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Market and Economic **Update**

How Corporate Profits and Dividends Affect Investor Returns

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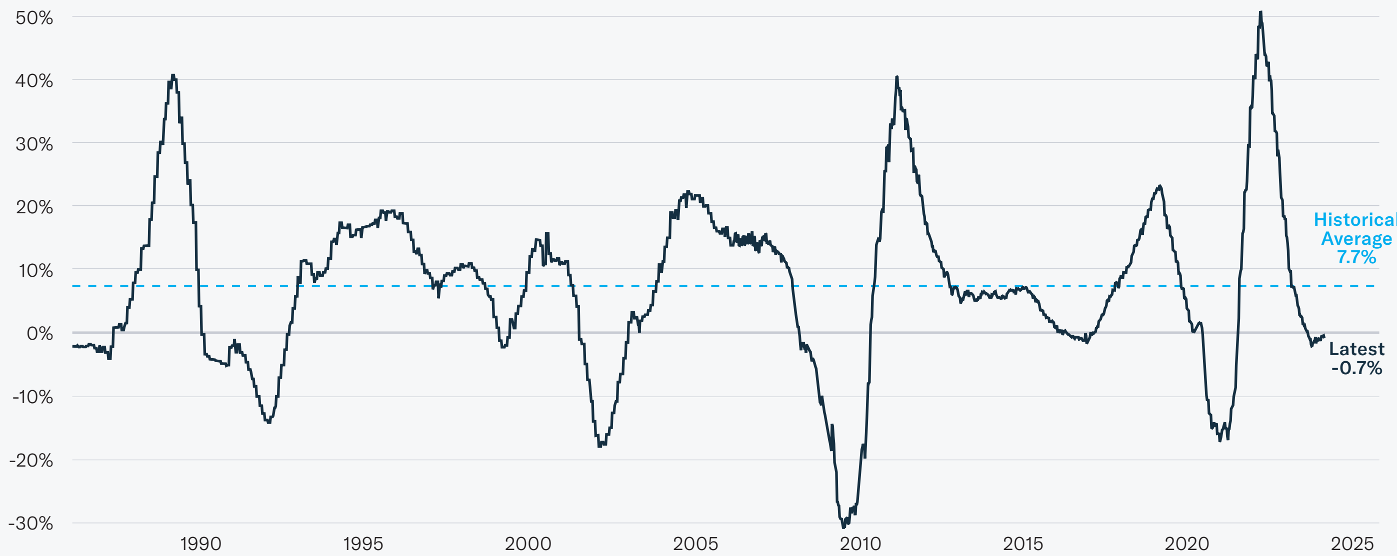
The stock market has been supported by a healthier-than-expected economy this year, generating returns that have helped many portfolios to partially recover from last year's bear market. Investors now hope these growth trends will translate into stronger corporate earnings since, in the long run, markets tend to follow the same trajectory as profits. With the future of the economy still uncertain, what signs are there that companies might begin to see improved profitability?

The third quarter earnings season is nearly wrapped up with almost all S&P 500 companies reporting their results. This is likely to be the first quarter of positive growth in a year, a notable inflection point that mirrors the surprising stability of the underlying economy. Consensus Wall Street estimates are for earnings to be flat this year at about $217 per share but to then rebound in 2024 by 11%. While this is somewhat at odds with economic forecasts for slowing growth in the coming quarters, it's safe to say that any acceleration in earnings would be welcomed by investors.

1. Earnings growth may have reached an inflection point

S&P 500 EARNINGS GROWTH RATE
Trailing 12 month earnings per share



Past performance is no guarantee of future results.
Source: Clearnomics, Refinitiv. January 2001 to November 27, 2023.

As the accompanying chart shows, the growth of corporate profits has been slowing since its peak in 2021 but may have reached a turning point. Historically, large public companies have increased their earnings by an average of 7.7% per year, but this fluctuates alongside the business cycle. To oversimplify the earnings cycle, in good times companies increase their sales faster than their expenses, boosting profits and margins. In bad times, companies experience slowing revenues and cut costs to maintain margins. Better cost structures then allow companies to be more profitable once the economy turns around.

It may seem obvious that profits matter and that, over long time frames, they should reflect the value created by companies. Business owners, executives, and corporate boards have strong incentives to maintain and boost profitability and thus shareholder returns. When it comes to investing, there are three specific reasons why this matters to investors.

First, the stock market tends to follow corporate earnings in the long run. While the price and earnings of the S&P 500 do not line up perfectly, they follow the same broad trends. This is because economic growth boosts earnings which in turn pushes stock prices higher. So, while the economy and the stock market are not one and the same, the two are closely related through the performance of companies.

Second, determining whether the stock market is “cheap” or “expensive” depends not only on stock prices, but also on corporate performance, where earnings can be considered a crucial aspect. The price-to-earnings ratio, for instance, is simply the price of a stock or index divided by some earnings measure, such as expected earnings over the next twelve months.

What this means is that even if prices don’t change, increasing earnings will make the market more attractive, and vice versa. Currently, the forward price-to-earnings ratio of the S&P 500 is 18.7, which is above the historical average of 15.6 but well below the 2020 peak of 23. If earnings growth does begin to accelerate, this measure could improve further.

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Third, profits support dividend payments. From a corporation’s perspective, dividends are a way to return cash to shareholders. In theory, if a corporation has no attractive investment opportunities, it makes sense to return cash to shareholders who can invest it themselves. In general, however, corporations pay steady dividends in order to attract investors, especially if they can grow these payments over time. Additionally, there has been a trend among certain companies to amass increasing amounts of cash, and certain sectors, such as technology, pay relatively low dividends.

For investors, dividends are an integral part of total returns. Historically, dividends - and not price appreciation - were one of the primary reasons for investing. Today, many investors seem to focus on stock prices except in cases where portfolio income is needed, such as for those nearing or in retirement.

While bond yields have risen this year and the market has been volatile, many sectors still have very attractive dividend yields. Not surprisingly, sectors that have underperformed this year, including Real Estate, Utilities, and Energy, can generate yields just under 4%. Sectors that have seen the most price appreciation, namely Communication Services, Consumer Discretionary, and Information Technology, also have the lowest yields. Consequently, it’s important to diversify across sectors in order to benefit from all phases of the market cycle, especially if earnings do continue to turn around.