Yardeni Research

MORNING BRIEFING
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Earnings, Inflation & Europe

Check out the accompanying chart collection.

Executive Summary: Industry analysts are starting to lower their earnings estimates for some of the companies they follow. They aren't doing so because they suddenly see an imminent recession but rather profit margins getting squeezed. …We don't expect this morning's June CPI release to show a peaking of inflation just yet. July's CPI should do so. We see inflation moderating during the second half of this year and further in 2023. … Also: A peek into the world of Europe's credit markets. These markets have been buffeted lately, first by the ECB's hawkishness, then by its reassurances of help for the most indebted of the Eurozone's nations.

Earnings I: Recession or Margin Squeeze? Joe and I tend to be optimists. Nevertheless, we marvel at the remarkable optimism of industry analysts about company prospects despite the mounting recession concerns that have fed the valuation-led bear market in stocks so far this year. Indeed, the S&P 500's forward earnings has been making new highs almost every week this year (through the June 30 week), though the ascent has started to look a bit toppy over the past three weeks (*Fig. 1*). All but two S&P 500 sectors (Communication Services and Consumer Discretionary) have forward earnings at or near recent record highs.

But on closer inspection, it seems that a few analysts now might have gotten the recession memo from the companies they follow:

(1) *Consensus earnings estimates for 2022 & 2023.* Here are the ytd percent changes in analysts' consensus estimates for the 2022 and 2023 earnings of the S&P 500 and its 11 sectors through the June 30 week: Energy (79.4%, 65.2%), Real Estate (15.1, 5.2), Materials (14.4, 10.3), S&P 500 (2.9, 1.9), Information Technology (2.7, 2.0), Health Care (0.6, -1.7),Utilities (-0.4, 0.5), Financials (-1.3, 0.3), Industrials (-1.4, 0.8), Consumer Staples (-1.6, -2.2), Communication Services (-7.5, -6.8), and Consumer Discretionary (-15.7, -7.9). (See Tables 7E and 8E in our *Performance Derby: S&P 500 Sectors & Industries Forward Earnings & Revenues*.) Six of the sector estimates for this year and four of them for next year show downward revisions (ytd).

(2) *Forward revenues boosted by inflation.* Remarkably, the forward revenues of the 11

sectors all have been rising since the start of this year, with all but three of them at record highs (*Fig. 2*). Obviously, any hint of a possible recession in forward revenues has been more than offset by the positive impact of rapidly rising price inflation on revenues.

(3) *Profit margins.* We have to conclude from the available data that the analysts who have been cutting their earnings outlook aren't doing so because they've received recession memos from the companies they follow but rather memos on profit margin squeezes being experienced (*Fig. 3*).

Here is are the ytd percentage changes in the forward profit margins of the S&P 500 and its 11 sectors through the June 30 week and the latest readings of those margins: Energy (up 27.7%, 11.7%), Real Estate (11.0, 18.1), Information Technology (0.9, 25.2), Materials (0.2, 13.3), Financials (-0.3, 18.7), S&P 500 (-0.4, 13.3), Industrials (-0.6, 10.3), Consumer Staples (-3.0, 7.4), Health Care (-3.9, 10.9), Communication Services (-4.5, 16.0), Utilities (-5.9, 13.8), and Consumer Discretionary (-7.9, 7.5). (See Table 3 and Table 1 in *Performance Derby: S&P 500 Sectors & Industries Forward Profit Margins*.) Forward profit margins have been revised down for six of the 11 sectors of the S&P 500.

US Inflation: Persisting for Now. June's CPI report is coming out this morning. Bloomberg is showing consensus estimates of up 1.1% (8.8% y/y) for the headline and 0.6% (5.8% y/y) for the core inflation rates. There's no peak represented by these numbers given that the headline and core CPI inflation rates on a y/y basis were 8.6% and 6.0% in May. The same can be said of other recently released measures of inflation, though a few do support our view that inflation should moderate during H2-2022.

We are forecasting that the headline PCED measure of inflation, which ranged between 6% and 7% y/y during H1-2022, will ease to 4%-5% during H2-2022 and to 3%-4% during 2023 (*Fig. 4*). We don't expect that getting there will require a hard landing for the economy. Rather, our base-case economic outlook (with a 55% subjective probability) is a short and shallow recession (*Fig. 5*). Let's review the latest inflation readings:

(1) *Inflationary expectations.* The New York Federal Reserve Bank has been conducting a monthly survey of consumers' inflationary expectations since mid-2013 (*Fig. 6*). June's one-year-ahead expectations rose to a record 6.8%, while three-year ahead expectations edged down to 3.6%. Fed officials are likely to conclude that they must proceed with their tightening of monetary policy since longer-term inflationary expectations are being held down by expectations that the Fed will do just that until actual inflation subsides.

(2) *Wage inflation.* A recent survey from Insight Global found that 78% of US workers would be worried about job security if the US enters another recession. The staffing company surveyed over 1,000 workers in mostly white-collar professions. The survey found that 54% of workers said they would take a pay cut if it meant not getting laid off. All the talk about a possible recession may be starting to moderate wage inflation. June's average hourly earnings (AHE) measure of inflation was up 5.1% y/y, but the three-month annualized rate was 4.2% (*Fig. 7*).

Here are the major industries where the AHE year-over-year rates are above their annualized three-month percent changes (suggesting that inflationary pressures are easing): education & health services (6.1%, 5.8%), utilities (6.1, 4.6), professional & business services (5.8, 3.2), transportation & warehousing (5.3, 0.7), wholesale trade (4.5, 4.1), retail trade (4.4, 1.1), durable goods manufacturing (4.3, 3.1), nondurable goods manufacturing (3.8, 3.4), and financial activities (2.4, 0.7).

Here are the major industries where the year-over-year rates are below their three-month annualized rates (suggesting that inflationary pressures are persisting): leisure & hospitality (9.1%, 10.2%), construction (5.6, 6.3), information services (4.4, 8.8), and other services (2.9, 3.6), with the natural resources' (3.7, 3.8) rates virtually even.

(3) *Small business owners survey.* The National Federation of Independent Business conducts a monthly survey of small business owners. They are a very unhappy lot indeed. On balance, a net -61% of them expect that the economic outlook over the next six months is better rather than worse than now (*Fig. 8*). This measure has been falling to record lows since March. That's mostly because 34% of them said that inflation is their number-one problem (*Fig. 9*).

They are also complaining about a shortage of workers, as 50% of them have job openings and 60% reported that there are few or no qualified applicants for their open positions (*Fig. 10*). As a result, 28% of small business owners are planning to raise worker compensation in the next three months (*Fig. 11*). Meanwhile, a whopping 69% are raising their average selling prices, while 44% are planning to do so (*Fig. 12*).

(4) *Freight rates.* About a year ago, the cost to ship containers from China to the US had jumped from $2,000 pre-pandemic to $20,000. According to one *report*, Flexport, a tech-enabled freight forwarder, has seen rates drop from highs of around $20,000 per container to $10,000.

(5) *Used car prices.* The Manheim index of wholesale used car prices fell to 9.7% y/y during June. That's down from a recent high of 46.6% during December and the lowest since mid-2020 (*Fig. 13*). The used-car component of the CPI has been a major contributor to measures of consumer price inflation over the past year.

(6) *Food and energy commodity prices.* Finally, the S&P GSCI energy and agricultural commodity price indexes are down 15.4% and 23.0% from their most recent peaks on June 9 and May 17 through July 11 (*Fig. 14*). This augurs well for a moderation of the energy and food inflation components of July's CPI. The overall S&P GSCI index is down 15.3% from its recent peak on March 8 through July 11 (*Fig. 15*). These developments suggest that inflation may be peaking and help to explain why the S&P 500 bottomed on June 16.

Europe Credit I: Positives for Highly Indebted Sovereigns. After the European Central Bank's (ECB) June 9 policy meeting, a huge sell-off in the European high-yield bond and other credit markets occurred as investors reacted negatively to the ECB's super-hawkish tone.

The 10-year German bund yield hit a recent high of 1.76% following the release of the ECB's June 9 *Monetary Policy Statement* (*Fig. 16*). "Given the dramatic bund move, the all-in cost for borrowers is not just wider spreads, but much higher base rates," said a high-yield fund manager quoted in an S&P Global *article*.

To address the sudden rise in high-yield bonds and spreads, the ECB *announced* on June 15 that it would accelerate the completion of a new anti-fragmentation instrument to direct funds toward heavily indebted European countries, even as it tightens monetary policy overall to combat inflation. Bond market reactions suggest cautious optimism that the new policy tool will help to stave off a recurrent European debt crisis.

The next day, Christian Lindner, Germany's finance minister, also attempted to quell market jitters when he *told* CNBC: "Yes, of course we are witnessing some rising spreads amongst the member states, but there is no need for any concern." And on June 27, Germany's financial stability committee *said* that the effects of Russia's war on Ukraine are manageable.

So far, the European Commission (EC) has said nothing officially about a possible Eurozone recession. But speaking to CNBC, EU Economics Commissioner Paolo Gentiloni admitted that "We are navigating troubled waters" but said a recession isn't inevitable. He added that the situation "means that we will have to concentrate our fiscal policies, in reforms, in investments, in a prudent policy, especially for countries with a high level of debt."

Europe's financial situation indeed is fragmented by country. Greece and Italy had the two highest *debt-to-GDP ratios* at year-end 2021—of 193% and 151%, respectively, versus 69% for the more austere Germany and 96% for the Eurozone overall. But Melissa and I found a surprising number of positives in the recent credit profiles of Europe's two most heavily indebted countries:

(1) *Fitch's positive outlook on Greece.* On July 8, Fitch affirmed Greece's sovereign debt rating of "BB" with a "Positive Outlook." Fitch's ratings *release* noted: "The Positive Outlook reflects a sustained expected decline in public sector indebtedness, in the context of still low average borrowing costs, despite the sharp rise in government bond yields this year. Greek banks have made substantial progress on asset quality improvement, sharply reducing the level of [non-performing loans] in the banking sector."

The government's debt-to-GDP ratio is projected to fall further to about 172% by 2024 from about 193%, "driven by improving primary balances and favorable growth-interest costs dynamics." While the debt ratio in 2024 is still forecast to be among the highest of Fitch-rated sovereigns, mitigating factors support debt sustainability: substantial liquidity, low debt-servicing costs, and manageable amortization schedules.

The 10-year government bond yield for Greece rose sharply from 1.3% at the end of 2021 to average around 4.0% in June 2022 (*Fig. 17*). However, at around 20 years, the average maturity of Greek debt is among the longest of any sovereign, and the debt is mostly fixed rate, limiting the impact of market interest-rate rises.

Despite the improving credit outlook, however, Greece's macroeconomic outlook has worsened because of the war. That's especially because Greece is vulnerable to further energy price shocks, as it relies on Russia for around 40% of overall gas imports.

(2) *Italian déjà vu with differences.* "Whatever it takes [to rescue the euro]," was former ECB President Mario Draghi's famous pledge at the height of the 2012 sovereign debt crisis. That reassurance and his follow-up actions—"mop[ping] up a fifth of Italian bonds," in Reuters' *words*—calmed investor fears, causing Italy's 10-year bond yield to drop.

The ECB's June 15 reassurances about a new tool to help troubled states worked like Draghi's magic words: On June 14, Italy's 10-year government bond spiked above 4.0%, the highest since 2013, on renewed concerns about Italy's ability to sustain its debt under macroeconomic pressure (*Fig. 18*). The ECB's announcement the next day brought Italian benchmark yields back toward 3.0%.

We think the rise above the 4.0% threshold was concerning; but notably, back in 2011 Italian 10-year yields rose above 7.0%. Italian banks remain heavily exposed to domestic sovereign debt but not as much so as in the past. For Italy's top five banks, the ratio of domestic bond holdings to core capital is 148%, according to JPMorgan's data cited by Reuters, but that's a lot less than the 261% hit in 2017.

Italy's bank restructuring that began during the 2012 sovereign debt crisis has progressed but remains incomplete. The top two lenders are sound, noted former ECB executive Ignazio Angeloni at a conference in June, but the mid-sized banks are not yet fully stabilized. Problem loans "could rise again as businesses face higher lending costs, record prices for energy and raw materials as well as disrupted supply chains and the phasing out of COVID support measures," the Reuters article noted.

Europe Credit II: High Stakes, Low Defaults in High-Yield. In the aftermath of the recent bond scare, investors have been shying away from higher-yielding European debt assets in general. "European high-yield bond issuance is set for the lowest first-half total since the global financial crisis, as volatile interest rates and fears over rising inflation forced investors to assess the impact of a global recession on the asset class," wrote S&P Global in a June 22 *article*. Here's more:

(1) *Investors orderly fleeing high yields.* The selling of riskier bonds isn't frantic but orderly. Starting in February, a 10-week closure of the primary market was triggered by the Ukraine war, which escalated fears over inflation and rising interest rates. As a result, the European high-yield asset class faced outflows of 15.6% of assets under management through June 20, according to Spread Research data cited in the S&P Global piece. European high-yield issuance of €15.3 billion in H1-2022 was the lowest since H1-2009, when markets were reacting to the Global Financial Crisis, according to Leveraged Commentary & Data noted S&P Global's article.

(2) *High-yields ascend to double digits.* Meanwhile, yields in Europe's secondary credit markets rose, according to July 20 data from Spread Research. At the lowest end of the ratings spectrum, the CCC yield was quoted at 11.7%. "The current generous pricing in some deals currently in the high yield market is fine if we assume the default rate will remain below the historical average of 4% over the next two years," Sergio Grasso, director

at iason, wrote in a June 28 report. However, “if the current and future restrictive monetary policies will tilt the economies into recession,” then even the current risk on pricing is still “not enough.”

(3) *Defaults expected to remain low.* The good news is that while European high-yield bond and leveraged loan default rates will increase in 2023 (to 2.5% from 1.5% and to 3.0% from 2.5%, respectively), they’re still expected to remain below 4.0% and below long-term historical levels, according to a June 15 Fitch Ratings *report*. Fitch does not expect a “severe near-term recession that would lead to wholesale downgrades of credits, unlike the pandemic impact.”

(4) *Pain beyond high yield.* Even so, the anticipation of higher interest rates ahead is causing pain in not only the high-yield market but also the investment-grade debt market. An index of investment-grade European debt has suffered a record 12.9% loss over the past 12 months, *observed* Bloomberg on June 24. According to the Bloomberg index, the average yield on euro corporate bonds has risen 2.9 percentage points this year to 3.4%. That compares to a rise of 1.62 points in 2008, the next highest. “We could see earnings impacted because of this rather unexpected rise in the cost of debt,” said ING credit strategist Timothy Rahill.

Calendars

US: **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. **Thurs:** Headline & Core PPI 0.8%m/m/10.7%y/y & 0.5%m/m/8.1%y/y; Jobless & Continuous Claims 235k/1.383m; Natural Gas Storage; Waller. (Bloomberg estimates)

Global: **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. **Thurs:** Japan Industrial Production & Capacity Utilization; China GDP 0.6%q/q//4.4%y/y; China Industrial Production 4.0% y;y; China Retail Sales -0.3% y/y; China NBS Press Conference; Mauderer. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q2 Earnings Season Monitor (*link*): With just 4% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, revenues are beating the consensus forecast by 1.4%, but earnings have exceeded estimates by only a well-below-trend 3.9%. At the same point during the Q1 season, revenues were 1.1% above forecast and earnings beat by 1.5%. For the 19 companies that have reported Q2 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed from their readings from Q2-2021 to Q1-2022. The small sample of 19 reporters so far collectively has a y/y revenue gain of 10.9% and an earnings gain of 16.5%. While just 84% of the Q1 reporters so far has reported a positive revenue surprise, 90% has beaten earnings forecasts. Fewer companies have reported positive y/y earnings growth in Q1 (74%) than positive y/y revenue growth (84%). These figures will change markedly as more Q2-2022 results are reported in the coming weeks. While we expect y/y growth rates to remain positive in Q2, we think revenue and earnings surprises will moderate q/q due to the slowing economy, missed deliveries, and higher costs.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "As inflation continues to dominate business decisions, small business owners' expectations for better business conditions have reached a new low," notes NFIB Chief Economist Bill Dunkelberg. "On top of the immediate challenges facing small business owners including inflation and worker shortages, the outlook for economic policy is not encouraging either as policy talks have shifted to tax increases and more regulations." June's Small Business Optimism Index (SBOI) sank 3.6 points m/m and 9.4 points ytd to 89.5—the sixth successive month below the 48-year average of 98.0 and the lowest since January 2013. In June, all 10 components were in the red, led by steep declines in sales expectations (-13ppts to -28%), expect the economy to improve (-7 to -61—a record low), and plans to increase employment (-7 to 19), followed by now is a good time to expand (-3 to 3), current inventory (-3 to 5), plans to increase inventories (-3 to -2), current job openings (-1 to 50), earnings trend (-1 to -25), and expected credit conditions (-1 to -5). In June, 34% of owners still reported inflation as their single most important problem, up from 28% in May and the highest since 1980—and not far from its record high of 41% during Q4-1974. Labor shortages remain a problem—with the report noting that, of the small businesses trying to hire new workers, a whopping 94% reported that few or no qualified workers applied for the position they were trying to fill. In June, 48% of owners said they increased pay—near its record high of 50% at the start of this year—while 28% noted they plan to increase compensation in the next three months, holding near its record high of 32% during the final three months of last year.

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