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# DISSECTING THE IMPACT OF STRONG DOLLAR WITH AN EARNINGS GURU

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On May 8, Professor Jeremy Siegel and I chatted with David Bianco, Head of U.S. Equity Strategy at Deutsche Bank, about S&P [valuations](#), earnings growth and the impact of a stronger dollar and weaker oil prices on earnings. Professor Siegel dubs him “the S&P earnings guru.” Below we share a few key points from our conversation.

**What Is Driving Earnings Estimates Lower?** In the last few months, Bianco sees the biggest slashing of earnings estimates—outside of recessionary times—since good forward estimates were first kept in the mid-1980s. However, Bianco believes this earnings season was much better than feared. As of our conversation, 447 companies had reported, representing 92% of aggregate [S&P 500](#) earnings. In the end, it was one of the biggest “beats” for earnings. While the average beat is typically 6% for a given quarter, in the first quarter of 2015 it was closer to 8% to 9%. Bianco cautions against focusing too much on this though. Historically, two-thirds of companies beat earnings expectations, and 50% beat sales growth expectations. Bianco prefers looking at year-over-year sales and earnings growth figures. For the S&P 500 ending first quarter 2015:

- Earnings growth is higher by 2% for the S&P 500, with the growth in earnings being dragged down by a collapse in Energy earnings and a stronger U.S. dollar.
- Bianco has full-year 2015 earnings estimated at \$118, similar to the 2014 calendar year when looking at current Index constituents.

**Multinational Nature of the S&P 500** Dissecting the impact of the strong dollar, Bianco cites the following statistics for the multinational nature of the S&P 500:

- One-third of S&P 500 [revenues](#) come from abroad.
- 40% of S&P [profits](#) are derived overseas.
- 25% of S&P profits come in foreign currency, primarily in the euro, pound, yen and Canadian dollar.
- why the disconnect between 40% of profits from abroad and 25% of profits exposed to foreign currency impact? A number of stocks earn profits abroad but are paid in U.S. dollars. Bianco points to the Energy sector, which conducts transactions in U.S. dollars, and enterprise-level technology sales, which he also believes happen in U.S. dollars.

**Impact of a Stronger USD on Earnings** The \$118 earnings estimate on the S&P 500 above is based on the assumption that the U.S. dollar will continue to strengthen into year-end—and reach a level of close to 1 compared to the euro (from levels around 1.11 per euro as of our conversation). Bianco estimates that for every dime the euro depreciates, a 10% move, U.S. earnings may drop 1%. If we consider all other currencies across the world, earnings will be impacted more meaningfully. Consider the Bloomberg Index on USD: Bianco estimates that a 10% appreciation in the dollar weighs on earnings by approximately \$3 (from the \$118 base earnings). Of the \$118 earnings estimated figure in 2014, he estimates that U.S. earnings took a \$5 hit from a stronger dollar and a \$7 hit from weaker oil prices. Bianco sees this as a one-time slowdown and sees earnings heading back up in 2016 with more reasonable growth rates.

**How Much Hedging Do Companies Employ?** Given the large amount of discussion on how the U.S. dollar impacts earnings, we asked Bianco how much hedging he sees corporations employing. His evaluation shows that companies tend to run hedges that are not much longer than their accounts receivables. Considering his estimate that 25% of S&P 500 profits come in the form of foreign currency, and that earnings number has not been hit nearly as badly, there is some degree of currency hedging going on. The key for Bianco, though, is that the hedges need to be rolled over

and that ongoing earnings are likely to take a hit. This presents an opportunity for companies to raise prices, but they have been hesitant to do so thus far. *This is an important point regarding the competitiveness of companies. Companies like BMW in Europe may have placed hedges on their U.S. dollar revenue exposure and do not see the full benefit from a weaker euro immediately. But once those hedges roll over, those companies become much more competitive and see future earnings support at the lower exchange rate—just as Bianco believes these U.S. companies see further headwinds to earnings with the stronger U.S. dollar—even if they employed hedges that protected earnings this year.*

**Margins Continue at 10%; Multiples May Rise** Despite the headwinds to profits, net margins are still hovering around 10%. Bianco believes these margin levels are sustainable. The S&P is trading at multiples closer to 18 to 18.5x trailing price-to-earnings (P/E) ratio on the Index level. Bianco believes that a multiple higher than 19 and 20 times is reasonable for many sectors other than Financials and Energy. He believes there is P/E upside if long-term interest rates stay lower for longer. He foresees the 10-Year Treasury yield trading back to 3% to 3.5% by the end of 2017 and is increasingly leaning in to the idea that if long-term real interest rates stay below 1% to 1.5%, a 20 multiple is likely. As a result, he is over-weight Health Care and Technology, since they have the best sales and earnings growth by far. *Read the Conversations with Professor Siegel Series [here](#). Unless otherwise stated, data source is Deutsche Bank Research. These comments represent the general investment analysis and economic views of David Bianco and are provided solely for informational purposes. These comments do not relate to any specific fund or portfolio.*

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## DEFINITIONS

**Valuation**: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

**S&P 500 Index**: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**Revenue**: Income that a company receives from its normal business activities, usually from the sale of goods and services to customers.

**Net profit**: A measure of profitability after accounting for all costs.

**Hedge**: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

**Multiple expansion**: Term for a rising P/E ratio, meaning that share prices are rising faster than earnings are growing.