MORNING BRIEFING
May 18, 2022

Analysts Are from Venus; Investors Are from Mars

Check out the accompanying chart collection.

Executive Summary: Industry analysts are accentuating the positives of inflation; they've been raising their revenues and earnings estimates in response to it all year long. Investors are accentuating the negatives of inflation; they've been dropping how much they're willing to pay for estimated earnings all year long. A recession would prove the investors right, but that's not our expectation. … We see stagflation ahead, with a slowly expanding economy and slowly moderating inflation. … And: Melissa recaps the UN FAO's disconcerting analysis of Ukraine war impacts on global food inflation and hunger. … Also: How certain recent Biden administration actions may unwittingly exacerbate both.

Strategy I: Optimists vs Pessimists. Stock market investors seem to believe that industry analysts are becoming increasingly delusional. The latter have been raising their revenues and earnings estimates since the start of the year, while the former have been cutting the valuation multiples they are willing to pay for those estimates. And both actions have been in response to the same development, raging inflation.

The analysts seem to be raising their projections partly to reflect rapidly rising prices, while the investors have been worrying that higher inflation will force the Fed to tighten until a recession occurs. A recession would force analysts to scramble to cut their estimates. In this scenario, investors would continue to slash valuation multiples—and they would have "we told you so" bragging rights.

Consider the following recent developments:

(1) *Forward revenues, earnings, and margins.* The forward revenues per share and forward earnings per share of the S&P 500, S&P 400, and S&P 600 indexes continued to rise in record-high territory during the May 5 and May 12 weeks (*Fig. 1* and *Fig. 2*). The forward profit margins of both the S&P 500/400 indexes rose to record highs during the May 5 week, while that of the S&P 600 remained near its recent record high (*Fig. 3*). Nevertheless, the S&P 500/400/600 stock price indexes are down 15.6%, 14.5%, and 15.2% ytd through Friday's close, as their forward P/Es fell even more because forward earnings have been rising (*Fig. 4*).

(2) *Q1 earnings hooks.* Once again, we are seeing significant upward earnings hooks during the latest earnings season for Q1's S&P 500/400/600 (*Fig. 5*). Here are the y/y growth rates of the estimated earnings for the three composites just before the start of the earnings season during the March 31 week and the latest blended estimate during the May 12 week: S&P 500 (4.9%, 11.7%), S&P 400 (15.5, 31.3), and S&P 600 (11.8, 21.7) (*Fig. 6*).

(3) *Earnings revisions.* Interestingly, S&P 500/400/600 earnings estimates for Q2, Q3, and Q4 of this year all are still on their uptrends that started in early 2021. There are no signs that the upward earnings hooks or managements' forward guidance had much impact one way or the other on the uptrends.

Strategy II: Less Magnificent MegaCap-8. Since the S&P 500 peaked at a record high on January 3, the market capitalization of the index has dropped 16% by $6.6 trillion to $34.0 trillion through Friday's close (*Fig. 7*). Over this same period, the collective market capitalization of the eight high-cap stocks in the S&P 500 Growth composite dubbed the "MegaCap-8" is down 28% by $3.4 trillion to $8.9 trillion. Excluding the MegaCap-8, the S&P 500's float-adjusted market cap is down 12% by $3.6 trillion to $26.3 trillion.

Here are the market caps of the individual MegaCap-8 as of Friday and their market cap losses since January 3: Alphabet ($1,531 billion, -20%), Amazon (1,150 billion, -33), Apple (2,381 billion, -20), Meta (538 billion, -43), Microsoft (1,953 billion, -22), Netflix (83 billion, -69), Nvidia (443 billion, -41), and Tesla (797 billion, -34) (*Fig. 8*).

US Economy: Concerning Inflation and Recession. The latest batch of economic indicators is consistent with our stagflationary outlook for the economy, involving real GDP growing around 2.0%, while inflation remains elevated but moderates through next year. (See *YRI Economic Forecasts*.) Consider the following:

(1) *Retail sales.* The good news is that April's retail sales rose 0.9% m/m and 8.2% y/y (*Fig. 9*). March was revised upward from 0.7% to 1.4%. The increase in retail sales was led by receipts at auto dealerships, which rebounded 2.2%.

April's CPI for goods fell 0.3% m/m and rose 13.0% y/y. So inflation-adjusted retail sales rose 1.2% m/m, but fell 4.8% y/y, which mostly reflected mean reversion to the pre-pandemic upward trendline (*Fig. 10*).

(2) *Business sales and S&P 500 revenues.* Yesterday, along with April's retail sales, we learned that March's manufacturing and trade sales rose 13.9% y/y (*Fig. 11*). This series

closely tracks S&P 500 aggregate revenues, which probably increased by about as much during Q1.

However, the price deflator for business sales rose 15.4% y/y during February, suggesting that real business sales of goods was down slightly during March versus a year ago (*Fig. 12*). That's not too surprising since post-lockdown pent-up demand for goods has been more than satisfied. On the other hand, there is still plenty of pent-up demand for services.

(3) *NY regional business survey.* Also confirming our stagflationary outlook was May's regional business survey conducted by the Federal Reserve Bank of NY. The region's general business conditions index fell to -11.6, while its prices-received index remained high at 45.6 (*Fig. 13*).

(4) *Industrial production.* There were no signs of a recession in April's industrial production release yesterday. It was up 1.1% m/m and 6.4% y/y to a new record high. Motor vehicle assemblies increased 7.5% m/m and 22.3% y/y to 10.6 million units (saar), suggesting that parts shortages are easing (*Fig. 14*). Production of high-tech equipment remained unchanged at a record high (*Fig. 15*).

(5) *GDPNow.* The latest batch of economic indicators resulted in an increase in the Atlanta Fed's *GDPNow* tracking model to 2.5% real growth for Q2, up from 1.8%. The "nowcasts" of real personal consumption expenditures growth, real gross private domestic investment growth, and real government spending growth increased from 4.3% to 4.8%, -2.8% to -1.3%, and 1.4% to 1.6%, respectively. (There's another GDPNow update due out this morning.)

(6) *Wage inflation.* Last week, in the May 9 *Morning Briefing*, Debbie and I found some evidence that wage inflation may be peaking. We observed that on a y/y basis, average hourly earnings (AHE) for all workers rose 5.5% through April. However, the three-month wage inflation rate has been falling below this rate for the past three months and was down to 3.7% during April.

The Atlanta Fed's wage growth tracker (WGT) showed an increase of 6.0% in the y/y percent change of its three-month moving average (*Fig. 16*). We can't do the same sort of analysis on this measure as we did on the AHE series. However, we observe that leading the way higher in the WGT is the measure for 16- to 24-year-olds (*Fig. 17*). Much of the inflationary pressure in the labor market seems to be among young low-wage workers. Those pressures could dissipate quickly since such workers don't have much clout in the labor market.

Global Inflation I: War's Effects on Food Prices. Until this year, Russia and Ukraine ranked among the world's top three exporters of wheat, maize, rapeseed, sunflower seeds, and sunflower oil. In addition, Russia led the world in fertilizer exports (ranking last year as the leading supplier of nitrogen fertilizers and second leading supplier of potassic and phosphorus ones). Accordingly, the war in Ukraine poses grave risk to global agricultural markets, warned the United Nation's Food and Agriculture Organization (FAO) in a recent *report*.

Leading into the war, food prices already were elevated. The FAO Food Price Index shows that food prices, in nominal terms, reached an all-time high during February 2022. During 2021, international prices of wheat and barley rose 31% y/y, "buoyed by strong global demand and tight exportable availabilities resulting from weather-induced production contractions in various major wheat and barley exporting countries."

FAO simulations gauged the potential impacts of a reduction in grain and sunflower seed exports by Russia and Ukraine, finding that alternative sources could only partially compensate for the shortfalls during the upcoming market season. Concerningly, the resulting global supply gap could push up international food and feed prices by 8%-22% above their already elevated levels, the FAO concluded.

The FAO also modeled the price increases for various agricultural products under two scenarios: a severe shock to exports from Ukraine and Russia and a moderate one, both assuming crude oil prices of $100 per barrel. The projected price increases for the 2022/23 season over the previous one: wheat (8.7% with a moderate shock, 21.5% severe), maize (8.2, 19.5), other coarse grains (7, 19.9), and oilseeds (10.5, 17.9). Fertilizer prices would rise around 13% primarily owing to the increase in crude oil prices.

Here's more from this important report:

(1) *Significant crop shares.* Between 2016 and 2021, Russia and Ukraine together accounted for the following shares of global output: wheat 19%, barley 14%, maize 4%, sunflower oil just over 50%, global rapeseed 6%, and soybean production 2%.

In 2021, Russia led as the top global wheat exporter, shipping a total of 32.9 million tonnes of wheat and meslin, or 18% of global shipments. As the fifth largest wheat exporter in 2021, Ukraine exported 20 million tonnes of wheat and meslin, for a 10% global market share.

In the sunflower oil sector, the two countries' world export market share approached 64% last year. Many countries in North Africa and Western and Central Asia are highly dependent on food exports from Russia and Ukraine.

In 2021, Russia also ranked as the top exporter of nitrogen fertilizers and the second leading supplier of both potassic and phosphorous fertilizers. Many countries in Eastern Europe and Central Asia depend on Russia for over 50% of their fertilizer imports.

(2) *Lots of collateral damage to agriculture.* Damages to transport infrastructure as well as storage and processing facilities, port closures, the suspension of oilseeds crushing operations, and the uncertainty over Ukraine's ability to harvest crops with labor at war are a major risk to Ukraine's export capabilities in the coming months. Around a quarter of the Ukrainian land where winter cereals, maize, and sunflower seed are grown either won't be planted or won't be harvested this season. Russia's export prospects likely will be hindered by economic sanctions imposed on the country.

(3) *Increasing the number of undernourished.* Globally, additional upward pressure on food prices would most significantly harm already economically vulnerable countries. Prior to the conflict, high international food and fertilizer prices already were a problem for many importing countries. FAO's simulations suggest that the war could increase the number of undernourished people globally by between 8 million and 13 million over the next year.

(4) *Fueling higher food prices.* Energy-intensive products used in food production, like fertilizers, are expected to increase in price considerably, hiking input costs and food prices. Russian shipments account for 18%, 11%, and 10% of coal, oil, and gas imports globally.

Global Inflation II: Unintended Consequences. Recent US policy moves to ameliorate the impacts of the Ukraine war may have serious unintended consequences, like exacerbating food inflation and aggravating the global food crisis. Consider:

(1) *Burning food for fuel.* Why would nations burn their food when food prices are rising? That's essentially what happens when higher energy prices make "agricultural feedstocks (especially maize, sugar and oilseeds/vegetable oils) competitive for the production of bio-energy," the FAO report said, potentially pulling up bio-energy input prices to their "energy parity equivalent."

In 2013, a US Environmental Protection Agency (EPA) *study* found that "each billion gallon expansion in ethanol production yields a 2-3 percent increase in corn prices." That dynamic was in evidence on April 12, when corn futures prices rose on *news* that the Biden administration's EPA would allow the sale of gasoline blended with increased levels of ethanol to offset natural gas price increases from the Ukrainian war. Ethanol is made from a byproduct of corn. So tempered prices at the pump may come at the expense of higher prices for corn eaten by livestock and humans, reflecting the higher overall corn demand. Furthermore, the EPA noted that "the literature suggests that biofuels expansion will raise the number of people at risk of hunger or in poverty in developing countries."

Similarly, limiting natural gas production—as the Biden administration has done—impacts the prices of fertilizer products, which use natural gas as an input.

(2) *Trading in fertilizer*. Will the Biden administration's *efforts*, announced on May 11, to double-fund domestic fertilizer production from $250 million be enough to offset potential real and humanitarian costs of its sanctions impacting foreign fertilizers?

The FAO report's number-one policy recommendation was to keep trade in food and fertilizers open by preventing the conflict from negatively affecting productive and marketing activities in both the Ukraine and Russia so that they'll be able to meet domestic production and consumption needs while also satisfying global demand.

"Russia could suspend exports of fertilizers, state news agency TASS reported, a move that would remove a large portion of global supply from the market," *reported* the *WSJ* on March 4. Reports have it that this would be in retaliation for the sanctions that the US and other countries have imposed on Russia. "Major international shipping groups including container lines this week suspended almost all cargo shipments to and from Russia to comply with the Western sanctions," *reported* Reuters. "The ministry had to recommend Russian producers temporarily suspend export shipments of Russian fertilizers until carriers resume rhythmic work and provide guarantees that Russian fertilizer exports will be completed in full," the Russian ministry said.

Sanctions on trade for critical products are a natural wartime development. Nevertheless, they should be undertaken with full awareness of the potential consequences, and increasing starvation worldwide is a big one this time.

Calendars

US: **Wed:** Housing Starts & Building Permits 1.773mu/1.810mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Leading Indicators 0.3%; Initial & Continuous Jobless Claims 200k/1.32m; Philadelphia Fed Manufacturing Index 18.0; Existing Home Sales 5.66mu; Natural Gas Storage. (Bloomberg estimates)

Global: **Wed:** Eurozone Headline & Core CPI 0.6%m/m/7.5%y/y & 1.1%m/m/3.5%y/y; UK Headline & Core CPI 2.6%m/m/9.1%y/y & 0.8%m/m/6.2%y/y; UK PPI Input & Output Prices 1.1%m/m/19.0%y/y & 1.0%m/m/12.5%y/y; Japan Industrial Production & Capacity Utilization; Japan Core Machinery Orders 3.7%; Canada Headline & Core CPI 0.5%m/m/6.7%y/y & 0.4%m/m/5.4%y/y; Australia Employment Change 30k; Australia Unemployment & Participation Rates 3.9%/66.4%; ECB Financial Stability Review; ECB Non-monetary Policy Meeting; McCaul; Enria; Balz; Beermann. **Thurs:** Eurozone Current Account; UK Gfk Consumer Confidence -39; Japan CPI 2.1% y/y; PBOC Loan Prime Rate; ECB Publishes Account of Monetary Policy Meeting; Guindos; Balz; Wuermeling. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q1 Earnings Season Monitor (*link*): With 92% of S&P 500 companies finished reporting revenues and earnings for Q1-2021, revenues have beat the consensus forecast by 2.7% and earnings have exceeded estimates by 7.5%. We don't expect these figures to change markedly as the remaining companies report Q1 results. At the same point during the Q4 season, revenues were a lower 2.5% above forecast and earnings beat by a lower 5.8%. For the 460 companies that have reported Q1 earnings through mid-day Tuesday, the aggregate y/y revenue growth rate remains strong, but the earnings growth rate has decelerated considerably from its high double-digit percentage readings from Q2-2021 to Q4-2021. The current sample of Q1 reporters so far collectively has a y/y revenue gain of 13.9% and an earnings gain of 13.0%. While 77% of the Q1 reporters so far has reported a positive earnings surprise, just 75% has beaten revenues forecasts for the lowest reading in five quarters. Substantially fewer companies have reported positive y/y earnings growth in Q1 (66%) than positive y/y revenue growth (85%).

US Economic Indicators

Retail Sales (*link*): April retail sales rose a larger-than-expected 0.9%, triple the 0.3% increase in the CPI during the month, for a 0.6% gain in real spending during the month. This has been the pattern the first four months of this year, with nominal spending up 6.8% over the time span to a new record high, and real sales 3.7% higher to within 0.6% of a new record high. The control group—which excludes autos, gasoline, building material, and food—advanced for the fourth successive month in April, by 1.0% m/m and 5.2% over the period, to a new record high. Of the 13 nominal retail sales categories, nine rose during April while four fell, with sales in gasoline service stations in the bottom slot in April after being in the number-one spot in March. Here's a snapshot of the sales performances of the 13 categories during April as well as the performances versus a year ago and relative to their pre-Covid levels: miscellaneous store retailers (4.0, 18.6, 40.9), motor vehicles & parts dealers (2.2, -1.7, 27.7), nonstore retailers (2.1, 12.7, 59.5), food services & drinking places (2.0, 19.8, 22.7), electronics & appliance stores (1.0, -5.2, 5.4), clothing & accessories stores (0.8, 8.0, 15.2), furniture & home furnishing stores (0.7, 0.8, 18.7), health & personal care stores (0.7, 2.1, 12.6), general merchandise stores (0.2, 1.2, 14.1), building materials & garden equipment & supplies dealers (-0.1, 1.7, 31.7), food & beverage stores (-0.2, 7.1, 18.7), sporting goods & hobby stores (-0.5, -5.4, 34.4), and gasoline stations (-2.7, 36.9, 48.3).

Business Sales & Inventories (*link*): Nominal business sales in March climbed to a new record high, while February real business sales (reported with a lag) is in a volatile uptrend, moving back toward March 2021's record high. Nominal business sales advanced for the sixth time in seven months in March, jumping 1.8% in March and 12.0% over the period; it's up 60.3% from its pandemic-related bottom. Meanwhile, real business sales took a step back in February, slipping 0.8%, after a 1.2% gain and a 0.6% loss the prior two months, and is within 1.5% of its record high posted last March. Real sales for wholesalers dipped 1.0% in February after soaring seven of the prior eight months by 7.5% to a new record high, while real sales for retailers rose 2.6% the first two months of this year after sliding 4.0% during the two months through December; sales were 6.3% below last March's record high. Real manufacturing sales continued to move in a volatile flat trend, though fell 2.0% during the two months through February, dropping to the bottom of the range. Meanwhile, the real inventories-to-sales ratio moved up to 1.42 in February from its recent low of 1.38; it was at 1.45 last February. The nominal ratio edged up to 1.28 in March, after slipping from 1.29 in December to 1.27 the first two months of this year. It was at a near-record low of 1.26 in November.

Industrial Production (*link*): Industrial output in April continued to reach new record highs, going back to the start of the data in January 1921! Despite supply-chain disruptions and shortages driven by the war, headline production rose for the sixth time in seven months, by 1.1% in April and 5.7% over the period, with manufacturing output up 0.7% and 5.1% over the comparable periods, to its highest level since summer 2008. April's gain, as was March's, was driven by motor vehicle & parts production, which was up 3.9% in April and 12.5% over the two-month period, pushing it up to within 0.8% of its pre-pandemic level. By market group, consumer goods production remains on an accelerating trend, jumping 3.6% ytd and 23.8% since its April 2020 bottom to its highest level since July 2008. Over the comparable periods, consumer durable goods production rose 4.8% and 98.4% to a new record high, while output of consumer nondurable goods climbed 3.2% and 11.2% to its highest levels since December 2011. Meanwhile, business equipment production climbed 1.8% in April and 52.8% since its April 2020 bottom to its highest level since November 2019. Within business equipment, production of information processing equipment continues to reach new highs, though recent movements have been more subdued, while industrial equipment output remains on an upswing, jumping 34.8% since April 2020 to its highest level since January 2015. Transit equipment production is showing signs of life, soaring 3.3% in April and 9.3% during the three months ending April.

Capacity Utilization (*link*): The headline capacity utilization rate in April jumped to its highest percentage since December 2018, with the manufacturing rate the best since spring 2007. The headline capacity utilization rate climbed for the fourth month from 76.4% in December to 79.0% last month, with the rate 15.6ppts above April 2020's low of 63.4%.The manufacturing rate climbed from 77.1% at the end of last year to 79.2% in April—3.7ppts above its pre-pandemic level and above its long-run average by 1.1ppt—after moving above the average in March for the first time since August 2018. The capacity utilization for mining jumped to 80.1% in April, the highest since March 2020, while the utilities' rate climbed to 77.0%, the best since February 2021; both remain well below their long-run averages.

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