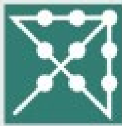

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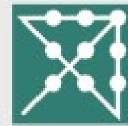

MORNING BRIEFING
July 12, 2022

Thumbs Up or Down for Q2 Earnings?

Check out the accompanying chart collection.

Executive Summary: Ready for the earnings season? Investors have been fearing a recession since this year began, as depressed stock valuations attest, while industry analysts have catapulted their earnings and revenues estimates to record highs. There's certainly no recession evident in forward revenues or forward earnings. … We think Q2 earnings calls will be full of examples of inflation boosting companies' results and the Fed's response to inflation not yet depressing them. However, the strong dollar and weaker global economic growth will weigh on earnings. Today, we provide a sector-specific rundown of issues that we expect to hear a lot about on Q2 earnings calls.

Strategy I: Clash of the Titans. As the Roman emperors once said: "Let the games begin!" The latest earnings reporting season is about to begin. The games in the Roman Colosseum usually were brutal. The question today is whether investors are about to face a brutal earnings season if the actual results turn out to be much worse than industry analysts have been predicting. Investors have been fearing such an outcome since the S&P 500 peaked on January 3 of this year and the Nasdaq peaked on November 19, 2021.

The earnings outlook has been thumbs down as far as investors are concerned, as evidenced by the freefalls in the forward P/E multiples of the S&P 500, S&P 400, and S&P 600 indexes since the start of this year (*Fig. 1*). Yet industry analysts have kept up the good fight, raising their annual revenues and earnings estimates for 2021 and 2022 since the start of this year.

As a result, the forward revenues and forward earnings of the S&P 500/400/600 indexes have been rising to record highs all year (*Fig. 2* and *Fig. 3*). The forward profit margins (i.e., forward earnings divided by forward revenues) hovered at record highs during H1-2022 (*Fig. 4*). (FYI: "Forward" earnings and revenues are the time-weighted average of analysts' estimates for the current and next years.)

Let's have a closer look:

(1) *Earnings vs valuation.* Here are the percent changes in the forward P/Es and forward earnings of the S&P stock indexes on a y/y basis through July 7: S&P 500 (-24.4%, 18.0%),

S&P 400 (-34.2, 30.3), and S&P 600 (-34.5, 28.4) (*Fig. 5*). These comparisons confirm what we've been saying for the past few months: Investors and industry analysts are from different planets, with the former from Mars and the latter from Venus.

(2) *Revenues.* Here are the current consensus expected growth rates for revenues per share this year and next year: S&P 500 (11.5%, 4.6%), S&P 400 (13.3, 3.8), and S&P 600 (13.4, 3.6). These estimates undoubtedly are boosted by analysts' expectations that inflation will remain elevated this year and moderate next year. Most importantly, analysts collectively clearly aren't expecting a recession either this year or next year, while investors have been fretting about the recession scenario all year.

(3) *Earnings.* Here are the current consensus expected growth rates for operating earnings per share this year and next year: S&P 500 (9.9%, 9.3%), S&P 400 (14.3, 6.3), and S&P 600 (10.8, 11.4). Notwithstanding these upbeat forecasts, during the past couple of weeks, analysts' consensus earnings projections for this year and next year have started to look a wee bit toppy. Joe observes that for a second straight week through the July 7 week, none of these three indexes had forward earnings at a record high. That hasn't happened since January 2021.

(4) *Margins.* The forward profit margins of the S&P 500/400/600 at the end of June were 13.3%, 8.9%, and 7.0%. All three have been fluctuating at record highs since the start of this year. Collectively, industry analysts are implying that profit margins have been holding up remarkably well under the circumstances.

Strategy II: A Guide to the Games. On their Q2 earnings calls, most company managements are likely to report that they are concerned about a recession but aren't seeing it in their businesses so far. We think they'll say that inflation is boosting their revenues and that the Fed's tighter monetary policies in response to inflation aren't depressing their unit sales so far. That would certainly explain why analysts have been raising their estimates for revenues.

Analysts also have been raising their earnings estimates along with their revenues estimates, implying that overall profit margins are holding firm and not getting squeezed by rapidly rising labor and materials costs or by labor and parts shortages. So it will be interesting to see whether that's actually been the case during Q2. Other key points that corporate managements undoubtedly will be discussing are the impacts on revenues, earnings, and margins of labor shortages, supply-chain problems, inventory issues, the strong dollar, China's zero Covid policy, and the Ukraine war.

Joe and I expect company managements to say that while labor shortages are weighing on their companies' expansion plans, productivity gains are providing some relief. Furthermore, they are likely to report that supply-chain challenges are easing, though that may reflect weakening demand in some cases. Unintended inventories may be piling up, especially among retailers, requiring price cuts to clear them.

The managements of US multinationals undoubtedly will confirm that the strong dollar is weighing on their revenues and earnings from overseas. Geopolitical concerns are challenging the globalization of business. China's pandemic-related lockdowns are depressing sales in that important market for many companies. We expect to hear increasing concerns that Europe is likely to fall into a severe recession as a result of the region's energy crisis caused by the Ukraine war.

Now let's consider the outlook for the S&P 500's major sectors as the Q2 earnings reporting games are about to begin:

(1) *S&P 500 sectors.* Joe reports the following consensus expected y/y growth rates for the revenues and earnings of the S&P 500 and its 11 sectors as of the July 8 week (i.e., the start of the earnings reporting season): S&P 500 (10.6%, 5.7%), Communication Services (3.9, -14.4), Consumer Discretionary (10.9, -5.5), Consumer Staples (5.6, -1.7), Energy (59.2, 239.1), Financials (-4.0, -20.8), Health Care (7.0, 1.6), Industrials (12.9, 30.8), Information Technology (7.8, 2.5), Materials (15.7, 17.4), Real Estate (15.4, 4.2), and Utilities (0.7, -12.2). (See our Earnings Season Monitor *tables*.)

(2) *Consumer Discretionary.* As we observed yesterday, solid payroll and wage gains are bolstering nominal personal income. However, consumers' purchasing power continues to be eroded by inflation. That's depressed spending on consumer discretionary goods as households are forced to spend more on essentials such as food, fuel, and rent. In addition, consumers' pent-up demand for discretionary goods has been satiated by the post-lockdown buying binge of 2020 and 2021, and now they are pivoting toward spending more on services.

Retailers report their results near the tail end of earnings seasons. Many of them have seen their inventories rising relative to sales as consumers have reduced their spending on discretionary goods. Here is the inventory-to-sales ratios of various retailers during April and a year ago: all retailers (1.18, 1.09), motor vehicle & parts dealers (1.28, 1.22), furniture, home furnishings, electronic & appliance stores (1.62, 1.27), building materials, garden

equipment & supplies (1.87, 1.58), and general merchandise stores (1.58, 1.19) (*Fig. 6*).

The retailers have been forced to discount their excess inventories to clear them. Industry analysts have slashed their earnings expectations for the industry. As a result, the forward profit margin of S&P 500 General Merchandise Stores has dropped by more than a percentage point in recent weeks to 5.2% at the end of June (*Fig. 7*).

(3) *Energy.* May's value of petroleum shipped by US refineries rose $45.8 billion since its April 2020 bottom, to its highest level since August 2014 (*Fig. 8*). This series is highly correlated with the forward earnings of the S&P 500 Energy sector. Despite the recent weakness in crude oil prices, industry analysts continue to raise their 2021 and 2022 revenues and earnings estimates for the sector. That's partly because crack spreads remained very high during June. (See our *S&P 500 Industry Briefing: Energy*.)

(4) *Financials.* The big banks will report their earnings this week. JPMorgan Chase and Morgan Stanley go first on Thursday, followed by Citigroup and Wells Fargo on Friday. On June 1, JPMorgan Chase CEO Jamie Dimon said he is preparing the biggest US bank for an economic hurricane on the horizon. Presumably, he is tightening up lending standards and boosting loan loss reserves.

If the big banks increase these reserves, that will weigh on their earnings. However, Jackie and I monitor the weekly data compiled by the Fed on US commercial banks' allowances for losses, and they've continued to decline during Q2 as they did during Q1 (*Fig. 9*). In addition, demand for commercial and industrial loans has increased every week but one since mid-February, and the banks have obviously been accommodating it (*Fig. 10*).

(5) *Industrials.* The S&P 500 Industrials sector includes lots of multinational corporations that are likely to report that a strong dollar has eroded their overseas profits. They may also report that the Ukraine war has wiped out their business in Russia, while China's lockdowns have slowed their sales in that country. Both the S&P 500 Agricultural & Farm Machinery and Construction & Engineering industries undoubtedly were hit by these developments during Q2.

Nevertheless, new orders for construction, farm, and mining machinery have been rising during the first five months of this year. New orders for industrial, metalworking, and materials handling equipment have remained near their record highs at the beginning of the year (*Fig. 11*).

Transportation corporations are also included in the S&P 500 Industrials sector. Trucking continues to enjoy a booming business. The industry's forward earnings rose to another record high at the end of June as its forward profit margin recently rose to a record high of 11.2%. The trucking companies clearly are passing soaring labor and fuel costs on to their customers. (See our *S&P 500 Industry Briefing:Trucking*.)

(6) *Information Technology.* The Q2 earnings of the S&P 500 Information Technology sector will also be negatively impacted by the strong dollar. The slowdown in China's economic growth rate is another negative. Yet data through May showed worldwide semiconductor sales soared to another record high in May (*Fig. 12*). In the US, industrial production of high-tech equipment remained on the solid uptrend that started after the 2020 lockdown recession through May of this year (*Fig. 13*).

Strategy III: No Recession in Forward Revenues. S&P 500 forward revenues per share is up 14.5% y/y in current dollars (through the June 30 week) and 5.9% on an inflation-adjusted basis (through May using the CPI) (*Fig. 14* and *Fig. 15*). Both are at record highs. The same can be said for forward earnings. It is up 18.0% y/y in current dollars (through the July 7 week) and 10.8% on an inflation-adjusted basis (through May) (*Fig. 16* and *Fig. 17*). They're both at record highs too.

So there's no recession yet evident in either forward revenues or forward earnings. Their growth rates are likely to fall closer to zero but avoid falling into the negative territory consistent with past "official" recessions. That's if our base-case economic outlook plays out with an "unofficial" mild recession scenario, as we discussed yesterday. That would be consistent with similar mid-cycle slowdowns like the ones during the mid-1980s and mid-2010s.

Calendars

US: Tues: NFIB Small Business Optimism; API Weekly Crude Oil Inventories; OPEC Monthly Report; EIA Short-Term Energy Outlook; WASDE Report. **Wed:** Headline & Core CPI 1.1%m/m/8.8%y/y & 0.6%m/m/5.7%y/y; Federal Budget; MBA Mortgage Applications; Crude Oil Inventories & Import; Gasoline Production; Beige Book; IEA Monthly Report. (Bloomberg estimates)

Global: Tues: Eurozone ZEW Economic Sentiment; Germany ZEW Economic Sentiment -

38.0; Australia Consumer Sentiment; China Trade Balance ¥75.7b; China Exports & Imports 12.0%/3.9% y/y; EU Economic Forecasts; Nagel; Balz; Bailey; Cunliffe; Mauderer. **Wed:** Eurozone Industrial Production 0.3%m/m/0.3%y/y; Germany CPI 0.1%m/m/7.6%y/y; France CPI 6.5% y/y; Spain CPI 10.2% y/y; UK GDP 0.0%3m/3m/2.7%y/y; UK Industrial & Manufacturing Production 0.2%m/m/-0.5%y/y & 0.1%m/m/0.3%y/y; UK NIESR Tracker; UK Trade Balance -22.5b; Australia Employment Change 25k; Australia Unemployment & Participation Rates BOC Interest Rate Decision 2.25%; BOC Monetary Policy Report. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): For a second straight week, none of these three indexes had forward earnings at a record high. That hasn't happened since January 2021. SmallCap was the only one of these three indexes to have forward earnings fall last week. LargeCap's has fallen in three of the past 10 weeks and remains less than 0.1% below its record high at the end of June. MidCap's rose for the first time in four weeks, but remains 0.5% below its record high in early June. MidCap's recent three-week decline was its first since May 2020. SmallCap's fell 1.6% w/w, and is down 2.6% from its record high in mid-June. In what was an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 104 of the past 111 weeks, with the other down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings misses for Q1-2022 and Q2-2021, Walmart's Q1-2022 miss, and index changes last September and December. MidCap's forward earnings is up in 103 of the past 109 weeks, and SmallCap's posted 99 gains in the past 110 weeks. SmallCap had been steadily making new highs each week until mid-December. 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 70.1% from its lowest level since August 2017; MidCap's is now up 140.2% from its lowest level since May 2015; and SmallCap's has soared 196.6% from its lowest point since August 2013. In the latest week, the rate of change in LargeCap's forward earnings fell to a 15-month low of 18.0% y/y from 18.4%; that's down from a record-high 42.2% at the end of July 2021 and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings was steady w/w at a 15-month low of 30.3% y/y. 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 fell to a 15-month low of 28.4% y/y from 31.5%. It's down from a record high of 124.2% in June 2021 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' consensus earnings forecasts for 2021 to 2023 to improve instead of decline as is typical, but their forecasts are likely to head lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (9.9%, 9.3%), MidCap (14.3, 6.3), and SmallCap (10.8, 11.4).

S&P 500/400/600 Valuation (*link*): Valuations rose for these three indexes last week. LargeCap's forward P/E gained 0.3pts to 16.3 from 16.0 a week earlier, and is up from a 26-month low of 15.3 several weeks before that. It's down from a six-month high of 21.5 in early November. 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 rose 0.1pt to 11.7 from 11.6, and is up from a 27-month low of 11.1 in mid-June. That's down from a 13-week high of 17.1 in early November. It had been at a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's picked up 0.3pts to 11.5 from 11.2 a week earlier. Its 10.7 reading several weeks before that was the lowest since it bottomed at a record low of 10.2 in November 2009 during the Great Financial Crisis. That compares with a 13-week high of 16.1 in early November and record high of 26.7 in early June 2020 when forward earnings was depressed. 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 28% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 99th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% reading is near its biggest discount 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 56th straight week; the current 2% discount 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 Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022. In the latest week, the Q2-2022 earnings-per-share forecast rose 16 cents w/w to $55.51, and is now down 0.7% from its $55.92 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 5.2% y/y on a frozen actual basis and 5.7%

on a pro forma basis. That's down from Q1-2022's 11.6% y/y on a frozen actual basis and an 11.4% y/y gain on a pro forma basis. Double-digit growth is expected for just three sectors in Q2-2022, and five are expected to record a y/y decline. That compares to Q1-2022's count of seven sectors with double-digit growth, one with a single-digit gain, and three with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q2-2022 versus their Q1-2022 growth rates: Energy (239.1% in Q2-2022 versus 269.5% in Q1-2022), Industrials (30.8, 40.5), Materials (17.4, 46.3), S&P 500 (5.7, 11.4), Real Estate (4.2, 25.5), Health Care (1.6, 18.3), Information Technology (2.5, 14.6), Consumer Staples (-1.7, 7.9), Consumer Discretionary (-5.5, -27.9), Utilities (-12.2, 24.6), Communication Services (-14.4, -2.8), and Financials (-20.8, -17.1).

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