MORNING BRIEFING
June 3, 2020

OK, Zombies?

Check out the accompanying chart collection.

(1) Ugly followed by uglier earnings data. (2) Looking past the bad news. (3) RPS and EPS should start recovering during Q3, but new highs unlikely until 2022. (4) Consensus earnings estimates for 2020 and 2021 getting cut at slower rate. (5) S&P 500 forward earnings up for the past two weeks following weekly drops since early March. (6) Analysts may not be pessimistic enough about revenues, thus exaggerating likely drop in profit margin. (7) Flash credit crunch in March followed by surge in corporate bond issuance ytd! (8) That's despite a wave of downgrades and defaults. (9) Warren Buffett thanks the Fed. (10) The biggest Fed Put of all times.

Earnings: Forward Earnings Bottoming Already? Joe reports that S&P 500 data for revenues and earnings now are available through Q1-2020. As a result of the global economic shutdown and the plunge in oil prices during March caused by the COVID-19 pandemic, the data were downright ugly. While the Q2 data undoubtedly will be much uglier, all that bad news was mostly discounted by the 33.9% plunge in the S&P 500 during the 33-day bear market from February 19 to March 23. The 36.6% rebound since then through Monday's close suggests that investors expect earnings to recover in Q3 and beyond. We do too. Let's review the Q1 results and think about the future of earnings:

(1) *Revenues down sharply.* S&P 500 quarterly revenues per share (RPS) tumbled 8.6% q/q to $337.60 from Q4-2019's record high of $370.19 (*Fig. 1*). That was the biggest such drop since Q1-2015. The y/y growth rate decelerated from 6.6% during Q4-2019 to -0.4%, the weakest since Q4-2015 (*Fig. 2*).

RPS peaked at a record $1,415 during 2019 (*Fig. 3*). We expect it will fall 15% this year to $1,200 before recovering to $1,350 in 2021 and $1,500 in 2022. Industry analysts have been cutting their revenues estimates for this year and next since late February, but they still significantly exceeded ours as of the May 21 week. We expect they will catch up with our numbers in coming weeks, and that their estimates should bottom during July, assuming, as we do, that the global economy continues to reopen.

(2) *Earnings in a cliff dive.* During Q1, S&P 500 operating earnings per share (EPS using Refinitiv data) dropped 20.6% q/q and 14.8% y/y in the worst declines since the Great Financial Crisis (GFC) (*Fig. 4* and *Fig. 5*). EPS is now down 21.8% from its record high during Q3-2018.

EPS totaled $163 last year (*Fig. 6*). We expect it will drop 26% to $120 this year and recover to $150 next year, on its way to $175 in 2022. Since late February, industry analysts have been slashing their 2020 and 2021 EPS estimates, which should decline at a slower pace through the rest of the year. As of the May 28 week, the analysts were down to $125.24 for this year and $163.69 for next year. So they are close to our 2020 estimate, but have some more cutting to do for 2021, in our opinion. If their annual estimates fall below our estimates in the next few weeks, we expect that they'll revise them back up closer to our numbers, assuming, as we do, that the economy will recover from the lockdowns during the second half of this year.

(3) *Forward earnings moving up.* Joe and I had thought that analysts' consensus earnings estimates might undershoot our targets for 2020 and 2021, but the latest data show that they are slowing the pace of lowering their EPS estimates for both years. It's actually possible that S&P 500 forward earnings (i.e., the time-weighted average of this year's and next year's estimates) is already starting to bottom around $140 per share (*Fig. 7*).

As Joe noted yesterday, S&P 500 forward earnings rose last week for a second week, after dropping every week since the week of March 5. We aren't surprised since we'd been thinking that this might happen in June given how quickly and sharply consensus estimates have been slashed in recent weeks. The 2020 estimate is falling faster than the 2021 estimate, which is why forward earnings may be starting to bottom—i.e., the 2021 estimate gains more weight in the forward earnings calculation as that year approaches.

(4) *Profit margin drops too.* Joe and I calculate the S&P 500's operating profit margin using the operating EPS series compiled by Refinitiv and divide it by the RPS compiled by S&P (*Fig. 8* and *Fig. 9*). Before Trump's Tax Cut and Job's Act (TCJA) took effect in Q1-2018, the quarterly profit margin rose to a record high of 10.9% during Q4-2017; it continued to rise over the next few quarters to a record high of 12.5% during Q3-2018. During Q1-2020, the quarterly margin fell to a four-year low of 9.9% from 11.3% in Q4-2019.

The TCJA provided a permanent boost to the profit margin, i.e., permanent as long as the TCJA remains in force. Prior to Q1's substantial drop, the decline in the profit margin in Q4-

2019 likely reflected rising cost pressures that could not be passed through to prices or offset with productivity. Q1's margin reflects the opening salvo of the economic shutdown and will get worse during Q2. We expect it will rebound sharply, as it typically does during recoveries, during H2-2020.

Our EPS and RPS estimates imply that the annual profit margin should fall from 11.2% last year to 10.0% this year, recovering to 11.1% in 2021 and 11.7% in 2022 (*Fig. 10*). In this case, the industry analysts have turned more pessimistic than we are for this year, as their consensus EPS and RPS estimates imply a profit margin of 9.4% during the May 21 week.

Frankly, we are surprised that they haven't cut their 2020 RPS estimate more significantly by now, in line with the drop in their EPS estimate for this year. Since the last week of February through the May 21 week, the former is down 10.1%, while the latter is down 28.6%. That seems odd to us since the revenues of so many businesses dropped close to zero during the lockdowns that started in March and continued until late May.

(5) *Time to walk the walk.* Back in the Wednesday, March 25 *Morning Briefing*, we concluded that the stock market had probably bottomed on Monday. Since then, the market has soared even as forward earnings has tumbled, causing the forward P/E to skyrocket. Now, we are calling a bottom in forward earnings. If it continues to rise, as it has during the past two weeks, then it will have bottomed eight weeks after the market did so on March 23. That would be similar to the GFC experience, when forward earnings bottomed nine weeks after the March 9, 2009 trough in the S&P 500's index price.

The initial rally from the GFC's March 9, 2009 bottom was fueled by an explosion in the forward P/E multiple as investors anticipated, rather correctly, that forward earnings would eventually bottom and begin rising again. That appears to have happened again. The trillion-dollar question is: Where does the market go from here? A V-shaped recovery in forward earnings would do wonders in alleviating concerns about bloated forward valuations. The market has talked the talk; now it's time for forward earnings to walk the walk.

Credit I: On the Verge of the Zombie Apocalypse. During March, investors dumped their corporate bond holdings, fearing that corporate cash flows would dry up during the global social and economic lockdowns brought on by the viral pandemic.

It was widely feared that the Zombie Apocalypse was at hand as more and more corporations struggled to survive the calamity. Some scrambled to stay alive by drawing down their bank lines of credit, causing commercial and industrial bank loans to soar $390 billion from the end of February through the end of March (*Fig. 11*). The banks increased their allowance for loan losses by $31 billion to $142 billion from January through April (*Fig. 12*).

But in a dramatic turn, the "flash credit crunch" in the bond market was followed by a massive wave of bond issuance. Corporate investment-grade bond sales soared to $1 trillion ytd by May 28; over the past eight years, that mark hasn't been met until a year's second half, as a May 28 Bloomberg article highlighted. About $700 billion of the $1 trillion was issued in the period following the Fed's March 23 announcement that, in addition to implementing QE4Ever, it would directly support the corporate bond market, CNBC reported.

As liquidity improved, companies rushed to the corporate bond market to raise cash and refinance maturing debt. Before discussing how the specific actions taken by the Fed saved the day, let's first review the damage in the market for nonfinancial corporate (NFC) bonds so far:

(1) *Angels turning into zombies*. NFC bond debt rose from $3.2 trillion at the end of 2009 to $5.8 trillion at the end of 2019 (*Fig. 13*). According to the Federal Reserve's May *Financial Stability Report*: "At the beginning of 2020, about half of investment-grade debt outstanding was rated in the lowest category of the investment-grade range (triple-B)—near an all-time high. The amount of debt downgraded from investment grade to speculative grade in 2019 was close to the historical average over the past five years. However, almost $125 billion of nonfinancial investment-grade corporate debt has been downgraded to speculative grade since late February, and expected defaults may rise if the economic outlook and corporate earnings are revised downward."

During March, the pace of bond and loan downgrades was the fastest on record, reported an article in the May 7 issue of *The Economis*t. It noted that as of May 5, S&P had "downgraded or put on negative watch a fifth of the corporate and sovereign issuers that it rates, in response to the virus and a tumbling oil price—and over three-fifths in the worst-hit industries, such as cars and entertainment." Looking ahead, the May 28 S&P Global analysis indicated that "[n]early half of speculative-grade issuers and one-third of investment-grade issuers are now poised for downgrades."

On a global basis, "[p]otential downgrades reached their all-time high of 1,287, above their previous record of 1,087 during the 2009 subprime crisis and nearly double February's 649 issuers. Out of 550 new potential downgrades since April, 90% of the ratings were affected by economic and financial consequences of the COVID-19 pandemic," observed S&P Global in a May 26 note.

It added: "Media and entertainment [including leisure and lodging], automotive, and transportation have the highest proportion of issuers on CreditWatch with negative implications." The rating agency said: "Generally, we expect heavy credit erosion in coming months as issuers, especially those in the lower-rated spectrum come under heavy fire from poor earnings, continued difficulties in managing cost structures, and market volatility creating limited funding opportunities."

(2) *Rising default risk*. "The U.S. default rate picked up to 3.5% as of March 31, 2020, and is expected to keep climbing," reported S&P Global in its May 26 note. Of the US corporate defaults in April, 52% were due to missed interest payments and 14% reflected filings for bankruptcy. "It is only a matter of time before many issuers declare bankruptcy to handle debt," stated the report. S&P Global predicts that default rates could rise to 11% in the US as a base-case scenario, "owing to a harsh economic landscape, pressured revenues, and liquidity concerns for many issuers vulnerable to stoppage in business operations due to social distancing as well as a sharp drop in oil prices," according to the May 28 report.

Credit II: How the Fed Averted the Zombie Apocalypse. Forget about the fastest pace of bond and loan downgrades on record during May. Never mind that the fastest monthly pace of bankruptcies since the Great Recession occurred in May. Don't pay attention to the high level of corporate leverage out there. The Fed's promise to buy corporate debt on March 23 was all that was required to stimulate enough demand to completely turn around the credit markets.

On May 2, at Berkshire Hathaway's first virtual annual meeting, Warren Buffett said: "Every one of those people that issued bonds in late March and April ought to send a thank you letter to the Fed because it wouldn't have happened if they hadn't operated with really unprecedented speed and determination." Distressed asset funds are also scooping up failing firms and restructuring them, as we've discussed before. So too, the Coronavirus Aid, Relief, and Economic Security (a.k.a. CARES) Act aided credit markets with its allotment of $450 billion for the US Treasury to invest in the Fed's special purpose vehicles (SPVs) for the Fed to leverage into loans up to $4.0 trillion in total, as we discussed in our May 6 *Morning Briefing*.

Initially, the Fed announced on April 9 that it would fund up to $2.3 trillion in credit market instruments with its SPVs. Of that, the Fed's Primary and Secondary Corporate Credit Facilities (PMCCF and SMCCF) are set up to purchase up to $750 billion in corporate debt, including exchange-traded funds (ETFs), as we detailed in our April 15 *Morning Briefing*. Eligible bonds include investment-grade corporate bonds as well as BBB-rated bonds that recently went over the edge. Any such "fallen angels" that dropped below that rating after March 22 may still be purchased by both facilities, according to the updated term sheets of the PMCCF and the SMCCF.

Corporate debt purchases by the Fed were expected to begin in early May, but so far the Fed has not purchased any individual issues under the PMCCF, which remains nonoperational. Compared to the potential size of purchases, the transactions so far have not amounted to much. On May 12, the Fed began purchasing corporate-bond ETFs through the SMCCF. As of May 19, the Fed's purchases totaled $1.3 billion, according to the bank's credit facilities update dated May 28. About $223 million was allocated to high-yield bond ETFs. The bank noted: "The Board continues to expect that the SMCCF will not result in losses to the Federal Reserve."

So far, the Fed seems to have averted the Zombie Apocalypse with the biggest Fed Put of all times!

CALENDARS

US: **Wed:** ADP Employment Change -9.0m, Factory Orders -12.5%, ISM NM-PMI 44.0, IHS Markit C-PMI & NM-PMI 36.4/36.9, MBA Mortgage Applications, EIA Crude Oil Inventories. **Thurs:** Jobless & Continuous Claims 1.8m/20.1k, Merchandise Trade -$49.0b, Productivity & Unit Labor Costs -2.6%/50%, EIA Natural Gas Stock. (DailyFX estimates)

Global: **Wed:** Eurozone, Germany, and France C-PMIs 30.5/31.4/30.5, Eurozone, Germany, France, and Italy NM-PMIs 28.7/31.4/26.5/26.5, UK C-PMI & NM-PMI 28.9/28.0, Eurozone Unemployment Rate 8.2%, Germany Unemployment Change & Unemployment Rate 195k/6.2%, Italy Unemployment Rate 9.5%, BOC Rate Decision 0.25%. **Thurs:** Eurozone Retail Sales -15.0%m/m/-22.3%y/y, UK Gfk Consumer Confidence -34, Japan Household Spending -8.7%m/m/-15.4%y/y, ECB Interest Rate Decision 0.00%, ECB Deposit Facility Rate -0.50%. (DailyFX estimates)

US ECONOMIC INDICATORS

Auto Sales (*link*): Motor vehicle sales rebounded in May as states began to reopen. Sales jumped 41.5%, or 3.6mu, to 12.2mu (saar) after plummeting 49.6% during the two months through April—from 17.1mu to a record-low 8.6mu. Domestic light-truck sales climbed to 7.2mu (saar) in May, after being virtually cut in half the first four months of the year, from a cyclical high of 10.0mu in January to 5.2mu (saar) in April (the lowest since mid-2011). Domestic car sales edged up to 1.9mu (saar) last month after sliding from 3.6mu at the end of last year to a record low of 1.5mu in April. Sales of imports in May recovered to 3.1mu (saar) after tumbling from a recent peak of 3.9mu in February to 1.9mu in April—its weakest performance since January 1998.

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