Yardeni Research

**MORNING BRIEFING**
**November 3, 2021**

## No Shortage of Earnings!

*Check out the accompanying chart collection.*

(1) The definition of a meltup. (2) Earnings-led vs P/E-led meltups. (3) S&P 500 flying to record altitudes along with Blue Angels. (4) How to move a wagon train. (5) Q3 earnings beating expectations. (6) Consensus earnings estimates rising for next five quarters. (7) Record highs for forward revenues and earnings. (8) Why aren't SMidCaps beating LargeCaps? (9) Profit margins set to stall at record highs? (10) M-PMI remains bullish for earnings. (11) Inflation target practice at the Fed.

**Strategy I: Defining a Meltup.** Joe and I have been in the meltup camp for a long time. We are hearing more and more strategists describing the recent action in the stock market as a meltup. However, we associate meltups with a soaring forward P/E for the S&P 500. That's what we saw happen last year when this valuation multiple soared 79.8% from a low of 12.9 during March 23 to a high of 23.2 during September 2 (*Fig. 1*). Since then, it has been range bound between roughly 20.0 and 23.0.

The S&P 500's forward earnings bottomed last year during the May 14 week (*Fig. 2*). It has soared 54.2% since then to a new record high during the last week of October this year. In other words, this year's so-called meltup has been led by a "meltup" in earnings rather than in valuation. An earnings-led bull market is much better than a P/E-led bull market. The former is less prone to selloffs and corrections because it is supported by fundamentally strong earnings. That's especially important now since the forward P/E is high by historical standards.

Our Blue Angels chart shows S&P 500 forward earnings multiplied by forward valuation multiples of 10.0 to 24.0 in increments of two (*Fig. 3*). These eight series fly in a parallel formation, never colliding. The S&P 500 is the stunt plane that flies in between the vapor trails of these Blue Angels. It shows that last year's initial rebound in the S&P 500 was led by the P/E, and that since the May 8 week it has been flying higher in between the 20.0 and 22.0 vapor trails.

We are still projecting that forward earnings per share will be end up this year at $220 (up from $217 currently) and rise to $235 at the end of 2022 and $250 at the end of 2023. Our targets for the S&P 500 by the ends of 2021, 2022, and 2023 are 4800, 5200, and 5500. We are assuming that the forward P/E will remain high around its current level. So the meltup should continue to be led by earnings.

**Strategy II: Forward Ho!** On the old TV series Wagon Train, the wagon master shouted "Forward ho!" when it was time to move on. In the army, officers move their troops by saying "Forward march!" But in a wagon train, people who aren't riding in or on wagons or horses are walking or running alongside—which is why the wagon master just yells "Forward ho" to let everyone know it's time to move forward in whichever manner pertains.

It's been "Forward ho!" for the stock market since March 23, 2020. Forward earnings have been leading the S&P 500/400/600 to new highs since they bottomed during May of last year. Despite shortages of parts and labor, there has been no shortage of earnings to do so. Consider the following:

(1) *Q3 earnings reporting season and guidance.* We are well into the Q3 earnings reporting season, and it has been going surprisingly well. The latest "earnings hook" shows that Q3's blend of estimated and reported numbers jumped to $52.38 per share during the October 28 week, up 6.7% since the start of the season and 35.4% y/y (*Fig. 4*). Even more impressive is that despite lots of reasons to worry about rising costs as well as parts and labor shortages, forward guidance, on balance, boosted consensus earnings expectations for Q4 and for the four quarters of next year (*Fig. 5*). That's clearly remarkable under the circumstances!

(2) *S&P 500/400/600 forward metrics.* The forward revenues of the S&P 500/400/600 stock composites all rose to record highs during the October 21 week (*Fig. 6*). The forward earnings of all three did so the very next week (*Fig. 7*). Since they bottomed last year, the forward earnings of the S&P 500/400/600 are up 54.2%, 100.2%, and 160.5% through the end of October. So it's surprising that the S&P 400/600 indexes (a.k.a. "SMidCaps") underperformed the S&P 500 ("LargeCaps") earlier this year and have just been keeping pace with it over the past couple of weeks (*Fig. 8*).

The forward P/Es of all three indexes have declined since the early summer, with the S&P 400/600 P/Es dropping much more than the S&P 500 P/E as their stock prices stalled while their forward earnings soared (*Fig. 9*). That pattern may be about to change, as the forward P/Es of all three may be bottoming now, with more upside potential for the SMidCaps than the LargeCaps.

(3) *Profit margins.* Joe and I calculate forward profit margins simply by dividing forward earnings by forward revenues (*Fig. 10*). The forward profit margins of the S&P 500/400/600 all have been in record territory since the summer. During the week of October 21, they were 13.2%, 8.5%, and 6.8%. All three may be starting to peak, which wouldn't surprise us given all the anecdotes about rising costs. Some of those costs can be offset by raising prices and boosting productivity. If so, then margins should stabilize around current levels.

**Strategy III: Still Fundamentally Strong.** While real GDP rose just 2.0% during Q3, lots of other macroeconomic indicators remain more positive for earnings and the S&P 500. The y/y growth rate of S&P 500 aggregate revenues is highly correlated with the M-PMI (*Fig. 11*). The latter remained near its recent cyclical high during October, at 60.8. The M-PMI is also highly correlated with the S&P 500's net earnings revisions index, which has been solidly in positive territory for the past 15 months (*Fig. 12*). The y/y growth rate in S&P 500 forward earnings is highly correlated with the M-PMI as well (*Fig. 13*).

**The Fed: Target Practice.** Recall that the Fed changed its *approach* to inflation targeting back in August 2020. Before then, the Fed's stated inflation goal was "symmetric" around 2.0% (as measured by the annual change in the price index for personal consumption expenditures, or PCE)—meaning that undershoots or overshoots would be equally tolerated. Since then, the Fed has adopted a Flexible Average Inflation Targeting, i.e., "FAIT" based approach.

Under FAIT, the Fed still targets stable inflation of around 2.0% but not as a symmetric goal. Persistent overshoots are welcome, to make up for past persistent undershoots. From 2012 until just recently, the PCE rate had been below the 2.0% mark, leaving plenty of make-up room (*Fig. 14*).

St. Louis Federal Reserve Bank President James Bullard shared his opinion on inflation targeting in a recent *interview*, informed by 2020 staff *research*. In a nutshell, he said that the Fed "really is" aiming for 2.0% inflation over a five-year window. (Notably, Bullard is not a voter on the FOMC this year, but he is next year—when the interest-rate discussion is likely to become more pressing.)

Here's more:

(1) *Meat on the bones*. After the Fed's adoption of FAIT last year, Bullard worried that it would not get a good test run—i.e., there'd be no overshoots to tolerate. That would make the Fed's change of approach "kind of a moot point," he said. But there was no need for that

worry: "Instead, in 2021, beginning in the spring, we've had this big inflation shock. So, now we have actual meat on the bones where we can test the new framework, and we can see how it works." (Editorial: Hooray, and the meat costs more!)

(2) *Picking a window*. Bullard observed that the test will be how well the Fed can "control that inflationary process." He suggested looking at core PCE inflation over a five-year window of time. "Now, that window, you could have it be trailing, you could have it be including the current year and trailing years, you could have it be centered, so that you take the current year as the middle of a centered five-year moving average—all of those might be useful in various ways."

(3) *Carving a new path.* Bullard referred to FAIT as a "US experiment" that takes "a step toward" price level, or "nominal GDP targeting," which he has advocated. He noted that a "price level path" can result in "a better equilibrium outcome than inflation targeting" because the latter ignores past misses and just "tries to get it right going forward. Whereas price level targeting makes up for past misses."

(4) *Ready, aim.* Bullard said he wants "optionality," meaning the option to raise rates sooner if inflation gets out of control. To have that option, the Fed first would need to get its bond tapering done soon. Then it could assess "the date of lift-off, which will become the key policy variable at that point," he said.

(5) *Moving target.* Bullard didn't touch on it, but a former Fed official and a Peterson Institute for International Economics contributor recently put forth a *case* for raising the Fed's FAIT target from 2.0% to 3.0%, as a September 1 *WSJ* *article* discussed. The article noted that in 2010, Olivier Blanchard, then the chief economist of the International Monetary Fund, *suggested* that the problem of persistently low inflation could be solved with an inflation target of 4.0%.

(6) *Top turkey.* If that catches on with a more progressive FOMC in 2022, it would certainly keep rates lower for even longer. The FOMC could become more progressive if Biden populates the currently and potentially open Fed governor positions with more progressive folks. In light of the recent insider trading controversy among Fed officials, Melissa and I think that current Fed Chair Jerome Powell could be on the chopping block, to be replaced with a much more progressive head like Fed Governor Lael Brainard.

Brainard has been speaking more about climate change and global inequities these days than FAIT, but she was a big *proponent* of it when the Fed opted for the approach.

## Calendars

**US:** **Wed:** ADP Employment Change 400k, C-PMI & NM-PMI 57.3/58.2, ISM NM-PMI 62.0, Factory Orders 0.1%, MBA Mortgage Applications, Crude Oil Inventories, Fed Interest Rate Decision. **Thurs:** Nonfarm Productivity & Unit Labor Costs -3.0%/7.0%, Trade Balance -$74.1b, Initial & Continuous Jobless Claims 275k/2.118m, OPEC Meeting. (Bloomberg estimates)

**Global:** **Wed:** Eurozone Unemployment Rate 7.4%, Italy Unemployment Rate 9.2%, UK C-PMI & NM-PMI 56.8/58.0, UK Nationwide HPI 0.4%m/m/9.3%y/y, Lagarde, Elderson, Mauderer, Gravelle. **Thurs:** Eurozone, Germany, and France C-PMIs 54.3/52.0/54.7, Eurozone, Germany, France, Italy, and Spain NM-PMIs 54.7/52.4/56.6/54.5/55.8, Germany Factory Orders 2.0%, Japan Household Spending 2.8%m/m/-3.9%y/y, BOE Interest Rate Decision 0.10%, BOE Inflation Report, RBA Monetary Policy Statement, Lagarde, Mauderer, Bailey, Cunliffe, Beermann. (Bloomberg estimates)

## Strategy Indicators

**S&P 500 Q3 Earnings Season Monitor** (*link*): With nearly two-thirds of S&P 500 companies finished reporting revenues and earnings for Q3-2021, revenues have beaten the consensus forecast by a well-above-trend 2.6%, and earnings have exceeded estimates by 11.6%. At the same point during the Q2 season, revenues were a higher 4.3% above forecast and earnings beat by a greater 17.0%. For the 323 companies that have reported Q3 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates and the percentage of companies reporting a positive revenue and earnings surprise have slowed considerably from their Q2 measures. The Q3 reporters collectively have a y/y revenue gain of 19.0% and an earnings gain of 44.6%. That compares to y/y growth of 28.0% for revenues and 120.9% for earnings at the same point during Q2. Just over 83% of the Q3 reporters so far has reported a positive earnings surprise, and 77% has beaten revenues forecasts. Fewer companies have reported positive y/y earnings growth in Q3 (83%) than positive y/y revenue growth (89). These figures will change markedly as more Q3-2021 results are reported in the coming weeks. With the US economy largely re-opened compared to a year earlier, the y/y growth rates have slowed considerably in Q3 compared to Q2. The revenue and earnings surprises are moderating as well due to missed deliveries and higher costs.

## Global Economic Indicators

**Global Manufacturing PMIs** (*link*): “Growth of global manufacturing output slows amid record supplier delays, rising costs and stalling export trade” was the headline of October’s report. The JP Morgan M-PMI was little changed at 54.3 in October after falling from an 11-year high of 56.1 in May to 54.1 in August, where it held during September. October’s uptick reflected a record lengthening of vendor lead times, higher inventories, and stronger jobs growth, which offset slower growth in both production and orders. The index is up 14.7 points since bottoming at 39.6 last April. The M-PMI for advanced economies eased for the third month to 56.6 in October, down from its recent high of 59.8 posted in both July and May. The M-PMI for the emerging economies climbed for the second month to 51.6, after falling eight of the prior nine months from 53.9 in November to 49.6 by August—which was its first reading in contractionary territory since June 2020. Of the 31 nations for which October data were available, all except Mexico and Myanmar recorded M-PMI readings above the breakeven point of 50.0. Once again, the Eurozone was a bright spot—with five of its members leading the pack, with the US finishing in sixth place. Here’s a country ranking of October M-PMIs from highest to lowest: Netherlands (62.5), Ireland (62.1), Italy (61.1), Austria (60.6), Greece (58.9), US (58.4), EUROZONE (58.3), Australia (58.2), Germany (57.8), UK (57.8), Canada (57.7), Spain (57.4), Indonesia (57.2), India (55.9), Taiwan (55.2), Czech Republic (55.1), WORLD (54.3), Colombia (54.0), Poland (53.8), France (53.6), Japan (53.2), Malaysia (52.2), Vietnam (52.1), Brazil (51.7), Kazakhstan (51.6), Russia (51.6), Turkey (51.2), Philippines (51.0), Thailand (50.9), China (50.6), South Korea (50.2), Mexico (49.3), and Myanmar (43.3).

---

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