



## MORNING BRIEFING

October 12, 2021

### Profit Margin Winners & Losers

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

(1) Demand for energy outpacing renewable supplies. (2) Renewable energy sources are unreliable. (3) Hard to say which way the wind will blow, if at all. (4) Grim choice: natural disasters vs freezing in the dark. (5) Bigger natural disasters because more people in harm's way. (6) Unintended consequence for ESG investors: Dirty energy could outperform clean energy in the stock market. (7) Energy has tiny market-cap share currently. (8) An ideal scenario for dirty Energy's profit margin. (9) Q3 earnings reporting season likely to be full of tales of labor and parts shortages and rising costs. (10) SMidCaps' fundamentals stronger than LargeCaps, and their stocks are cheaper.

**Strategy I: Climate Change & Energy Stocks.** Climate change activists are working hard to save humankind from natural disasters, which they believe are getting unnaturally worse as a result of all the CO2 that humans are spewing into the atmosphere. Whether the activists are right or wrong, they are making progress in weaning us off fossil fuels. The problem is that demand for energy is increasing faster than renewable sources of energy can replace the looming shortage of fossil fuels as energy companies slash their spending on developing these traditional sources.

In addition, renewable energy sources are much less reliable than oil, gas, and coal. Wind turbines don't work when the wind isn't blowing. Hydroelectric power can't be generated during droughts. Solar cells generate electricity when the sun is shining, but battery technologies aren't ready to store enough of it when the sun isn't shining, like at night.

Ironically, climate change may be making renewable sources of energy even less reliable if it is changing wind and precipitation patterns. As a result, we will continue to need fossil fuels at least as backup sources of energy when the renewable sources are down. But there may not be enough fossil fuels to back us up if energy companies stop investing in obtaining them.

The paradox of our human condition is that we may be at risk from more frequent and more catastrophic natural disasters if we don't address climate change more quickly, but we could also freeze in the dark if renewable energy sources fail while the traditional fossil sources are becoming scarcer and extremely costly just when we most need them. Governments

pushing for a rapid transition are likely to get lots of pushback from their citizens if the lights go out too often and utility bills soar.

Between 1980 and 2021, 19 wildfire, 29 drought, 56 tropical cyclone, 141 severe storm, 35 flooding, 19 winter storm, and 9 freeze billion-dollar disaster events affected the US, according to the National Oceanic and Atmospheric Administration (NOAA). This NOAA [chart](#) shows that they have become increasingly costly. This supports the climate change activists' anxiety and rush to replace fossil fuels with renewable energy sources. However, keep in mind that our population has been growing, with more Americans choosing to live in harm's way, i.e., exposing themselves to more risks of being hit by natural disasters.

For investors, the dilemma is that the more they invest in clean energy, the less capital will be available for fossil fuels. The result could be higher fossil fuel prices, with the stock prices of fossil fuel producers (with the lowest ESG—or environmental, social, and corporate governance—scores) rising faster than those of companies with low carbon footprints (with high ESG scores).

The bottom line is that investors who aren't constrained by ESG mandates are likely to overweight energy stocks in their portfolios, and those stocks are likely to outperform the S&P 500 for the foreseeable future. That's assuming that the fossil fuel industry continues to experience the same dynamics, i.e., a dearth of capital spending on the production of fossil fuels and high or rising fossil fuel prices. Fossil fuel producers will see higher margins as a result of higher prices and less capital spending. Consider the following:

(1) *Energy's market-cap and earnings shares are low.* In this scenario, it won't take much of an overweight in the S&P 500 Energy sector to beat the S&P 500. The sector currently accounts for only 2.8% of the index's market cap and 4.2% of the index's earnings share ([Fig. 1](#)). The comparable stats for the S&P 400 and S&P 600 are comparably tiny ([Fig. 2](#) and [Fig. 3](#)). During 2008, when the price of oil soared, the market-cap shares of the S&P 500/400/600 ranged about 10%-15%.

(2) *Energy fundamental metrics and the oil price.* The forward revenues, forward earnings, and forward profit margin of the S&P 500 Energy sector all are highly correlated with the price of a barrel of Brent crude oil ([Fig. 4](#), [Fig. 5](#), and [Fig. 6](#)). Not surprisingly, the same can be said about the S&P 500 Energy sector's stock price index ([Fig. 7](#)).

(3) *Energy's profit margin.* The prices of all fossil fuels are soaring, including oil, natural gas, and coal ([Fig. 8](#)). In the past, fossil fuel companies would have responded to such price

signals by ramping up their capital spending to increase their capacity to produce more. This time is likely to be different because they are facing mounting pressure from climate change activists both in and out of governments to spend more on developing renewable sources of energy and less on fossil fuel sources. In the short term, overall energy capital spending is likely to remain depressed, especially on fossil fuels.

The result should be higher margins for the fossil fuel industry. The weekly forward profit margin of the S&P 500 Energy sector is a good leading indicator for that industry's actual quarterly profit margin ([Fig. 9](#)). The weekly series has rebounded from last year's low of 0.2% during the April 30, 2020 week to 7.7% during the September 29 week, the highest reading since December 6, 2018. Joe and I will be watching it.

**Strategy II: Q3's Earnings Season.** During the previous earnings reporting season, for Q2-2021, companies handily beat expectations for both revenues and earnings. The y/y growth rates in both marked this cycle's peaks for them. Both growth rates will be lower for the Q3 earnings reporting season, starting this week. In addition, managements' guidance will likely be far more cautious as more company managements raise caution flags about higher labor and materials costs as well as shortages of workers and parts. Rapidly rising energy input costs undoubtedly will also be mentioned in most of the conference calls with company managements.

Analysts are likely to ask managements about the expected impact of a corporate tax hike on earnings. Managements are likely to say that they can't say until they know what the tax rate will be. They might be asked about the impact of the global 15% minimum corporate tax rate that 130 countries just agreed to.

Managements no doubt will discuss how all the above is likely to impact their profit margins. Many of them are likely to say that they are raising prices and scrambling to use technology to offset at least some of the pressures on their margins. Now consider the following:

(1) *Analysts' consensus estimates for Q3.* As of the October 7 week, industry analysts estimated that S&P 500 earnings increased 26.5% y/y during Q3 compared to 88.6% during Q2 ([Fig. 10](#)). Their estimate for Q4 growth is currently 20.3%.

Here are the Q3 earnings growth rates currently expected for the S&P 500 and its sectors: S&P 500 (26.5%), Communication Services (23.8), Consumer Discretionary (7.7), Consumer Staples (3.5), Energy (1,487.8), Financials (18.1), Health Care (15.3), Industrials (75.9), Information Technology (28.8), Materials (92.4), Real Estate (17.2), and Utilities

(0.3). (See our [Earnings Season Monitor: S&P 500 Sectors](#).)

(2) *Forward metrics remain strong for S&P 500.* The forward revenues of the S&P 500 rose to yet another record high during the final week of September, while the index's forward earnings did the same during the first week of October ([Fig. 11](#)).

The S&P 500's forward profit margin was flat at a record 13.1% during the last week of September. This implies that, so far, companies have been able to offset rising costs by raising their prices and/or increasing their productivity. We continue to believe that productivity could increase fast enough over the next few years to avert a 1970s-style wage-price spiral.

**Strategy III: Investment Style Guide.** In recent weeks, Joe and I have observed that while the S&P 500 stock price index was climbing to new record highs, at least until its recent peak on September 2, the S&P 400/600 SMidCap indexes were moving sideways. That was the case since around mid-March ([Fig. 12](#)). In recent days, the SMidCaps have started to outperform ([Fig. 13](#)).

That makes more sense to us since the forward earnings of the S&P 400/600 have rebounded faster from their 2020 lows significantly faster than the forward earnings of the S&P 500 has done ([Fig. 14](#)). As a result, the forward P/Es of the S&P 400/600 dropped sharply in recent weeks to close at 16.3 and 15.6 at the end of last week, while the forward P/E of the S&P 500 fell to 20.2, remaining in the 20.0-23.0 range it has been in since the second half of last year ([Fig. 15](#)).

Joe and I had a look at the stock price charts for the S&P 500/400/600 sectors ([Fig. 16](#), [Fig. 17](#), and [Fig. 18](#)). We are seeing bullish patterns in the Energy and Financials sectors of the three indexes and mostly sideways patterns in the other sectors.

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## Calendars

**US: Tues:** NFIB Small Business Confidence, Job Openings 10.925m. **Wed:** Headline & Core CPI 0.3%m/m/5.3%y/y & 0.3%m/m/4.0%y/y, MBA Mortgage Applications, Federal Budget Balance, OPEC Monthly Report, FOMC Meeting Minutes, API Crude Oil Inventories, Brainard, Bowman. (Bloomberg estimates)

**Global: Tues:** Germany ZEW Economic Sentiment 24.0, UK Employment Change 3m/3m 243k, UK Unemployment Rate 4.5%, UK Average Earnings Including & Excluding Bonus 7.0%/5.9% y/y, Japan Core Machinery Orders 1.7% m/m/14.7% y/y, China Trade Balance \$47.6b, China Exports & Imports 21.5%/19.2% y/y. **Wed:** Eurozone Industrial Production - 1.6% m/m/4.7% y/y, Germany CPI 4.1% y/y, UK GDP, UK Headline & Manufacturing Industrial Production 0.2% m/m/3.1% y/y & 0.1% m/m/4.1% y/y, UK Trade Balance - £12.0b, China CPI & PPI 0.9%/10.5% y/y, Australia Employment Change & Unemployment Rate - 120k/4.7%, Cunliffe, Debelle. (Bloomberg estimates)

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## Strategy Indicators

**S&P 500/400/600 Forward Earnings ([link](#)):** Two of these three indexes had forward earnings at a record high last week. LargeCap's was at a record high for a second straight week after dropping a hair below in late September due to Match's addition to the index. MidCap's dropped 0.2% w/w from a record high a week earlier in its first drop in 35 weeks, and SmallCap's was at a record for a fifth week after dropping six weeks ago for the first time in 26 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 70 of the past 73 weeks, with the two other down weeks due to Tesla's addition to the index last December and Amazon's earnings shortfall in August. MidCap's is up in 68 of the past 71 weeks, and SmallCap's posted 68 gains in the past 72 weeks. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 53.2% from its lowest level since August 2017; MidCap's is now up 99.2% from its lowest level since May 2015; and SmallCap's has soared 159.0% from its lowest point since August 2013. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act 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 was 36.1%, down from a record-high 42.2% at the end of July. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings fell w/w to 59.0% y/y; that's down from a record high of 78.8% at the end of May and up from a record low of -32.7% in May 2020. SmallCap's rate dropped to 87.3%; it's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings

growth rates for 2021 and 2022: LargeCap (44.0%, 9.6%), MidCap (74.1, 7.0), and SmallCap (113.1, 13.7).

**S&P 500/400/600 Valuation ([link](#)):** Valuations were mixed for these three indexes.

LargeCap's forward P/E remained steady w/w at an 11-month low of 20.3. LargeCap's forward P/E compares to a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's edged up 0.1pt to 16.3 from a 17-month low of 16.2. That compares to a seven-month high of 20.5 in early March and is 6.6pts below its record high of 22.9 in June 2020. SmallCap's fell 0.1pt to 15.6, and remains near its 17-month low of 15.4 in mid-September. It's now down 11.1pts from its record high of 26.7 in early June 2020. During March 2020, MidCap's 10.7 and SmallCap's 11.1 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 53rd week. That's the longest stretch at a discount since 2002-03; SmallCap's current 23% reading is near its biggest since 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 17th straight week; SmallCap's current 4% discount to MidCap's is near its biggest since 2003.

**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. Those gains have endured even through the current Q3 earnings warnings season, when forecasts typically decline. In the latest week, the S&P 500's Q3-2021 blended earnings-per-share estimate fell 15 cents w/w to \$48.96. That \$48.96 estimate for Q2-2021 represents a gain of 26.5% y/y on a frozen actual basis and a 29.6% y/y gain on a pro forma basis. That would mark a third straight quarter of double-digit percentage growth and compares to a pro forma gain of 96.3% in Q2-2021. All 11 sectors are again expected to post positive y/y earnings growth during Q3-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q3-2021 versus their final Q2-2021 growth rates: Energy (1,487.8% in Q3-2021 versus 243.3% in Q2-2021), Materials (92.4, 139.5), Industrials (75.9, 698.4), S&P 500 (29.6, 96.3), Information Technology (28.8, 49.6), Communication Services (23.8, 72.8), Financials (18.1, 158.2), Real Estate (17.2, 38.7), Health Care (15.3, 27.2), Consumer Discretionary (7.7, 380.5), Consumer Staples (3.5,

20.4), and Utilities (0.3, 12.6).

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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, 570-228-9102

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