

Stocks poised to keep rising in 2014: Fidelity

By Kerry Pechter Thu, Dec 26, 2013

With foreign sales producing about 40% of the revenues of large U.S. manufacturing companies, Fidelity said, rapid economic growth in emerging markets and economic stability in China and Europe bode well for the S&P500 Index in 2014.

A new report from Fidelity Investments, *U.S. Corporate Earnings: A Key Driver of Equity Market Returns in 2014*, asserts that the 2012-2013 bull market is sustainable for the following reasons:

- **Reasonable corporate profitability.** The aggregate corporate return on equity (earnings relative to shareholders' equity) for S&P 500 companies was 14.1% in the third quarter of 2013, slightly above the index's 13.6% long-term average. From 1990 to 2013, the maximum trailing annual return on equity for the S&P 500 Index was 18.8%, while the minimum was 4.1%. Based on this measure, profitability for the U.S. equity market looks reasonable relative to history, and there is potential for further upside.
- **Overseas revenue is an increasing contributor to U.S. earnings.** During the past decade, foreign sales have represented more than 40% of total revenues for S&P 500 companies, and the proportion has grown over this period. The growing global diversification of the revenue stream for U.S. companies could continue to provide a positive influence on earnings going forward, for two reasons. First, sales growth in some emerging market sectors continues to be higher than the growth in developed economies, in part due to the burgeoning middle class populations in such countries as China and India. In addition, if the recent economic stabilization in Europe and China continues, it would provide a backdrop supportive of higher future profit growth.
- **Prudent capital allocation policies.** U.S. companies have been disciplined with their use of capital in recent years, and a continuation of this trend could support future earnings growth. In particular, merger and acquisition activity has been subdued, and overall capital expenditures as a percentage of sales have remained at a moderate level. Despite increased share buyback activity and dividend payouts, corporate cash balances are at elevated levels, providing managements with a cushion with which to further increase capital returns to shareholders.
- **Reasonable valuation.** During the post-2008 period, the 106% upward move in stocks (through Sep. 30, 2013) has coincided with a 111% increase in corporate earnings. At the same time, U.S. economic conditions have been stable, if unremarkable; the nation's nominal GDP growth has been 16% since the end of 2008. In December 1999, the equity market's price-to-earnings (P/E) ratio using trailing earnings was 28.4, implying unsustainably high earnings growth. Comparatively, at the end of 2008, the S&P 500 Index's aggregate trailing P/E ratio was only 18.2, below the historical average of 19.5. Today, the equity market's valuation is still quite reasonable and somewhat below its long-term average, despite the market's significant move during the past four-plus years — implying that investors generally expect a moderate level of earnings growth.