MORNING BRIEFING
January 12, 2022

Earnings Season Starting

Check out the accompanying chart collection.

(1) Latest earnings reports should beat expectations again. (2) Real Q4 GDP tracking at 6.8%. (3) S&P 500 forward earnings at another record high. (4) Our latest forecasts for S&P 500 earnings and the stock price index. (5) Profit margins likely to stall at record high. (6) Consumers shopped and borrowed at solid paces during Q4. (7) Homebuilders seeing demand and raising prices. (8) US petroleum usage at record high. (9) Financials boosting profits by reducing loan-loss reserves. (10) Industrials experiencing record new orders, especially for capital goods. (11) Global M&A likely to continue to boom in 2022.

Strategy I: Looking Forward. The Q4 earnings season has started. We are expecting another strong season, with actual results once again beating expectations. After all, the Atlanta Federal Reserve Bank's *GDPNow* model showed Q4's real GDP tracking at 6.8% (saar) as of January 10. Real consumer spending is showing a solid gain of 4.5%, and real gross private domestic investment growth is tracking at 17.8%. Inflation is also likely to boost Q4's results given that the CPI is up 6.8% y/y through November. Of course, costs are also going up, but profit margins seem to be holding up remarkably well. Consider the following:

(1) *Q4 earnings growth.* The analysts' consensus estimate for S&P 500 earnings per share has been hovering around $51 for Q4 since mid-2021 (*Fig. 1*). That means that Q3's better-than-expected results didn't change Q4 expectations much. The expected y/y growth rate for Q4 has been hovering around 20.0% since mid-2021 (*Fig. 2*).

(2) *Another earnings hook.* Following the recession of 2020, the y/y growth rate of S&P 500 earnings per share peaked at 88.6% during Q2 (*Fig. 3*). It eased to 39.3% during Q3. Joe and I expect yet another "earnings hook" during the current earnings season, with Q4 results beating estimates. That's a frequent phenomenon; it occurred during the previous three quarters and in fact during most earnings seasons in the past.

(3) *Forward earnings.* Indeed, the y/y growth rate in S&P 500 forward earnings on a monthly basis is highly correlated with the comparable growth rate in the actual quarterly results (*Fig. 4*). ("Forward earnings" is the time-weighted average of analysts' consensus estimates

for this year and next.) The former was up 32.9% during December. That's more than 10 percentage points above analysts' current consensus outlook. The level of forward earnings tends to be a good year-ahead leading indicator of actual earnings (*Fig. 5* and *Fig. 6*).

During the January 6 week, S&P 500 forward earnings rose to yet another record high of $223.78 per share (*Fig. 7*). This series has been rising in record-high territory since March 4, 2021, and it remains on the steep uptrend that started during the spring of 2020. Industry analysts currently expect that earnings per share will be $223.35 in 2022 (up 8.5% y/y), and $245.71 in 2023 (up 10.0%).

(4) *Our annual earnings forecasts.* We are forecasting S&P 500 earnings per share will be $220.00 this year (up 4.8%), $235.00 next year (up 6.8%), and $250.00 in 2024 (up 6.4%) (*Fig. 8*).

(5) *Our forward earnings forecast.* Our forecasts for the S&P 500 stock price index are based on our forecasts of forward earnings. We are currently projecting that by the end of this year, forward earnings will rise to $235.00 from $223.78 during the January 6 week, and we project $250.00 by the end of 2023 (*Fig. 9*).

(6) *Our S&P 500 forecasts.* Assuming as we do currently that the S&P 500 forward P/E will remain around 22.0, our projection is that the S&P 500 stock price index will be 5200 by the end of this year and 5500 by the end of 2023 (*Fig. 10*).

Strategy II: On the Margin. Joe and I derive the profit margin of the S&P 500 by dividing S&P 500 operating earnings per share by the composite's revenues per share. Consider the following:

(1) *Revenues.* Revenues growth peaked at a record high of 21.8% y/y during Q2-2021 (*Fig. 11*). It slowed to a still-robust growth rate of 13.9% during Q3. We are expecting to see revenues grow 3.1% this year and 3.0% next year (*Fig. 12*).

(2) *Quarterly profit margin.* The S&P 500 operating profit margin averaged a record 13.1% during the four quarters through Q3-2021 (*Fig. 13*). That's also our forecast for all of 2021. For this year and next year, we are predicting 13.2% and 13.8%, just about the same as the analysts' consensus currently.

(3) *Weekly margin proxy.* By the way, we also derive a weekly operating profit margin by dividing forward earnings by forward revenues (*Fig. 14*). It is a very good weekly coincident

indicator of the actual quarterly profit margin. It suggests that the profit margin is currently peaking around 13.0%.

Strategy III: Sector Stories. Where among the 11 sectors of the S&P 500 might the Q4 revenues and earnings surprises be concentrated? Lots of macroeconomic variables seem to be providing hints. Here's what they tell us about the Q4 surprise prospects of several of the sectors:

(1) *Consumer Discretionary.* Omicron may have depressed retail sales. However, total retail sales rose to a new record high during November. The same can be said excluding motor vehicles and gasoline. Auto sales have been depressed by a shortage of dealer inventories. Gasoline sales have been boosted by price increases.

Also at or near record highs were retail sales of furniture & home furnishings stores, clothing & accessory stores, health & personal care stores, sporting goods stores, and general merchandise stores. Restaurants and bars had record sales too, though some of that strength undoubtedly reflected higher prices to offset rapidly rising costs.

By the way, consumers are using their credit cards again. Revolving credit jumped $20 billion during November, the biggest monthly gain on record (*Fig. 15*), excluding the $50 billion outlier during January 2006.

Homebuilders still report plenty of prospective-buyer traffic. That's even though both median and average new home prices are up around 15% y/y through November. Of course, those increases reflect not only demand for new homes but also rapidly rising construction costs.

(2) *Energy.* At the end of last year, petroleum products usage rose to a new record high for that time of year. It exceeded December 2019 usage (*Fig. 16*). The average price of a barrel of Brent crude oil was around $80 during Q4-2021, up almost 100% from the Q4-2020 average.

(3) *Financials.* Commercial banks reduced their loan-loss provisions by $52.7 billion from $221.7 billion at the end of 2020 to $169.0 billion at the end of 2021 (*Fig. 17*). As discussed in the next section, 2021 was a banner year for the M&A business of investment banks.

(4) *Industrials.* The transportation subsector of the S&P 500 Industrials sector faced lots of challenges as employees had to stay home if they were hit with Omicron. However, the airports were packed during the holiday season. It's not clear whether airfares were up or

down. November’s CPI and PCED for airfares were down 3.7% and up 13.5%, respectively, on a y/y basis.

There’s no ambiguity about durable goods orders. They were up 14.8% y/y through November. Over the same period, nondefense capital goods orders excluding aircraft rose 11.7% to yet another record high. Orders were particularly strong for primary metals, fabricated metal products, electrical equipment, and industrial machinery. (See our *Durable Goods Orders & Shipments*.)

(5) *Q4 consensus sectors earnings growth.* Here are analysts’ consensus forecasts for y/y revenues and earnings growth during Q4 for the S&P 500 and its 11 sectors: S&P 500 (12.1%, 20.1%), Communication Services (8.9, 9.6), Consumer Discretionary (11.3, 8.1), Consumer Staples (7.4, 3.3), Energy (72.7, -/+), Financials (-5.0, 2.2), Health Care (11.2, 19.4), Industrials (12.6, 51.5), Information Technology (10.8, 15.9), Materials (24.2, 64.2), Real Estate (14.9, 13.9), and Utilities (4.3, 0.8).

Global M&A: New Records. Global M&A activity well exceeded the $5 trillion mark during 2021 for the first time ever. It was fueled by corporates’ access to unprecedented levels of cash and cheap capital during the pandemic. Dealmakers expect activity to increase to new records in 2022. However, several challenging factors on the horizon could either slow M&A activity or further support it. For example, companies facing supply-chain disruptions and ESG (environmental, social, and governmental) pressures could turn to M&A to solve their problems. Consider the following:

(1) *Setting global records in 2021.* Reuters *reported* that the total value of global M&A transactions through December 31 was $5.8 trillion, a record since the start of the data, up 64% from the same period a year before, according to Refinitiv. Over 63,000 M&A deals were announced during 2021, another record, according to Refinitiv.

Completed global deals valued above $100 million reached 1,047 in 2021, up significantly from 674 in 2020, *reports* Willis Towers Watson (WTW). That’s the highest volume for any year since the company began counting in 2008.

(2) *Companies have amassed cash.* Companies have put cash they’ve amassed during the pandemic to work on deals. Cash and equivalents at S&P 500 firms increased 11% y/y during Q3 to about $3.8 trillion, according to S&P Global Market Intelligence, *reported* MSN. Indeed, US corporate cash flow hit a new record high that quarter of $3.2 trillion, according to the Bureau of Economic Analysis’ data (*Fig. 18*).

(3) *Issuances remain on a high.* With all that cash on hand, companies haven't issued as many new securities; new issues fell in both the bond and stock markets toward the end of 2021.

Businesses raised $1.4 trillion during December 21 from US investment-grade bond sales, down 22% from a year earlier when pandemic activity peaked, Refinitiv said, according to MSN. Federal Reserve Financial Accounts data also show that new corporate issues in both the bond and stock markets slowed in recent months through November (*Fig. 19*). However, new issues remained elevated from a historical viewpoint, buoyed by historically low interest rates.

(4) *Big money in certain sectors.* Reuters recounted the following blockbuster transactions: AT&T Inc. and Discovery Inc.'s $43 billion media asset merger; the $34 billion leveraged buyout of Medline Industries Inc; Canadian Pacific Railway's $31 billion takeover of Kansas City Southern; and the breakups of General Electric Co and Johnson & Johnson.

Other recent big deals include Block Inc.'s (formerly Square) $29 billion acquisition of Afterpay Ltd. and Oracle Corp.'s $28.3 billion acquisition of medical records company Cerner Corp., MSN has reported.

Most M&A volume has been concentrated in the Technology, Financials, Industrials, and Energy sectors. Many deals were pursued despite high valuations. Bain & Co said that multiples for transactions (i.e., the ratio of median enterprise value to earnings before interest, taxes, depreciation, and amortization) increased across industries in 2021 over 2020. The Technology and Health Care sectors' multiples were the highest, at 28 times and 24 times, respectively, reported MSN.

(5) *Across-the-border volume up.* Deal volume was up across all regions that WTW evaluated, including the US, Europe, and Asia. "While China cross-border activity has been modest, corporates from other Asian countries have stepped up to buy global assets," Goldman Sachs's Global Vice Chair of Investment Banking *told* Reuters.

(6) *Alternative deals abound.* Last year's heightened interest in SPACs (special purpose acquisition companies—essentially, publicly traded cash pools) is likely to generate additional deal-making in 2022 because these entities usually have about two years to close a deal. SPAC deals accounted for about 10% of the global M&A volumes, reported Reuters.

Bain also said that private-equity and venture-capital firms increased their share of total M&A transaction values in 2021 by about 2ppts over 2020 levels, to 19% and 8%, respectively. As we discussed in our December 1 *Morning Briefing*, private-equity and venture-capital funding recently reached record highs.

(7) *Turning challenges into opportunities.* Datasite surveyed 600 dealmakers in the US, UK, and EU to understand what kinds of opportunities and challenges are ahead for global M&A, *reported* Business Wire. More than 70% of global dealmakers said rising inflation affected a deal they had worked on in 2021, by changing company operating assumptions or affecting deal valuations, found Datasite.

For 2022, according to the Datasite survey, dealmakers say that the biggest challenges to getting deals done are supply-chain issues, labor shortages, and ESG risks. ESG trends could also promote dealmaking, however, as companies search for ESG-friendly targets to climatize their business, WTW pointed out. WTW also expects that supply-chain challenges could drive many companies to look for more self-sufficiency in their products and services through deal activity.

(8) *Policy could slow M&A.* Fiscal and monetary policy could, however, dampen the pace of deals. The Fed's anticipated interest-rate increases and balance-sheet wind-down certainly could curb enthusiasm in deal markets. So could antitrust regulators' increased scrutiny, especially of technology companies.

Calendars

US: Wed: Headline & Core CPI 0.4%m/m/7.0%y/y & 0.5%m/m/5.4%y/y; Fed Budget Balance -$25.0b; Crude Oil Inventories & Gasoline Production; Cleveland CPI; Beige Book. **Thurs:** Initial & Continuous Jobless Claims 200k/1.733m; Headline & Core PPI 0.4%m/m/9.8%y/y & 0.5%m/m/8.0%y/y; Brainard. (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production 0.5%m/m/0.6%y/y; Enria; Cunliffe. **Thurs:** Italy Industrial Production 0.5%m/m/3.7%y/y; Japan PPI 0.3%m/m/0.8%y/y; China Trace Balance ¥74.5b; China Exports & Imports 20.0%/26.3% y/y; ECB Economic Bulletin; Elderson; Buch; Hakkarainen. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q4 Earnings Season Monitor (*link*): With just 4% of S&P 500 companies finished reporting revenues and earnings for Q4-2021, revenues are beating the consensus forecast by a well-above-trend 3.0% and earnings have exceeded estimates by a bigger-than-usual 6.6%. At the same point during the Q3 season, revenues were 2.1% above forecast and earnings beat by 3.9%. For the 20 companies that have reported Q4 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings during Q2 and Q3. The small sample of Q4 reporters so far collectively has a y/y revenue gain of 12.8% and an earnings gain of 34.0%. Just 70% of the Q4 reporters so far has reported a positive earnings surprise, but nearly all (95%) have beaten revenues forecasts. Fewer companies have reported positive y/y earnings growth in Q4 (80%) than positive y/y revenue growth (90). These figures will change markedly as more Q4-2021 results are reported in the coming weeks. We expect the y/y growth rates to continue easing in Q4 compared to Q2 and Q3. We also think the revenue and earnings surprises will moderate as well due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Small businesses unfortunately saw a disappointing December jobs report, with staffing issues continuing to impact their ability to be fully productive," said NFIB Chief Economist Bill Dunkelberg. "Inflation is at the highest level since the 1980s and is having an overwhelming impact on owners' ability to manage their businesses." December's Small Business Optimism Index (SBOI) edged higher for the second month, by 0.5 points m/m and 0.7 points over the period to 98.9. Seven of the 10 components of the SBOI rose last month, while three fell. The biggest positive contributions in December were hiring plans (to 28% from 25%), earnings trends (-14 from -17), and those expecting business conditions to improve (-35 from -38)—with the latter holding deep in negative territory, down 26ppts the past six months. Modest upticks were recorded in sales expectations (3 from 2), now is a good time to expand (11 from 10), and job openings (49 from 48)—with the latter far above the 48-year historical average of 23%. Meanwhile, current inventory (9 from 15) was the biggest drag on December's SBOI, followed by plans to increase inventories (8 from 10) and expected credit conditions (-4 from -3). Quality of labor (25%) and inflation (22) were the two biggest problems facing small business owners in December, the latter jumping 20ppts since February's low of 2%, while the former holds

near November's record-high 29%; the cost of labor (13) rounded out the top three. NFIB's December jobs report noted that a record net 48% of owners reported raising compensation during the month, while those planning to raise compensation over the next three months held at November's record high of 32%.

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