MORNING BRIEFING
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Another Earnings Season Seasoned with Inflation

Check out the accompanying chart collection.

Executive Summary: Investors should have lots of questions for company managements during the upcoming earnings calls season. First-quarter macroeconomic and survey data paint a picture of modestly improving supply-chain problems but still high costs for manufacturers. For services providers, supply-chain and cost issues continue to strain their ability to meet demand. Profit margins should hold steady this year provided that price increases offset cost increases as we expect. … While earnings and revenue growth rates probably peaked during Q2-2021, analysts' estimates suggest both remain solidly positive during Q1. … Also: Why the job market in Europe withstood the pandemic better than in the US.

Strategy I: Asking the Right Questions. Joe and I wish we had more time to listen to earnings calls by the managements of the S&P 500 during earnings seasons. We do attend a few and read summaries of others. We also get feedback from many of you, our accounts. As the current earnings season starts for Q1-2022, we are especially interested to hear managements answer the following dozen questions:

(1) Are supply-chain challenges remaining the same, easing, or getting worse?
(2) Which commodities and parts are in short supply?
(3) Are you moving away from just-in-time inventory management?
(4) Are you reshoring?
(5) Are you reassessing your business relationships with China?
(6) How has the war in Ukraine affected your business, if at all?
(7) How are you dealing with labor shortages?
(8) What are you doing to increase productivity?
(9) Are your cost pressures remaining the same, easing, or worsening?
(10) Are you passing cost increases through to prices?
(11) In other words, is your profit margin rising, falling, or staying the same?
(12) Are your orders and sales getting stronger or weaker when adjusted for inflation?

Strategy II: A Few Answers. The underlying theme in our questions is: How are you dealing with inflation, and how is it impacting your earnings? We clearly have some insights from the macroeconomic indicators and business surveys that have come out for Q1-2022 so far. Consider the following:

(1) *Manufacturing.* The March survey of manufacturing purchasing managers conducted by the Institute for Supply Management (ISM) showed that the composite M-PMI fell to 57.1 during March (*Fig. 1*). That's down from October's 60.8. The latest reading is still a robust one. The new orders index at 53.8 fell below the production index at 54.5. That explains why the inventory index was relatively high at 55.5. However, the customers' inventories index remained very low at 34.1.

There has been some modest improvement in supply-chain issues. However, both the supplier deliveries and backlog of orders indexes remained elevated at 65.4 and 60.0. The prices-paid index rebounded during March to 87.1, the highest since June 2021's 92.1—which was the highest since 1979. The ISM report attributed this increase mostly to energy costs.

(2) *Services.* The March survey of nonmanufacturing purchasing managers conducted by the ISM was released yesterday (*Fig. 2*). The composite NM-PMI ticked up to 58.3, while the production index edged up to 55.5 and the new orders index climbed from 56.1 to 60.1. They are all down sharply from their record highs late last year. Both supplier deliveries (63.4) and backlog of orders (64.5) remain elevated, signaling ongoing supply-chain disruptions. The prices-paid index, at 83.8, was just a tick below December's record high of 83.9.

The ISM NM-PMI report observed: "Respondents continue to be impacted by supply chain disruptions, capacity constraints, inflation, logistical challenges and labor shortages. These conditions have affected the ability of panelists' businesses to meet demand, leading to a cooling in business activity and economic growth."

(3) *Employment.* Interestingly, the latest ISM manufacturing report observed: "In March, progress was made to solve the labor shortage problems at all tiers of the supply chain, which will result in improved factory throughput and supplier deliveries. Panelists reported lower rates of quits and early retirements compared to previous months, as well as improving internal and supplier labor positions." The M-PMI and NM-PMI employment indexes were at 56.3 and 54.0 during March.

(4) *Profit margins.* The S&P 500's quarterly operating profit margin peaked at a record high of 13.7% during Q2-2021 (*Fig. 3*). It was down to 12.8% during Q4-2021. It averaged 13.4% during 2021 as a whole, and we used that number as our forecast for this year and next year when we derived our earnings estimates for 2022 and 2023 from our revenues estimates, as explained in yesterday's *Morning Briefing*.

These estimates rest on our assumption that price increases will offset cost increases—which puts us out on a limb. But so far, we are encouraged by what we see in our weekly forward profit margin, which tracks the actual quarterly data quite well. The weekly series has been edging higher in record territory since mid-2021 to a high of 13.3% during the March 24 week. That's despite rapidly rising labor and materials costs, labor shortages, and supply-chain disruptions.

(5) *Capital spending.* The Business Roundtable conducts a quarterly survey of CEOs (*Fig. 4*). Their CEO Outlook Index dipped during Q1-2022 but remained near Q4-2021's record high. It is highly correlated with the y/y growth rates in both nominal and inflation-adjusted capital spending. Debbie and I continue to expect that businesses will respond to chronic labor shortages by increasing their spending on productivity-enhancing capital equipment and technologies.

Strategy III: Inflated Earnings Growth. The M-PMI is highly correlated with the y/y growth rate of S&P 500 quarterly revenues per share and earnings per share (*Fig. 5* and *Fig. 6*). It confirms that both growth rates peaked during Q2-2021 but remain solidly positive.

Joe and I are seeing some evidence that industry analysts are raising their revenues-per-share and earnings-per-share estimates at a faster pace to reflect higher-for-longer inflation. Their consensus estimates for each have increased by 2.6% and 2.0% since the start of this year through late March (*Fig. 7* and *Fig. 8*).

Strategy IV: Q1 Earnings by the Numbers. As the latest earnings season begins, S&P 500 industry analysts are estimating a gain of 10.9% y/y for revenues per share and 9.9% for earnings per share. Here are their latest Q1 and full-year 2022 earnings growth estimates for the 11 sectors of the S&P 500:

(1) *Q1-2022:* Communication Services (-5.2%), Consumer Discretionary (-11.9), Consumer Staples (1.9), Energy (233.5), Financials (-21.4), Health Care (10.2), Industrials (36.8), Information Technology (8.7), Materials (35.0), Real Estate (16.0), and Utilities (6.7).

(2) *Full-year 2022:* Communication Services (2.3%), Consumer Discretionary (27.9), Consumer Staples (5.3), Energy (62.6), Financials (-10.6), Health Care (7.8), Industrials (34.2), Information Technology (13.2), Materials (10.5), Real Estate (-19.4), and Utilities (1.4) (*Fig. 9*). Joe observes that the most significant upward revision in these growth rates has been for the S&P 500 Energy sector, which rose by 32ppts ytd (*Fig. 10*).

Global Economy: The Pandemic & Labor Markets. The labor market in Europe faced less job destruction than that of the US during the pandemic. Employees remained attached to employers through government-funded job-retention schemes. In the US, more workers were laid off with no guarantee of returning to their prior jobs, though compensated through enhanced unemployment benefits. That's why Europe's unemployment rate rose much less dramatically than the US's during the pandemic.

Unemployment rates largely have recovered in both Europe and the US, but employment levels remain divergent. Europe's job gains in the public sector are responsible for the difference, primarily in the education industry. Europe retained teachers during the pandemic better than the US did because schools over there mostly remained open, while they closed in much of the US for most of the pandemic. Let's explore:

(1) *Divergent unemployment rates and employment levels.* US unemployment rate rose to 14.7% during April 2020, when pandemic lockdowns began, from 3.5% during January and February 2020, just before the pandemic started. In the euro area, the unemployment rate rose to just 8.6% during August and September 2020 from 7.2% during March. In both regions, the rates now are back near their pre-pandemic levels (*Fig. 11*).

However, US employment losses remain below pre-pandemic levels, whereas in the euro area job losses are back up to pre-pandemic levels, according to Bureau of Labor Statistics data. Most of the divergence is in the government sector, where euro area employment is up 1.5 million from pre-pandemic levels while US employment is down 600,000, observed the New York Federal Reserve Bank's (FRB-NY) Liberty Street Economics *publication* titled "How Have the US and Euro Area Labor Market Recoveries Differed?"

(2) *Labor force participation rates and retention schemes.* The reason that the unemployment rate has recovered faster in Europe than in the US while the employment recoveries remain divergent lies in the labor force participation rate (which includes unemployed workers actively looking for work but not those out of work who aren't looking). The US labor force participation rate remains just over a percentage point below the last quarterly pre-pandemic reading, for Q4-2019, while the euro area's rate has recovered since then.

That may largely be because *job retention schemes* maintained worker-employer bonds during the pandemic. European governments supplemented labor costs for employers and wages for employees, observed the FRB-NY note. The European Central Bank *explained* that 20% of jobs in the euro area were on job retention programs in 2020. In the US, workers who suffered pandemic-related job losses went on enhanced unemployment benefits.

(3) *Education gained jobs in Europe, lost jobs in US.* The FRB-NY provided further insights into these data. Looking at employment levels by industry reveals that about 20% of the job market in the US accounted for about 80% of the shortfall. From Q4-2019 to Q4-2021, US accommodation and food services lost 1.5 million jobs, local government lost 600,000 jobs, and nursing/elderly care lost 400,000 jobs. Interestingly, the accommodation and food services industry has struggled to recover in the euro area too because many of its workers were on temporary contracts and thus not eligible for job retention schemes.

Accounting for much of the difference in the US's versus Europe's jobs recovery, public-sector jobs increased by 1.3 million (as of the latest data during Q3-2021 from two years prior) in the euro area. Digging down deeper in the public-sector realm, the education industry gained 320,000 jobs in Europe and lost 370,000 jobs in the US.

(4) *Schools stayed open in Europe.* Job retention schemes no doubt aided Europe's education workers, but the fact that schools there widely *remained open* during the pandemic, unlike in the US, must have contributed greatly to the divergent labor market outcomes. Notoriously, many teachers left the workforce in the US during the pandemic, either quitting or retiring early. Many were burnt-out from remote-teaching large classes attended by frustrated parents. Some even had to multitask their teacher/parent roles as they helped their own kids remote-learn in their classes too!

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories; FOMC Meeting Minutes. **Thurs:** Initial & Continuous Jobless Claims 200k/1.331m; Consumer Credit $16.7b; Natural Gas Storage; Williams; Evans; Bullard. (Bloomberg estimates)

Global: Wed: Eurozone PPI 1.3%m/m/31.5%y/y; Germany Factory Orders -0.2%; DeGuindos; Panetta; Lane; Noguchi. **Thurs:** Eurozone retail Sales 0.6%m/m/4.8%y/y; Germany Industrial Production -0.2%; Japan Leading & Coincident Indicators; ECB Publishes Account of Monetary Policy Meeting; RBA Financial Stability Review; Balz. (Bloomberg estimates)

US Economic Indicators

Merchandise Trade (*link*): The real merchandise trade deficit narrowed slightly from January's record shortfall, though is well above the gap during the final months of 2021, suggesting trade will be a big drag on Q1 real GDP. February's gap narrowed to $116.3 billion after widening from $96.6 billion in October to a record $117.9 billion in January. The trade deficit averaged $117.1 billion the first two months of 2022, well above the $106.1 monthly average during Q4-2021. Real exports fell for the second month by 0.8% in February and 4.6% the first two months of this year, while real imports fell 1.1% and 1.0% over the comparable periods. Real exports declined across the board during the first two months of 2022, led by exports of other goods (-9.8%), consumer goods ex autos (-8.1), autos & parts (-8.0), and industrial supplies & materials (-6.1). Declines in exports of foods, feeds & beverages (-1.8) and capital goods ex autos (-0.2) were more modest—with the latter little changed. Real imports were more of a mixed bag, with declines in other goods (-11.3), auto vehicles & parts (-5.7), industrial supplies & materials (-2.3), and foods, feeds & beverages (-0.8) in the red during the two months through February, while real imports of capital goods ex autos (+2.0) and nonfood consumer goods ex autos (1.1%) increased—both to new record highs.

US Non-Manufacturing PMIs (*link*): The two NM-PMI measures moved higher in March—with both growing at the same rate—reflecting a rolling back of Covid restrictions. In the meantime, these companies continue to face rising costs. The ISM's NM-PMI accelerated to 58.3 in March after slowing from a record-high 68.4 in November to 12-month low of 56.5 by February. The new orders (to 60.1 from 56.1) measure rebounded back to 60 after falling below in February for the first time in a year, while employment (54.0 from 48.5) in the service sector moved from contraction to expansion; the production (55.5 from 55.1) gauge was little changed. Meanwhile, the supplier deliveries (63.4 from 66.2) measure is moving in the right direction, though it's still a high reading. Price pressures are intense, with ISM's prices-paid (to 83.8 from 83.1) index moving back up to within a tick of December's record high of 83.9. As for the IHS Markit NM-PMI measure, it accelerated in March for the second month to 58.0 in March, after slowing the prior three months from 58.7 in October to an 18-month low of 51.2 in January, with many companies reporting the easing of Covid-10 restrictions boosting store traffic. Meanwhile, output prices increased at the fastest pace on record as rising input costs were passed on to customers.

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