Welcome to Trump Casino

Tim Farrelly | farrelly's | 11 April 2017

The S&P500 is trading at a PE ratio of 24.1 times trailing earnings – which is much higher than the historical norms of 15 to 17 times EPS. Of course, the market is expecting a big pick-up in earnings from Trump's business friendly tax cuts, deregulation and an infrastructure spending boom. But will it be enough? It is interesting to see what level of EPS growth we'd need to see in the next five years to justify these sorts of frothy valuations.

I have calculated the growth in EPS that is required over the next five years to give an 8% total return from US equities in three scenarios: if PE ratios in five years are a modest 15 times earnings; a speculative 20 times earnings; or, somewhere in between.

Figure 1 shows the EPS growth required in each scenario. Even in the high PE scenario, EPS must grow by 61% or 10% per annum over the next five years in order for US equities to return 8% per annum. If the PE ratio retreats to around 15 times trailing earnings, EPS growth of 115% or 17% per annum is required over the next five years.

Figure 1: S&P500 – EPS growth needed to deliver 8%pa return

	Low PE	Med PE	High PE
US PE in 2022	15.0	17.5	20.0
Required EPS Growth (%)	115	84	61
Required EPS Growth (%pa)	17	13	10

Source: S&P, farrellys. 1. PE now 24.1. 2. Target return 8% pa

To put those growth numbers into historical perspective, S&P500 earnings have grown at 5.1% per annum over the past 30 years, 4.7% per annum over the past 20 years and just 1.7% per annum over the past 10 years.

Is EPS growth of 10% to 17% per annum possible? Yes – but it is a stretch. The new administration and US corporates will need to make every post a winner to get there.

Welcome to Trump Casino. I hope you're feeling lucky.

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