



MORNING BRIEFING

December 15, 2020

Corporate Financial Matters

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

(1) One more time: higher S&P 500 earnings and targets. (2) Reviewing corporate sector's balance sheet and income statement. (3) Nice rebound in profits, but with record corporate debt. (4) Refinancing at record-low interest rates. (5) Revenues rebounding along with GDP. (6) A happy outlook for profit margin. (7) NIPA profits include S&P 500 earnings and more. (8) Undistributed profits boost cash flow to record high. (9) Capital spending rebounds with cash flow. (10) Lots more gross corporate debt issuance, some for refinancing at record-low rates. (11) Big jump in corporate liquid assets. (12) Stock issuance is hot, while buybacks are cold. (13) Popular story about buybacks has it backward.

Corporate Finance I: Accounting for Fun & Profits. Yesterday, Joe and I raised our estimates for S&P 500 revenues and earnings per share and profit margins to the following: 2020 (\$1,400, \$140, 10%), 2021 (\$1,545, \$170, 11%), and 2022 (\$1,625, \$195, 12%). As a result, our S&P 500 year-end targets for this year and the next two years are now 3740, 4290, and 4620. (See [YRI Earnings Forecasts](#).)

Today, let's focus on the broader related topic of corporate finance. On the income statement side of this topic, we will examine the latest profits data provided for all corporations in the National Income and Product Accounts (NIPA) compiled by the Bureau of Economic Analysis. On the balance sheet side, we will analyze the data compiled in the [Financial Accounts of the United States](#) by the Federal Reserve Board. Both sets of data were recently updated through Q3-2020.

The bottom line is that during Q3 profits have recovered remarkably well from the lockdown recession during the first half of this year. On the other hand, corporate balance sheets are loaded up with more debt than ever. However, much of it has been refinanced at record-low interest rates. It's all bullish for the economy and the stock market as long as interest rates stay low.

Corporate Finance II: Revenues, Costs & Profits. Let's start with a review of the latest data on corporate revenues, costs, and profits. All are remarkably upbeat, on balance, considering the extraordinary circumstances:

(1) *Revenues & GDP.* Corporate revenues have rebounded smartly along with real and nominal GDP. S&P 500 aggregate revenues rose 10.1% q/q during Q3 following a drop of 14.7% during the first half of the year ([Fig. 1](#)). Nominal GDP increased 8.4% (not annualized) during Q3 following a 10.2% drop during the first two quarters of the year. The revenues rebound has been led by goods-producing industries, while many service-providing ones have remained pandemic challenged. Business sales of goods have fully recovered since they bottomed in April through October. Nominal GDP of goods rose to a record high during Q3, while GDP of services remained 5.4% below the Q4-2019 peak ([Fig. 2](#)).

We also raised our real GDP forecast yesterday to 10% (saar) during Q4-2020 to reflect the strength in the Atlanta Fed's [GDPNow](#) tracking model (currently showing 11.2%). We lowered our outlook for the first half of 2021 to reflect renewed lockdown restrictions during the third wave of the pandemic. We boosted the second half's growth rates, assuming that widespread vaccinations during the first half will boost the lagging service providers significantly starting next summer. (See [YRI Economic Forecasts](#).) As a result of our revisions, we see real GDP fully recovering by mid-2021 ([Fig. 3](#)).

(2) *Profit margin & productivity.* During Q3, S&P 500 revenues rose faster than costs. As a result, both reported and operating margins are almost back to where they were at the end of last year before the pandemic hit ([Fig. 4](#)). During Q3, nonfarm business productivity rose 4.6% (saar), following a 10.6% jump during Q2 ([Fig. 5](#)). Unit labor costs fell 6.6% during Q3. The latest compensation data are very funky, showing a jump of 24.3% (saar) during Q2 and a drop of 2.3% during Q3, mostly because low-wage workers bore the brunt of the layoffs during Q2. Nevertheless, we believe that the pandemic accelerated the pace of technological innovation and adoption in ways that will continue to significantly boost productivity, thus keeping a lid on labor costs and boosting margins.

(3) *Corporate profits.* Reflecting the rebound in revenues and margins, the NIPA data show that after-tax book profits (reported on a tax-accounting basis) jumped 36.6% q/q (not annualized) during Q3 ([Fig. 6](#)). It's at a new record high, though not much above its range-bound performance from 2012 through 2019. It is up only 13% since Q1-2012 through Q3-

2020; yet the S&P 500's reported earnings per share is up 43.8%, and the S&P 500's aggregate after-tax reported earnings is up 31.9%, over this same period.

The S&P 500 accounts for roughly 50% of NIPA profits, which also includes S corporations, which are owned by no more than 100 shareholders. S corporations do not pay corporate taxes. Instead, their profits are paid and taxed as dividends to their shareholders. In other words, it doesn't make much sense to use NIPA profits when thinking about and forecasting the S&P 500. (Perma-bears occasionally make that rookie's mistake.)

Corporate Finance III: Dividends, Retained Earnings & Cash Flow. So what are corporations doing with their profits? The NIPA accounts focus on after-tax "profits from current production," which is book profits including the Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj). These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP ([Fig. 7](#)). We prefer to call this measure "cash-flow profits" ([Fig. 8](#)). They are allocated to dividends and to undistributed profits.

As a result of the lockdown recession, companies reduced their dividends during 2020 slightly from last year's record high. That allowed more of the Q3 rebound in profits to show up as a 202% q/q (not annualized) bounce in undistributed cash-flow profits. This category is back to where it was before the pandemic hit. As a result, corporate cash flow, which is the sum of undistributed cash-flow profits and tax-reported depreciation, rose to a record \$2.63 trillion (saar) during Q3 ([Fig. 9](#)). That's impressive.

Corporate Finance IV: Capital Spending. Just as impressive is the rebound in current-dollar capital spending, which not surprisingly tracks corporate cash flow closely. This is particularly so for nonfinancial corporate cash flow versus nonfinancial corporate capital spending, both using data compiled by the Fed ([Fig. 10](#)). Nonfinancial corporate capital spending accounts for most of nonresidential fixed investment in the GDP accounts ([Fig. 11](#)). The latter has been trending higher in record-high territory since Q4-2011. In current dollars and real dollars, it has increased 68% and 58% since the start of the expansions during Q4-2009 through Q3-2020, and both rebounded 5.1% q/q (not annualized) during that quarter, regaining most of the losses during the lockdown recession.

Corporate Finance V: Borrowing & Debt. The bottom line, literally, is that there is plenty of cash flow to finance rising capital spending, which seems to be sufficient to support the

productivity-led expansion of corporate America. Nevertheless, progressives have charged that undistributed corporate profits have been wasted on buybacks to boost earnings per share to enrich corporate managements. They've also charged that corporations have borrowed funds in the bond market to buy back their shares. Before we go there, let's review corporate borrowing and debt using data compiled by the Fed.

Nonfinancial corporate business debt jumped during Q1 as many companies cashed in their bank lines of credit during March, fearing a credit crunch. When the Fed dramatically eased credit conditions later that month, they scrambled to issue bonds, both to raise cash and to refinance debt at record-low interest rates. Here are some specific figures:

(1) *Debt and liquid assets.* Nonfinancial corporate (NFC) debt jumped \$0.3 trillion during Q2 to a record \$11.1 trillion ([Fig. 12](#)). It edged down to \$10.9 trillion during Q3. NFC bonds edged up to a record \$6.5 trillion, while loans edged down to \$3.7 trillion ([Fig. 13](#)).

The Fed report includes equities and mutual fund shares in the liquid assets held by NFCs ([Fig. 14](#)). Melissa and I prefer to exclude these items from liquid assets. On this basis, liquid assets held by NFCs jumped \$0.9 trillion y/y to \$3.5 trillion during Q3. The ratio of NFC short-term debt to the smaller measure of liquid assets was at a record low during Q3 ([Fig. 15](#)).

(2) *NFC debt relative to cash flow.* On the other hand, the ratio of total NFC debt to cash flow jumped to a record high of 28.2 during Q3 ([Fig. 16](#)). However, monetary interest paid by NFCs fell to a record low this year as a result of the Fed's ultra-easy monetary policies in response to the pandemic ([Fig. 17](#)).

(3) *Refinancing outstanding bonds.* The Fed compiles a monthly series on NFC gross bond issuance ([Fig. 18](#)). Over the past 12 months through October, they totaled a record \$1.5 trillion. The Fed's quarterly database shows that net issuance totaled a record \$0.7 trillion over the past four quarters through Q3, implying that a record \$0.8 trillion was refinanced at record-low yields ([Fig. 19](#)).

Corporate Finance VI: Stock Issuance & Buybacks. The Fed also tracks monthly corporate stock issuance by both financial and nonfinancial corporations ([Fig. 20](#)). Total issuance rose to a record \$302 billion over the 12 months through October, led by a record \$172 billion in NFC stock issuance and a \$130 billion increase in stocks issued by financial corporations. Data available only through June show that NFC equity issuance over the 12 months through that

month reflected a record gain of \$125 billion in seasoned equity offerings and \$22 billion in IPOs ([Fig. 21](#)).

What about stock buybacks? They dropped sharply during Q2-2020 to the slowest pace since Q1-2012 ([Fig. 22](#)). In our *Topical Study* dated May 20, 2019 and titled “[Stock Buybacks: The True Story](#),” Joe and I concluded:

(1) Most buybacks are aimed at offsetting earnings dilution resulting from employee stock compensation plans. The funds for these buybacks are treated as compensation expense. So they aren't paid for with either undistributed profits (at the expense of workers or capital spending) or funds raised in the bond market.

(2) The close correlation between buyback activity and the S&P 500 stock price index has been widely interpreted to mean that the former drives the latter. In fact, the performance of the stock market is driven by earnings and the economy, which have a direct influence on overall compensation, including stock grants and options.

(3) Neither compensation nor capital spending has been meaningfully depressed by buybacks aimed at boosting earnings per share.

CALENDARS

US: **Tues:** Headline & Manufacturing Industrial Production 0.3%/0.3%, Capacity Utilization 72.9%, Empire State Manufacturing Index 6.8, Import & Export Prices 0.3%/0.2%, API Crude Oil Inventories. **Wed:** Retail Sales Total & Ex Autos -0.3%/0.1%, Business Inventories 0.7%, NAHB Housing Market Index 88, IHS Markit M-PMI & NM-PMI Flash Estimates 55.8/55.0, MBA Mortgage Applications, EIA Crude Oil Inventories, FOMC Interest Rate Decision 0.25%, FOMC Economic Projections. (DailyFX estimates)

Global: **Tues:** France CPI 0.2% y/y, Italy CPI -0.2% y/y, UK Employment Change & Unemployment Rate -250k/5.1%, Lane, Macklem. **Wed:** Eurozone, Germany, and France C-PMI Flash Estimates 45.8/50.4/42.9, Eurozone, Germany, and France M-PMI Flash Estimates 53.0/56.4/50.1, Eurozone, Germany, and France NM-PMI Flash Estimates 41.9/44.0/40.0, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 51.3/55.9/50.5, UK Headline & Core CPI 0.6%/1.4% y/y, Canada CPI 0.8% y/y, Australia Employment Change & Unemployment Rate 50k/7.0%, Guindos, Schnabel, Weidmann, Buch. (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 30 straight weeks, MidCap's is up in 27 of the past 28 weeks, and SmallCap's posted its 27th gain of the past 30 weeks. LargeCap's forward earnings is now up 19.1% from its lowest level since August 2017; MidCap's has risen 39.1% from its lowest level since May 2015; and SmallCap's is up 66.5% 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 6.2% below its record high at the end of January. MidCap's and SmallCap's are 7.5% and 8.8% 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 -5.3% y/y from -5.7%. 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 -2.6% y/y from -3.0% 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 -0.6% y/y from -0.9% 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 still down substantially since early March but have been improving since July as companies easily beat low-balled consensus estimates for Q2 and Q3. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-15.2%, 22.5%), MidCap (-25.1, 43.8), and SmallCap (-37.1, 74.9).

S&P 500/400/600 Valuation ([link](#)): All three of these indexes had their valuations edge down last week. LargeCap's forward P/E dropped 0.3pts to 21.8 from a 14-week high of 22.1. 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 fell to 19.4 from a 14-week high of 19.6 the week before; its current level is down 3.5pts from its record high of 22.9 in early June. SmallCap's dropped to 19.4 from an eight-week high of 19.6, which is down 7.3pts 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, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 16th week, such a long stretch 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. SmallCap's P/E was a hair below MidCap's and at a discount to that index for a sixth straight week and for the first time since mid-March. Prior to that, it had been below very briefly for three weeks during the Great Financial Crisis.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Since the Q2 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. In the latest week, the S&P 500's Q3 blended EPS estimate/actual rose one penny w/w to \$39.43, and the Q4 estimate rose 10 cents to \$37.30. That \$37.30 estimate for Q4-2020 represents a decline of 11.2% y/y on a frozen actual basis and -10.7% y/y on a pro forma basis. That compares to a pro forma 6.1% decline in Q3-2020, a 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 and Q3 when their respective earnings seasons began. Three sectors recorded positive earnings growth in Q2, and six did so in Q3. That was a big improvement from Q1 when all 11 sectors posted a y/y decline in earnings. For Q4, three of the 11 sectors are expected to post positive y/y earnings growth, but seven of the 11 sectors are expected to post worse growth on a q/q basis. That shortfall likely reflects continued pessimism among the analysts despite the reopening of the US economy. Energy is expected to return to a profit in Q4 following two quarterly losses. Here are the S&P 500 sectors' latest Q4-2020 earnings growth rates versus their Q3-2020 growth rates: Materials (5.2% in Q4-2020 versus -1.4% in Q3-2020), Information Technology (3.6, 9.8), Health Care (3.0, 11.8), Consumer Staples (-0.9, 6.3), Utilities (-3.4, 0.9), Financials (-7.9, -2.8), Real Estate (-11.9, -12.7), Communication Services (-12.5, 3.8), Consumer Discretionary (-23.3, 0.8), Industrials (-41.3, -53.7), and Energy (-98.2, -108.2).

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production ([link](#)): Output accelerated in October after slowing to a near standstill in August and September. Industrial production jumped 2.1% in October following gains of 0.1% and 0.5% the prior two months; it was on a tear during the three months through July, rebounding 29.9%. Output is within 3.5% of pre-Covid levels. Here's a look at how the main industrial groups fared during the six months through October and where they stand relative to their pre-pandemic levels: consumer durable goods (+107.0% & 1.4%), capital goods (+56.6 & -5.4), intermediate goods (+31.6 & -3.1), consumer nondurable goods (+14.4 & -1.9), and energy (+11.6 & 1.4)—with consumer durable goods back in the plus column after a brief dip into negative territory during September. Here's the same exercise for total production among the top four Eurozone economies: Italy (+69.6% & -2.2%), France (+47.3 & -3.5), Spain (+46.6 & -0.9), and Germany (+32.0 & -5.6). Looking ahead, November's IHS Markit M-PMI (to 53.8 from 54.8) showed manufacturing activity in the overall Eurozone slowed a bit from October's 27-month high, though growth remained well above the long-run survey average. Germany's (57.8) manufacturing sector remained the strongest among the Eurozone countries, followed by the Netherlands (54.4) and Ireland (52.2). Meanwhile, Italy (51.5) was the only other country among top four Eurozone economies to show an expansion in manufacturing activity, with Spain (49.8) and France (49.6) just below the demarcations line between expansion and contraction.

Contact us by [email](#) or call 480-664-1333.

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](#).