Financials, HC and AAPL, AMZN & GOOG 2015 S&P EPS growth is ~2.5%; this is the underlying trend with ~4% FX drag that should fall to ~1.5%.

Stronger revenue growth is key to achieving healthy S&P EPS growth in 2016. Strong revenue growth at Health Care, better capex on productivity enhancers like tech equip/software, slower but still strong revenue growth at consumer oriented big cap Tech are key to our 4% S&P sales growth, 1% share shrink and flat net margin estimates for 2016. Some cyclically risky sectors like Auto, Airlines, Chemicals & Semiconductors must avoid losing any earnings power.

Margin expansion is possible, but upside counterbalanced by downside risk. Fierce price competition at Retailers, more global competition at Industrials and the political threats at Health Care pose some sales risk, but mostly margin risk. There is also tax rate risk. Many are concerned about wage pressure on margins, but this is not a major risk for S&P firms. However, a tighter than expected labor market could lead to more Fed hikes than expected and thus EPS risks via dollar, oil or PE risk via credit market or a Tsy yield jump. Fed hikes are a small boost to S&P EPS.

5% delineates healthy from unhealthy S&P EPS growth and supports an 18 PE. Our 1 year target of 18x trailing S&P EPS uses a 5.5% real and 7.5% nominal CoE. EPS is retained, so real EPS g must = real CoE - div yld to justify a PE = 1/real CoE.

S&P 500 Key Forecasts

Price	2089.17		
Next 5%+ move	Balanced Risk		
	2014	2015E	2016E
Year-end Target	2058.90	2050-2100	2250-2300
EPS	\$118	\$119	\$125
Target P/E	17.4x	17.4x	18.2x
Current P/E	17.7x	17.6x	16.7x
DPS	\$38.30	\$41	\$44

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