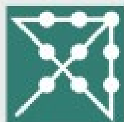 Yardeni Research

MORNING BRIEFING
March 8, 2022

Past & Future Earnings

Check out the accompanying chart collection.

Executive Summary: Today, we examine the fundamental data that drive the stock market, as just reported for Q4 and as projected by industry analysts and by us for this year and next. S&P 500 companies' Q4 results show record highs for revenues and earnings, but the profit margin continued to edge down from the Q2 peak. … Our stagflation economic forecast prompts us to raise our S&P 500 revenue, but not earnings, estimates. We expect relatively flat S&P 500 profit margins around 13% this year and next. … Also, we look at what declining forward P/Es have meant for the four major investment styles.

Strategy I: Looking Back. The latest earnings reporting season, for last year's final quarter, is over. On a per-share basis, weekly forward revenues and forward earnings of the S&P 500 have done a very good job of anticipating the record highs in the S&P 500's quarterly revenues per share and earnings per share during Q4-2021 (*Fig. 1*).

The same cannot be said for the forward profit margin: It hasn't anticipated the fall in the actual quarterly profit margin—to 12.7% during Q4-2021 from a record high of 13.7% during Q2-2021—but instead has continued to edge up in record-high territory since late last year through the February 24 week. In other words, the weekly forward profit margin has yet to signal the top in the actual profit margin, which clearly occurred during Q2-2021.

(Note: "Forward" revenues and earnings are the time-weighted averages of industry analysts' consensus estimates for revenues and operating earnings for this year and next; as such, they're a better measure of the results that investors are expecting over the coming 12 months [and 52 weeks] than are analysts' annual estimates. We calculate the weekly forward profit margin by dividing forward earnings by forward revenues. The S&P 500 quarterly profit margin is calculated by us from the quarterly revenues provided by Standard & Poor's and operating earnings compiled by I/B/E/S Refinitiv.)

Let's have a closer look at the latest fundamental data that drive the stock market:

(1) *Revenues.* S&P 500 quarterly revenues per share bottomed during Q2-2020 at $1,262 billion (at an annual rate and not seasonally adjusted). They are up 34.6% since then through the end of last year to $1,699 billion. They've been rising in record-high territory

since Q2-2021. It certainly has been a V-shaped recovery.

Revenues increasingly are getting a boost from rapidly rising prices. Forward revenues is up 15.2% y/y through February, the fastest pace since September 2008, and quarterly revenues rose 15.6% y/y during Q4-2021, while the nonfinancial corporate business price deflator rose 5.1% y/y through Q3-2021 (*Fig. 2* and *Fig. 3*).

Weekly data for industry analysts' consensus expectations show that they raised their 2022 and 2023 revenues estimates to record highs of $1,680 (up 8.5% y/y) and $1,773 (up 5.5% y/y) during the week of February 24 (*Fig. 4* and *Fig. 5*). Revenue surprises and revisions are likely to increasingly reflect rapidly rising prices.

(2) *Earnings.* Forward earnings per share rose 29.1% y/y through February (*Fig. 6*). Quarterly operating earnings per share rose 27.1% y/y during Q4-2021, better than the 20.1% growth rate expected by industry analysts at the start of the earnings season. More than half of the increase in quarterly earnings was attributable to the growth of quarterly revenues, with the quarterly profit margin rising 1.1ppts, or 10%, y/y through Q4-2021 even though it has fallen for the past two quarters.

But the quarterly margin is likely to be flat at best this year. It could continue to fall as cost pressures mount. So some (or all) of the boost that revenues get from higher prices will be offset by higher costs, as evidenced by the recent quarterly margin compression.

Nevertheless, industry analysts still raised their 2022 and 2023 earnings estimates to new highs of $222 (up 8.9% y/y) and $244 (up 9.9% y/y), respectively, during the February 24 week (*Fig. 7* and *Fig. 8*).

(3) *Profit margin.* The annual profit margin estimates derived from analysts' weekly estimates of annual revenue and earnings rose throughout most of last year. So far this year, they've been sliding, to 13.2% for 2022 and 13.7% for 2023 as of the February 24 week (*Fig. 9*).

(4) *Sectors.* On a per-share basis, the revenues of six of the 11 sectors of the S&P 500 rose to record highs during Q4-2021 (*Fig. 10*). The laggards were Communication Services, Consumer Staples, Energy, Financials, and Utilities. The most economically sensitive sectors have contributed the most to the V-shaped bust and boom cycle in S&P 500 revenues since the start of the pandemic. They include Consumer Discretionary, Energy, Industrials, and Materials. Their revenue performances tend to get amplified by increases in

their prices during booms. Remaining more or less on their multi-year upward revenue trends are Consumer Staples, Health Care, and Information Technology.

On a y/y and per-share basis, the growth of operating earnings per share peaked for nine of the 11 S&P 500 sectors during Q2-2021, using I/B/E/S data by Refinitiv (*Fig. 11*). Regarding the other two, Health Care's growth peaked during Q1-2021, while Energy is likely to peak this year.

Here are the Q4 y/y earnings growth rates from highest to lowest: Energy (to a profit from a loss), Materials (61.0), Consumer Discretionary (43.8), Industrials (39.8), S&P 500 (27.1), Information Technology (22.4), Health Care (21.1), Real Estate (18.4), Communication Services (15.9), Financials (8.3), Consumer Staples (6.9), and Utilities (-1.0).

Among the 11 sectors of the S&P 500, operating profit margins rose to new record highs during Q4-2021 only for Energy and Information Technology (*Fig. 12*). Energy is getting a big boost from higher prices and cost cutting as a result of the pressure imposed on the sector by climate activists and geopolitical tumult. The Consumer Discretionary sector's margin seems to be holding up, while the remaining sectors are showing signs of margin compression.

Here are last quarter's operating profit margins from highest to lowest: Real Estate (27.1%), Information Technology (25.9), Communication Services (17.1), Financials (16.8), Materials (12.8), S&P 500 (12.7), Health Care (10.6), Energy (9.7), Utilities (9.5), Industrials (7.8), Consumer Discretionary (7.7), and Consumer Staples (7.3).

Strategy II: Looking Ahead. Now let's look ahead to 2022 and 2023. Yesterday, Debbie and I raised our inflation outlook mostly as a result of the inflationary impact that the Ukraine crisis is having on commodity prices. The Fed is likely to tighten monetary policy more gradually because of the uncertain effect of the crisis on slowing the global and domestic economies. In other words, the crisis has increased the odds of a stagflationary path this year, with more inflation and less growth.

How does this macroeconomic forecast affect our outlook for S&P 500 revenues, earnings, and the profit margin? Consider the following:

(1) *Revenues.* The bottom line is that we have to increase our revenues estimates to reflect higher inflation. For 2022, we now forecast revenue growth of 10.0% (up from 7.7%) to $1,710 per share and for 2023 revenue growth of 9.0% (up from 6.0%) to $1,846 per share

(*Fig. 13*).

(2) *Earnings.* Joe and I decided not to change our earnings-per-share forecasts given the offsetting crosscurrents we see swirling around the S&P 500 companies. So we are sticking with $225 (up 7.1%) this year and $250 (up 11.1%) next year (*Fig. 14*).

(3) *Profit margin.* We feel comfortable with those estimates because they imply that the profit margin will remain relatively flat at 13.2% this year and 13.5% next year. It was 13.4% in 2021 (*Fig. 15*).

(4) *Forward earnings.* We are almost ready to update our targets for the S&P 500 for the end of this year and the end of next year. To do so, we need to estimate what forward earnings will be at those times. Forward earnings at the end of any year is the same as the analysts' consensus estimate for the coming year's earnings. For now, we see no compelling need to change our forecasts of $250 and $265 for the ends of 2022 and 2023 (*Fig. 16*).

(5) *Forward P/Es.* We are giving up on the notion that the S&P 500's forward P/E will hold above 20.0. It is already down to around 19.0. We are now estimating 16.0 by year-end and back to 19.0 in 2023 (*Fig. 17*). Stagflation isn't conducive to above-average valuation multiples.

(6) *S&P 500 targets.* As we announced in yesterday's *Morning Briefing*, we are lowering our year-end 2022 target for the S&P 500 from 4800 to 4000 and lowering our year-end 2023 target from 5200 to 5000. We are maintaining our 2024 target at 5600 (*Fig. 18*). Those numbers are based on our forecasts for forward earnings and forward P/Es.

Call us optimists (or perma-bulls), but we are predicting that the forward P/E will rebound to 19.0 in 2023. We aren't giving up on a productivity growth boom during the Roaring 2020s. There are still seven years and eight months left in the decade. (See the tables and charts in *YRI S&P 500 Earnings Forecast*.)

Strategy III: Looking Forward. While the forward earnings of the major S&P stock price indexes continued to trend higher in record-high territory through early March, forward P/Es continued to decline. Let's have a look how this is playing out among the major investment styles:

(1) *LargeCaps vs SMidCaps.* Our Blue Angels framework shows that the forward earnings

of the S&P 500/400/600 indexes mostly rose to new record highs during the March 3 week (*Fig. 19*). However, the forward P/E of the S&P 500 tumbled from 21.5 at the start of this year to 18.9 on Friday (*Fig. 20*). The forward P/Es of the S&P 400/600 indexes (a.k.a. SMidCaps) have been falling since mid-2020, when they peaked at 23.4 and 27.3, respectively. Now they are down to 14.1 and 13.7. We think there is more downside in the valuation multiples of the LargeCaps (since we are now targeting 16.0 for this year) than the SMidCaps.

By the way, the forward P/E of the MegaCap-8 (the eight largest-cap stocks in the S&P 500) is down from 33.8 at the start of this year to 27.4 on Friday. The MegaCap-8's forward P/E is down 29% from its August 2020 peak of 38.5.

(2) *Growth vs Value.* The forward earnings of the S&P 500 Growth index has been outperforming that of S&P 500 Value since the end of the lockdown recession in early 2020 (*Fig. 21*). However, since the MegaCap-8 account for about 50% of the market capitalization of Growth, the forward P/E of Growth has tumbled from 28.5 at the start of this year to 23.2 on Friday (*Fig. 22*). Value's forward P/E is down from 17.4 at the start of this year to 16.2 on Friday.

(3) *S&P 500 sectors.* The decline in the forward P/Es of the S&P 500 sectors has been relatively broad based since the start of this year; Energy is the only exception. Here are the numbers at the start of this year and during the February 24 week: Communication Services (20.9, 17.2), Consumer Discretionary (31.9, 25.2), Consumer Staples (21.8, 20.9), Energy (10.9, 12.0), Financials (14.8, 14.2), Health Care (17.3, 15.1), Industrials (20.7, 18.6), Information Technology (28.5, 22.7), Materials (17.0, 15.0), Real Estate (53.1, 42.9), and Utilities (20.6, 18.7) (*Fig. 23*). We continue to favor overweighting Energy, Financials, and Information Technology (as this sector has gotten cheaper).

(4) *Stay Home vs Go Global.* The forward earnings of the US MSCI divided by the forward earnings of the All Country World ex-US has been on a solid uptrend since early 2009 (*Fig. 24*). Not surprisingly, the ratio of these two stock price indexes shows that the US continues to outperform the rest of the world (*Fig. 25*).

The forward P/E of the ACW ex-US has tended to closely track the forward P/E of the S&P 500 Value index (*Fig. 26*). They've diverged significantly since early last year with the former down to 13.2 and the latter at 16.2. Here are the latest forward P/Es for the major MSCI indexes: US (19.0), EMU (13.8), Japan (13.1), Emerging Markets (11.9), and UK (12.0) (*Fig. 27*).

Although the rest of the world is cheaper than the US, we would continue to overweight the US, especially under the current circumstances.

Calendars

US: Tues: NFIB Small Business Optimism; Trade Balance -$87.1b; Wholesale Trade Inventories & Sales 0.8%/1.2%. **Wed:** Job Openings 19.925m; MBA Mortgage Applications; WASDE Report; Crude Oil Inventories. (Bloomberg estimates)

Global: Tues: Eurozone GDP 0.3%q/q/4.6%y/y; Germany Industrial Production 0.5%; Italy Retail Sales; Spain Industrial Production 4.4% y/y; Japan Leading & Coincident Indicators; Canada Trade Balance $2.0b; Japan GDP 1.4%q/q/5.6%y/y; China CPI & PPI 0.8%y/y/8.7%y/y; Australia Westpac Consumer Sentiment; Lowe. **Wed:** Italy Industrial Production 3.2% y/y; Japan Machine Tool Orders; Debelle. (Bloomberg estimates)

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 tenth week after dropping for a week earlier due to index changes. MidCap's was at a record high for a 13th straight week after dropping 0.1% below at the end of November. SmallCap's dropped 1.2% w/w from its record high a week earlier. It had been consistently making new highs until mid-December, but since then it has done so in only five of the 11 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 89 of the past 93 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings shortfall last August, and index changes in September and December. MidCap's forward earnings is up in 87 of the past 91 weeks, and SmallCap's posted 85 gains in the past 92 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 62.8% from its lowest level since August 2017; MidCap's is now up 123.6% from its lowest level since May 2015; and SmallCap's has soared 182.4% 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 an 11-month low of 28.2% y/y from 28.4%; 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 edged down w/w to 44.4% y/y from 44.6%, but remains above its 11-month low of 44.2% in mid-February. 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 48.6% y/y from 49.0% a week earlier and compares to an 11-month low of 48.4% the week before that. 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 (49.3%, 8.2%), MidCap (86.6, 8.7), and SmallCap (126.2, 11.1).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower for these three indexes last week. LargeCap's forward P/E fell 0.3pt w/w to a 23-month low of 18.9 from 19.2. 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 January 2021 and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's fell 0.4pt to a 23-month low of 14.1 from 14.5. That's down from a 13-week high of 17.1 in early November. That also compares to a seven-month high of 20.5 in March 2021 and is 8.8pts below its record high of 22.9 in June 2020. SmallCap's edged up 0.1pt w/w to 13.7 from 13.6, and remains slightly above its 22-month low of 13.5 at the end of January. That's down from a 13-week high of 16.1 in early November and is now down 13.0pts 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 25% discount to LargeCap is up from a 28% discount on February 2, which was its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 80th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 27% reading has improved from 32% on February 2, which was its biggest since February 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 36th straight week; SmallCap's current 3% discount to MidCap's is up from a 9% discount in December, but remains near its lows during 2000-01.

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 is nearly final now at $54.14, up 49 cents w/w, and compares to a $51.08 estimate at the beginning of the quarter. That $54.14 actual represents a gain of 27.1% y/y on a frozen actual basis and a 32.0% y/y gain on a pro forma basis. Q4 marked the fourth straight quarter of double-digit percentage earnings growth, but growth slowed for a second straight quarter. Ten of the 11 sectors posted positive y/y earnings growth, down from all 11 doing so during Q2-2021 and Q3-2021. Double-digit growth occurred for nine sectors; that's down from 10 sectors doing so during Q3. Looking ahead to Q1-2022, analysts expect S&P 500 earnings growth to weaken substantially to 4.9% y/y on a frozen actual basis and 6.2% on a pro forma basis. Double-digit growth is expected for just five sectors in Q1-2022, and three are expected to record a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q1-2022 versus their Q4-2021 growth rates: Energy (203.4% in Q1-2022 versus 14,395.2% in Q4-2021), Industrials (37.5, 43.6), Materials (35.4, 64.2), Real Estate (15.4, 17.7), Health Care (10.2, 28.0), Information Technology (8.4, 24.6), Utilities (6.2, -1.3), S&P 500 (6.2, 32.0), Consumer Staples (1.3, 7.7), Communication Services (-4.4, 16.5), Consumer Discretionary (-9.5, 53.1), and Financials (-19.9, 10.0).

Global Economic Indicators

Germany Manufacturing Orders (*link*): German factory orders in January expanded for the third month, led by strong foreign demand. Manufacturing orders rose a larger-than-expected 1.8% in January, following an upwardly revised 3.0% (from 2.8%) increase in December—jumping 8.6% during the three months through January. Foreign demand soared 9.4% in January and 13.7% over the three-month period, driven by gains in orders from outside the Eurozone of 17.0% and 18.6% over the comparable periods. Billings from within the Eurozone contracted 2.6% in January, following a 1.9% drop December, though these declines were preceded by a 10.3% surge in October. Domestic demand plunged 8.3% at the start of 2022 after shooting up 11.4% at the end of 2021. Compared to a year

ago, total orders climbed 7.3%, led by a double-digit gain in billings from outside the Eurozone (11.3% y/y), while growth in both orders from inside the Eurozone (5.4) and domestic orders (4.5) were less than half that pace. Here's a look at movements in domestic orders along with the breakdown from both inside and outside the Eurozone for the main industry groupings during January, both m/m and y/y: capital goods (-13.5%, -3.9%, +29.6% m/m & +7.6%, +6.3, +19.5 y/y), consumer nondurable goods (-5.9, -2.6, -2.1 & +22.6, +19.9, -4.0), consumer durable goods (-5.0, -14.0, +1.7 & -7.4, +9.2, +10.5), and intermediate goods (-2.3, +0.8, -6.1 & -0.1, +2.0, -4.0).

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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