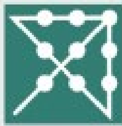
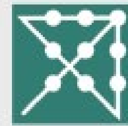
 Yardeni Research 

MORNING BRIEFING
February 2, 2022

Great-Looking Fundamentals

Check out the accompanying chart collection.

(1) January was bad for stock prices but good for their fundamentals. (2) Omicron didn't infect analysts' outlook for earnings. (3) Neither did supply-chain disruptions. (4) Both pandemic and supply problems may be receding. (5) Record highs, again, for S&P 500/400/600 forward revenues, earnings, and margins. (6) NRRIs and NERIs declining but remain positive. (7) M-PMI implies slower growth in revenues and earnings—and smaller stock gains. (8) Searching for hints of a peak in latest inflation data. (9) Rapidly rising home prices: Rounding up all the suspects. (10) Plenty of business for both single-family and multi-family homebuilders.

Strategy: Happy Fundamentals. The S&P 500/400/600 stock price indexes fell during January by 5.3%, 7.3%, and 7.3% (*Fig. 1*). The LargeCaps continued to outperform the SMidCaps, as they have since mid-2021 (*Fig. 2*). The former actually has been outperforming the latter since 2019, with a brief exception during the first few months of 2020.

Meanwhile, the stock market's fundamentals remained remarkably strong during January based on forward revenues, forward earnings, and forward profit margins. ("Forward" revenues and earnings are the time-weighted averages of analysts' consensus estimates for this year and next, and "forward profit margins" are the profit margins we calculate from those estimates.) There wasn't even a hint that the Omicron variant of Covid-19 weighed on the stock market's fundamentals. Perhaps it held them back from doing even better? In any event, the latest wave of the pandemic is rapidly abating, which is bound to boost the stock market's fundamentals (*Fig. 3* and *Fig. 4*).

There's also no sign in the forward-looking data that supply-chain disruptions have depressed business activity. In any event, this problem also seems to be abating, as evidenced by regional and national surveys of unfilled orders and delivery times (*Fig. 5* and *Fig. 6*).

(1) *Forward revenues and earnings.* The forward revenues of the S&P 500 and the S&P 400 (a.k.a. MidCaps) both continued rising in record-high territory through the January 20 week (*Fig. 7*). The forward revenues of the S&P 600 (SmallCaps) edged down over the past

five weeks from a record high during the December 16 week. However, the forward earnings of all three indexes have been rising almost every week since February 2021 to record highs.

(2) *Profit margins.* Inflation is undoubtedly boosting revenues. However, rising labor and materials costs—as well as shortages of both—aren't depressing earnings, as evidenced by the fact that S&P 500/600 forward profit margins both rose to record highs of 13.3% and 7.2% during the January 20 week. The forward profit margin for the S&P 400 has stalled recently around a record high of 8.5% (*Fig. 8*).

Here are the forward profit margins of the S&P 500 for the week of January 20 from highest to lowest: Information Technology (25.0%), Financials (18.6), Communication Services (16.7), Real Estate (16.3), Utilities (14.7), Materials (13.3), S&P 500 (13.3), Health Care (11.4), Industrials (10.3), Energy (9.2), Consumer Discretionary (8.0), and Consumer Staples (7.6). Nine are at or near record highs: Communication Services, Consumer Discretionary, Consumer Staples, Financials, Health Care, Industrials, Information Technology, Materials, and Utilities (*Fig. 9*).

(3) *Net earnings revisions.* The Net Revenues Revisions Index (NRRI) and Net Earnings Revisions Index (NERI) of the S&P 500 both are highly correlated with the M-PMI, which was released yesterday for January (*Fig. 10* and *Fig. 11*). The M-PMI declined from a cyclical high of 63.7 during March 2021 to 57.6 last month. NRRI and NERI also have been declining but remained solidly in positive territory during January.

Here are the NRRIs and NERIs for the S&P 500 and its 11 sectors during January: S&P 500 (14.1, 8.0), Communication Services (-1.1, -4.1), Consumer Discretionary (12.7, 8.7), Consumer Staples (13.3, 1.3), Energy (24.0, 23.7), Financials (33.6, 21.0), Health Care (10.5, 4.7), Industrials (9.3, 4.1), Information Technology (13.8, 10.2), Materials (17.3, 4.2), Real Estate (5.2, 5.2), and Utilities (5.8, -1.0).The highest readings are for Energy and Financials, two of the sectors we recommend overweighting, along with Information Technology. (See our *Net Revenue & Earnings Revisions* chart book.)

(4) *M-PMI.* By the way, the M-PMI is also highly correlated with the y/y growth rates of S&P 500 revenues per share and earnings per share (*Fig. 12* and *Fig. 13*). So not surprisingly, it is also highly correlated with the y/y percent change in the S&P 500 stock price index (*Fig. 14*). The recent weakness in the M-PMI is signaling that we can expect slowing growth in earnings, revenues, and stock market gains.

Inflation: Peaking? The ideal scenario for the stock market would be that the pandemic is finally abating, supply-chain disruptions are dissipating, and inflationary pressures are easing. Above, we cited some evidence that the first two conditions are improving. Now let's update the latest developments on the inflation front:

(1) The most current data on inflation are the regional business surveys conducted by five Federal Reserve district banks. The averages of the five prices-paid and prices-received indexes both have stalled at their record highs for the past six months through January (*Fig. 15*). That's neither particularly encouraging nor discouraging. The prices-paid index included in the M-PMI edged up in January to 76.1, but it is down from its most recent peak of 92.1 during June (*Fig. 16*). That's a bit more encouraging.

(2) The latest data we have on consumer prices are the CPI and PCED for December, when they rose 7.0% and 5.8%, respectively (*Fig. 17*). One of the main reasons we are expecting a peak in both soon is that their spikes last year were led by soaring durable goods prices, particularly used and new auto prices (*Fig. 18* and *Fig. 19*).

We expect that these prices will be declining soon, assuming as we do that the parts-shortages problem in the auto industry will ease. Strength in Japan's auto production in November and December suggests that the auto industry may be finding the semiconductor chips needed to build more cars, which should bring soaring used and new car prices back down.

US Housing: Speculative Boom? It's no secret that a shortage of US housing supply is driving up home prices; many of us have relatives and friends in the housing market who have felt the effects of that fact first-hand. Nationwide, existing-home prices have risen 30% over just the past two years, from an average of $274,500 at the end of 2019 to $358,000 at the end of 2021, as the availability of homes for sale shrank to a record-low 910,000 units at the end of last year. It was as high as 1.92 million units at 2019's peak. As we mentioned in the January 24 *Morning Briefing*, we don't think this appreciation represents a bubble, much though it may look that way, because the inventory shortage relative to demand is what accounts for it, not overzealous speculation by housing investors.

The reasons for the supply crunch include not only the pandemic-provoked stay-at-home trends of remote work and parents leaving the workforce for childcare purposes but also longer-term demographic trends like Baby Boomers "aging in place" and Millennials finally buying homes, a milestone they're crossing much later in life than prior generations. But it's not only insufficient supply pushing up housing prices; demand-side forces are contributing

too. Today, we explore where they're coming from.

Melissa and I continue to believe that the spike in demand of recent years mostly reflects would-be homeowners rather than return-minded investors, with a strong emphasis on the "mostly." Investing homebuyers—both the mom & pop and institutional variety—have played smaller roles.

Examples of the former variety include older buyers who have benefited from asset-price appreciation—both of their homes and other wealth classes—and are now in the market for a second home; they've been active in the housing market recently. Examples of the latter variety include large investment funds that have been upping their purchases of single-family properties, mostly to rent out to younger cash-strapped buyers. Younger first-time homebuyers have been very big players in the housing market recently, but they're bumping up against an affordable housing shortage.

Will institutional buyers look to take advantage of the supply and demand dynamics in the housing market in the coming years? Of course, they will! Might they seek to buy or build affordable rental units to meet that demand? Sure! Could those trends shift the balance of demand in the housing market toward institutional buyers and away from individual ones? Maybe, but that point seems to be a long way off.

Consider the following:

(1) *Not many sellers are out there.* Existing-home sales declined in December, following a streak of three months of gains, *according* to the National Association of Realtors® (NAR) (*Fig. 20*). Despite the drop, overall sales for 2021 increased 8.5%. "December saw sales retreat, but the pullback was more a sign of supply constraints than an indication of a weakened demand for housing," said Lawrence Yun, NAR's chief economist.

Reversing inventory "gaps like the ones we've seen recently will take years to correct," he added. Total housing inventory hit an all-time low at the end of December of 910,000 units, down 14.2% from 1.06 million a year earlier. Unsold inventory sat at a 1.8 months' supply, down from 2.1 in November and 1.9 in December 2020 (*Fig. 21*). The median existing-home price for all housing types in December was $358,000, up 15.8% from December 2020 (*Fig. 22*).

(2) *Large institutional investors are buying.* Investors' share of purchases for investment rental did remain elevated in December 2021, at 17% compared to 14% one year ago,

according to the NAR *research*, but institutional investors are hardly gobbling up all the available inventory. Our assessment in the June 30 *Morning Briefing* remains true: Institutional investors aren't to blame for the runup in home prices. For a sense of scale, the US has roughly 140 million housing units, of which about 80 million are stand-alone single-family homes. Of those 80 million, about 15 million are rental properties. Institutional investors own about 300,000 of those. Nevertheless, the *impact* of institutional investors on the housing market may be felt more in certain regions (e.g., Phoenix and Dallas) than others.

The media last summer was abuzz over the notion that institutional investors were spiking housing demand and prices, but there has been no news on that angle since. For example, CNN *wrote* last summer that for institutional investors "starved of returns on government bonds, 'Generation Rent,' the mostly millennial cohort born between 1981 and 1996, provides an opportunity for reliable long-term income." But it added that institutional investors still own only about 2% of all single-family rentals in the US, according to John Burns research, and that firm's research director sees institutional activity having only a limited impact on US house prices notwithstanding regional variation.

iBuyers, a flashy newer competitor breed in the housing market, often covered in the media, don't represent major demand either: They accounted for only 1% of all home sales in the US during September 2021, *reported* *The New York Times*. Some iBuyer companies are still expanding; but as we recently discussed, one of the largest ones, Zillow's iBuying arm, recently imploded.

(3) *Mom & pop investor buyers are cooling off.* Individual investors, or second-home buyers who make up many cash sales, purchased 17% of homes in December 2021, up from 14% in December 2020. All-cash sales accounted for 23% of transactions in December, up from 19% from December 2020. Some of the cash competition may have come from *new types of loans* for first-time homebuyers; but more commonly, the transactions represented experienced property owners cashing in on home equity and other asset winnings.

Prices in vacation-home-heavy counties rose at a faster pace than others in 2020, according to research from Redfin *cited* by CNN. After a runup early in the pandemic, Redfin *reported* a significant cooling off of that segment of the residential real estate market. The report observed that demand for second homes fell 21% y/y in July for the second consecutive month after a 13-month surge, perhaps squelched by soaring home prices.

Wealthy real-estate buyers from overseas certainly did not drive up US home price activity

during the pandemic. US real-estate purchases from foreign buyers dropped from a pre-pandemic $267 billion in 2018 to $107 billion during 2021, according to NAR data *quoted* by CNBC. That could turn around, however, as pandemic-era travel restrictions are lifted.

(4) *Boomer buyers are giving Millennials a run.* Baby Boomers may be gaining on them, but Millennials are still the biggest players in the US housing market. Homebuyers by age remains significantly higher for the 18- to 39-years-old cohort (42% in 2019) than the 40- to 59-years-old (34) or the 60 years old and over (24) cohorts, according to Zillow data cited in an October 2021 *Business Insider* *article*. However, because Baby Boomers "are more likely to be homeowners who can use the proceeds from the sale of their current home toward their next one, they have a built-in advantage in a bidding war against younger buyers, who are often buying their first home," *explained* Zillow.

Nevertheless, first-time buyers were responsible for a healthy 30% of sales in December (up from 26% in November), just slightly below the year-ago level of 31%. Rising mortgage rates in the coming months could reduce interest from beginner buyers, but we think that higher employment prospects and rising wages could counterbalance the higher cost of owning a home. Regionally, Millennial buyers are seeing more luck in less expensive areas like Buffalo and Salt Lake City, whereas homebuyers aged 60-plus made up a bigger share in sunny retirement destinations, said Zillow.

(5) *Joe the Builder isn't making a dent. Barron's* recently *explained* why US President Joe Biden's affordable housing plan won't make much of a dent in the housing market: The nation's supply deficit of 6.8 million affordable housing units, according to estimates by National Low Income Housing Coalition, dwarfs the 100,000 units the plan would add. "Even the administration's longer-term plan of spending over $300 billion to add two million affordable units is still less than a third of the number required."

Calendars

US: Wed: ADP Employment 207k; MBA Mortgage Applications; Crude Oil Inventories; FOMC Minutes. **Thurs:** Initial & Continuous Jobless Claims 245k/1.62m; ISM & IHS Markit NM-PMIs 59.5/50.9; Motor Vehicle Sales; Factory Orders -0.2%; Productivity & Unit Labor Costs 3.2%/1.5%; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Eurozone CPI 4.4% y/y; Italy CPI 3.8% y/y; Canada Building Permits -1.5%;

Wuermeling; Mauderer; Macklem. **Thurs:** Eurozone, Germany, and France C-PMIs 52.4/54.3/52.7; Eurozone, Germany, and France NM-PMIs 51.2/52.2/53.1; UK C-PMI & NM-PMI 53.4/53.3; ECB Interest Rate Decision 0.00%; BOE Interest Rate Decision 0.50%; RBA Monetary Policy Statement; Bailey. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q4 Earnings Season Monitor (*link*): With 37% of S&P 500 companies finished reporting revenues and earnings for Q4-2021, revenues have beat the consensus forecast by 2.3% and earnings by 4.6%. 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 185 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 sample of Q4 reporters so far collectively has a y/y revenue gain of 18.0% and an earnings gain of 32.6%. 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 (82%) 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

Construction Spending (*link*): Total construction spending reached yet another record high in December, posting only one decline since June 2020. Total spending edged up 0.2%, slowing steadily from September's 1.0% gain. It has increased an impressive 14.3% since bottoming in mid-2020. Private construction spending led the recovery, also reaching a new record high, as residential investment spending made the record books yet again. Meanwhile, nonresidential spending remains on an upward trend, though stalled in December following a five-month jump of 4.9%. Within residential investment, single-family construction climbed 2.1% in December and 4.1% over the two months ending December,

boosting it to a new cyclical high, while multi-family construction finished 2021 at a new record high, rising 1.1% the last four months of the year. Home-improvement spending dipped 0.1% in December and 0.8% the last two months of the year, following a three-month spurt of 7.1% to a new record high in October. In the meantime, public construction spending contracted 1.6% in December, its first decline in six months, expanding 4.2% during the five months through November.

Global Economic Indicators

Global Manufacturing PMIs (*link*): Global manufacturing activity began 2022 on a down note, expanding at its slowest pace in 15 months in January, reflecting "weaker growth of incoming new work, declining international trade volumes, supply chain disruptions and rising Covide-19 infections (in part due to the Omicron variant)," according to the report. New export orders contracted for the first time in 17 months. The JP Morgan Global M-PMI sank to 53.2 after posting steady readings of 54.1 to 54.3 the last five months of 2021. The M-PMI (50.0) for emerging economies slowed to a standstill in January after averaging 51.5 during the final quarter of last year, while the M-PMI for advanced economies shows manufacturing activity remained at a healthy, though slower, pace—declining five of the last six months through January—from 59.8 in July to 56.3 last month. In January, 22 out of the 27 countries for which data are available expanded, though 13 of them recorded a weaker rate of increase than in December—including the US, UK, France, Italy, and China. Meanwhile, Japan bucked the global trend, posting its best reading in 95 months. Activity contracted in China, Mexico, Brazil, Kazakhstan, and Myanmar. Here's a country ranking of January M-PMIs from highest to lowest: Austria (61.5), Netherlands (60.1), Germany (59.8), Ireland (59.4), Czech Republic (59.0), EUROZONE (58.7), Italy (58.3), Greece (57.9), UK (57.3), Canada (56.2), Spain (56.2), USA (55.5), France (55.5), Japan (55.4), Australia (55.2), Taiwan (55.1), Poland (54.5), India (54.1), Vietnam (53.7), WORLD (53.2), Colombia (52.6), Russia (51.8), Thailand (51.7), Turkey (50.5), China (49.1), Myanmar (48.5), Brazil (47.8), Mexico (46.1), and Kazakhstan (43.8).

US Manufacturing PMIs (*link*): Manufacturing activity in January remained robust, though has slowed dramatically according to both M-PMI measures, while price pressures also eased in both surveys. ISM's M-PMI fell for the third month, from 60.8 in October to a 14-month low of 57.6 by January. It peaked at 63.7 last March and averaged 60.6 for all of 2021. The new orders index (to 57.9 from 61.0) fell below 60.0 for the first time since September 2020, while the production measure (57.8 from 59.1) was below for the second

month. The employment gauge, meanwhile, moved further above 50.0, improving for the fifth successive month, from 50.0 last August to a 10-month high of 54.5 during January, while the supplier deliveries component of the M-PMI eased for the third month, from 75.6 in October to a 14-month low of 64.6 last month. Timothy Fiore, chairman of ISM, noted that the manufacturing sector remained in a demand-driven, supply chain-constrained environment, but he was encouraged by the "indications of improvements in labor resources and supplier delivery performance." Meanwhile, inventories expanded at a slower pace for the third month, from 56.4 in October to 53.2 at the start of this year, though Fiore expects them to improve in February and March. ISM's price (76.1 from 68.2) index accelerated this month, though is considerably below last year's high of 92.1 in June—which was the fastest since summer 1979. Looking at IHS Markit's M-PMI, it slowed for the sixth month since reaching a record-high 63.4 last July, slumping to 55.5 during January—the slowest pace since October 2020. According to the report, both output and production growth slowed during the month, while the rate of job creation was the weakest in 18 months. However, the firms were the most upbeat regarding the outlook for growth in 14 months. On the inflation front, both input and output costs eased, with both the slowest since spring 2021.

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

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.