



MORNING BRIEFING

October 13, 2020

'Tis the Earnings Season: Leaders & Laggards

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

(1) The Halloween month. (2) Remarkable rebound in real GDP after remarkable fall. (3) Mapping GDP into S&P 500 revenues and earnings. (4) The first services-led recession. (5) In the past, revenues cycle was driven more by goods than by services GDP. (6) Buybacks don't make much of a difference to per-share revenues and earnings growth rates. (7) No change in our earnings recovery outlook. (8) Q2 earnings season had a big upside hook. (9) S&P 500 forward revenues, earnings, and profit margin all continuing to recover. (10) Drilling down to the forward earnings of sectors and industries.

Earnings I: Looking Ahead. The Q3 earnings season is starting. It always takes place during October, the month that ends with Halloween. Investors are expecting more treats than tricks during the latest reporting season. That's because despite the 33% (saar) plunge in *nominal* GDP during Q2, earnings didn't fall as steeply as feared, and now *nominal* GDP is expected to be up 37% during Q3. The latest reading from the Atlanta Fed's [GDPNow](#) tracking model for Q3's real GDP growth rate is currently 35%.

For *real* GDP, Debbie and I are still predicting a gain of 30% during Q3 followed by a 10% increase during Q4. If Q3 turns out better than our current estimate, we will probably lower our estimate for Q4. So our forecast for this year calls for a V-shaped recovery during the second half of the year. Next year, we expect that the V will morph into the Nike swoosh, with real GDP recovering all that was lost during the lockdown recession by the second half of 2021 ([Fig. 1](#)).

Of course, the relationship between S&P 500 earnings and real GDP growth isn't a tight one. Earnings are determined by revenues and profit margins. So to get at what the GDP forecast implies for earnings, it is best to compare S&P 500 revenues—on an aggregate basis rather than a per-share basis—to nominal GDP growth, both on a y/y basis. Even that approach is necessarily imperfect given that something like 30%-40% of S&P 500 revenues is derived from overseas. Even if we accurately predict revenues, there's still the profit margin to consider

when attempting to map GDP to earnings. Despite this hedge clause, let's do our best to do all of the above:

(1) *Revenues & nominal GDP in 2020*. The growth rates of S&P 500 aggregate revenues and nominal GDP are positively correlated, but not as highly as widely thought ([Fig. 2](#)). Their cycles coincide, but the former is more volatile than the latter. When we disaggregate nominal GDP into its goods and services components, we find that the growth rate of S&P 500 aggregate revenues is more highly correlated with the goods component, which is the more cyclical of the two ([Fig. 3](#)). Until the unprecedented lockdown recession, there was very little correlation between the growth rate of nominal GDP of services and S&P 500 aggregate revenues ([Fig. 4](#)).

This is the first recession to have hit the services economy. In fact, on a y/y basis, nominal goods GDP growth typically has turned negative during recessions, while services GDP growth never did so until this year's lockdown recession ([Fig. 5](#)). Not surprisingly, the growth rate of the quarterly S&P 500 aggregate revenues series is very highly correlated with the growth rate of the monthly series for manufacturing and trade sales, which includes goods but no services ([Fig. 6](#)).

Here are the y/y growth rates through Q2 and for the troughs of the previous recession for S&P 500 aggregate revenues (-10.7%, -19.6%), nominal GDP (-8.5, -3.3), nominal GDP goods (-8.6, -8.2), and nominal GDP services (-9.1, -0.4).

Our q/q forecasts for real GDP translate into y/y growth rates of -3.6% during Q3 and -1.8 during Q4, or -1.6% and 0.2% for nominal GDP (adding 2.0ppts for inflation).

We believe that should be consistent with y/y growth in both aggregate and per-share revenues of -4% during Q3 and -3% during Q4 ([Fig. 7](#)). Despite all the commotion about buybacks, the spread between the growth rates of aggregate and per-share S&P 500 revenues has been relatively small since 1994 ([Fig. 8](#)). That's because, as Joe and I previously have estimated, roughly two-thirds of buybacks have been made to offset share dilution from employee stock plans rather than to artificially juice up earnings per share. (See our May 20, 2019 [Stock Buybacks: The True Story](#).)

(2) *Revenues & nominal GDP in 2021 and 2022*. Next year, Debbie and I are predicting that real GDP will rise 3.0% Q4/Q4, with nominal GDP up 5.0% over this period. For 2022, we see

comparable growth rates of 2.0% and 4.0%. We are currently predicting that S&P 500 revenues per share will fall 5.3% this year, then increase 8.2% and 5.2% in 2021 and 2022, respectively ([Fig. 9](#)).

(3) *Earnings and margins in 2020*. We are currently projecting that S&P 500 earnings per share will fall 23.3% from last year's \$163 to \$125 this year, and rise 24.0% to \$155 next year and 16.1% to \$180 in 2022 ([Fig. 10](#)). In our forecast, the profit margin rises from 9.3% this year to 10.7% next year and 11.8% in 2022 ([Fig. 11](#)). Of course, if a new administration in the White House next year raises the corporate tax rate, we will have to lower our projected margins.

As for the current and coming earnings seasons, we are predicting y/y growth rates for S&P 500 earnings per share of -28.8% for Q3 and -16.7% for Q4. Industry analysts are currently predicting -21.8% and -14.1% as of the October 8 week ([Fig. 12](#)). They had been too pessimistic going into the Q2 earnings season, resulting in an upside hook for the quarter in our Earnings Squiggles charts.

We might raise our Q3 and Q4 earnings estimates after we see banks' earnings reports this week. Banks are certainly the wild card with respect to their impact on aggregate S&P 500 earnings. During tough times, they usually increase their provisions for loan losses for several quarters. So far, they've only done so during Q2.

The two-month lockdown recession started in March and ended in April. The economic recovery during May and June helped to lift Q2's actual results relative to expectations. In addition, many companies and their workers adapted quickly to the lockdowns and continued to operate virtually if they could do so or on premises by following social-distancing guidelines. Furthermore, quite a few companies actually saw their sales boosted by the pandemic.

Earnings II: Looking Forward at the Sectors. As you may know, Joe and I are impatient. We can't wait around for quarterly data to assess the current and prospective outlook for earnings. So we put a lot of weight on the weekly S&P 500 forward revenues, forward earnings, and forward profit margin—all of which are great high-frequency coincident indicators of their comparable quarterly series ([Fig. 13](#)). All three signaled bottoms during the week of May 28. All three have been recovering steadily since then. All three suggest that their quarterly comparable series bottomed during Q2 and should recover over the rest of the year. (See our [S&P 500 Earnings, Valuation & the Pandemic: A Primer for Investors](#).)

Let's focus on the 12.9% recovery in S&P 500 forward earnings since the May 28 week through the October 1 week, and examine which sectors and industries have led and lagged the overall advance over this period. (See our [S&P 500 Sectors & Industries Forward Earnings](#).) I asked Joe to run our performance derby table for forward earnings over this period ([Table 1](#)). Here is what we found:

(1) *Sectors*. All of the 11 sectors of the S&P 500 bottomed at about the same time as the total for the S&P 500 ([Fig. 14](#)). At new highs since the start of the bull market in March 2009 are Information Technology and Health Care. Here is the sectors' performance derby over the recovery period so far: Energy (333.7%), Consumer Discretionary (40.0), Industrials (20.8), Materials (18.7), Financials (13.3), S&P 500 (12.9), Health Care (9.7), Communication Services (8.6), Information Technology (8.0), Consumer Staples (5.2), Utilities (0.8), and Real Estate (-6.1).

(2) *Information Technology & Health Care industries*. Leading the way to new highs in the S&P 500 Information Technology sector are Technology Hardware, Storage & Peripherals (9.8%) and Systems Software (8.2) ([Fig. 15](#)). Semiconductor (8.5) and Semiconductor Equipment (14.2) are back to their record highs of 2018 ([Fig. 16](#)).

In the S&P 500 Health Care sector, both Biotechnology (6.2%) and Managed Health Care (6.4) remain on never-ending moonshots, while Pharmaceuticals (7.8) have recently resumed edging higher into record territory ([Fig. 17](#)).

(3) *Industrials, Energy, and Materials*. In the S&P 500 Industrials sector, most of the major industries are showing upturns from their recent bottoms but remain below their pre-pandemic levels, including Air Freight & Logistics (39.2%), Construction Machinery & Heavy Trucks (25.8), Electrical Components & Equipment (11.4), Industrial Machinery (20.9), and Railroads (9.0) ([Fig. 18](#)).

Still down-and-out among the Industrials, though bottoming, are Aerospace & Defense (5.8%) and Industrial Conglomerates (7.3). The same can be said of the major industries in the S&P 500 Energy sector.

In the S&P 500 Materials sector, both Industrial Gases (8.6%) and Metal & Glass Containers (8.0) are back at cyclical highs. Also bottoming are Diversified Chemicals (6.7), Fertilizers & Agricultural Chemicals (11.2), Specialty Chemicals (9.5), and Paper Packaging (9.3).

(4) *Financials*. In the S&P 500 Financials sector, the following industries are mostly off their bottoms but still well below their pre-pandemic highs: Asset Management & Custody Banks (14.3%), Consumer Finance (48.5), Diversified Banks (19.5), Investment Banking & Brokerage (20.0), and Life & Health Insurance (7.4) ([Fig. 19](#)).

(5) *Consumer Discretionary and Consumer Staples*. Among the S&P 500 Consumer Discretionary sector's industries, the biggest recoveries have occurred in work-from-home-housing-related ones: Automotive Retail (23.3%, new high), Computer & Electronics Retail (30.4, new high), General Merchandise Stores (25.6, new high), Homebuilding (54.8), Home Furnishings (61.4), Home Improvement Retail (18.3, new high), Household Appliances (38.9), Internet & Direct Marketing Retail (52.4, new high), and Restaurants (22.3) ([Fig. 20](#)).

Struggling to find/make bottoms are Casinos & Gaming, Hotels Resorts & Cruise Lines (negative), Movies & Entertainment (8.6%), and Specialty Stores (8.4).

In the Consumer Staples sector, at or near record highs are Household Products (6.1%), Hypermarkets & Super Centers (7.6), and Tobacco (6.4) ([Fig. 21](#)). Bottoming are Packaged Foods & Meats (5.9) and Soft Drinks (5.2). Still falling is Drug Retail (-13.5).

CALENDARS

US: **Tues:** CPI Headline & Core CPI 1.4%/1.8% y/y, NFIB Small Business Optimism Index, IMF/World Bank Virtual Annual Meeting. **Wed:** Headline & Core CPI 1.4%/1.8% y/y, MBA Mortgage Applications, EIA Crude Oil Inventories, IMF/World Bank Virtual Annual Meeting, Clarida, Quarles, Kaplan. (DailyFX estimates)

Global: **Tues:** Eurozone ZEW Economic Sentiment Index 73, Germany CPI -0.2%/m/-0.2%/y/y, UK Employment Change & Unemployment Rate -24k/4.3%, UK Claimant Count Change 80k, Japan Industrial Production -13.3% y/y, EU General Affairs Council Meeting, Buch, Wuermeling. **Wed:** Eurozone Industrial Production 0.8%/m/m/-7.2%/y/y, China CPI & PPI 1.8%/-1.8% y/y), Australia Employment Change & Unemployment Rate -35k/7.1%, Lagarde, Mersch, Lane. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of these

indexes last week. In a typically V-shaped recovery, LargeCap's forward earnings has risen for 21 straight weeks, MidCap's is up in 18 of the past 19 weeks, and SmallCap's posted its 18th gain of the past 21 weeks. LargeCap's forward earnings is now up 12.5% from its lowest level since August 2017; MidCap's has risen 25.3% from its lowest level since May 2015; and SmallCap's is up 38.2% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. LargeCap's forward earnings is now 11.4% below its record high at the end of January. MidCap's and SmallCap's are 16.7% and 24.3% 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 yearly rate of change in LargeCap's forward earnings improved to -10.7% y/y from -11.1%. That's up from mid-May's -19.3%, which was the lowest since October 2009, and down from 23.2% in September 2018, which was the highest since January 2011. The yearly rate of change in MidCap's forward earnings rose w/w to -13.4% y/y from -14.1% y/y, and is up from a record low of -32.7% at the end of May; that compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's rate improved to -17.7% y/y from -20.2% y/y, and is up from a record low of -41.5% in early June. SmallCap's prior record low in its y/y percent change occurred during July 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 since early March but have been relatively stable since late May. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-20.0%, 27.4%), MidCap (-30.7, 48.5), and SmallCap (-51.9, 110.2).

S&P 500/400/600 Valuation ([link](#)): Valuations rose across the board last week, but remain below their recent cyclical and record highs. LargeCap's forward P/E rose to 21.9 from 21.2 a week earlier. That compares to a 19-year high of 22.7 at the end of August and is up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's rose to 19.2 from 18.4 and is down 3.7pts from its record high of 22.9 in early June. SmallCap's was up to 19.9 from 19.6 and is down 6.8pts from its record high of 26.7 in early June. That compares to MidCap's 10.7 and SmallCap's 11.1 in mid-March, which were their lowest readings since March 2009. LargeCap's forward P/E in mid-February—before COVID-19 decimated forward earnings—was 18.9, 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 was below LargeCap's P/E yet again last

week, where it mostly has been since August 2018. It was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for an eighth week and for the first time since May. SmallCap's P/E had been mostly below from May 2019 to May 2020 after being solidly above since 2003. During mid-March, SmallCap's P/E was briefly below MidCap's for the first time since July 2008.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Analysts adjusted their Q3 estimates slightly higher for an eighth straight week, which is not the typical pattern before an earnings season begins. Since the Q2 earnings season—which came in substantially better than greatly reduced forecasts—analysts have been raising nearly all of their future quarterly forecasts instead of lowering them as is the norm. In the latest week, the S&P 500's Q3 blended EPS estimate/actual rose 6 cents w/w to \$32.97. That \$32.97 estimate represents a decline of 21.8% y/y on a frozen actual basis and -21.0% y/y on a pro forma basis. That compares to a pro forma 30.6% decline in Q2-2020, a 12.8% decline in Q1-2020, a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). The last time earnings fell markedly y/y was during the four quarters through Q2-2016. All 11 sectors had been expected to record negative y/y earnings growth for Q2 when that earnings season began, but three recorded positive y/y earnings growth: Health Care, Tech, and Utilities. That was a big improvement from Q1 when all 11 sectors posted a y/y decline in earnings. Looking ahead to Q3, a y/y earnings decline again is expected for all 11 sectors, but seven are expected to post less worse growth on a q/q basis, reflecting the reopening of the US economy. Energy is expected to report a second straight quarterly loss during Q3. Here are the S&P 500 sectors' latest Q3-2020 earnings growth rates versus their Q2-2020 growth rates: Information Technology (-0.5% in Q3-2020 versus 5.6% in Q2-2020), Health Care (-2.0, 6.8), Consumer Staples (-3.5, -4.2), Utilities (-3.7, 6.4), Real Estate (-14.4, -15.2), Materials (-14.9, -28.6), Financials (-19.1, -46.7), Communication Services (-20.5, -16.8), Consumer Discretionary (-34.0, -64.6), Industrials (-65.5, -85.3), and Energy (-114.9, -168.1).

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