

# Harvesting the truth

## Let's get the facts straight

There is always an abundance of generalized notions circulating amongst investors regarding the economy and the stock market. In most cases they are true at some level, but are often exaggerated or misunderstood by the general investing community. We thought an in-depth look at the details underlying these theories would make for some good holiday conversation, and may help investors decide whether or not such ideas are worth bringing with them into 2010.

### Demystifying 5 common investor misperceptions

Below are 5 common investor misperceptions that we hear as reasons that the market rally is unsustainable. Inside this report, we look at each one in detail to "separate the wheat from the chaff."

1. "The consumer is 70% of US GDP"
2. "China is dependent on exports to US"
3. "Nothing is made in the US anymore"
4. "The US economy is grossly overlevered"
5. "Profit margins must mean-revert lower"

## Equity Strategy

Equity Strategy | United States  
25 November 2009

# Bank of America Merrill Lynch



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### S&P 500 Data

Price	1,109
12-Month Target	1,275
Date Established	23-Nov-2009
52-Week Range	667 - 1,114
Market Value (\$tn)	9.77

### Estimates (Current Constituents)

	Pro-Forma EPS	P/E
2007A	86.84	12.8
2008A	68.46	16.2
2009E	63.00	17.6
2010E	73.00	15.2
2011E	83.00	13.4
<b>Normalized 2010E</b>	<b>79.00</b>	<b>14.0</b>

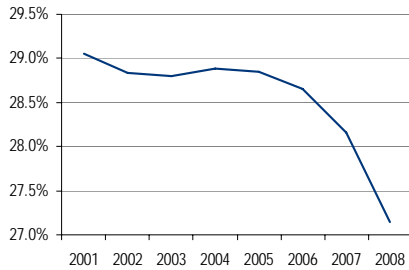
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Refer to important disclosures on page 11 to 12.

## 1. "The consumer is 70% of US GDP"

Personal Consumption Expenditures (PCE) do indeed make up about 70% of US GDP, making total US PCE or household spending about 15% of the global economy and bigger than the entire Chinese economy (Chart 2). How then can the US economy and the rest of the world grow with the US consumer in retrenchment? To answer that, we take a closer look at the composition of PCE.

**Chart 1: Retail Sales\* as a % of GDP**



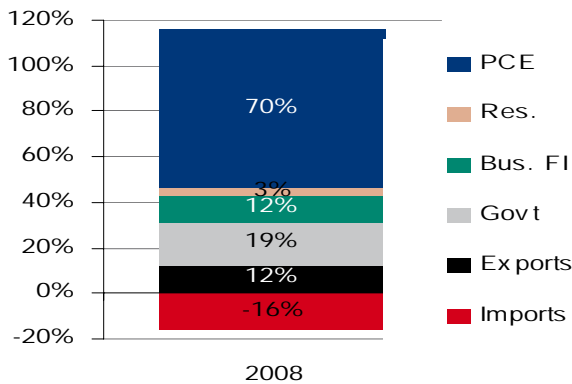
Source: BofA Merrill Lynch US Equity Strategy, Census Bureau  
\* excluding supermarket and other grocery stores

### Only 25% of personal consumption is discretionary spending

What many investors fail to realize is that the majority of PCE is not made up of iPods, handbags and dinners at the local Outback Steakhouse. Instead, about 75% of household spending is non-discretionary in nature, such as housing, healthcare, energy, food eaten at home and other household staples. We think it is worth noting that most of these non-discretionary items are made in the US.

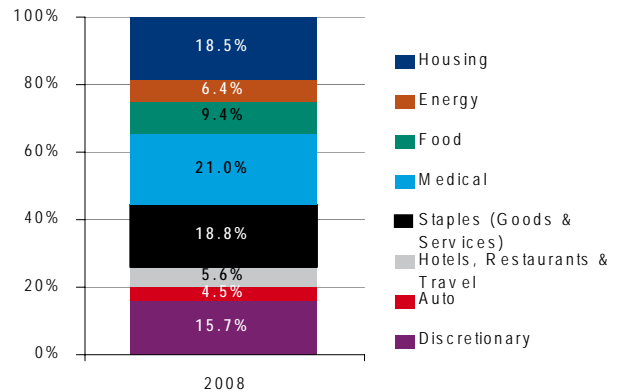
While there is certainly room to reduce non-discretionary spending, the areas of consumer spending feeling the brunt of higher household saving rates are cars, travel, apparel, restaurants and other discretionary items that make up about 25% of PCE, equivalent to 20% of US GDP (Chart 3) or less as many of these non-discretionary items are imported. 20% of US GDP is still significant, but far less than the 70% figure that makes the headlines. Another figure sure to make the headlines this time of year is retail sales. The contribution to US GDP from retail sales has actually been declining for over ten years. Excluding supermarkets, retail sales are under 40% of total consumption, or about 25% of GDP (Chart 1).

**Chart 2: Share of US GDP (%)**



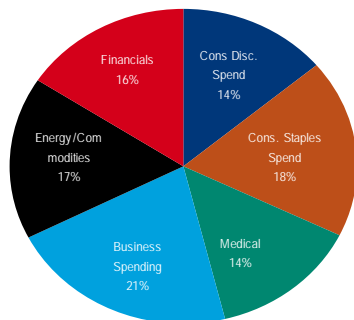
Source: BofA Merrill Lynch US Equity Strategy

**Chart 3: US PCE by type: only 25% is discretionary spending**



Source: BEA, BofA Merrill Lynch US Equity Strategy

**Chart 4: Share of S&P EPS by end-markets**



Source: BofA Merrill Lynch US Equity Strategy

### Discretionary consumption is less important to the S&P 500

We estimate that the S&P 500's total exposure to household spending is 40%, with discretionary personal consumption making up less than 15% of earnings (100% of Discretionary; 30% of Info Tech; 25% of Staples). The mix of the S&P 500 is more geared toward business spending and global consumption (especially commodities) than is US GDP (Chart 4). Thus, we remain bullish on S&P 500 earnings growth in the face of a sluggish consumer spending recovery in the US.

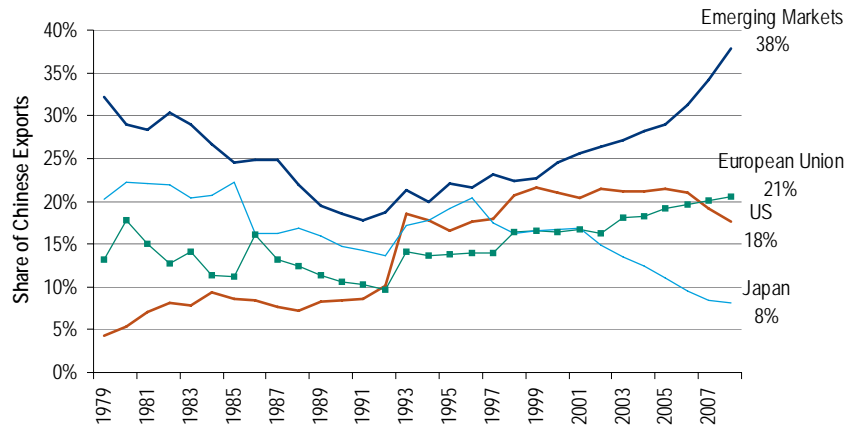
## 2. "China is dependent on exports to US"

The share of China's exports headed to EM is growing rapidly, while the share of exports to the developed markets is shrinking.

### Emerging markets drive China's export economy, not US

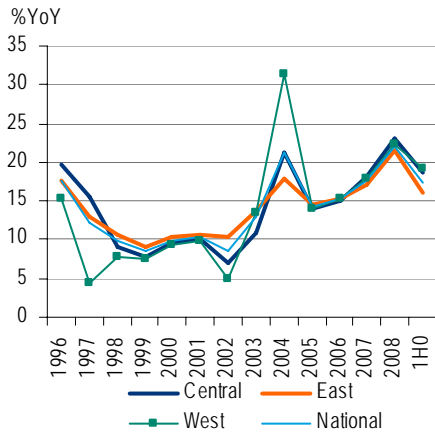
Although the US remains the largest single country consumer of China's exports, that share is less than half that of emerging markets. Not only that, but the share of China's exports headed to emerging markets is growing rapidly, while the share of exports to the developed markets such as the US, Hong Kong and Japan is shrinking (Chart 5). Europe now imports more from China than the US.

Chart 5: EM is a growing share of Chinese exports



Source: BofA Merrill Lynch US Equity Strategy, International Monetary Fund

Chart 6: Retail sales by region



Source: CEIC, Wind and BofA Merrill Lynch calculations

### And China's domestic demand is on the rise

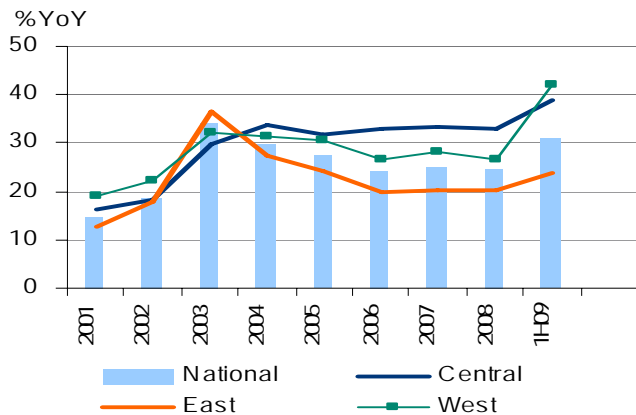
The secular emergence of China's economy appears to have won out over the cyclical impact of the global recession. Our China Economist Ting Lu estimates near-9% GDP growth this year and forecasts even higher growth in 2010. But beneath the surface, Lu notes some interesting structural shifts that are changing the nature of China's economy ([China Economics, 9 September 2009](#)).

China's less-developed and less externally-focused economy of West China has benefited from three key factors:

- the longstanding national strategic plan to develop this region,
- the shift of companies' production facilities toward lower-cost regions and
- the stimulus package (Chart 7).

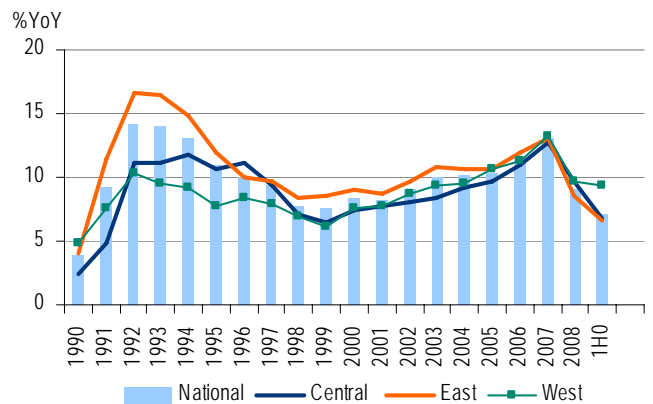
As a result, growth in West China has surpassed that of East China over the last two years (Chart 8). The increasing contribution of the West to China's overall economic growth is a sign that domestic demand is becoming an expanding driver of China's economy, while its export-dependence is gradually shrinking (Chart 6).

Chart 7: Investment growth by region



Source: CEIC, Wind and BofA Merrill Lynch calculations

Chart 8: West now grows faster than the rest of China

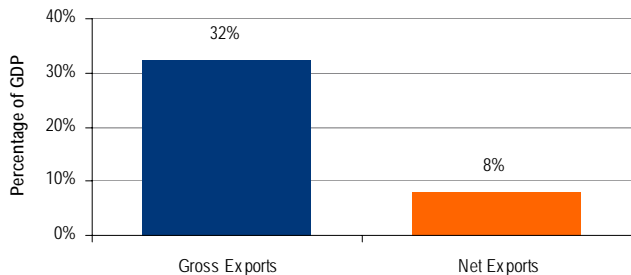


Source: CEIC, Wind and Banc of America Securities - Merrill Lynch calculations

### Don't forget that China also imports goods

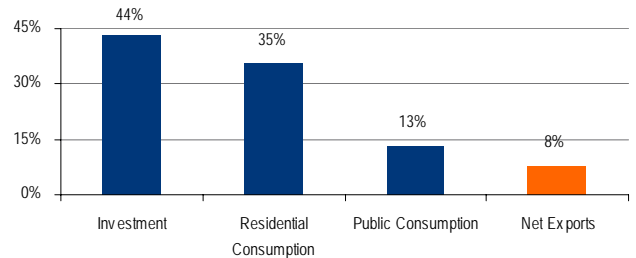
While gross exports represent 32% of China's GDP, it is its net exports (8%) that help its domestic GDP growth and it is its gross imports (24%) that contribute to the growth of the rest of the world (Chart 9). Currently, China's net exports are the smallest contributor to GDP and the previously mentioned investments in the inland regions should cause it to shrink even further over time (Chart 10). This shift toward a balanced current account should allow the region to contribute increasingly more to global growth.

Chart 9: Net exports are what drive GDP growth, not gross exports



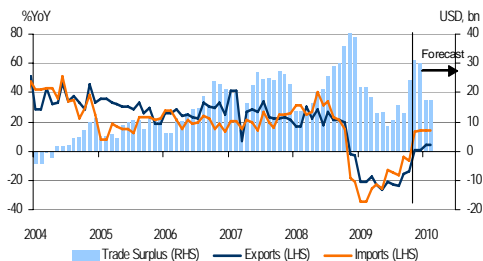
Source: BofA Merrill Lynch US Equity Strategy, China National Bureau of Statistics

Chart 10: Net exports is the smallest contributor to GDP



Source: BofA Merrill Lynch US Equity Strategy

Chart 11: China exports are poised to rebound



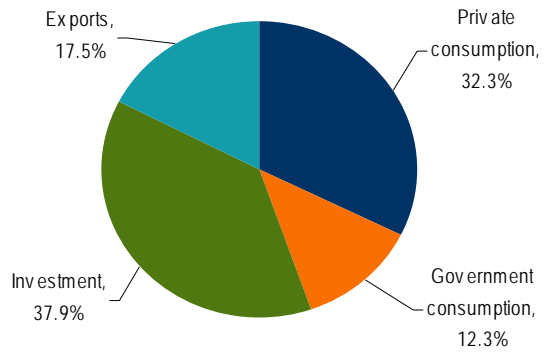
Source: CEIC, BofA Merrill Lynch calculations

### Value added exports are half the value of gross exports

Much of the value of China's exports is actually imported as part of China's supply chain. For instance, a Chinese manufacturing company may import components from other Asian countries and assemble the product in a plant in China. In such cases, the value of the parts and labor added by China's part in the supply chain would be much less than the value of the final product. In fact, [Lu's analysis](#) suggests that domestic value added (DVA) exports only represent approximately 14% of China's GDP, but to be more conservative he uses the 17.5% figure quoted in the academic works of He and Zhang (*How dependent is the Chinese economy on exports and in what sense has its growth been export-led?*, He and Zhang, 2008, HKMA Working Paper 14/2008). This implies that every percentage point drop in export growth would result in only a 17.5bp drag on GDP growth. Furthermore, with exports set to rebound in 2010, this would be a positive for Chinese GDP, not a negative (Chart 11).

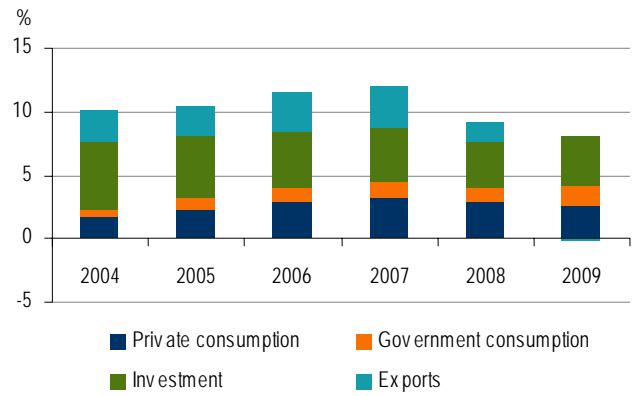
25 November 2009

**Chart 12: Domestic value-added expenditure in China in 2008**



Source: CEIC and Merrill Lynch calculations

**Chart 13: Contribution to GDP growth by expenditure**



Source: CEIC and Merrill Lynch calculations

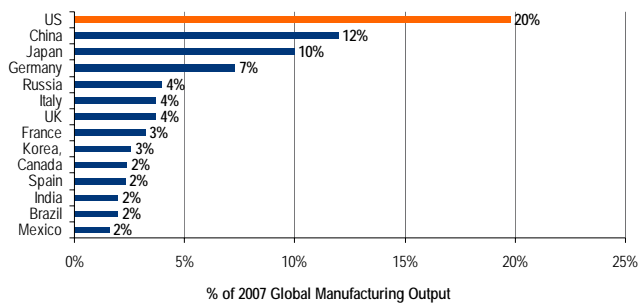
### 3. "Nothing is made in the US anymore"

The US is still the global manufacturing powerhouse...

#### The US is still the global manufacturing powerhouse

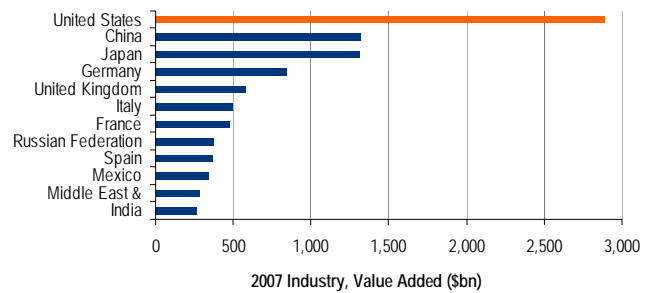
It is true that the mix of the US economy is shifting away from manufacturing toward services, but this shift is very gradual. In fact, Services still only make up about 30% of our gross exports, while the remaining 70% that is Goods has decreased less than 1.5ppt over the last 17 years. So, the idea that the nothing is made in the US anymore is simply untrue. In fact, the US is still the largest manufacturer by a long shot, making up 20% of the world's total manufacturing output (Chart 14). Furthermore, when focusing on the value added (as defined by the World Bank), the US contributes more than double the production of the next largest producer, China (Chart 15).

**Chart 14: The US still ranks #1 in manufacturing output**



Source: BofA Merrill Lynch US Equity Strategy, United Nations

**Chart 15: And more than double China's value added production\***



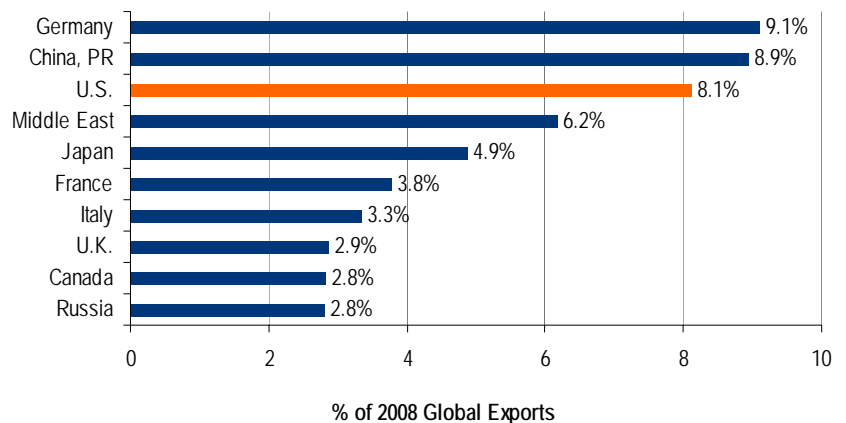
Source: BofA Merrill Lynch US Equity Strategy, World Bank

\* Value added in industry includes mining, manufacturing, construction, electricity, water, and gas (ISIC divisions 10-45). Value added is the net output of a sector after adding up all outputs and subtracting intermediate inputs.

#### And the US is a leading global exporter

The US fell from its top spot as the global leader in gross exports in 2002, but remains firmly in the top 3 alongside Germany and China (Chart 16).

**Chart 16: The US still ranks #3 in global exports**



Source: BofA Merrill Lynch US Equity Strategy, International Monetary Fund

...and a leading global exporter.

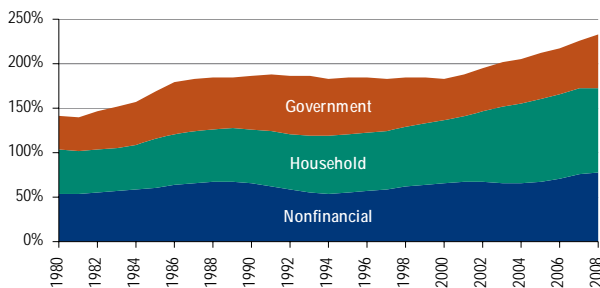
## 4. "The US economy is grossly overlevered"

### The credit bubble was concentrated in the household sector

As we noted in our recent note, *Turning Japanese*, the US credit bubble was primarily a function of household leverage and concentrated subprime credit risk at financial institutions of systemic importance (Chart 17). Therefore, unlike Japan's Lost Decade, where the need for extensive corporate balance sheet repair hobbled Japan's economy and stocks, the balance sheets for the US nonfinancial sector remain quite healthy. This is particularly true for the S&P 500 ex-Financials universe, in which the companies tend to be larger and better-capitalized than the rest of the economy. The net debt/market cap of the S&P 500 Industrials index was 16% in 2008, down significantly from 25% levels seen in the 80s. And we note that today is a lower interest rate environment (Chart 19).

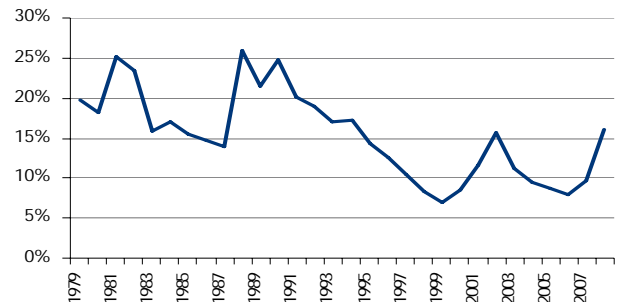
The balance sheets for the US nonfinancial sector remain quite healthy.

Chart 17: Nonfinancial Debt to GDP



Source: BofA Merrill Lynch US Equity Strategy, Bureau of Economic Analysis

Chart 18: S&P 500 Industrials Net Debt / Market Equity



Source: BofA Merrill Lynch US Equity Strategy, S&P

In aggregate, credit defaults are a net positive for household balance sheets and a net negative for bank balance sheets

### Rising credit losses will reduce household debt

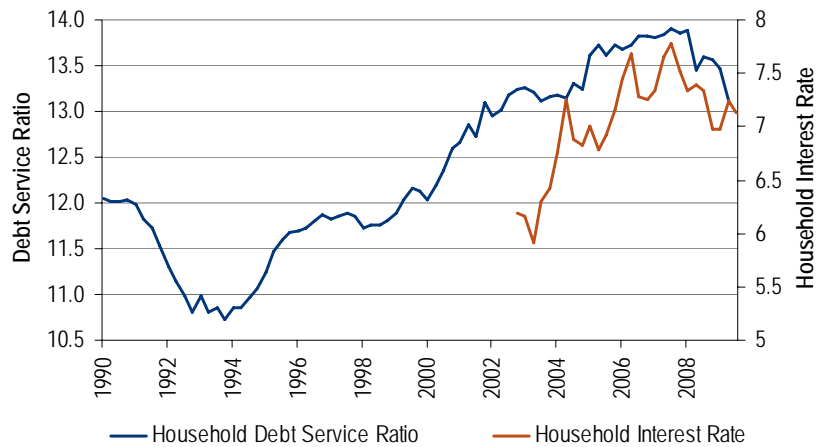
While the increasing number of delinquent and defaulting loans results in an increasing amount of charge-offs on bank balance sheets, the silver lining is that this also results in lower household debt levels. While bankruptcy is certainly an unpleasant situation for individual households, in aggregate such transactions are a net positive for household balance sheets and a net negative for bank balance sheets. Remember, the reason that debtors default is because their (relevant) assets are not enough to cover their liabilities. That shortfall is the cost that lenders are forced to eat. The banks know that this is coming, which is why they are over-reserving and taking the hit to earnings today in anticipation of further increases in future default rates. We estimate that \$1-2tn of household debt will disappear by 2011 yearend as credit costs to banks and credit investors. In addition to the lower debt levels from bankruptcies and workouts, households have also been proactively lowering their leverage through more traditional means of debt repayment. This has been a key driver of the rise in the personal savings rate since April 2008.

The combination of lower debt levels and lower interest rates will continue to reduce the burden on households.

### Households are also benefiting from lower interest rates

The interest rates that households are paying have fallen by nearly 100bp since the peak in August 2007. The combination of lower debt levels and lower interest rates has reduced the household debt service ratio from 13.9x to 13.1x over that same period (Chart 19). We expect that this trend will continue as households continue to pay down debt (and default) and interest rates remain low.

Chart 19: Household Debt Service Ratio vs. Household Interest Rate



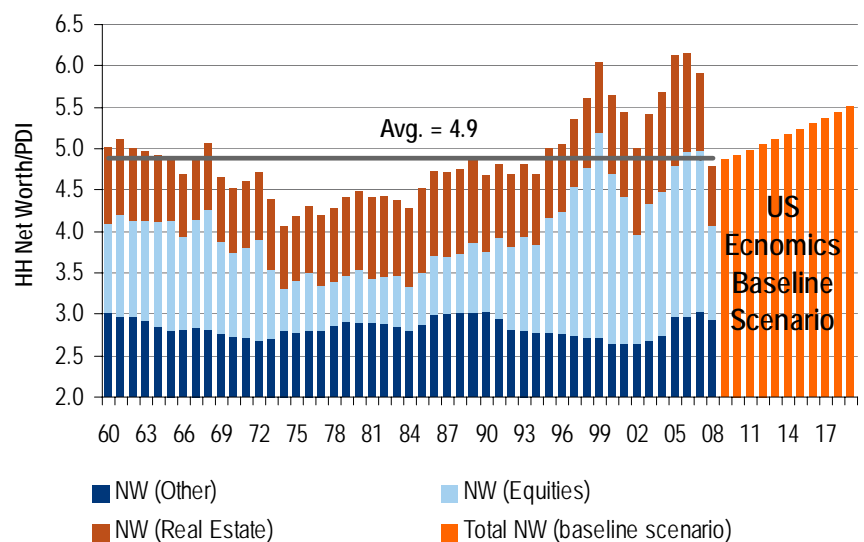
Source: BofA Merrill Lynch US Equity Strategy, BofA Merrill Lynch US Economics, Federal Reserve Board

The household net worth to personal disposable income ratio is already in line with its historical average and well above its level during almost all of the 1970s and 1980s

### And perhaps US households can grow into their debt

According to the US Economics team, the impact of household balance sheet repair on future consumption is greatly exaggerated and oversimplified ([Economic Commentary, 9 October 2009](#)). Their analysis suggests that households can grow into their debt levels by allocating some of their savings toward asset accumulation rather than solely through paying down debt. The report argues that this could be accomplished through an increase in the personal savings rate – from 3% today – to between 5-10% while allocating just 20% of the new savings toward buying assets (with the remaining 80% going toward paying down debt). This scenario would only result in a moderate drag on consumer spending growth of 0.25-0.75ppt per year. We also note that the household net worth to personal disposable income ratio is already in line with its historical average and well above its level during almost all of the 1970s and 1980s (Chart 20).

Chart 20: The baseline scenario: cutting debt



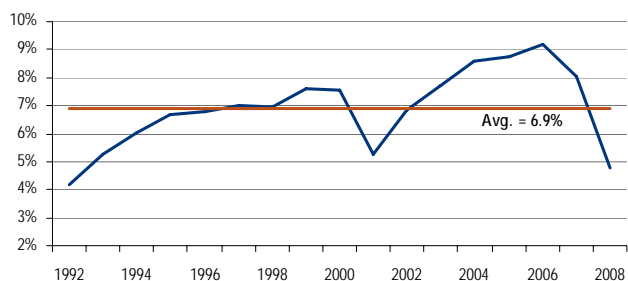
Assumes a linear movement in the savings rate to 5%  
Source: BofA Merrill Lynch, Federal Reserve

## 5. "Profit margins must mean-revert lower"

### Mean reversion would suggest HIGHER margins from 2009

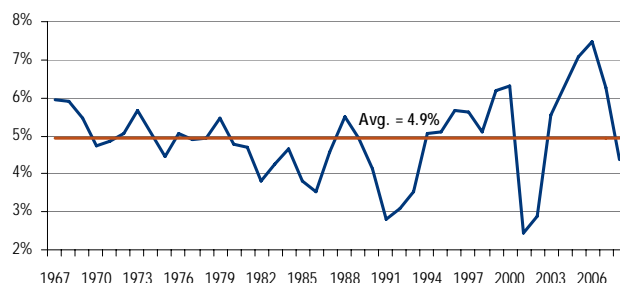
In 2008, net margins for the S&P 500 dropped to their lowest level since 1992, so 2008-2009 margins are not high by any standard. However, the peaks of the previous cycle were record margin levels owing to two factors: (1) S&P 500 non-financials benefited from lower effective tax rates, interest expense, higher commodity prices and more profitable foreign operations. (2) Financials earned unsustainably peaked margins due to increased leverage and other risk taking. We believe that the non-financial margins of the S&P 500 will return to the levels achieved in 2006-2008 by late 2011 or 2012. But we do not believe that financial margins can return to peak levels. Nevertheless, financial margins should improve from the very depressed 2009 levels through 2011.

Chart 21: S&P 500 Net Margin



Source: BofA Merrill Lynch US Equity Strategy, Standard & Poor's

Chart 22: S&P 500 Industrials Net Margin



Source: BofA Merrill Lynch US Equity Strategy, Standard & Poor's

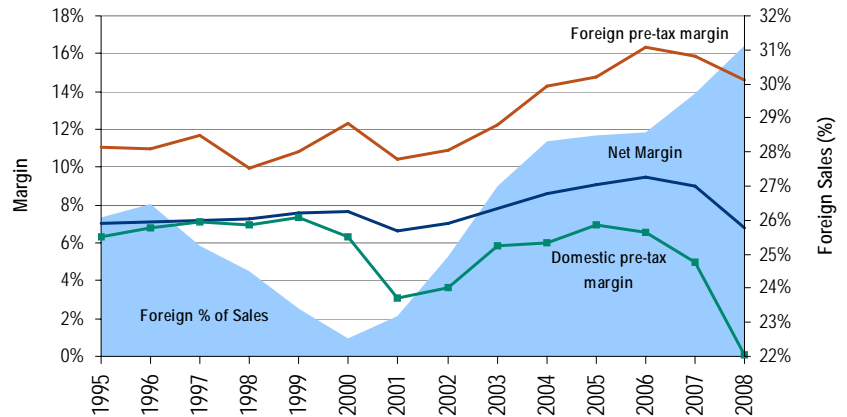
The rise in S&P 500 margins was not just due to the credit bubble in financials, but also a secular shift driven by global growth.

### S&P 500 foreign profits are higher margin and growing faster

Not only are [foreign pre-tax margins higher than domestic margins](#), but foreign taxes rates are significantly lower, resulting in an even greater disparity between margins on an after-tax basis. Add to that the growing share of revenues coming from outside the US and it becomes increasingly evident that the rise in S&P 500 margins was not just due to the credit bubble in financials, but also a secular shift driven by global growth (Chart 23). Our Economic team's above-consensus forecast for foreign GDP growth of 4.5% and 4.8% for 2010 and 2011 are important drivers of our view that S&P 500 EPS growth that will outpace the US economic recovery.

We expect S&P 500 top-line growth in 2010 and 2011 to be led by [Technology](#), [Energy](#), [Industrials and Materials](#). The revenue outlook for these sectors is encouraging due to their foreign GDP as well as their business spending and commodity production exposure and limited consumer exposure. Because these four sectors have very high operating leverage, moderate index sales growth led by these sectors should produce strong incremental margins and profit growth. Our S&P 500 net margin assumptions are 7.0% for 2009, 7.7% for 2010 and 8.4% for 2011. Our "2010E normal EPS" of \$79 assumes an 8.25% net margin on higher SG&A and net interest expense than 2011E.

**Chart 23: Foreign profits are higher margin and growing faster**

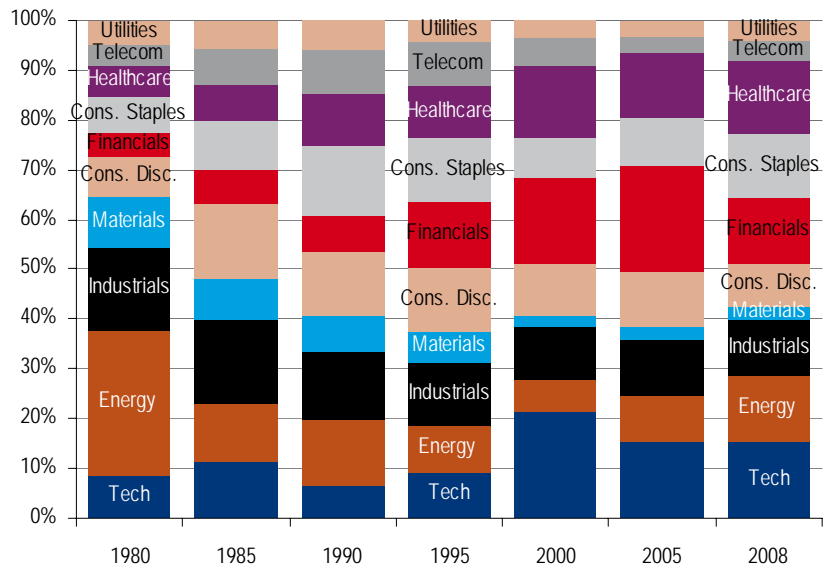


Source: BofA Merrill Lynch US Equity Strategy

**Lower Financial and HC margins offset by Energy and Tech**

Financial sector margins are likely to be lower for the foreseeable future when compared to the credit boom years. Additionally, the upcoming policy changes in Health Care are also likely to have long-term negative implications for the sector's margins. However, we expect these pressures to be largely offset by increasing margins and revenue share from the Energy and Technology sectors (Chart 24). The Energy sector should directly benefit from higher oil prices, particularly if they rise further to the BofA Merrill Lynch Commodity Strategists' forecasted price of \$85/bbl for 2010. We expect the headwinds from higher oil prices to non Energy industries to be offset by the benefits to Industrial and Material companies. Meanwhile, Tech is already the sector with the highest margins and it has strong sales growth potential driven by further consolidation and global growth.

**Chart 24: Changing S&P 500 composition by Market Cap: 1980- 2008**



Source: S&P and BofA Merrill Lynch US Equity Strategy

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