

Inside S&P 500 Update

Raising S&P500 EPS Forecast as US Growth Outlook Tilts Higher

- We are raising S&P 500 EPS estimates in conjunction with a somewhat stronger U.S. economic growth forecast for 2013. Key policy risks remain unresolved amid an incomplete fiscal deal, but evidence suggests our outlook had been biased toward too much caution. The 2013 S&P 500 operating EPS forecast has been raised from \$108 to \$110 (+6.4%). Real U.S. GDP over the coming four quarters has been raised from +2.0% to +2.4% with the slowest growth near-term.
- We also expect S&P 500 dividend payments to rise nearly 25% over the coming two years as dividends lagged behind the earlier profit boom and tax rate uncertainty has been resolved.
- Near-term, the payroll tax and other tax increases should weigh on consumer demand. Delayed tax refunds could confuse this impact and result in a larger growth scare. More importantly, the fiscal battle of the coming two months might still result in greater 2013 fiscal tightening than our previous estimates. However, the New Year's decision to limit tax increases suggests a greater chance of postponing further immediate fiscal pain.
- Aside from slightly less fiscal restraint, demand strength in 4Q, including some recovery in business investment spending, suggests greater economic resilience in 2013. Profits from production continued to grow through a period of very moderate economic growth. Stronger economic activity, including a larger recovery in housing, should boost both profits and wages at the current stage of the expansion.

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Stronger Growth Means Stronger Profits

As discussed in recent weekly commentaries, the more resilient fourth quarter U.S. demand pace - coupled with the willingness of policymakers to postpone immediate fiscal reckoning - suggests a stronger outlook for U.S. growth and corporate profits in 2013 than our recent assumptions.

We expect real U.S. GDP growth to accelerate from 1 ½% in 1Q to about 3% in 4Q 2013 with growth sustained.

The new U.S. forecast shows real GDP growth of 2.4% over the coming four quarters compared to 2.0% previously (Please see the latest *U.S. Economics Weekly* for full discussion). Growth is expected to accelerate from just over 1 ½% in the current quarter to just over 3% by the fourth quarter (also see appendix 1). Coupled with even stronger indications from the fourth-quarter earnings reporting season than we highlighted last week (please see *Macro EPS Brief*, January 14, 2013), we have made moderate upward revisions to S&P 500 EPS estimates over the forecast horizon (see figure 1 and appendix 2).

Figure 1. Citi S&P 500 EPS Estimates and "Bottom Up" Consensus

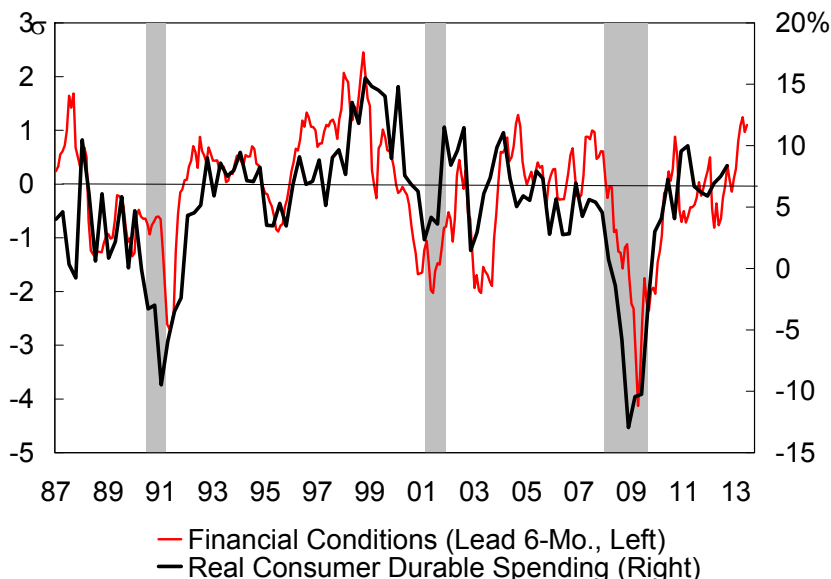
Y/Y%	U.S. Real GDP	4Q/4Q % Chg	S&P 500 Oper EPS level	% chg	"Bottom Up" EPS Consensus	% chg
2008	-0.3	-3.3	61.79	-26.8		
2009	-3.1	-0.1	62.05	0.4		
2010	2.4	2.4	85.28	37.4		
2011	1.8	2.0	97.82	14.7		
2012 e	2.2	1.8	103.40	5.7	102.75	5.0
2013 e	1.9	2.4	110.00	6.4	113.29	10.3
2014 e	3.1	3.3	115.50	5.0	125.91	11.1

Sources: S&P, Thomson Financial, Citi Research.

The changes reflect a balance of risks to the forecast that tilted somewhat higher since the "cliff avoidance" deal of January 1, once incorporating the more resilient U.S. data of 4Q. Considerable risk to the forecast remains in both directions. As these risks are largely policy-dependent, changes could be abrupt and unpredictable.

We have reduced the estimated pace of decline in government spending in 2013 as "sequestration" is likely to be blunted or postponed in our judgment. The forecast for real government outlays in 2013 has been "raised" to -0.7% from -1.2%. Yet spending, along with a resolution to the debt ceiling limit, remains an entirely unsettled matter. However, other elements of the outlook, including a favorable financial response to the tax rate compromise, suggest strengthening growth ahead (please see figure 2).

Figure 2. Citi Financial Conditions Index (lead 6 mo) vs Real Consumer Durable Spending Q/Q%

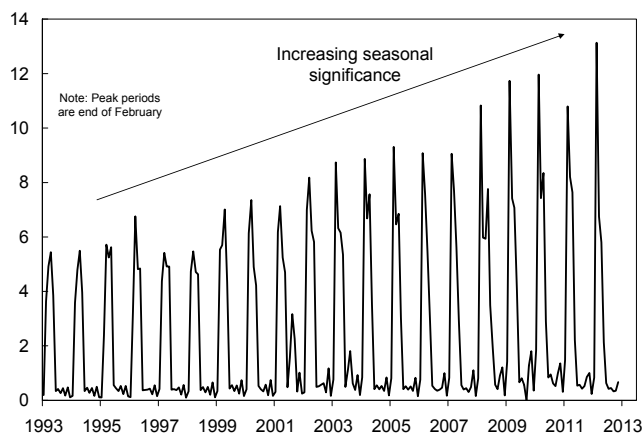


Source: BEA, Citi Research Note: FCI data monthly, consumer durable spending quarterly. The Citi Financial Conditions Index is a weighted average of corporate credit spreads, equity values, mortgage rates, money growth, the U.S. dollar's value and consumer energy costs measured as standard deviations from their trends.

Potential for confusion over the recovery pace in the near term.

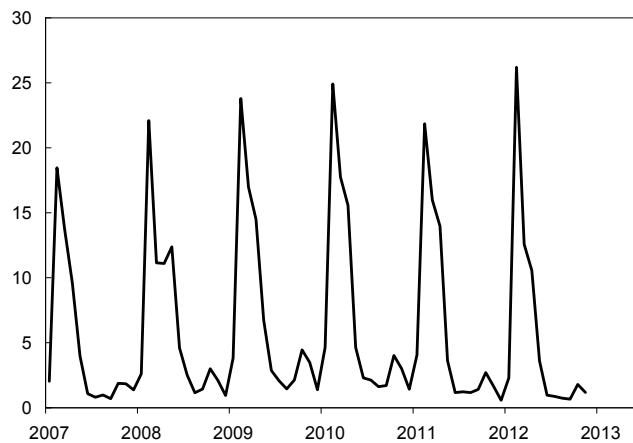
In the near term, the risk clearly remains that fiscal policy and related uncertainty could be a larger drag than even our previous assumptions. With a consumer unfazed by the fiscal cliff debate in the quarter past, actual tax increases close to half the pace of aggregate wage gains will drag on middle-income consumers in 1H, albeit discretely. We remain concerned that a potential short delay in the timing of annual tax refunds in the first quarter – which ordinarily peak at over \$100 billion in February – might exaggerate the apparent impact of the more fundamental rise in the payroll tax (see figures 3-4).

Figure 3. Gross Personal Tax Refunds paid by Check as % of Disposable Income, Monthly



Sources: U.S. Treasury, BEA

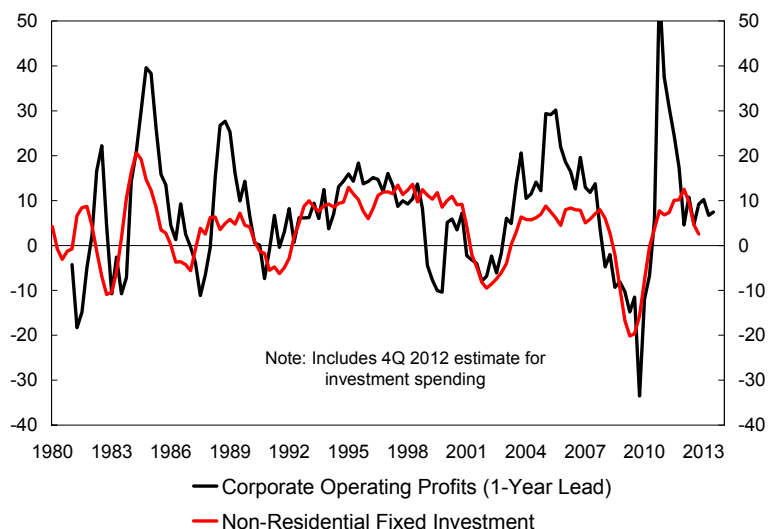
Figure 4. Total Gross Personal and Business Tax Refunds (all sources) as % of Disposable Income, Monthly



Sources: U.S. Treasury, BEA Note: peak period is end of February

The outlook for the U.S. economy over a period longer than the coming quarter or two appears far more solid. As figure 5 shows, the growth of corporate operating profits never faltered completely even amid the rather mediocre growth of 2012. Business investment fell modestly in the third quarter, and remained constrained in 4Q amid severe policy uncertainty, but fundamentals suggest a recovery at a stronger pace than 2H 2012.

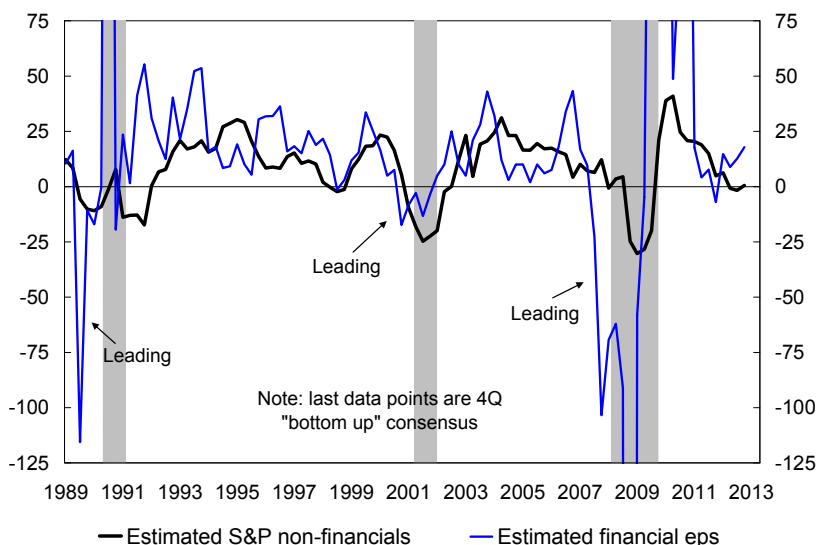
Figure 5. U.S. Corporate Operating Profits (1yr lead) vs Non-Residential Fixed Investment Y/Y%



Source: BEA, Citi Research

The composition of recent profit strength – with financial conditions easing and profits rising – suggests some reacceleration of non-financial profits within 2013 (see figure 6). A recovery in business investment suggests Industrial sector profits will regain strength.

Figure 6. S&P 500 Financial vs Non-Financial Operating EPS Y/Y%

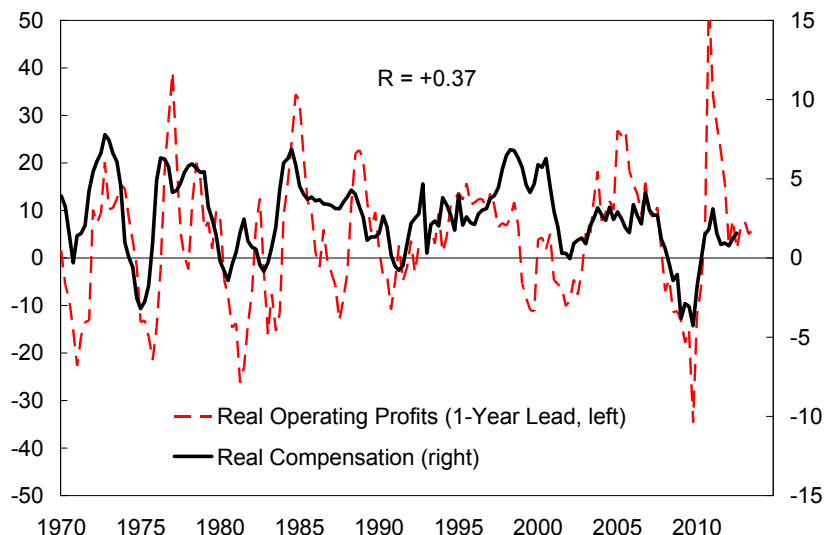


Source: S&P, Thomson Research, Factset, Bloomberg, Citi Research

Wages are *positively correlated* with corporate profits as the broader economy expands.

Stronger investment, like wages, holds back the *immediate* profits of firms engaged in the spending, but *boosts* the revenues and profits of other firms. While profit margins are already stunningly high in the U.S., compensation costs are not poised to immediately drag down profits in a stronger growth environment, as typical of some late cycle periods (see figure 7).

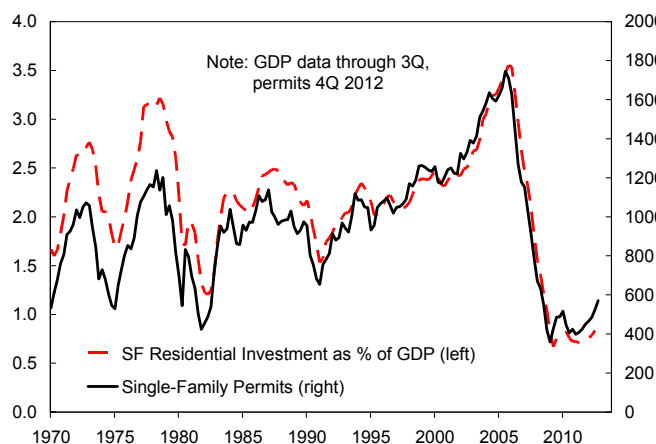
Figure 7. Real Corporate Operating Profits (1-yr Lead) vs Real Employee Compensation Y/Y%



Source: BEA, Citi Research

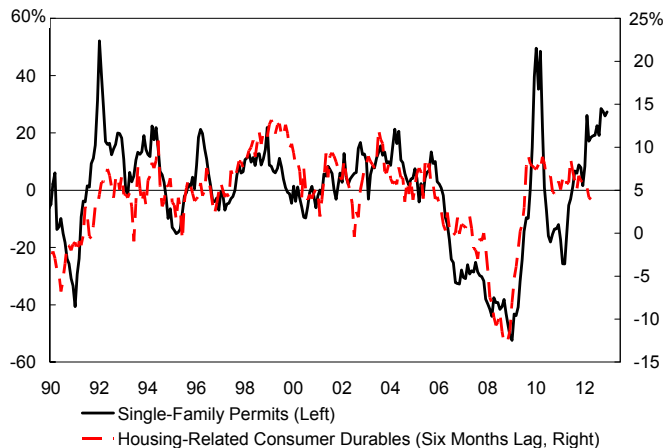
Lastly, even amid a multi-family (rental unit) construction boom, total residential investment remains less than half its level reached at the peak seven years ago. The 2H 2013 strength of higher value-added single-family residential building permits suggests an accelerating growth contribution from housing going forward, with spillovers to wider areas (see figures 8-9).

Figure 8. Single-Family Housing Permits Single-Family Residential Investment Spending as % of GDP



Sources: Census, BEA

Figure 9. Single-Family Permits and Consumer Spending on Housing-Related Durables (Six Months Lag), Y/Y%

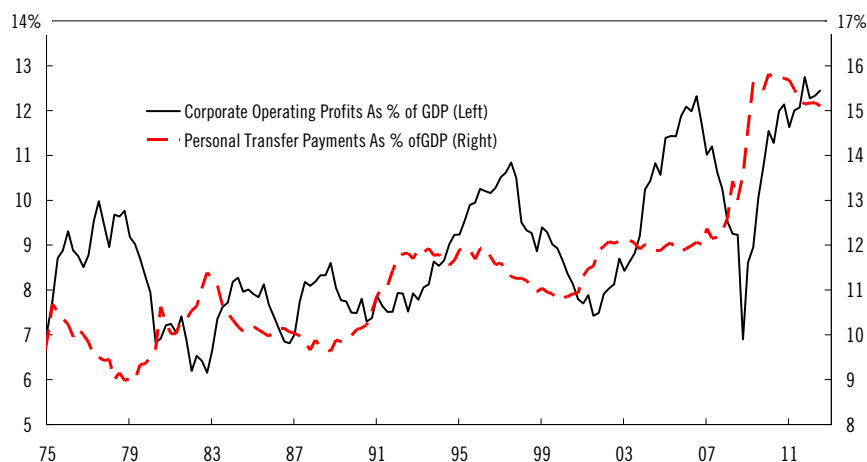


Sources: Census, BEA, and Citi Research. Note: Last data point for permits is Dec; consumer spending is Nov.

We expect a stabilization rather than decline in aggregate profit margins.

Our EPS forecasts essentially reflect a stabilization of profit margins with stronger internal growth absorbing the modest rise in national savings implied by fiscal tightening (see figure 10). Long-term risks of fiscal instability have been left completely neglected (please see "Bare Cliff Avoidance," January 2, 2013).

Figure 10. Corporate Operating Profits as % of GDP vs Government Transfer Payments to Persons As % of GDP

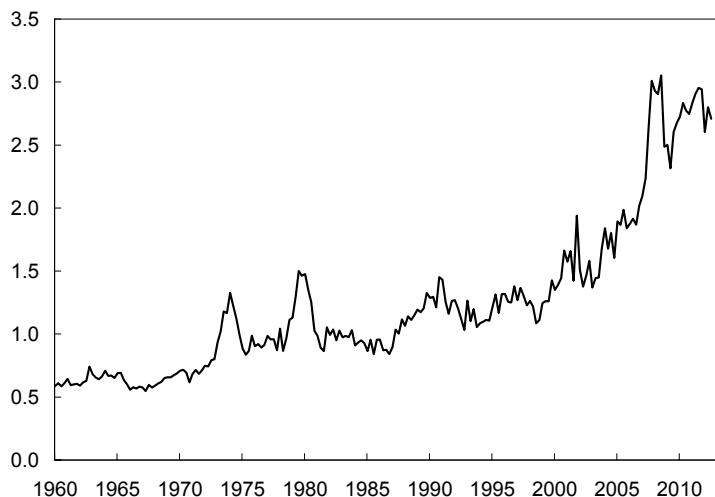


Source: BEA, Citi Research

There is clearly no assumption of a sharp reacceleration in EPS growth as seen earlier in the cycle. Business costs are the revenues of other firms, but they are still costs. EPS should grow close to revenues, slightly faster than nominal U.S. GDP, reflecting a somewhat different composition of revenues than the U.S. economy (more cyclical and growth oriented) and a trend of external penetration by U.S. firms (see figure 11). (Note: a revision of our industry sector EPS forecasts will be possible after more complete 4Q EPS results).

Among other uses of cash, dividend payments may grow at a surprisingly strong clip as recovery matures.

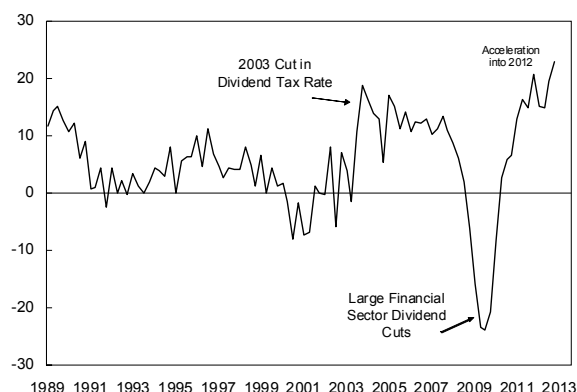
Figure 11. Net U.S. Corporate Profits Earned Abroad as % of U.S. GDP



Source: BEA

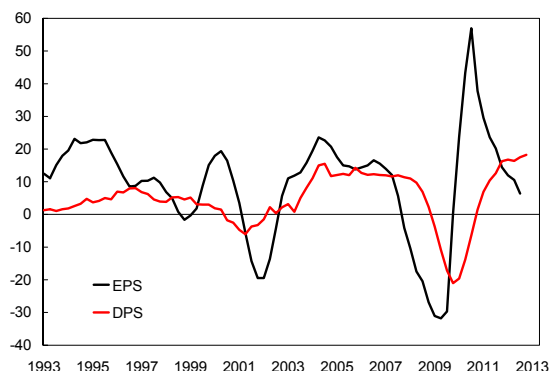
As a side issue, as we noted during the fiscal cliff debate, we believe dividend payments would be poised for historically strong increases if the maximum personal tax rate is limited to increases in other tax rates. The 20% maximum personal tax included in the budget agreement was far lower than the law would have allowed, and the sharp increases in profitability early in the cycle suggests growth in S&P 500 dividends per share of about 12% and 11% in 2013 and 2014. This would leave the DPS level in 2013 and 2014 at \$35 and \$39 respectively. This would also leave a 2014 yield on the current index price at 2.64% (see figures 12-13).

Figure 12. S&P 500 Dividends Per Share Y/Y%



Sources: S&P

Figure 13. S&P 500 Operating EPS and DPS Y/Y%, Four-Quarter Moving Avg Y/Y%



Sources: S&P, Thomson Financial

Appendix 1

Figure 1. U.S. Economic Outlook Highlights (Annualized Percent Change Unless Noted), 2012-14F

	2012F	2013F	2014F	2012		2013			
	4Q/4Q	4Q/4Q	4Q/4Q	3Q	4QF	1QF	2QF	3QF	4QF
Real GDP	1.8 %	2.4 %	3.3 %	3.1 %	0.7 %	1.6 %	1.9 %	2.9 %	3.1 %
Domestic Demand	1.8	2.4	3.3	1.9	1.5	1.2	2.0	3.1	3.2
Consumer Spending	2.0	2.3	3.2	1.6	2.4	1.2	1.9	3.0	3.1
Housing	13.7	20.2	17.8	13.5	12.6	14.5	21.1	22.6	22.0
Investment	2.7	4.5	6.3	-1.8	1.9	2.1	3.8	5.9	6.2
Exports	1.4	4.0	5.5	1.9	-5.5	3.5	3.6	4.3	4.6
Imports	0.9	4.2	4.9	-0.6	-1.5	3.5	3.7	4.8	4.9
Government	-0.7	-0.7	-0.1	3.9	-2.8	-0.9	-0.8	-0.6	-0.5
Inventory Change	-0.2	0.1	0.0	0.6	-0.4	0.5	0.0	0.0	0.0
Net Exports (Contrib.)	0.0	-0.2	-0.1	0.4	-0.5	-0.1	-0.1	-0.2	-0.2
Unemployment Rate (Pct, Q4)	7.8	7.5	6.9	8.1	7.8	7.8	7.8	7.6	7.5
PCE Deflator	1.5	1.7	2.1	1.6	1.3	1.0	1.9	2.0	2.0
Core PCE Deflator	1.5	1.6	2.1	1.1	0.9	1.4	1.6	1.8	1.7

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, and Citi Research.

Appendix 2

S&P 500 Earnings and Estimates

Annual Data:

	Pre-Write-off (Operating) Earnings (\$/Shr)	Year/Year Change (%)	Reported (GAAP) EPS (\$/Shr)	Year/Year Change (%)
Citi Estimates:				
2010	85.28	37.4	77.35	51.8
2011	97.82	14.7	86.95	12.4
2012	103.40	5.7	91.00	4.7
2013	110.00	6.4	97.50	7.1
2014	115.50	5.0	103.00	5.6
2015	121.00	4.8	108.00	4.9
2016	127.00	5.0	112.00	3.7

Quarterly Data:

Actual:

1Q07	22.71	9.6	21.33	8.3
2Q07	24.40	9.4	21.88	8.8
3Q07	21.31	-5.7	15.15	-29.4
4Q07	16.04	-28.5	7.82	-61.4
1Q08	18.96	-16.5	15.54	-27.1
2Q08	19.78	-18.9	12.86	-41.2
3Q08	17.49	-17.9	9.73	-35.8
4Q08	5.56	-65.3	-23.25	-397.3*
1Q09	12.83	-32.3	7.52	-51.6
2Q09	16.03	-19.0	13.51	5.1
3Q09	16.39	-6.3	14.76	51.7
4Q09	16.80	202.2	15.18	165.3*
1Q10	19.71	53.6	17.48	132.4
2Q10	21.48	34.0	19.68	45.7
3Q10	21.75	32.7	19.52	32.2
4Q10	22.55	34.2	20.67	36.2
1Q11	23.50	19.2	21.44	22.7
2Q11	24.14	12.4	22.24	13.0
3Q11	25.65	17.9	22.63	15.9
4Q11	24.55	8.9	20.64	-0.1
1Q12	25.60	8.9	23.03	7.4
2Q12	25.84	7.0		
3Q12	26.00	1.4		

Forecasts

4Q12	25.96	5.7	*absolute value change	
1Q13	26.88	5.0		
2Q13	27.47	6.3		
3Q13	27.55	6.0		
4Q13	28.10	8.2		
1Q14	28.40	5.7		
2Q14	28.90	5.2		
3Q14	28.95	5.1		
4Q14	29.25	4.1		

Appendix A-1

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