MORNING BRIEFING
January 12, 2021

Will Blue Wave Increase or Decrease Earnings?

Check out the accompanying chart collection.

(1) Valuations vs mutating virus. (2) Retail sales stalled late last year. (3) Our proxy for wages and salaries continued to recover in December as government benefits declined. (4) Here comes another round of pandemic support checks to lift consumer spending. (5) Unbelievable: Real GDP has almost fully recovered. (6) Santa delivered bullish PMIs. (7) Signaling solid revenues recovery this year. (8) We are more positive on revenues than the analysts. They are more positive on profit margins than we are. (9) Buybacks should make a comeback this year unless they are drowned by the Blue Wave tsunami.

Strategy I: Bullish PMIs. Joe and I are on meltup watch. We've been concerned that stretched valuation multiples could get more stretched, setting the stage for a meltdown. On the other hand, we are relieved to see corporate earnings continue to recover along with the US economy from the unprecedented two-month lockdown recession during March and April of last year.

The majority of monthly economic indicators have shown remarkable V-shaped rebounds. They mostly continued to surprise on the upside late last year, even though the third wave of the pandemic has been the worst so far. However, state governors have mostly avoided implementing the draconian lockdown measures that sent the economy into a tailspin last March and April. As we discussed yesterday, the new worry is that mutations of the virus might spread more rapidly than the original, and that vaccinations aren't occurring fast enough to keep up with the new strains. The UK has been forced to reimpose strict lockdown restrictions since late last year as a result. The risk is that the same could happen here.

Last year's V-shaped recovery was led by consumer and business spending on IT hardware and software, allowing millions of us to work and study from home. Sales of homes and housing-related retail sales soared as a result of deurbanization and home improvements. Even low-tech capital spending rebounded sharply. Of course, many service-producing businesses remain challenged by the pandemic and social-distancing restrictions.

During November and December, some of the V-shaped economic indicators started to stall or swoosh. Retail sales fell 1.1% m/m during November, after a 0.1% downtick in October, albeit from September's record high. Personal consumption expenditures on goods followed the same path (*Fig. 1*). Consumer spending on services edged down too during November and remained 6.0% below its record high during February.

Personal income received a huge boost from government social benefits during April, which pushed the overall number to a record high, more than offsetting the drop in wages and salaries (*Fig. 2* and *Fig. 3*). Personal income has been falling since then along with the benefits, but wages and salaries has recovered and, in November, was only 0.4% below the record high for the series during February.

Clearly disappointing was the 140,000 drop in payroll employment during December. However, our Earned Income Proxy for private wages and salaries rose 0.4% m/m during the month, as a 0.8% increase in average hourly earnings more than offset the 0.4% drop in aggregate weekly hours (*Fig. 4*). A second round of $600 pandemic-support checks is in the mail, and the Biden administration is expected to send a third round of $2,000 checks soon after Inauguration Day. That should boost consumer spending during Q1.

On Friday, January 8, after the release of December's employment report, the Atlanta Fed's GDPNow tracking model showed real GDP rising 8.7% (saar) during Q4. That's quite impressive following the 33.4% jump during Q3. It would put Q4's real GDP just 1.4% below its record high during Q4-2019!

Among the most bullish of the recently released fundamental indicators for the stock market were December's surprisingly strong PMIs. Consider the following:

(1) *PMIs and S&P 500 stock price index.* Both the ISM M-PMI and NM-PMI are highly correlated with the yearly percent change in the S&P 500 stock price index (*Fig. 5* and *Fig. 6*). The S&P 500 was up 16.3% y/y during December. The M-PMI shot up to 60.7 during the month. That was just a tick below August 2018's 60.8—which was the best performance since May 2004 (61.4). The M-PMI's major components were also very strong: new orders (67.9), production (64.8), and employment (51.5) (*Fig. 7*).

The NM-PMI remained surprisingly solid given that social-distancing restrictions have been tightened by state governors in reaction to the third wave of the pandemic. It edged up to 57.2

during December, led by new orders (58.5) and production (59.4). On the other hand, the NM-PMI's employment component edged back down below 50.0 from 51.5 during November to 48.2 last month (*Fig. 8*). Keep in mind that the nonmanufacturing index isn't limited to services. It includes construction-related businesses.

(2) *PMIs and S&P 500 revenues.* Both the M-PMI and NM-PMI are highly correlated with the growth rate of S&P 500 revenues per share (*Fig. 9* and *Fig. 10*). The latter was -2.3% during Q3. December's readings of the two PMIs suggest that revenues-per-share growth is likely to turn positive during the first half of 2021. It might even match the previous cyclical peak growth rate of 11.2% during Q2-2018.

(3) *YRI revenues forecasts.* That outlook is consistent with our forecast for S&P 500 revenues per share. Here are our numbers for the levels and growth rates of revenues per share: 2020 ($1,400, -1.1%), 2021 ($1,545.00, 10.4%), and 2022 ($1,625, 5.2%) (*Fig. 11*).

During the week of December 31, 2020, industry analysts' consensus expectations for the level of S&P 500 revenues per share were well below our forecasts: 2020 ($1,328, -3.0%), 2021 ($1,435, 8.1%), and 2022 ($1,536, 7.0%).

Monthly "Revenues Squiggles" data since 2004 show that industry analysts typically start out too optimistic about the outlook for revenues and reduce their expectations as earnings reporting seasons approach (*Fig. 12*). They usually get too pessimistic during recessions and have to raise their expectations during recoveries. We believe that will happen again in 2021, especially if the Blue Wave leads to a tsunami of government spending.

(4) *YRI earnings estimates.* Interestingly, our forecasts for S&P 500 earnings per share are closer to the analysts' comparable estimates. Here are ours and theirs: 2020 ($140, $136), 2021 ($170, $168), and 2022 ($195, $196) (*Fig. 13*).

We are more optimistic on revenues than they are, while they are more optimistic on profit margins. Here are our profit margin estimates versus the analysts' consensus: 2020 (10.0%, 10.0%), 2021 (11.0%, 11.4%), and 2022 (12.0%, 12.5%) (*Fig. 14*). We do expect a rebound in productivity, which will boost profit margins. But we also expect that some of that lift will be weighed down by an increase in the corporate tax rate.

(5) *Bottom line.* The Biden administration is likely to boost government spending and economic growth. That will also boost corporate revenues and earnings. On the other hand, the Biden administration is likely to increase the corporate tax rate, which will weigh on corporate profit margins. On balance, Joe and I are anticipating a relatively normal recovery in profits during 2021 and 2022.

(6) *Earnings season.* The Q4 earnings reporting season has arrived. Here are the y/y growth rates for S&P 500 operating earnings per share for the first three quarters of last year: Q1 (-15.4%), Q2 (-32.3%), and Q3 (-8.2%). We are expecting Q4 to be -6.7%, or about half as bad as the -12.1% estimated by industry analysts during the week of January 11 (*Fig. 15* and *Fig. 16*). There were significant upside "earnings hooks" during the earnings reporting seasons for Q2 and Q3 last year. We expect another one for Q4.

Strategy II: The Future of Buybacks in 2021. Will buybacks make a comeback this year, thus boosting earnings per share? Joe recently updated our *S&P 500 Shares Outstanding* and *S&P 500 Buybacks & Dividends* chart publications. We carefully analyzed these data in our *Topical Study* dated May 20, 2019 and titled "Stock Buybacks: The True Story." In it, we concluded that from Q1-2011 through Q4-2018 roughly two-thirds of buybacks were probably associated with offsetting dilution from employee stock compensation plans. The remaining one-third boosted earnings per share.

In other words, the data refute the progressive narrative that buybacks benefit mostly a few C-suite executives at the expense of workers. Nevertheless, progressives undoubtedly will harness the power of their Blue Wave congressional majority to severely limit buybacks, if not eliminate them entirely.

Let's review the latest data:

(1) *Playing it safe.* S&P 500 buybacks fell sharply during Q2-2020 to a 22-quarter low of $88.7 billion from $198.7 billion during Q1 (*Fig. 17*). Companies were scrambling to preserve cash amid the uncertain economic outlook caused by Covid-19. Buybacks edged up 14.8% q/q during Q3-2020 to $101.8 billion, still among the lowest levels since Q1-2013.

The drop in buyback activity was widespread during Q2 and Q3 last year among the 11 sectors of the S&P 500. However, the declines were less pronounced for Information Technology and Communication Services. These two sectors thrived during the pandemic and probably didn't cut employee compensation and continued to pay some of it through stock plans. So they continued to buy back shares to offset dilution.

(2) *Buyback bottom?* Following the cut in the corporate tax rate at the start of 2018, the S&P 500 Financials sector had been among the biggest repurchasers of shares among the S&P 500 sectors. Then Covid-19 struck, and the Fed ordered banks to halt buybacks in order to preserve capital amid a rapidly deteriorating economic environment. On December 18, the Fed reversed course and allowed banks to resume buybacks with limitations.

Bank shares have been among the top performers since the Fed's announcement. The S&P 500 Regional Banks and Diversified Banks industries have soared 13.8% and 13.3%, respectively, since December 18 compared to a 3.1% gain for the S&P 500. (See our *S&P 500 Performance Derby: Sectors & Industries*.)

(3) *Shares outstanding rising, for now.* On a q/q basis, the total basic shares outstanding for the S&P 500's companies ticked up less than 0.1% during Q3-2020 (*Fig. 18*). However, that was the first increase since Q1-2012. Looking at the index's 11 sectors, just two had q/q declines in their basic share counts: Tech and Materials.

In the y/y share-count-change derby, Financials remains the biggest share-count decliner, ahead of Tech. Here's how the sectors ranked by their y/y percent change in shares: Real Estate (3.2%), Industrials (2.2), Health Care (2.1), Utilities (2.0), Energy (0.9), Communication Services (0.8), S&P 500 ex-Financials (0.2), S&P 500 (-0.4), Consumer Staples (-0.4), Materials (-0.8),Consumer Discretionary (-0.9), Information Technology (-2.2), and Financials (-3.7). The 0.4% decline in S&P 500 shares outstanding was the lowest rate of decline since Q3-2011 (*Fig. 19*).

(4) *Top-heavy share reductions?* Joe looked at the top 20 S&P 500 companies with y/y reductions in their share counts and compared them to rest of the index. The top 20 companies saw their aggregate basic shares outstanding fall 7.5% y/y during Q3-2020. The rest of the index actually had their shares outstanding rise, but only by 0.3% y/y.

(5) *The future.* Buybacks are likely to make a comeback in 2021. Will they boost earnings per share? Our work shows that they really didn't do so in the past as much as widely believed. In any event, the Blue Wave is likely to put significant limitations on them sooner rather than later. That will be bad news for employee stock compensation plans.

CALENDARS

US: Tues: JOLTS, API Crude Oil Inventories, Brainard. **Wed:** Headline & Core CPI 1.3%/1.6% y/y, Monthly Budget Statement, MBA Mortgage Applications, Beige Book, Brainard, Clarida, Harker. (DailyFX estimates)

Global: Tues: Italy Retail Sales, Broadbent. **Wed:** Italy Industrial Production -0.4%m/m/-3.3%y/y, China Trade Balance $72.4b, Japan Machine Orders -15.4% y/y, Lagarde, Kuroda. (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 during 33 of the past 34 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 30 of the past 32 weeks, and SmallCap's posted its 31st gain of the past 33 weeks. LargeCap's forward earnings is now up 19.3% from its lowest level since August 2017; MidCap's has risen 42.3% from its lowest level since May 2015; and SmallCap's is up 73.6% 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 6.1% below its record high at the end of January 2000. MidCap's and SmallCap's are 5.4% and 4.9% 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 yearly rate of change in LargeCap's forward earnings improved to -5.4% y/y from -5.8%. 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 -2.2% 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 dropped to -0.1% y/y from 1.2% 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 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 (-

16.7%, 23.4%), MidCap (-25.0, 44.7), and SmallCap (-36.8, 77.9).

S&P 500/400/600 Valuation (*link*): All three of these indexes had their valuations rise last week. LargeCap's forward P/E rose 0.2pts to 22.7, slightly exceeding its 19-year high of 22.7 at the end of August. That's up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's increased to a 21-week high of 20.5 from 19.7; its current level is 2.4pts below its record high of 22.9 in early June. SmallCap's surged 1.2pts w/w to an 18-week high of 20.4, which is down 6.3pts 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 21st week, the longest stretch since May and during 2002-2003. 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 at a discount to MidCap's for an 11th straight week, and a week earlier was the most below that index since January 2006.

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 Q4 estimate rose four cents to $36.92, instead of posting its typical decline ahead of the start of the earnings season. That $36.92 estimate for Q4-2020 represents a decline of 12.1% y/y on a frozen actual basis and -9.8% y/y on a pro forma basis. That compares to a pro forma 6.5% 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, four of the 11 sectors are expected to post positive y/y earnings growth. That's up from three a week earlier, but seven of the 11 sectors are still 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, but barely so. Here are the S&P 500 sectors' latest Q4-2020 earnings growth rates versus their Q3-2020 growth rates: Materials (7.6% in Q4-2020 versus -1.5% in Q3-2020), Information Technology (3.9, 9.9), Health Care (3.7, 11.8), Consumer Staples (0.9, 6.3), Utilities (-3.0, 0.9), Financials (-4.5, -2.8), Real Estate (-11.8, -12.8), Communication Services (-12.5, 3.7), Consumer Discretionary (-22.5, -2.3), Industrials (-42.0, -54.7), and Energy (-99.4, -108.2).

US ECONOMIC INDICATORS

Merchandise Trade (*link*): The real merchandise trade deficit widened for the second month in November to a new record high, suggesting trade will be a drag on Q4 real GDP. There is a caveat, however: Both exports and imports remain on an upswing. The gap swelled to -$96.5 billion in November after narrowing from -$91.3 billion in July to -$87.7 billion by September, as imports (5.9%) outpaced exports (3.3) over the two months through November. The October/November average deficit was -$93.2 billion—above Q3's average monthly deficit of -$90.4 billion. Real exports and imports have rebounded since May, with the former up 34.7% and the latter up 24.8% over the six-month span. The biggest gain in exports over the six months through November occurred in autos (268.1), followed by consumer goods (nonfood) ex autos (48.8), capital goods ex autos (24.5), industrial supplies & materials (23.9), and food (9.7). The same exercise for imports shows autos (247.9) also took the number-one spot, followed by consumer goods (nonfood) ex autos (33.2), capital goods ex autos (21.7), food (15.1), and industrial supplies & materials (-21.9).

GLOBAL ECONOMIC INDICATORS

Germany Manufacturing Orders (*link*): German factory orders increased for the seventh straight month in November by 2.3% m/m and 65.0% over the period—surpassing pre-Covid levels by 2.8%. November's increase was driven by strong billings from inside the Eurozone (6.1%) along with domestic (1.6) orders; billings from outside the Eurozone (0.9) were more subdued following a string of solid gains. Over the seven months through November, foreign and domestic orders soared 73.4% and 51.8%, respectively—with foreign orders from both inside (86.5%) and outside (68.8) the Eurozone posting robust recoveries. Domestic orders, as well foreign orders from both inside and outside the Eurozone, are above their pre-Covid readings. Here's a look at the performance by market group for total orders, foreign orders from inside & outside the Eurozone, and domestic orders, respectively, since bottoming in

April: capital goods (96.1%, 149.7%, 101.3%, 67.4%), intermediate goods (43.3, 50.8, 32.7, 45.7), consumer durable goods (40.1, 67.2, 7.4, 49.6), and consumer nondurable goods (2.5, 6.7, 1.2, 1.2). Consumer goods orders have lost momentum, with both durable and nondurable goods billings dipping a bit recently.

Germany Industrial Production (*link*): Industrial production increased for the seventh straight month in November, though the pace slowed a bit after accelerating the prior two months. Germany's headline production (which includes construction) climbed 0.9% in November, following gains of 3.4% and 2.3% the previous two months, to within 3.8% of its pre-pandemic reading; it's up 27.4% since bottoming in April. Manufacturing output advanced 1.2% in November and 35.1% since April and is 4.6% below its pre-Covid reading. Excluding construction, production increased 0.8% in November and 33.6% over the seven months through November. Here's a snapshot of movements in the main industrial groupings since April, and where they stand relative to their pre-pandemic levels: capital goods (65.5% & -6.7%), consumer durable goods (42.2 & +1.0), intermediate goods (21.7 & -2.4), and consumer nondurable goods (4.6 & -8.3). Consumer nondurable goods production took another step back in November, falling 5.8% the past two months, after climbing three of the prior four months by 12.4%, while consumer durable goods output has rebounded 7.3% the past two months, after a brief 3.6% dip in September—which followed a four-month surge of a 37.5%.

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