MORNING BRIEFING
February 1, 2022

The Big Chill? Not!

Check out the accompanying chart collection.

(1) Blaming the slow-acting Fed for volatility. (2) The arithmetic behind our new S&P 500 targets. (3) No change in our outlook for revenues, earnings, or margins. (4) Lowering our forward P/E assumption. (5) Making the case for relatively high P/E. (6) A minor correction for the S&P 500, so far. (7) *Businessweek* cover showing bull buried in snow is bullish. (8) Home, sweet home. (9) Indecisive excerpts from Powell's presser.

Strategy I: S&P 500 Arithmetic. In yesterday's *Morning Briefing*, we blamed the Fed for causing most of the volatility in the stock market since the beginning of the year. Fed Chair Jerome Powell and his colleagues have been making the tough transition from easy to tight monetary policy more painful and possibly more prolonged than it has to be. Below, we review all the decisions that the FOMC did *not* make at the latest meeting of the Fed's policy-setting committee on January 25-26.

The resulting uncertainty about the course of monetary policy tightening has unnerved stock investors. That's a good thing to the extent that several asset bubbles have deflated without any serious consequences for the financial markets or the economy. However, we would like to see the Fed get on with what needs to be done.

While we and the rest of the world await the Fed's next move, Joe and I have responded to the Fed's indecisiveness by tweaking our targets for the S&P 500 stock price index. (By the way, our valuation work is always based on "forward earnings," or the time-weighted average of analysts' consensus estimates for this year and next—which more closely approximate the earnings that investors expect at any particular point in the year than do full-year estimates.) Here are our latest projections for the S&P stock price index (P) along with our forecasts for the index's forward earnings per share (E) and the forward valuation multiple (P/E) based on those earnings:

(1) *S&P 500 targets.* We now expect that the S&P 500 will rise to about 4800 by the end of this year, leaving the index essentially unchanged for the year. We are moving our 5200 target from year-end 2022 to during H2-2023 (*Fig. 1*).

(2) *Forward earnings.* We are not changing our outlook for S&P 500 revenues per share,

operating earnings per share, or the profit margin (*Fig. 2*, *Fig. 3*, and *Fig. 4*). We are still forecasting earnings per share of $225 and $250 for this year and next year.

We are also still comfortable with our projections for S&P 500 forward earnings per share of $250 by the end of this year and $265 by the end of next year (*Fig. 5*). By year-ends, forward earnings match analysts' consensus expectations for the coming years, so those should match their consensus estimates for 2023 and 2024, respectively.

(3) *Valuation.* Reverse engineering our projected numbers for P and E results in forward P/E estimates of 19.2 at the end of this year and 19.6 at the end of next year. We had been projecting 20.8 for both. Admittedly, our latest estimates are still relatively high. They imply that we think that most of the decline in the forward P/E of the S&P 500 is over, since it was down to 19.7 on Friday from readings ranging between 20.0 and 23.0 during 2021 (*Fig. 6*).

The current forward P/E of the S&P 500 is almost back down to where it was just before the pandemic began, at 19.0 (on February 19, 2020). Of course, back then the monetary policy outlook calling for continued easing was more conducive to higher valuation than today's widely expected imminent tightening.

(4) *Bottom line.* You might be wondering why in the world we aren't bearish. Based on our forward earnings estimate for year-end 2022, here are the price levels of the S&P 500 at more "reasonable" forward P/Es of 18.0 (4500), 17.0 (4250), 16.0 (4000), and 15.0 (3750). We believe that once the FOMC starts to raise the federal funds rate and details the pace of running off the Fed's balance sheet, the financial markets will learn to live with tightening monetary policy as long as it doesn't risk causing a recession.

Most importantly, we expect that inflation will peak within the next few months and head down during the second half of the year. We are counting on the durable goods components of both the CPI and PCED to lead on the way down. If and when that happens, stock investors are likely to rejoice by paying the relatively high multiples we project for the boon of falling inflation.

(5) *Another correction?* For now, Joe and I believe that *Panic Attack #73* has turned out to be a minor correction, i.e., when the S&P 500 falls between 5% and 10% (*Fig. 7*). This one saw the S&P 500 fall 9.8% from its record high of 4796.56 on January 3 through its recent low of 4326.51 on January 24. The intraday low that day was 4229.93. We doubt that low will be retested.

Strategy II: The Front-Cover Indicator. Contrarians take note: The *cover story* of the January 31 *Bloomberg Businessweek* is titled "The Big Chill: Investors are bracing for more pain as a cold snap descends on the market." On the cover is the *image* of a bull buried in snow. That's a bullish signal from a contrarian perspective. However, the story was actually well balanced in making both the bearish and bullish cases for stocks. Consider the following:

(1) *For the bears.* The story noted that the bears are talking about "long winters and bursting bubbles." It also observed that "the most speculative stuff is leading the way down," including Ark Innovation ETF and cryptocurrencies. We've concluded that taking the air out of the various speculative bubbles is actually bullish for the rest of the market since it has occurred without any noticeable consequences for the financial markets and the economy.

This has happened because the "Fed put" is in doubt, according to the article. We agree with that. Indeed, I was quoted in a January 21 *Barron's* *article* titled "Is the 'Fed Put' Kaput? Gone for Now but Not for Good." I said that the Fed has a serious inflation problem "and even if the S&P 500 corrects, the Fed will have to ignore it because it is behind the curve and its credibility is on the line."

(2) *For the bulls.* The *Businessweek* article then explained that this time corporations might provide a "CFO put." American corporations are in great financial shape, with the S&P 500 companies sitting on a record $2.4 trillion in cash and other liquid assets. We've observed that there is about $3 trillion in excess M2 liquidity in our financial system.

Corporations can use some of their cash to fund buybacks, which rose to a record high during Q3-2021 (*Fig. 8*). They undoubtedly also will use it to finance mergers and acquisitions. In January, Microsoft announced plans to acquire Activision Blizzard for $69 billion. Bloomberg *reported* yesterday that "Citrix Systems Inc.'s $13 billion buyout by a private equity consortium caps one of the busiest-ever months for dealmaking in the technology industry. The takeover—first reported by Bloomberg—means the tally for tech deals this January has more than doubled from a year earlier to hit $156 billion. That's the biggest month for the industry since January 2000 and the second-highest tally on record, according to data compiled by Bloomberg. The Citrix deal means the three largest acquisitions announced globally since the start of the year are all in the tech sector."

Strategy III: Staying Home. Joe and I have been recommending overweighting US stocks in global portfolios almost since the start of the current bull market. That advice has worked out well. We are sticking with that recommendation, although we've been getting some pushback recently because the US stock market has been a global underperformer so far this year, though less and less so recently. Consider the following:

(1) Since March 9, 2009, here is the performance derby of the major MSCI stock price indexes in dollars and in local currencies through Friday's close (January 28, 2022): US (557.2%), Emerging Markets (145.4, 171.2), EMU (134.5, 165.5), Japan (128.4, 166.1), UK (97.7, 102.7) (*Fig. 9* and *Fig. 10*).

(2) The US MSCI is down 7.7% ytd through Friday's close. That's among the weakest global underperformers (in dollars) over that short period (*Fig. 11*). The US was among the global outperformers last week, especially on Friday. (See Tables 1 and 2 in our *Global MSCI Share Price Indexes*.)

(3) The MegaCap-8 stocks (i.e., the eight highest-capitalization stocks in the S&P 500) have accounted for much of the US market's outperformance in recent years. They continue to have a large impact on the broader index's performance. All eight aren't in the S&P 500 Tech sector, which has also had a big impact on the global relative performance of the US stock market. The All Country World ex-US MSCI trades more like the S&P 500 Value index than the S&P 500 Growth index because it has fewer technology stocks and more stocks in the energy and financial services sectors (*Fig. 12*).

We like the opportunities currently in S&P 500 Energy and Financials sectors. But we are not giving up on the long-term outlook for the Tech sector notwithstanding its recent selloff along with the MegaCap-8.

The Fed: Excerpts of Indecision. The main source of the stock market's volatility since the start of this year has been the Fed. The uncertainty about monetary policy weighing on the market last week got a boost from Chair Powell's January 26 post-FOMC-meeting *press conference*. Of his 15 mentions of "decision," 14 were in the context of "no decision has been made." The one decision that was made was to reiterate the decision first made at the December 14-15 meeting that the FOMC would stop buying securities after March.

Take a gander at some of these decidedly indecisive decision-related excerpts from Powell's presser on Wednesday:

(1) "To provide greater clarity about our approach for reducing the size of the Federal Reserve's balance sheet, today the Committee issued a set of principles that will provide a foundation for our future decisions. These high-level principles clarify that the federal funds

rate is our primary means of adjusting monetary policy and that reducing our balance sheet will occur after the process of raising interest rates has begun."

(2) "Our decisions to reduce our balance sheet will be guided by our maximum employment and price stability goals. In that regard, we will be prepared to adjust any of the details of our approach to balance sheet management in light of economic and financial developments."

(3) "The Committee has not made decisions regarding the specific timing, pace, or other details of shrinking the balance sheet, and we will discuss these matters in upcoming meetings and provide additional information at the appropriate time."

(4) "[A]t this time, we haven't made any decisions about the path of policy. And I stress again that we'll be humble and nimble."

(5) "The labor market is far stronger. Inflation is running well above our 2 percent target, much higher than it was at that time. And these differences are likely to have important implications for the appropriate pace of policy adjustments. Beyond that, we haven't made any decisions."

(6) "So we had a discussion, as you know, at the last meeting, an introductory discussion of the balance sheet and teeing up of the issues. At this meeting, we've gone through and carefully put together a set of principles at a high level. And those are meant to guide the actual decisions we'll make about the pace and about all of the questions that you're asking. And I expect that this process will be something that we spend time on in coming meetings. I can't tell you how many; I can't say how long it will take."

(7 & 8) "Surveys show that market participants are expecting a balance sheet runoff to begin … at the appropriate time sometime later this year perhaps. We haven't made that decision yet. So, we feel like the communications we have with market participants and with the general public are working and that financial conditions are reflecting in advance the decisions that we make."

(9, 10 & 11) "We haven't made a decision yet, and we'll make that decision at the March meeting. We'll make a decision whether to raise the federal funds rate."

(12) "[W]e'll start the process of allowing runoff and shrinking the balance sheet at what we find to be the appropriate time. It's—I wish I could say more. But, honestly, we haven't

made those decisions."

(13) "So, as I mentioned, we have not made these decisions. We really haven't. And what I can tell you now, though, is that we fully appreciate that this is a different situation."

(14) "[S]o inflation right away, right away forces people like that to make very difficult decisions."

(15) "[T]hat's really where we are. In terms of your question about the size of rate increases, we haven't faced those decisions."

Odds are that the March 15-16 meeting of the FOMC will be much more decisive. My message to the committee: "The labor market is strong. Inflation is a problem. Can we just get on with what needs to be done, please?"

Calendars

US: Tues: ISM M-PMI & Price Index 57.5/79.5; IHS Markit M-PMI 55.0; Job Openings 11.075m; Construction Spending 0.6%; API Weekly Crude Oil Inventories. **Wed:** ADP Employment 207k; MBA Mortgage Applications; Crude Oil & Gasoline Inventories; OPEC Monthly Report. (Bloomberg estimates)

Global: Tues: Eurozone, Germany, France, Italy, and Spain M-PMIs 59.0/60.5/55.5/61.5/56.0; Eurozone Unemployment Rate 7.1%; Germany Retail Sales -1.2%m/m/-0.6%y/y; Germany Unemployment Change & Unemployment Rate -8k/5.2%; France CPI; UK M-PMI 56.9; UK Nationwide HPI 0.6%m/m/10.8%y/y; Canada GDP 0.4%m/m; ECB Bank Lending Survey; Buch, Lowe. **Wed:** Eurozone CPI & PPI 4.4%/22.9% y/y; Spain Unemployment Change -50.7k; Canada Building Permits -1.5%; Wuermeling; Mauderer; Macklem. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): All three of these indexes had forward earnings at a record high last week. LargeCap's was at a record high for a fifth week after dropping a week earlier due to index changes. MidCap's was at a record high for an eighth straight week after dropping 0.1% below at the end of November. SmallCap's was back in record-high territory for a second week after being below for four weeks due to index changes. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 84 of the past 88 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings shortfall in August, and index changes in late December and September. MidCap's forward earnings is up in 82 of the past 86 weeks, and SmallCap's posted 82 gains in the past 87 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 59.9% from its lowest level since August 2017; MidCap's is now up 117.5% from its lowest level since May 2015; and SmallCap's has soared 179.2% 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 dropped to 29.9% y/y from 31.3%; that's 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 47.2% y/y from 48.5%; that's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate dropped to 55.2% y/y from 58.4%; 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 (47.9%, 8.4%), MidCap (83.2, 8.5), and SmallCap (122.4, 13.1).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower for these three indexes last week. LargeCap's forward P/E edged up 0.1pt w/w to 19.7 from a 21-month low of 19.6. That's down from a six-month high of 21.5 in early November, and compares to its prior 11-month low of 20.3 in early October. LargeCap's forward P/E also 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 fell 0.2pt to a 22-month low of 14.3 and is down from a 13-week high of 17.1 in early November. That compares to a seven-month high of 20.5 in March 2021 and is 8.4pts below its record high of 22.9 in June 2020. SmallCap's also dropped 0.2pts, but to a 22-month low of 13.5. That's compares to mid-December's 20-month low of 14.4 and is down from a 13-week high of 16.1 in early November. It's now down 13.2pts from its record high of 26.7 in early June 2020 when forward earnings was depressed. 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; MidCap's current 27% discount to LargeCap is its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 75th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 31% reading is its biggest since April 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 32nd straight week; SmallCap's current 5% discount to MidCap's is near its biggest since July 2001.

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 endured through the latest Q4 earnings warnings season, when forecasts typically decline. The S&P 500's Q4-2021 earnings-per-share estimate rose 25 cents w/w to $51.91, and is up from $51.08 at the beginning of the quarter. That $51.91 estimate represents a gain of 21.9% y/y on a frozen actual basis and a 25.2% y/y gain on a pro forma basis. Q4 is on pace to mark the fourth straight quarter of double-digit percentage earnings growth, but growth is slowing for a second straight quarter. All 11 sectors are expected to post positive y/y earnings growth for a third straight quarter during Q4-2021, but double-digit growth is expected for only eight sectors; that's down from 10 sectors doing so during Q3. Here are the S&P 500 sectors' latest earnings growth rates for Q4-2021 versus their blended Q3-2021 growth rates: Energy (10,712.6% in Q4-2021 versus 1,798.0% in Q3-2021), Materials (63.9, 89.1), Industrials (37.5, 88.4), S&P 500 (25.2, 42.6), Information Technology (22.7, 38.2), Health Care (21.4, 29.0), Real Estate (14.5, 34.4), Communication Services (11.8, 35.6), Consumer Discretionary (10.5, 19.4), Financials (6.4, 35.9), Consumer Staples (4.0, 7.4), and Utilities (1.7, 10.3).

S&P 500 Q4 Earnings Season Monitor (*link*): With nearly 35% of S&P 500 companies finished reporting revenues and earnings for Q4-2021, revenues have beat the consensus forecast by 2.9% and earnings by 4.4%. These surprises are substantially weaker than those seen since Q1-2020. At the same point during the Q3 season, revenues were 2.3% above forecast and earnings beat by 12.8%. For the 172 companies that have reported Q4 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings during Q2 and Q3. The sample of Q4 reporters so far collectively has a y/y revenue gain of 15.9% and an earnings gain of 28.4%. Just 79% of the Q4 reporters so far has reported a positive earnings surprise, not much higher than the 76% that has beaten revenues forecasts. However, fewer companies have reported positive y/y earnings growth in Q4 (81%) than positive y/y revenue growth (89). These figures will change markedly as more Q4-2021 results are reported in the coming weeks, but the early read on earnings is disappointing compared to the previous six quarters. We expect the y/y growth rates to continue easing in Q4 compared to Q2 and Q3. We think the revenues and earnings surprises will moderate q/q as well due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

US Economic Indicators

Regional M-PMIs (*link*): Five Fed districts (New York, Philadelphia, Richmond, Kansas City, and Dallas) now have reported on manufacturing activity for January and show the manufacturing sector slowed for the second month, as activity in the New York region stalled after 18 months of positive readings and Dallas' was at a near standstill. The composite index eased to 11.3 from 18.6 in December and 22.9 in November. Manufacturing activity in the New York (to -0.7 from 31.9) region was slightly negative in January, while growth in the Dallas (2.0 from 7.8) area slowed to near zero and Richmond's (8.0 from 16.0) was cut in half. In the meantime, growth in the Philadelphia (23.2 from 15.4) region picked up steam last month after being more than halved in December, while Kansas City's (24.0 from 22.0) held around December's pace. The new orders (10.6 from 19.9) measure was also impacted by negative growth in the New York (-5.0 from 27.1) region, along with slower growth in both the Richmond (6.0 from 17.0) and Kansas City (14.0 from 22.0) regions last month. Meanwhile, orders growth in the Philadelphia (17.9 from 13.7) area was slightly faster, while Dallas' (20.0 from 19.8) virtually matched December's pace. Meanwhile, jobs growth slowed again in January to 19.6 from 24.7 and 26.4 the previous two months. Growth accelerated in the Richmond (24.0 from 18.0) region and slowed in the remaining four—Philly (26.1 from 33.9), Dallas (27.7 form 31.1), New York (16.1 from 21.4), and Richmond (4.0 from 19.0)—though hirings in the Philadelphia and Dallas regions held around their record highs of 33.9 and 32.0, respectively, during November and April of 2021.

Regional Prices Paid & Received Measures (*link*): We have prices-paid and -received data for January from the Philadelphia, New York, Kansas City, Richmond, and Dallas regions, and it's a mixed bag. (Note: The Philadelphia, New York, and Kansas City measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.) The prices-paid measure slowed from a record-high 89.2 in November to 83.7 in January. Regionally, the prices-paid measure in the Richmond (to 143.2 from 139.8) region reached a new record high again in January, while Philadelphia's gauge accelerated to 72.5 after easing from 80.6 to 66.1 in December. Meanwhile, both the New York (to 76.7 from 83.0 in November) and Dallas (62.1 from 83.3) gauges slowed for the second month—the latter from a record high—while Kansas City's eased to a 12-month low of 64.0 from 67.0 in December. (Prices-paid measures for the New York and Kansas City regions were at record highs of 83.5 and 88.0, respectively, last May.) The prices-received measure accelerated to 56.5 in January after easing from a record-high 56.9 in October to 53.2 by December. Richmond's prices-received (112.7 from 82.6) gauge jumped to a new record last month, while Kansas City's (49.0 to 46.0) accelerated a bit but remained below May's record-high 57.0. Meanwhile, both the Dallas and New York measures eased to 37.1 in January, the former from a record-high 50.9 in October and the latter from a record-high 50.8 in November. Meanwhile, Philadelphia's gauge slowed from 62.9 in November (close to its record high of 63.8 in the mid-1970s) to 46.4 by January.

Global Economic Indicators

Eurozone GDP Flash Estimate (*link*): The Omicron wave of Covid-19 infections slowed Eurozone real GDP growth during Q4—with Germany's economy especially weak. Growth in the overall Eurozone climbed 0.3% during Q4—slowing sharply from Q3's 2.3%—though the y/y growth rate was a respectable 4.6%. Spain posted the strongest growth among the member states last quarter, expanding 2.0%, not far from Q3's 2.6% and 5.2% above its Q4-2020 level. France (0.7%) and Italy (0.6) both outpaced the growth rate of the overall Eurozone, though their Q4 rates were considerably slower than their Q3 rates of 3.1% and 2.6%, respectively. Still, they were up a robust 5.4% and 6.4%, respectively, from their Q4-2020 levels. Meanwhile, Germany's GDP contracted 0.7% after expanding 1.7% and 2.2% the previous two quarters, as it was impacted by severe supply shortages as well as Omicron. However, it did finish the year in the plus column on a y/y basis, 1.4% above the rate in the final quarter of 2020, though a sharp slowing from Q2's 10.4%.

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