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The equity bull market is intact

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Two years ago, in January 2020 — a period sometimes called "BC" (before Covid-19) — we observed that the S&P 500 Index had eclipsed 3,000 and a path was paved for it to reach 5,000 in three to five years. Last January, one monumental year later, we described the pandemic as a "springboard" for many stocks and believed the S&P could reach that 5,000 milestone even sooner. Another January is upon us, along with many uncertainties, but we just finished yet another year of robust equity performance. As we begin 2022, where does our projection stand?

The S&P 500 is already within 7% of that 5,000 target. So is it overvalued? Is it time for a pause or even a retreat? For sure, there are newer key variables, such as inflation, the Federal Reserve taper, and a new Covid variant that poses a threat to advancing equities. Yet, a foundation for strong performance — corporate earnings growth and low nominal interest rates — remains intact. This, we believe, will power the S&P 500 past 6,000 by 2024.

Inflation and Omicron: Critical variables in 2022's first half

Rising inflation has been a potential party spoiler for equity markets. Some inflation is often an elixir for stocks, as discussed in our April 2021 Equity Insights. However, inflation sustained higher than 4% has been a clear drag on equity indexes. With recent monthly inflation prints above 6%, Fed Chair Jerome Powell insisting on dropping "transitory" from the inflation lexicon, and the Fed more keen on raising interest rates, concern is understandably heightened. If high inflation were to persist, spurring a rise in long-term interest rates, this would be a clear headwind for stocks, in the form of downward pressure on price/earnings multiples.

As for the pandemic, we are clearly still living with Covid-19. From an investing perspective in 2021, the equity market had largely moved on as the Delta variant seemed to be peaking. But the surprising new variant put pandemic worries back in the forefront. Omicron renders vaccines less effective and has quickly become the dominant strain globally, with cases exceeding prior peaks. Hopefully, the narrative proves true that Omicron is less severe than previous variants. But it is too early to determine its impact with only six weeks of data. With this uncertainty and hospitals starting to reach capacity, many jurisdictions are again restricting activity. Some individuals are choosing more isolated endeavors rather than traveling, eating out, or commuting to offices.

Variant could ease inflationary pressure

Coincidently, Omicron is an antidote for inflation. It dulls the edge of the sharp economic rebound we've experienced globally, which should help mitigate the pressure of upward prices. Supply chain bottlenecks and other logistic challenges should also start to ease. Many commodity prices will likely retreat, as we've already seen with chemicals. Moreover, the labor supply crunch might see some relief as businesses adjust to a wave of Omicron.

Looking at past inflationary periods can also provide perspective and some evidence that inflation can indeed be transitory. For example, in the commodities boom of the early 2000s, oil prices surged from $20 to $120. This was combined with a housing market bubble and low unemployment but did not result in meaningful inflation. Going forward, we see inflation trends retreating to 2%–4%. This is a bit higher than it has been for most of the past two decades, but comfortably below the current spike. This should be well received by equity markets.

TINA forces remain powerful: The advantage over bonds

Contained inflation is one of several important factors that should help sustain P/E ratios that are higher than the historical average. Lower inflation takes pressure off long-term interest rates, which supports higher equity valuations. Even with last year's inflation spike, the nominal yield on the 10-year U.S. Treasury note is 1.5% (as of December 22, 2021). The real yield on the 30-year U.S. Treasury is negative, at –0.4%, according to Bloomberg. This compares with an over 3% total return for the S&P 500 Index (1.3% dividend plus share repurchases). TINA forces — "there is no alternative" — remain powerful, motivating investors to choose the higher return potential of equities.

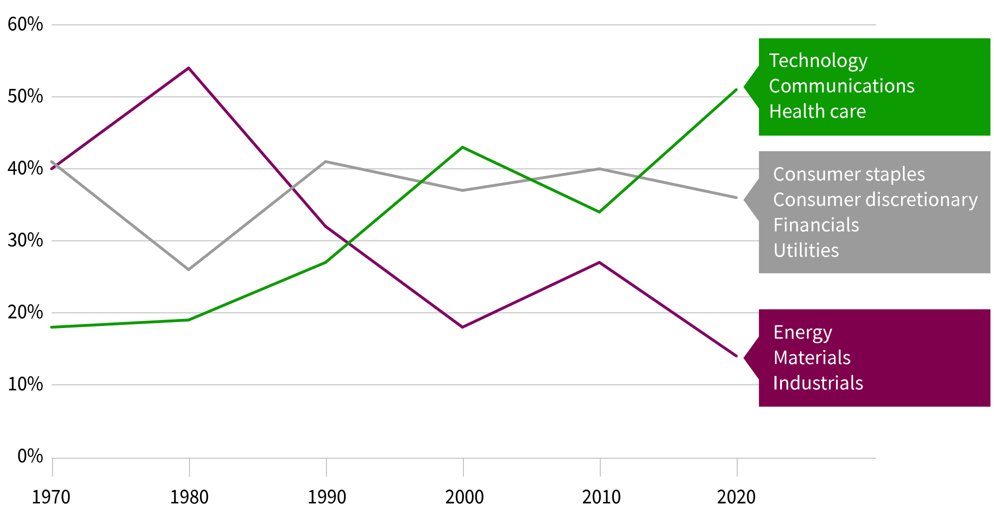
A very different S&P today

Another powerful force for equity valuations and performance is the composition of the S&P 500 Index, which has changed meaningfully over the past several decades. For example, in the 1970s, capital-intensive, cyclical companies in industries such as energy, materials, and industrials made up a significant portion of the index. Today, much more of the S&P consists of high-quality fast-growing companies that tend to be resilient in times of economic turbulence. They are higher-margin and capital-light businesses in sectors such as technology, communications, and health care, where higher P/E multiples are warranted.

Similarly, the structure of the index is meaningful. Today, the 10 largest companies comprise 30% of the S&P 500 Index, which is comparable to the index composition in the early 1970s. Both today and in the 1970s, those top 10 companies, while very different types of businesses, could be described as market-share takers and proven fast organic growers.

The changing composition of the S&P 500

Higher-margin, capital-light businesses make up more of the index today



Source: Putnam research. The chart shows the change in the combined weighting of each group over 10-year periods. Real Estate is included within Financials.

The pandemic could continue to be a headwind throughout 2022. However, since the onset of the pandemic, many of these large S&P companies, particularly in the technology sector, have proven to be less sensitive to economic swings. In fact, many have not been hurt by pandemic-related trends and may have actually benefited from them, due to continuous productivity-enhancing products and services. In 2021 (as of December 22, 2021), our "BATMANFAV" index — U.S. companies with market capitalizations of over $500 billion — gained 35.6% versus 25.5% for the S&P 500 Index overall and 21.8% for the S&P 500 excluding BATMANFAV. (BATMANFAV refers to the nine companies in the S&P 500 with a market capitalization of over $500 billion: Berkshire, Apple, Tesla, Microsoft, Amazon, Nvidia, Facebook, Alphabet, and Visa).

Many of today's leading companies are asset-light, high-margin businesses with fewer cyclical end markets.

Equities are powered by earnings growth

Despite the challenges of inflation fears and Covid-19, earnings growth was a key driver of equity market performance in 2021. Businesses are operating more efficiently, revenue growth is resilient, and margins are expanding. As mentioned, the leading companies are asset-light, high-margin businesses with fewer cyclical end markets. For these reasons and more, we believe earnings will continue to be a significant driving force for equity returns in 2022.

According to S&P Dow Jones Indices, just before the pandemic, in 2019, S&P 500 earnings per share were $157. For 2021, EPS rose to an estimated $202. This has been the big surprise. Despite the economic disruption caused by the global pandemic, S&P earnings will have grown much faster than expected at 30% over the preceding two years. As the economy continues to rebound over the next two years, we believe a strong earnings growth trajectory is likely to continue.

As an example, if we see annual earnings growth of 10% per year, a slower rate than we've experienced recently, we expect about $270 per share of S&P 500 earnings in 2024. Applying a P/E multiple of 22.5x — which we believe is warranted given low interest rates and the higher-quality composition of the S&P 500 — would bring the S&P 500 Index past 6,000 by 2024. This is more than 25% higher than its current level.

S&P potential for 2024

P/E	EPS growth		
	15%	**10%**	**5%**
27.5x	8,448	7,394	6,431
25.0x	7,680	6,722	5,846
22.5x	6,912	6,049	5,261
20.0x	6,144	5,377	4,677
17.5x	5,376	4,705	4,092

A strong earnings growth trajectory could power the S&P 500 past 6,000 by 2024.

Source: Putnam research. For illustrative purposes only. This data is not intended to forecast or predict future events and is not intended to be projections of performance. Like the output of any model, this analysis may be subject to limitations, is not guaranteed, and may produce results that diverge from any past or future results.

In our view, despite the elongated pandemic and fears about inflation, the bull market remains intact, supported by strong earnings growth and higher-than-expected P/E multiples applied to those earnings.

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