



MORNING BRIEFING

January 29, 2019

On the Margin

See the [collection](#) of the individual charts linked below.

(1) Puzzle: Why are analysts cutting their earnings estimates but not their revenues estimates? (2) Lots of good reasons why profit margins might be getting squeezed. (3) Analysts are natural-born optimists. (4) S&P 500 forward revenues at record high, while forward earnings are sliding from recent record high. (5) Wage version of Phillips curve making a comeback finally. (6) Pricing power isn't what it used to be back in the 1970s and 1980s. (7) Corporate managements took an oath after "Trauma of 2008" to keep their profit margins high. (8) Forward profit margins looking topky for the S&P 500 sectors. (9) Tech's profit margin stands out because it is outstanding.

Strategy I: The Revenues Puzzle. Joe and I have observed that analysts are cutting their 2019 estimates for S&P 500 earnings but remaining optimistic on revenues. That means that they are lowering their expectations for profit margins. We are a bit puzzled, since they tend to lower their estimates for *both* revenues and earnings when company managements' guidance during earnings-season conference calls suggests weakness ahead. Given mounting evidence of a global economic slowdown in recent months, it isn't surprising that analysts are lowering their earnings estimates. What's surprising is that they aren't doing the same for revenues.

The decline in analysts' expectations for profit margins is supported, however, by mounting evidence that labor costs are rising at a faster pace. Slower economic growth could also weigh on productivity. Trump's tariffs have increased costs for some companies. Trump's escalating trade war with China may be forcing manufacturers to spend more on diversifying their supply chains away from China. Trump's tax cut had a one-shot positive impact on profit margins last year, and the negatives may be starting to chip away at it.

Keep in mind that analysts have a tendency to be too optimistic. As earnings seasons approach, they become more realistic. Often in the weeks before earnings seasons, they turn too pessimistic, setting company managements up to beat their more cautious estimates. As we are about to show, the drop in their profit-margin estimates may simply reflect a typical realistic adjustment to their overly optimistic bias.

Consider the following:

(1) *Revenues.* As we observed last week, analysts have been raising their estimates for both 2019 and 2020 revenues growth ([Fig. 1](#)). During the 1/17 week, they estimated growth rates of 5.5% this year and 5.0% next year. At the end of last September, before the stock market meltdown during Q4, they were projecting 5.2% and 4.1%, respectively. They did that despite headline news reports about slower global economic growth. They also did that despite the 29% drop in the price of oil since October 3, which will weigh on the revenues of oil companies.

(2) *Earnings.* On the other hand, they've scrambled to lower their earnings growth rate for this year

from 10.3% at the end of September to 6.0% during the 1/17 week ([Fig. 2](#)). However, true to their optimistic bias, their 2020 earnings estimate is up a bit over this period to 10.9%.

(3) *Profit margin*. Joe and I closely monitor weekly data on forward earnings and forward revenues, which are time-weighted averages of analysts' expectations for these two variables during the current year and the coming year ([Fig. 3](#)).

Forward revenues tends to be a very good coincident indicator of actual S&P 500 revenues. The former rose to record highs so far during January. Forward earnings tends to be a leading indicator for actual earnings. The former rose to a record high of \$175.48 per share during the 10/25 week. It has declined slowly for the past 13 weeks through the 1/24 week to \$172.14.

We can derive the actual and forward profit margin from the earnings and revenues data. The former rose to a record high of 10.9% during Q4-2017 before the corporate tax cut was enacted on December 22, 2017. After the tax cut, the profit margin jumped to 11.9% during Q1, 12.3% during Q2, and 12.5% during Q3.

The forward profit margin peaked at a record 12.4% during the 9/13 week. It was down to 12.1% during the 1/17 week. The analysts' consensus estimate for the 2019 profit margin has dropped from 12.4% at the end of September to 12.0% during the 1/17 week, unchanged from their estimate for 2018 ([Fig. 4](#)). Their 2020 estimate has dropped from 13.1% to 12.7% over this same period. Undoubtedly, it will continue to fall down to at least 12.0%, maybe lower.

(4) *Earnings math*. All of the above suggests that the lowering of analysts' consensus earnings expectations in recent weeks reflects a more realistic, but still optimistic, outlook for the profit margin. The latest 2019 and 2020 profit-margin estimates remain at record highs near the 2018 record level. So it is premature to conclude that analysts are starting to warn that labor and other costs are cutting into profit margins.

That may be the next shoe to drop for earnings. If the profit margin remains unchanged, then revenues growth will determine earnings growth. If the profit margin gets squeezed by rising costs, then earnings growth will fall below revenues growth. Joe and I are expecting that earnings will grow at the same pace as revenues this year (4%) and next year (5%).

In other words, we don't expect that labor compensation and other costs will squeeze margins. Nor do we expect that an increase in those costs will boost prices. Rather, we are betting on improving productivity.

Strategy II: Profit Margin & the Cost of Doing Business. Last week, Melissa reviewed the Fed's latest *Beige Book*. There has been a clear trend of increasing labor shortages and rising labor costs mentioned in recent months by this survey of business conditions. That's consistent with the decline in the unemployment rate below 4.0% since last April ([Fig. 5](#)). The average hourly earnings measure of wages for production and nonsupervisory workers rose 3.3% y/y through December, the highest pace since April 2009.

This suggests that the Phillips Curve Model is finally working. Does this mean that price inflation is bound to head higher, assuming that companies can mark up selling prices to pass on the rise in their costs? That's not necessarily a good assumption. A comparison of wage inflation and price inflation (using the core PCED) shows that the two were relatively close during the 1970s and 1980s, when companies had less competition and more pricing power than now ([Fig. 6](#)). Since the mid-1990s, wage inflation has almost always exceeded price inflation. That's as a result of deregulation and globalization,

which have increased competitive pressures on prices.

Let's have a closer look at the historical record for the profit margin. Keep in mind that the S&P 500 profit margin is available only since Q1-1993. To get a longer-term view, we can construct a profit margin for all US corporations using the National Income & Product Accounts (NIPA) starting in 1947 ([Fig. 7](#)). The two have diverged, particularly since 2015. That's not surprising since the two are not strictly comparable. For example, the NIPA proxy includes the profit margin of sole proprietorships. Here goes:

(1) During the first half of the 1980s, the NIPA profit margin fell sharply. During the second half of the 1980s, it rebounded. Data available for the S&P 500 profit margin show that the uptrend continued through Q3-2018. On the other hand, the NIPA profit margin hit a record high of 11.7% during Q1-2012. It has been on a downward trend since then. Unlike the S&P 500, it did not get a boost last year from the tax cut, which obviously doesn't make much sense.

(2) Notwithstanding the recent puzzling behavior of the NIPA profit margin, especially compared to the S&P 500 profit margin, the former does show a plausible inverse relationship with the cost of doing business. Debbie and I derive this cost by adding the NIPA series on compensation of all employees to NIPA private fixed investment and dividing the total by nominal GDP ([Fig. 8](#)).

The NIPA profit margin tends to increase (decrease) when the cost proxy decreases (increases). While the latter has been on an uptrend since 2010, it has remained at the lowest levels in recent years (through Q3-2018) since the early 1960s. The relatively slow pace of hiring and capital spending during the current expansion has boosted the S&P 500 profit margin, though not the NIPA proxy ([Fig. 9](#)).

(3) Joe and I have often opined that the "Trauma of 2008" caused company managements to make maintaining and boosting their profit margins their number-one priority. In the past, they responded to economic booms by rapidly increasing their payrolls and expanding their capacity. So their profit margins started to erode during the booms, then to dive during the busts that inevitably follow the booms. That pattern is very clear in the NIPA profit margin series. This time, at least based on the S&P 500 profit margin, they are keeping a tighter rein on their costs. As a result, the economy isn't booming, which reduces the risk that it will bust anytime soon, in our opinion.

Strategy III: Drilling into the S&P 500 Sectors' Margins. Now let's see what is happening to the forward profit margins for the 11 sectors of the S&P 500 ([Fig. 10](#)). All except Health Care, Communication Services, and Utilities have been looking topky in recent weeks. Here is the sectors' latest performance derby through the 1/17 week: Information Technology (22.3%), Financials (18.9), Real Estate (15.4), Communication Services (14.8), Utilities (12.9), S&P 500 (12.1), Materials (11.0), Health Care (10.5), Industrials (10.3), Consumer Discretionary (7.5), Consumer Staples (7.5), and Energy (6.7).

We have weekly data for the forward profit margins of the sectors starting in 2006. The standout performer over this period is Information Technology. Its forward profit margin has widened from about 12% in 2006 to 22%. Another notable champ has been Utilities, with its forward margin increasing from about 9% to 13%. The Financials sector has been on a rollercoaster, going from 17% during 2006 down to 6% in 2009, before rising most recently to a record high of 19%. Health Care has been surprisingly bound over those years in a tight range around 10.5%.

CALENDARS

US. Tues: Consumer Confidence 124.8, S&P Corelogic Case-Shiller HPI 0.3%/m/4.9%/y, FOMC

Meeting Begins. **Wed:** ADP Employment 174k, Pending Home Sales 0.3%, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Announcement 2.375% (2.25% to 2.50%), Fed Chair Press Conference. (Econoday estimates)

Global. Tues: Japan Retail Trade, Australia Business Confidence. **Wed:** Eurozone Economic Confidence 106.8, Germany GfK Consumer Confidence 10.3, Germany CPI -0.8%*m/m*/1.6%*y/y*, France GDP 0.2%*q/q*/0.9%*y/y*, Japan Industrial Production -0.5%*m/m*/-2.3%*y/y*, Australia CPI 0.4%*m/m*/1.7%*y/y*, Mexico GDP 0.2%*q/q*/2.0%*y/y*. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell last week for all three of these indexes, continuing the declines that began during October. LargeCap's forward EPS is now 1.9% below its record high of \$175.48 in late October, while MidCap's and SmallCap's are now 1.6% and 4.5% below their mid-October highs, respectively. LargeCap's forward EPS is the most below its record high since July 2016, while MidCap and SmallCap have not been this far below since April 2016 and March 2015, respectively. The yearly change in forward earnings remains healthy compared to the past due to the boost from the Tax Cuts and Jobs Act (TCJA), but is tumbling now as *y/y* comparisons become more difficult. In the latest week, the rate of change in LargeCap's forward earnings fell to a 13-month low of 11.3% *y/y* from 13.0%. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's *y/y* change was down to a 19-month low of 12.5% from 14.2%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's dropped to an 11-month low of 18.5% from 19.8%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts have been dropping since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.2%, 5.8%, 11.2%), MidCap (21.3, 7.6, 11.3), and SmallCap (21.7, 12.8, 15.2).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios were unchanged *w/w* across the board after rising for four straight weeks from multi-year lows to seven-week highs. LargeCap's weekly forward P/E of 15.5 is up from a five-year low of 13.9 during December. That compares to a six-month high of 16.8 in mid-September, a multi-year high of 18.6 on January 26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E of 14.8 is up from 13.0 during December, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E of 15.7 is up from 13.6 during December, which had also marked its lowest reading since November 2011. That's well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). SmallCap's P/E was higher than LargeCap's P/E for a second week after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q4 earnings reports set to pick up this week, analysts have been cutting their Q1 forecasts as companies report. Last week, the S&P 500's Q4-2018 EPS forecast edged down 3 cents *w/w* to \$40.30. That's down 5.3% since the end of Q3, but up 3.6% since the beginning of 2018 and 4.4% since the passage of the TCJA. The \$40.30 estimate represents a forecasted pro forma earnings gain for Q4-2018 of 14.3%, compared to 14.2% a week earlier and 20.1% at the end of Q3. That marks the slowest growth since Q4-2017 and is down from 28.4% in Q3, which is sure to mark the peak of the current earnings cycle. Still, that *y/y* gain would be

its tenth straight after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q4-2018, with six rising at a double-digit percentage rate due to the lower corporate tax rate. That compares to all 11 positive during Q3, when 10 rose at a triple- or double-percentage rate. Four sectors are expected to beat the S&P 500's Q4 growth rate, the same as in Q3. However, Industrials and Real Estate are the only sectors expected to post improved growth on a q/q basis during Q4. Analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago, but the pace is slowing substantially from Q3. Here are the latest forecasted blended Q4-2018 earnings growth rates versus their Q3-2018 growth rates: Energy (59.7% in Q4-2018 versus 114.2% in Q3-2018), Industrials (26.3, 18.9), Communication Services (17.9, 26.1), Financials (17.1, 44.8), S&P 500 (14.3, 28.4), Consumer Discretionary (13.1, 25.4), Health Care (11.5, 16.5), Tech (8.9, 29.1), Real Estate (6.7, 5.3), Materials (3.3, 30.1), Consumer Staples (3.3, 11.4), and Utilities (-10.3, 10.9). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 12.4% y/y in Q4, well below the 25.0% in Q3. Looking ahead, the Q1-2019 EPS estimate has dropped 3.0% for the S&P 500 since the end of Q4, with 2/11 sectors rising and nine falling. Materials is the best performer, with its Q1-2019 forecast rising 0.2%, ahead of Industrials (0.1%). Energy is the biggest decliner, with its Q1-2019 forecast down 22.4% since the end of Q4, followed by Utilities (-3.5), Tech (-2.9), Financials (-2.4), and Consumer Discretionary (-1.9).

S&P 500 Q4 Earnings Season Monitor ([link](#)): With nearly a quarter of the S&P 500 companies finished reporting earnings and revenues for Q4-2018, y/y revenue and earnings growth remains strong, but the surprise metrics have weakened relative to Q3's results due to Q4's trading turmoil and rising loan loss provisions in the Financials sector. Of the 113 companies in the S&P 500 that have reported through mid-day Monday, just 72% exceeded industry analysts' earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 12.7% and exceeded forecasts by an average of 2.1%. On the revenue side, just 59% of companies beat their Q4 sales estimates so far, with results coming in 0.6% above forecast and 9.3% higher than a year earlier. Q4 earnings growth is positive y/y for 79% of companies, vs a higher 93% at the same point in Q3, and Q4 revenues have risen y/y for 82% vs a higher 84% during Q3. These figures will change markedly as more Q4-2018 results are reported in the coming weeks. Looking at earnings during the same point in the Q3-2018 reporting period, a higher percentage of companies (80%) in the S&P 500 had beaten consensus earnings estimates by a higher 4.2%, and earnings were up a higher 24.1% y/y. With respect to revenues at this point in the Q3 season, a higher 63% had exceeded revenue forecasts by a slightly lower 0.5%, and sales rose a tad lower 7.9% y/y. The early results for Q4 indicate a slowdown in revenue and earnings growth from Q3, but that comes as no surprise to investors. Q4-2018 should mark the tenth straight quarter of positive y/y earnings growth and the 11th for revenue growth. Looking at the Q4 results ex-Financials and Real Estate, the earnings surprise improves to 3.0% from 2.1%, but earnings growth falls to 8.2% from 12.7%. The ex-Financials and Real Estate revenue surprise would be 0.7% instead of 0.6%, with revenue growth improving to 11.1% from 9.3%.

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): The five Fed districts that publish data on manufacturing activity have now all reported for January—Philadelphia, New York, Richmond, Kansas City, and Dallas—and show growth remained stagnant. We average the composite, orders, and employment measures as data become available. The composite (to 5.0 from 2.7) index showed growth remained near December's sluggish pace this month—running well below the 23.2 monthly average recorded from June through September. The Philadelphia region's composite index (17.0 from 9.1) shows growth was almost double the pace of last month, though considerably below last year's high of 32.2. New York's (3.9 from 11.5) gauge shows the slowest pace of growth since May 2017, while Kansas City's (5 from 6) virtually matched December's rate. Meanwhile, Richmond's composite (-2 from -8) measure contracted for the second month, though is nearing the breakeven point, while Dallas' (1.0 from -5.0) moved just above

the breakeven point after falling below in December for the first time since September 2016. The new orders gauge (5.3 from 7.8) eased to a 27-month low, as the New York (3.5 from 13.4) and Kansas City (1 from 7) measures showed growth slowed to a standstill, while Richmond's (-11 from -9) contracted at the fastest pace since June 2016. Meanwhile, Philly's (21.3 from 13.3) accelerated at the fastest pace in six months, while Dallas' (11.6 from 14.4) showed decent growth, though less than half the pace of the first 8 months of 2018. According to the employment (9.9 from 14.3) measure, hirings were the slowest since June 2017, as manufacturers in the Philly (9.6 from 19.1), New York (7.4 from 17.5), and Dallas (6.6 from 11.0) regions added to payrolls at the slowest pace since September 2017, January 2018, and January 2017, respectively, while Richmond's (7 from 10) held fairly steady. Meanwhile, Kansas City (19 from 14) factories hired at a faster pace—not far from August 2018's peak rate of 25.0. In the meantime, inflationary pressures continue to ease, according to the prices-paid and -received indexes for all five regions. Here's a look at the prices-paid indexes for January versus their respective peaks during 2018: Philadelphia (to 32.7 from 60.0), New York (35.9 from 54.0), Richmond (3.3 from 5.7), Kansas City (23.0 from 52.0), and Dallas (21.2 from 54.4). Here's the same drill for the prices-received indexes: Philadelphia (24.8 from 35.0), New York (13.1 from 23.3), Dallas (6.4 from 26.2), Richmond (2.3 from 2.8), and Kansas City (23 from 27)—with the latter holding near its high. (Note: Richmond prices are not diffusion indexes but rather average annualized inflation rates.)

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