



MORNING BRIEFING

March 31, 2020

More on Earnings & Valuation During the Great Virus Crisis

Check out the accompanying [chart collection](#).

(1) Slashing revenues and earnings estimates. (2) The Great Disruption. (3) Industry analysts have lots of downward revisions to work on from their home offices. (4) Blue Angels show the way forward. (5) Forward earnings going down. (6) Analysts will probably be too pessimistic on 2021 by the end of this year. (7) Refusing to give in to viral bearishness, we think market bottomed a week ago and are seeing some blue in the sky. (8) B-52 money is thawing the credit freeze. (9) Please keep your distance and wear a mask.

Strategy I: Earnings. Yesterday, Joe and I slashed our outlook for S&P 500 revenues and earnings to reflect the lockdown of a significant portion of the US economy. The March 28 *WSJ* [reported](#): “More than half of U.S. states have imposed lockdown measures restricting gathering and social contact, disrupting the lives of more than 100 million people and suspending the operations of thousands of businesses.” On the other hand, the rapidly drafted executive orders also exempt millions of jobs and services deemed too essential to shut down.

Here is a recap and comparison to the comparable results during the 2007-09 bear market, which we believe is a useful base case:

(1) *Annual revenues.* We expect that S&P 500 revenues per share (RPS) will drop 15% from \$1,400 last year to \$1,200 this year ([Fig. 1](#)). By comparison, the four-quarter sum of RPS, which peaked during Q3-2008, fell 16.5% through Q3-2009. Notice that back then, revenues peaked late in 2008. This time, they peaked at the end of last year.

From the Q3-2009 low, RPS rebounded 6.7% by the end of 2010. This time, we expect that RPS will rebound during 2020-21 by 13% from \$1,200 to \$1,350.

Industry analysts have a lot of downward revising to do in coming weeks. During the week of March 19, they were estimating RPS will increase 2.7% from \$1,393 last year to \$1,432 this

year and 5.6% to \$1,513 next year ([Fig. 2](#) and [Fig. 3](#)). They probably just got the memo about the GVC recession.

On a year-over-year basis, S&P 500 quarterly RPS had negative growth during the four quarters from Q4-2008 through Q3-2009 ([Fig. 4](#)). The worst quarter was Q2-2009, when RPS dropped 19.9% y/y. This time, RPS could have similar negative growth rates during Q2 and Q3 of this year before turning positive during Q4 through the four quarters of 2021.

We expect that S&P 500 operating earnings per share (EPS) will drop 26% from \$163 last year to \$120 this year ([Fig. 5](#)). By comparison, the four-quarter sum of EPS, which peaked during Q2-2007, fell 44.9% through Q3-2009. Notice that back then, earnings peaked late in 2007. This time, they peaked at the end of 2019.

From the Q3-2009 low, the four-quarter sum of EPS rebounded 68.3% by the end of 2010. This time, we expect that EPS will rebound from 2020-21 by 25%, from \$120 to \$150.

Industry analysts will be revising their earnings estimates downward even more sharply than their revenue estimates, anticipating that profit margins will also be heading lower fast. During the week of March 26, they were estimating EPS will be \$163 this year, unchanged from last year, and up 15% to \$187 next year ([Fig. 6](#) and [Fig. 7](#)).

On a year-over-year basis, S&P 500 quarterly EPS had negative growth during the nine quarters from Q3-2007 through Q3-2009 ([Fig. 8](#)). The worst quarter was Q4-2008, when EPS dropped 65.2% y/y. This time, EPS could have similar negative growth rates during Q2 and Q3 of this year before turning positive next year. We are projecting the following quarterly EPS growth rates for this year: Q1 (-23.4%), Q2 (-51.6%), Q3 (-28.8%), and Q4 (-4.8%). (See [YRI S&P 500 Earnings Forecasts](#).)

Industry analysts are on another planet, but they are on their way back to Earth. During the March 26 week, they were estimating the following growth rates for this year's quarterly S&P 500 operating earnings: Q1 (-4.9%), Q2 (-7.2%), Q3 (1.0%), and Q4 (5.7%) ([Fig. 9](#)). The Q2 estimate had been at 4.6% during the first week of March.

(2) *Annual profit margin*. Using annual data, we see that the S&P 500 profit margin was 11.5% last year. This year, our forecasts for earnings and revenues imply it will fall to 10.0% and recover to 11.1% next year ([Fig. 10](#)). This reality check suggests that our earnings estimates

may be too high since the profit margin decline is likely to be steeper than they currently assume.

The bottom line is that while our current bottom-line estimates are more realistically pessimistic than the earnings estimates of industry analysts, even our numbers might not be pessimistic enough. We are monitoring the situation and will keep you updated.

(3) *Forward earnings.* We will be keeping close track of S&P 500 weekly forward revenues and forward earnings since they tend to be very good indicators of actual quarterly revenues and earnings ([Fig. 11](#) and [Fig. 12](#)). When we forecast the outlook for the S&P 500 stock price index, we do so based on our outlooks for forward earnings and the forward P/E. You can see this framework in our Blue Angels charts, which show the S&P 500/400/600 flying through the vapor trails of the Blue Angels traced out by forward earnings, multiplied by forward P/Es of 10 to 20 in increments of 2 ([Fig. 13](#)).

Interestingly, during 2009, all three stock price indexes troughed at forward P/Es of around 10.0 roughly two months before their forward earnings did so. On March 23, the forward P/Es of the S&P 500/400/600 fell to 12.9, 10.3, and 11.0. Notice that the last two were back to roughly 10.0, while the S&P 500 forward P/E was back to where it was in late 2013.

The problem, as we noted yesterday, is that forward earnings are just starting to jump off the recession cliff. Here are the peak-to-trough declines in S&P 500/400/600 forward earnings from their 2008 peaks to their 2009 troughs: -37.5%, -35.3%, and -40.2%. The good news is that these declines occurred over less than 12 months, actually around nine months.

How can that be when the previous recession lasted 18 months? Remember that forward earnings is a time-weighted average of analysts' consensus estimates for earnings during the current and coming year. Every day as next year gets closer, more weight is given to next year and less to this *annus horribilis*.

(4) *S&P 500 targets.* Forward earnings was \$173 per share for the S&P 500 during the March 19 week. As we observed yesterday, it can only go down from here. Let's say it drops 25% to \$130 by the end of the year. If the S&P 500 stock price index remains around its current level of 2600, the forward P/E would be 20.

Keep in mind that while industry analysts tend to be too optimistic during good times, they tend to be too pessimist during bad times. If forward EPS drops to \$130 by the end of this year, that number would be their forecast for all of 2021, when we think EPS could rebound to \$150, which would imply a forward P/E of 17.

For now, Joe and I see a way forward out of the Great Virus Crisis (GVC), as we discussed yesterday. So we are sticking with our revised targets for the S&P 500 at 2900 by the end of this year and 3500 by the end of next year.

Strategy II: Liquidity. The GVC is a world war against the virus, with battles being fought on the health, economic, and financial fronts. Last week on Monday, the Fed replaced its bazookas and helicopters with B-52 bombers. The Fed is dropping humongous amounts of money to win the battles in the credit markets. It seems to be working, as evidenced by credit-quality spreads, which have narrowed dramatically since the Fed implemented QE4ever last Monday, March 23.

In the prior three weeks, those spreads widened dramatically as the widespread reach-for-yield herd mentality switched to a mad dash for cash driven by the GVC's pandemic of fear, which spread faster than the virus.

Yesterday, we showed that bond mutual funds and exchange-traded funds saw outflows of \$114 billion just during the week of March 18. Liquid assets—i.e., total savings deposits (including money market deposit accounts), small-time deposits, and total money market mutual funds held by individuals and institutions—jumped \$290 billion during the four-week period through March 16 ([Fig. 14](#)). Companies tapped their lines of credit, causing commercial and industrial loans to jump \$187 billion during the March 18 week ([Fig. 15](#)).

Virology I: The Case for Masks, Again. In the March 25 [Morning Briefing](#), we wrote: “Hopefully, social distancing for a few weeks and widespread testing will allow us to return to our normal lives in a few weeks. Meanwhile, we should produce billions of surgical masks to wear when we venture out of our homes. Indeed, the government should mandate that everyone wear a mask outside their homes until the crisis passes. Authorities are doing that in many places in Asia now.

“Yes, we know: The Centers for Disease Control and Prevention (CDC) does not recommend that the general public wear N95 respirators or surgical masks to protect themselves from

respiratory diseases, including COVID-19. In particular, the latter don't filter or block very small particles in the air transmitted by coughs and sneezes. However, a friend in the medical supply business tells us that they are effective in stopping the release of those particles by infected people who wear them. Surgeons wear masks to protect patients from their mouth-borne germs, not the other way around. The CDC warning seems to be about saving the masks for the hospital workers. The solution is mass production in the millions per week."

Subsequently, medical experts have changed their minds: They now think we should wear face masks. Their advice is laid out in a new [report](#) in *Science* magazine. A doctor friend claims that if everyone wore a mask, the pandemic would end in a matter of a few weeks. This view jibes with a March 2019 [study](#) titled "Modeling the Effectiveness of Respiratory Protective Devices in Reducing Influenza Outbreak." Here is a very relevant excerpt:

"Outbreaks of influenza represent an important health concern worldwide. In many cases, vaccines are only partially successful in reducing the infection rate, and respiratory protective devices (RPDs) are used as a complementary countermeasure. In devising a protection strategy against influenza for a given population, estimates of the level of protection afforded by different RPDs is valuable. In this article, a risk assessment model previously developed in general form was used to estimate the effectiveness of different types of protective equipment in reducing the rate of infection in an influenza outbreak. ... An 80% compliance rate essentially eliminated the influenza outbreak."

Virology II: Taiwan's Masks. Wearing masks to eliminate the virus pandemic seems to be working in Taiwan, which has a population of 23.8 million. Taiwan is right next to mainland China, and lots of businesspeople and tourists travel between the two countries. Indeed, hundreds of thousands of Taiwanese work and invest in China.

As of yesterday, Taiwan had just 306 cases of COVID-19 and five deaths! Consider the following points gleaned from a February 10 VOA [article](#) titled "Taiwanese Scramble for Face Masks to Stop Deadly Virus From Nearby China":

(1) The island nation has a dense population where multiple generations live under the same roof. The Taiwanese are prone to influenza and a contagious gastrointestinal illness that has killed small children. They also recall the severe acute respiratory syndrome (SARS) epidemic of 2003. SARS originated in China and spread to Taiwan, killing 73 on the island.

(2) The disease-wary Taiwanese tend to wear surgical masks as a precaution against airborne pathogens at higher numbers than people elsewhere. In Taipei, a city of 2.6 million, 50% of people routinely wear face masks.

(3) The island's 80 mask producers have raised production recently to meet rising demand amid the COVID-19 pandemic, despite a rationing of sales to ensure that no one hoards the supplies.

(4) Demand for surgical face masks—to prevent cough-borne COVID-19 droplets from landing on others—has surged throughout East Asia. That's particularly true in Malaysia and Thailand, which get high numbers of Chinese tourists. Malaysia, with a population of 32.3 million, has had 2,626 cases of COVID-19 and 37 COVID-19-related deaths. Thailand has a population of 69.7 million, 1,524 cases, and 9 deaths.

CALENDARS

US: **Tues:** Consumer Confidence 112.0, Chicago Fed Purchasing Manager's Index 40.0, S&P Case-Shiller 20-City Composite 0.4%/m/m/3.3%/y/y. **Wed:** ADP Employment -150k, ISM & IHS Markit M-PMIs 45.0/48.0, ISM Prices Paid Index 41.6, Construction Spending 0.5%, MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

Global: **Tues:** Eurozone CPI Headline & Core Flash Estimate 0.8%/1/1% y/y, Germany Unemployment Change & Unemployment Claims Rate 25k/5.1%, Canada GDP, Japan Tankan Survey, China Caixin Official M-PMI 45.0, RBA Minutes of March 18 Policy Meeting. **Wed:** Eurozone, Germany, France, and Italy M-PMIs 44.6/45.5/42.9/41.0, Eurozone Unemployment Rate 7.4%, Germany Retail Sales 0.1%/m/m/1.5%/y/y, UK M-PMI 47.0. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell last week for these three indexes at the fastest rate since the Great Financial Crisis. LargeCap dropped 2.7% to its lowest level since June 2018; MidCap's fell 3.2% to a 24-month low; and SmallCap's tumbled 5.1% to a 25-month low. These indexes had begun a forward-earnings uptrend during March 2019 but stumbled from July to November before rising until mid-February. While LargeCap's is just 5.5% below its record high at the end of January, MidCap's and SmallCap's are 8.5% and 15.9% below their October 2018 highs. The yearly change in forward earnings soared to

cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings dropped to -1.9% y/y from 0.9%. That's the lowest since December 2009 and down from 23.2% in September 2018, which was the highest since January 2011. MidCap's fell w/w to -6.1% y/y from -3.0%. That was also the lowest since December 2009 and compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's dropped w/w to -8.5% y/y from -3.3%; that's still barely above the -9.6% in mid-September, which was the lowest since December 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October 2018. Analysts' y/y earnings growth forecasts for 2020 are down substantially in the past month, and have much further to fall. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (0.1%, 14.5%), MidCap (1.9, 13.4), and SmallCap (-4.3, 17.1).

S&P 500/400/600 Valuation ([link](#)): Valuations rebounded from multi-year lows for these three indexes last week. LargeCap's forward P/E was up to 15.0 from 13.3, which was its lowest since March 2013. MidCap's 12.5 and SmallCap's 13.0 were up from 10.7 and 11.1, which were the lowest since March 2009. LargeCap's forward P/E had been at 18.9 during mid-February, which was the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E is down from a 22-month high of 17.4 in mid-December and the record high of 20.6 in January 2002. However, 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 is down from mid-December's 16-month high of 18.1 and a 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. However, SmallCap's P/E is still below LargeCap's. It has been mostly below since last May—the first time that has happened since 2003. During mid-March, SmallCap's P/E was briefly below MidCap's for the first time since July 2008.

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): Five Fed districts have now reported on manufacturing activity for March—Philadelphia, New York, Richmond, Kansas City, and Dallas—and show a sharp contraction in activity. The composite index (to -23.8 from 10.8) plunged 34.6 points to its lowest reading since April 2009—after expanding at its fastest pace since November 2018 last month. The deterioration in the Dallas (to -70.0 from 1.2) region was eye-popping, contracting at its fastest pace on record! The New York (to -21.5 from 12.9), Kansas City (-17.0 from 5.0),

and Philadelphia (-12.7 from 36.7) measures also swung from expansion to contraction—with the New York and Kansas City regions contracting at their fastest paces since March 2009 and Philly's since July 2012. Meanwhile, Richmond's (2.0 from -2.0) showed growth was basically flat in that region. The new orders (-20.8 from 12.4) measure declined at the fastest pace since March 2009, after expanding at a solid pace in February, as measures for the Dallas (-41.3 from 8.4), Philadelphia (-15.5 from 33.6), Kansas City (-38.0 from 8.0), and New York (-9.3 from 22.1) regions tumbled 49.7 points, 49.1 points, 46.0 points, and 31.4 points, respectively; Richmond's (0.0 from -10.0) billings were flat—after contracting in February. March's employment measures dropped to -11.9 from 3.9 and 10.8 the prior two months as manufacturers in Richmond (-7.0 from 8.0) and New York (-1.5 from 6.6) began cutting payrolls, while Philly's (4.1 from 9.8) hired at its slowest pace in just over four years. Meanwhile, both Kansas City (-32.0 from -4.0) and Dallas (-23.0 from -0.9) factories recorded their steepest job cuts in over a decade.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators ([link](#)): The Economic Sentiment Indexes (ESI) in March, for both the Eurozone (-8.9 points to 94.5) and the EU (-8.2 to 94.8), posted record declines—plunging to their lowest readings since 2013. Among the Eurozone's largest economies, the steepest declines in ESIs were recorded in Italy (-17.6 points to 83.7) and Germany (-9.8 to 92.0), followed by smaller (though in normal times, would be considered large) declines in France (-4.9 to 100.6), the Netherlands (-4.0 to 98.2), and Spain (-3.4 to 99.3). Worth noting, according to the report: "While in principle the survey responses have been collected between 26 February and 23 March, there are considerable differences across countries as to when the fieldwork effectively stalled due to containment measures enacted to combat the spread of the virus. In many countries, the vast majority of survey responses were collected before such strict containment measures were enacted." At the sector level, within the Eurozone, there were record monthly declines in both services (-13.3 points to -2.2) and consumer (-5.0 to -11.6) confidence—with the latter led by a fall in expectations. Retail confidence (-8.1 to -8.3) also posted a large decline, followed by industry (-4.6 to -10.8) and construction (-2.7 to 2.7) confidence.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).