MORNING BRIEFING
March 23, 2021

Free Money Boosting Earnings

Check out the accompanying chart collection.

(1) Strength in average of NY and Philly business indexes augurs well for March M-PMI. (2) Also predicts strong growth in S&P 500 revenues. (3) Raising 2021 and 2022 earnings-per-share projections to $180 and $200. (4) Economic Impact Payments boosting economic and earnings growth. (5) Rebounding profit margin. (6) Analysts predicting double-digit earnings growth during Q1-Q4 and 25% increase for the year. (7) Forward earnings and revenues have fully recovered. (8) Still targeting S&P 500 at 4300 this year and 4800 next year. (9) The valuation question: Will all the free money offset rising bond yields? (10) How much of pandemic fiscal and monetary stimulus has leaked abroad?

YRI Podcast. In our latest video podcast, Dr. Ed discusses the main points of today's *Morning Briefing* focusing on the outlook for S&P 500 earnings.

Strategy I: Supercharged Earnings. Joe and I are raising our S&P 500 operating earnings forecast for 2021 from $175 per share to $180, a 27.8% y/y increase from 2020. We are also raising our 2022 forecast from $190 to $200, an 11% increase over our new earnings target for this year. We would have raised our 2022 estimate more but for our expectation that the Biden administration will raise the corporate tax rate next year.

As we observed in yesterday's *Morning Briefing*, the economy was hot before the third round of "relief" checks started going out last week. Now it is likely to turn red hot as the Treasury sends $1,400 checks or deposits to 285 million Americans in coming weeks.

Yesterday, we also observed that the average of the business activity indexes compiled by the Federal Reserve Banks (FRBs) of New York and Philadelphia for their districts jumped from 17.6 during February to 34.6 during March, the highest reading since July 2004 (*Fig. 1*). This is a very significant development for the following reasons:

(1) *Regional and national business surveys.* Their average tends to be a good leading indicator for the average of the five surveys conducted by these two FRBs along with the ones in

Richmond, Kansas City, and Dallas. The average of the five business activities indexes is highly correlated with the national M-PMI (*Fig. 2*). That means that the average of the New York and Philly indexes also are highly correlated with the national M-PMI and are signaling a solid number for the latter's March reading (*Fig. 3*).

(2) *Business indexes and S&P 500 revenues growth.* "What does this have to do with S&P 500 earnings?," you might be wondering. Good question. We won't keep you in suspense. Previously, we've observed that the M-PMI is highly correlated with the y/y growth rate in S&P 500 aggregate revenues (*Fig. 4*). February's M-PMI reading of 60.8 matches some of the best readings in this indicator since 2004! The March reading could be stronger, implying that S&P 500 revenues may be set to grow 10%-15% this year. That's certainly confirmed by the similar relationship between the growth in revenues and the average of the New York and Philly business activity indexes (*Fig. 5*).

(3) *Profit margin.* That strong outlook for revenues growth provides a very good tailwind for earnings growth, which will also get a lift from a rising profit margin. Joe and I think that the profit margin, which averaged 10.4% last year, could increase both this year and next year. Profit margins tend to rebound after recessions and during recoveries along with productivity.

(4) *Bottom line on the bottom line.* Let's put it all together now. We are raising our S&P 500 revenues forecast by $50 to $1,550 per share this year, up 14.0% from the 2020 level (*Fig. 6*). For next year, we are sticking with our $1,600 revenues estimate, representing just a 3.2% increase. That's because we believe that the relief checks, besides relieving pent-up demand, will pull forward some of next year's demand. Also, individual tax rates are likely to go up next year along with corporate ones.

We are projecting that the S&P 500 profit margin will increase from 10.4% last year to 11.6% this year and 12.5% next year (*Fig. 7*). The result would be S&P 500 earnings of $180 per share this year and $200 next year (*Fig. 8*). (See *YRI S&P 500 Earnings Forecast*.)

Strategy II: Analysts Bullish on S&P 500 Fundamentals. We aren't the only ones turning even more bullish on the fundamentals driving the stock market. Industry analysts also are raising their estimates for revenues, earnings, and profit margins for the S&P 500 for this year and next year. Consider the following:

(1) *Quarterly consensus earnings estimates for 2021.* The analysts' consensus estimates for quarterly S&P 500 earnings per share this year have been rising since mid-2020 (*Fig. 9*). As of the March 18 week, they were projecting the following y/y growth rates for S&P 500 operating earnings: Q1 (20.0%), Q2, (50.1), Q3 (18.0), and Q4 (12.5) (*Fig. 10*).

(2) *Annual consensus earnings estimates for 2021 and 2022.* As of the March 18 week, the consensus predicted that S&P 500 earnings per share will be $175.54 this year and $202.11 next year (*Fig. 11*). Currently, industry analysts are expecting that S&P 500 earnings will increase 25.5% this year compared to last year (*Fig. 12*). For 2022, they are anticipating a 15.2% growth rate.

(3) *Annual consensus revenues and margin estimates for 2021 and 2022.* Industry analysts are currently projecting that revenues will total $1,459.08 this year and $1,558.19 next year (*Fig. 13*). In other words, they are expecting revenues per share to grow 9.4% in 2021 and 6.8% during 2022 (*Fig. 14*).

Interestingly, their estimate for 2021 revenues growth has been increasing since the week of November 19, undoubtedly reflecting expectations that President Biden's American Rescue Plan would be enacted early this year and be very stimulative, adding roughly two percentage points to revenues growth. The expected growth rate for 2022 hasn't changed much since late last year.

Joe and I calculate the implied profit margins from the consensus estimates for earnings and revenues. The results show that margin estimates have been improving since last summer for 2020, 2021, and 2022. The latest readings for these in 2021 and 2022 are 11.8% and 12.7% (*Fig. 15*).

(4) *Forward ho!* Both S&P 500 forward revenues and forward earnings have now fully recovered what they lost during the first few months of the pandemic (*Fig. 16*). Both took much longer to recover during the Great Financial Crisis. The same can be said for the forward profit margin. The weekly forward revenues, earnings, and profit margin series are all excellent coincident indicators of the comparable actual comparable data (*Fig. 17*). All three of the weekly series remain bullish on the underlying fundamentals for the S&P 500.

We are raising our year-end 2021 and 2022 forward earnings forecasts by $5 each to $200 and $210 (*Fig. 18*). Think of these as our best guess of what industry analysts will be projecting earnings will be in 2022 and 2023 at the end of 2021 and 2022. (See our September 14, 2020 Topical Study titled *S&P 500 Earnings, Valuation, & the Pandemic* for a thorough explanation of forward earnings.)

(5) *S&P 500 targets and valuation.* Even though Joe and I are raising our forward earnings targets, we are keeping our S&P 500 stock price targets at 4300 and 4800 for the end of this year and next year. That buys us a bit more wiggle room on our valuation multiple assumptions, which are now 21.5 and 22.9 for the end of this year and next year (*Fig. 19*). The multiple is currently 21.6.

One of our accounts asked us yesterday whether we should lower our outlook for the forward P/E given that we predicted that the 10-year US Treasury bond yield is likely to rise back to its pre-pandemic range of 2.00%-3.00% over the next 12-18 months.

Normally in the past, we would have lowered our estimates for forward P/Es in a rising-yield environment. However, these are not normal times. In the "New Abnormal," valuation multiples are likely to remain elevated around current elevated levels because fiscal and monetary policies continue to flood the financial markets with so much free money, as we reviewed once again in yesterday's *Morning Briefing*.

US Economy: Free Money Leaking Overseas? Another one of our accounts asked us yesterday how much of all the free money provided by the three rounds of relief checks sent by the Treasury to more than 250 million Americans over the past year might be benefitting foreigners, especially Chinese exporters, by boosting US imports. Good question. Yesterday, we calculated that the three rounds of Economic Impact Payments (EIPs) totaled $840 billion over the past year. Now consider the following:

(1) *Quarterly GDP and trade in goods.* Current-dollar GDP data are available through Q4-2020. They show that GDP increased $1.97 trillion (saar) from Q2-2020 through Q4-2020. Over that same period, imports of goods jumped $624.1 billion. This suggests that a significant chunk of the EIPs was spent on imported goods. Of course, it's not that simple. Exports of goods increased $394.8 billion over the same period. So the net merchandise trade deficit widened by $229.3 billion. That's a somewhat less significant "leakage" of US growth than suggested by the imports data.

(2) *Monthly merchandise trade.* Again, consumers received $840 billion in free money over the past year. From April of last year through January, US imports of consumer goods excluding autos jumped $230.5 billion to a record $760.0 billion (saar) (*Fig. 20*). It's up $125.5 billion y/y. Clearly, some of the EIP-boosted consumer outlays were on imported goods rather than domestically produced ones.

(3) *Imports from China.* Meanwhile, US imports from China are up 21.7% y/y over the three months through January, the fastest pace since January 2011 (*Fig. 21*). Interestingly, this series is highly correlated with the US M-PMI.

(4) *Bottom line.* When the US economy is strong (weak), some of that strength (weakness) spills over to the world economy. Clearly, some of the US fiscal and monetary stimulus over the past year has benefitted the rest of the world. It doesn't follow that their gain was our loss, since global economic growth isn't a zero-sum game.

CALENDARS

US: **Tues:** New Home Sales 876k, Richmond Fed Manufacturing Index, Current Account Balance -$188.5b, Powell, Brainard. **Wed:** Durable Goods Orders Total and Ex Transportation 0.8%/0.6%, IHS Markit M-PMI & NM-PMI Flash Estimates 59.3/60.0, MBA Mortgage Applications, EIA Crude Oil Inventories, Powell Testimony. (DailyFX estimates)

Global: **Tues:** UK Employment Change & Unemployment Rate -170k/5.2%, UK Average Earnings Including Bonus 4.9%, BOJ Monetary Policy Meeting Minutes, Enria, Gravelle. **Wed:** Eurozone, Germany, and France C-PMI Flash Estimates 49.1/51.6/47.2, Eurozone, Germany, and France M-PMI Flash Estimates 57.7/60.8/56.5, Eurozone, Germany, and France NM-PMI Flash Estimates 46.0/46.2/45.5, Eurozone Consumer Confidence Flash -14.5, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 51.1/55.0/51.0, UK Headline & Core CPI 0.8%/1.4% y/y, ECB Non-Monetary Policy Meeting. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes last week and were at record highs simultaneously for the first time since October 2018. LargeCap's was at a record high for a third straight week; MidCap's for a sixth week; and SmallCap's for the sixth time in seven weeks. In what has shaped up to be a typical V-shaped recovery, LargeCap's forward earnings has risen during 43 of the past 44 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 40 of the past 42 weeks, and SmallCap's posted 40 gains in the past 43 weeks. LargeCap's forward earnings is now up 28.5% from its lowest level since August 2017; MidCap's has risen 57.1% from its lowest level since May 2015; and SmallCap's is up 92.9% 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. 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 a 14-month high of 4.3% y/y from 1.6%. 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 a 26-month high of 10.4% y/y from 7.5% 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 turned higher too, rising to a 26-month high of 19.3% y/y from 13.4% y/y; it 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, 2021, and 2022: LargeCap (-13.6%, 24.6%, 15.1%), MidCap (-22.8, 50.5, 15.8), and SmallCap (-27.8, 66.7, 20.2).

S&P 500/400/600 Valuation (*link*): Valuations dropped for all three of these indexes last week. LargeCap's forward P/E fell 0.3pt to 21.6. That's down from a 19-year high of 22.7 in early January and up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's dropped 0.4pt to 20.1 from a seven-month high of 20.5. Its current level is 2.8pts below its record high of 22.9 in early June. SmallCap's tumbled 0.7pts w/w to 20.9. It's now down 5.8pts from its record high of 26.7 in early June. That compares to MidCap's 10.7 and SmallCap's 11.1 in March 2020, which were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—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 31st week, but by only 0.7pt. That's the longest stretch at a discount since May and during 2002-03. 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 premium to MidCap's for a 10th week after 11 weeks at a discount. At the beginning of the year, it had been at the steepest discount to that index since January 2006.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q2-2020 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 Q1-2021 estimate rose 15 cents to $39.77, instead of declining as typically seen in the two weeks before the quarter's end. That $39.77 estimate for Q1-2021 represents a gain of 20.0% y/y on a frozen actual basis and a 22.9% y/y gain on a pro forma basis. That would be the first quarter of double-digit percentage growth since Q4-2018 and compares to a pro forma 4.1% gain in Q4-2020. Seven sectors are currently expected to post positive y/y earnings growth in Q1-2021, but the final results are likely to be higher. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2021 versus their final Q4-2020 growth rates: Consumer Discretionary (78.0% in Q1-2021 versus -2.6% in Q4-2020), Financials (65.2, 20.4), Materials (45.0, 22.7), Information Technology (23.5, 20.3), S&P 500 (22.9, 4.1), Health Care (17.8, 10.6), Communication Services (13.7, 10.2), Utilities (2.5, -2.7), Consumer Staples (-0.2, 5.4), Real Estate (-0.2, -10.7), Industrials (-12.4, -36.6), and Energy (-7.1. -105.2).

US ECONOMIC INDICATORS

Existing Home Sales (*link*): "Despite the drop in home sales for February—which I would attribute to historically-low inventory—the market is still outperforming pre-pandemic levels," said Lawrence Yun, NAR's chief economist. (During February, 74% of the homes sold were on the market for less than a month.) Existing home sales—tabulated when a purchase closes—fell 6.6% last month to 6.22mu (saar), only the second decline in nine months, with severe winter weather likely exacerbating February's loss. Still, February sales were 9.1% above last February's level. Single-family sales declined for the third time in four months, dropping 6.6% m/m and 8.2% over the period to 5.52mu (saar), a level 8.0% above a year ago. Inventories for both total and single-family homes were at record lows of 1.03mu and 870,000 units, respectively, during February, down 29.5% and 32.6% year over year. Meanwhile, multi-family sales fell 6.7% during February after reaching a new cyclical high at the start of this year, though were up 18.6% y/y. Regionally, total sales fell in three of the four regions last month, but all remained above year-ago levels: West (+4.6% m/m & +12.3% y/y), South (-6.1 & +9.9), Northeast (-11.5 & +13.2), and the Midwest (-14.4 & +2.3). The lack of inventory has boosted existing home prices at a double-digit pace in all regions since February 2020: West (20.6% y/y), Northeast (20.5), Midwest (14.2), and South (13.6). The outlook is promising according to Yun: "I still expect this year's sales to be ahead of last year's, and with more Covid-19 vaccinations being distributed and available to larger shares of the population, the nation is on the cusp of returning to a sense of normalcy. Many Americans have been saving money and there's a strong possibility that once the country fully reopens, those reserves will be unleashed on the economy."

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