Yardeni Research

MORNING BRIEFING
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The Dollar & Earnings

Check out the accompanying chart collection.

Executive Summary: Although Fed officials rarely discuss the US dollar's impact on the economy, the dollar's recent strength does exert an impact comparable to some degree of interest-rate hiking. Ditto the Fed's latest quantitative tightening program, QT2. Both effectively will lower the federal-funds-rate endpoint of this tightening cycle. … The dollar's recent strength reflects massive inflows into US financial markets from overseas given the troubled economies most everywhere else. So we continue to recommend a Stay Home investment strategy for US investors. … How does the dollar's strength affect corporate earnings? There's no rule of thumb to go by, but with S&P 500 companies deriving about 30%-40% of their revenues and earnings from abroad, the impacts can be significant.

The Dollar I: Above All Else. Since I began my career on Wall Street in 1978, the only time the dollar was discussed much at FOMC meetings was during 2015 and early 2016. The 26% appreciation of the trade-weighted dollar from mid-2014 through early 2017 certainly raised some concerns about its negative impact on exports at a time when the Fed was worrying about the slow pace of economic activity (*Fig 1*). In addition, the strong dollar weighed on import prices and inflation at a time when the Fed was hoping that its policies would boost inflation toward its 2.0% target.

The Fed began to normalize monetary policy in late 2014 when it terminated QE3 at the end of October and hiked the federal funds rate by 25 basis points during December 2015 (*Fig. 2*). Meanwhile, the other major central banks continued to pursue their ultra-easy monetary policies. As a result, the dollar soared just as the Fed was achieving its dual mandate, with the unemployment rate down to around 5.0% and core inflation approaching 2.0%. Fed officials mentioned their concerns about the adverse impact of a strong dollar on their dual-mandate mission but expected the impact to be transitory, passing once the dollar had peaked.

On September 12, 2016, Fed Governor Lael Brainard presented a *speech* titled "The 'New Normal' and What It Means for Monetary Policy," calling for "prudence in the removal of policy accommodation." She listed several reasons for this, including a very specific estimate of the impact of the strong dollar on the economy. She said, "In particular, estimates from the FRB/US model suggest that the nearly 20 percent appreciation of the dollar from June 2014 to January of this year could be having an effect on US economic activity roughly equivalent to a 200-basis-point increase in the federal funds rate."

I had been making the same point since late 2015. It was good to see in 2016 a top Fed official acknowledge that the foreign-exchange value of the dollar matters. There was much angst when the dollar continued to move higher through early 2017.

So what about now? Consider the following:

(1) *Fed is ahead of the pack.* The trade-weighted dollar is up 8% y/y through yesterday. Is that equivalent to a 100bps hike in the federal funds rate? The foreign-exchange value of the dollar was mentioned just once and only in passing during the June 14-15 FOMC meeting, according to the *minutes*. Melissa and I don't recall Brainard or any other Fed official raising this issue recently.

A big reason for the dollar's recent strength is that the Fed has turned more hawkish than the European Central Bank (ECB) since the start of this year. So the euro has plunged 13% y/y through yesterday (*Fig. 3*). The Fed has already raised the federal funds rate from a range of 0.00%-0.25% to 1.50%-1.75% and is expected to add 75bps to that at the end of this month. The ECB previously flagged that it would just start raising rates by 25bps at its policy meeting this morning to contain record-high inflation. Yesterday, the financial press reported that the ECB might go for a 50bps hike. That would increase the ECB's deposit facility rate from -0.50% all the way up to 0.00% (*Fig. 4*).

Meanwhile, the Bank of Japan remains committed to its ultra-easy monetary policy, including pegging the government's 10-year bond yield at zero. As a result, the yen is down 20% y/y through Monday (*Fig. 5*).

(2) *Quantitative tightening.* Fed officials' muteness on the strong dollar's economic impact is matched by their silence on another economically important development: They also haven't quantified the impact of the termination of QE4ever and the start of the latest round of quantitative tightening (QT2). The first round, QT1, started on October 1, 2017 and ended on July 31, 2019 (*Fig. 6*). The Fed's balance sheet was pared by $675 billion. That undoubtedly contributed to the economic slowdown that occurred during 2018 and 2019. The Fed terminated QT1 well ahead of normalizing its balance sheet as a result of illiquidity problems in the repo market in late 2019 and the pandemic in early 2020.

No one knows how long QT2 will last. It will take a very long time to reduce the Fed's mortgage-backed securities portfolio from $2.7 trillion during May back down to zero, which is the intention suggested by some Fed officials. The same can be said about reducing the Fed's holdings of Treasuries from $5.8 trillion during May to $2.4 trillion, which is where Treasury holdings stood during January 2020 just before the pandemic (*Fig. 7*, *Fig. 8*, and *Fig. 9*).

If the Fed succeeds in reducing its balance sheet by $2.8 trillion to $5.7 trillion by the end of 2024 under QT2, would the tightening impact be comparable to raising the federal funds rate by 100bps, 200bps, 300bps, or more? Fed officials undoubtedly have run their econometric model to come up with some estimates. But they haven't shared the results with the public.

(3) *Double whammy.* The 10% appreciation of the dollar and QT2 undoubtedly will lower the federal-funds-rate endpoint of this tightening cycle. But what will that point be? It's conceivable that two more rate hikes of 75bps each at the next two meetings of the FOMC will be enough given the additional tightening of credit conditions attributable to the strong dollar and to QT2!

The Dollar II: TINAC & TICS. As we observed yesterday, the geopolitical mess around the world continues to favor the US dollar, suggesting increasing net capital inflows from overseas into the US financial markets. That helps to explain the recent peaking of the bond yield, which should provide some support to the valuation multiples of stocks.

There is no end in sight for the Ukraine war. Europeans are preparing for a possible permanent shutoff of Russian gas. China continues to struggle with Covid and a bursting housing bubble. Emerging markets are facing soaring prices for energy and food and shortages of both, which are triggering political instability. So lots of global investors may be concluding that they must overweight US securities in their portfolios since there is no alternative country (TINAC).

Data compiled by the *Treasury International Capital System* (TICS) show that the US is experiencing massive net capital inflows, which have been boosting the dollar in the face of record current-account deficits. The monthly data show that total net capital inflows added up to $1.3 trillion during the 12 months through May, near the record high of $1.4 trillion during February (*Fig. 10*). Over this same period, the total private net capital inflows rose to $1.6 trillion, while the total official net capital inflows was -$226 billion (*Fig. 11*).

Here are the major components of the 12-month private net capital inflows through May: total ($1.6 trillion), all bonds ($797 billion), Treasury bonds ($583 billion), government agency bonds ($104 billion), corporate bonds ($110 billion), equities (-162 billion), Treasury bills ($73 billion), and other negotiable instruments ($336 billion) (*Fig. 12*).

The Dollar III: Stay Home vs Go Global. So while foreigners have bought lots of dollars over the past year, they invested them in US fixed-income securities and were net sellers of US equities. They were probably turned off by the relatively high forward P/E of the US MSCI stock price index compared to the All Country World (ACW) ex US forward P/E (*Fig. 13*). The ratio of the two shows that the former has been selling at a 40%-50% premium to the latter (*Fig. 14*). The current premium is 45%.

The forward P/Es of the major MSCI indexes around the world are much lower currently than those of the comparable US index (*Fig. 15*). Here were their latest readings during the week of July 7: US (16.5), Japan (12.3), EMU (10.8), Emerging Markets (10.9), and UK (9.5).

This year, through July 18, the US MSCI is down 20.7%, while the ACW ex US is down 12.8%. On the other hand, the ACW ex US is down 20.3% in dollar terms. The upward trends in the ratios of the US MSCI to the ACW ex US MSCI since 2009 in dollars and in local currencies remain intact (*Fig. 16*). We continue to recommend overweighting a Stay Home rather than Go Global investment strategy since the US still looks like a safe haven given the new world disorder.

The Dollar IV: Weighing on Earnings. Many US companies do lots of business overseas. By investing in these companies, US investors indirectly accrue plenty of exposure to the global economy. Many of these corporations not only export goods and services made in America but also generate profits from their overseas subsidiaries. Accordingly, the foreign-exchange value of the dollar greatly affects the profits of many US companies. Currency impacts are often discussed during quarterly earnings calls held by corporate managements with investors and industry analysts. Available data can provide some perspective:

(1) *Revenues from abroad.* On average, the S&P 500 companies derive roughly half of their revenues and profits from abroad. In 2016, the actual percentage of S&P 500 companies' sales from foreign countries was 43% of their total sales, down from 44% in 2015 and 48% in 2014. Importantly, however, S&P 500 foreign sales represent only goods and services produced and sold outside of the United States; they don't include US-made products that are exported and sold abroad.

(2) *Earnings from abroad.* Standard & Poor's provides no comparable figures for the

percentage of profits earned overseas by the S&P 500 companies. However, it's likely to be close to the percentage of revenues from abroad. The National Income and Product Accounts of the United States does have a data series on pretax corporate profits receipts from the rest of the world. It has risen from $3 billion at the start of 1959, accounting for 5.7% of total pretax profits, to $988 billion during Q1-2022, accounting for 34.3% of profits (*Fig. 17* and *Fig. 18*).

If all else were equal, one could expect a straightforward, consistent impact of currency-exchange effects on corporate profits: 10% appreciation (or depreciation) of the dollar should decrease (or increase) S&P 500 profits by 4%, assuming that roughly 40% of the index companies' earnings come from abroad. But the fact that Standard & Poor's excludes export revenues in its calculation of revenues from abroad—lumping export sales together with domestic sales—means that all else isn't equal; there's more to the story, because export revenues are affected by currency impacts as well. In other words, there is no simple rule of thumb for estimating the impact of a currency's move on either overall profits or an individual company's earnings.

Calendars

US: Wed: Existing Home Sales 5.38mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Leading Indicators -0.5%; Initial & Continuous Jobless Claims 240k/1.34m; Philadelphia Fed Manufacturing Index; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Eurozone Consumer Confidence -24.9; Germany PPI 1.3%m/m/33.9%y/y; UK Headline & Core CPI 0.7%m/m/9.3%y/y & 0.5%m/m/5.8%y/y; UK PPI Input & Output 1.4%m/m/23.2%y/y & 1.1%m/m/16.0%y/y; Canada Headline & Core CPI 8.4%/5.9% y/y; Japan Trade Balance – ¥1.5t; Japan Exports & Imports 17.5%/45.7% y/y; Australia Quarterly Business Confidence; China New Loans; BOJ Interest Rate Decision -0.19%.**Thurs:** France Business Survey 106; Japan CPI; ECB Interest Rate Decision & Deposit Facility Rate 0.25%/-0.25%. (Bloomberg estimates)

Strategy Indicators

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady w/w at 13.3%, down from its record high of 13.4% achieved intermittently from March to June. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 3.0ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings were both back at record highs after ticking down briefly in early February. They have both been making new highs since the beginning of March 2021 after peaking just before Covid-19 in February 2020. Since the Q2-2021 earnings season came in way better than expected, analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown period. Prior to this catch-up period, consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth fell 0.1ppt w/w to a 19-month low of 7.0%. That's down from a record high of 9.6% growth at the end of May 2021. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth fell 0.2ppt w/w to a five-month low of 9.0%. It remains above its 16-month low of 8.2% in early December. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. So far this year, analysts' revisions to their forecasts for 2022 revenues have outpaced their revisions for 2022 earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts has ticked down 0.3ppt to 12.9%. They expect revenues to rise 11.8% (unchanged w/w) in 2022 and 4.4% in 2023 (down 0.1ppt w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 10.7% in 2022 (down 0.2ppt w/w) and 8.5% in 2023 (down 0.3ppt w/w) compared to an earnings gain of 50.9% in 2021. Analysts expect the profit margin to drop 0.1ppt y/y to 12.9% in 2022 (down 0.1ppt w/w) compared to 13.0% in 2021 and to improve 0.5ppt y/y to 13.5% in 2023 (down 0.1ppt w/w). The S&P 500's weekly reading of its forward P/E ticked down 0.1pt w/w to 16.0, up from a 26-month low of 15.8 a month earlier. That's down from an eight-month high of 21.7 at the end of 2021 and compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio fell 0.03pt w/w to 2.12, up from a 26-month low of 2.10 during June. That compares to a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise for three of the 11 S&P 500 sectors, forward earnings gain for one sector, and the forward profit margin move higher for one sector. Just one sector has forward earnings at a record high now. Most of the other sectors are below recent record highs in their forward revenues, earnings, and profit margins. Energy still has forward revenues earnings well below a record high, but its forward earnings and profit margin rose to record highs this week. Utilities' forward revenues and margin are lagging, and its earnings are a hair below its record a week earlier. Only three sectors posted a higher profit margin y/y in 2020: Consumer Staples, Tech, and Utilities. During 2021, all but the Utilities sector posted a y/y improvement. Six sectors are now expected to see margins decline y/y in 2022: Communication Services, Consumer Discretionary, Consumer Staples, Financials, Health Care, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.1%, down from its 25.4% record high in early June), Financials (18.5, down from its 19.8 record high in August 2021), Real Estate (18.1, down from its 19.2 record high in 2016), Communication Services (16.0, down from its 17.0 record high in October), Utilities (13.9, down from its 14.8 record high in April 2021), Materials (13.1, down from its 13.6 record high in early June), S&P 500 (13.3, down from its record high 13.4 achieved intermittently since March), Health Care (10.9, down from its 11.5 record high in early March), Industrials (10.3, down from its 10.5 record high in December 2019), Energy (12.0, a new record high this week), Consumer Discretionary (7.5, down from its 8.3 record high in 2018), and Consumer Staples (7.3, down from its 7.7 record high in June 2020).

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI turned negative in July for the first time in 24 months and has declined m/m in 10 of the last 12 months. NERI fell to a 24-month low of -1.9% in July from 1.5% in June. It had been negative for 13 straight months through July 2020 due to the pandemic shutdown. Its now-ended 23-month positive streak had exceeded the prior 18-month positive streak during the cycle that ended October 2018, when NERI reached a tax-cut-induced, then-record high of 22.1% in March 2018. July's reading compares to a record-high 23.1% in July 2021 and an 11-year low of -37.4% in May 2020. Five of the 11 S&P 500 sectors had positive NERI in July, down from seven in June. Five sectors had NERI readings at post-pandemic two-year lows during the month, and only one had NERI improve m/m, down from three rising in June. Among the underperforming sectors, Communication Services was negative for a ninth month, Consumer Staples for a fifth, and Consumer Discretionary and Health Care for a fourth month. Here are the July NERIs for the S&P 500 and its sectors compared with their June readings: Energy (35.5% in July, down from 37.1% in June), Real Estate (4.6, 9.3 [7-month high]), Utilities (4.3, 5.2 [17-month high]), Materials (3.3, 9.8), Industrials (1.1, 5.1 [8-month high]), Information Technology (-1.8 [24-month low], 1.4), S&P 500 (-1.9 [24-month low], 1.5), Financials (-3.1 [24-month low], 5.4), Consumer Staples (-5.7, -8.3 [24-month low]), Health Care (-7.8 [24-month low], -5.2), Consumer Discretionary (-10.2 [24-month low], -

7.5), and Communication Services (-17.8 [24-month low], -15.1).

S&P 500 Sectors Net Revenue Revisions (*link*): The S&P 500's NRRI dropped for a fourth straight month in July and has weakened m/m in eight of the past 11 months. Its July reading of 1.7% was at a 24-month low and down from 5.0% in June, but was positive for a 24th month following 21 straight negative readings. That exceeds the prior 19-month positive streak during the cycle that ended October 2018, when NRRI reached a tax-cut-induced then-record high of 14.7% in March 2018. July's reading compares to a record-high 25.9% in August 2021 and an 11-year low of -35.8% in May 2020. Six of the 11 S&P 500 sectors had positive NRRI in July, down from eight a month earlier and down from all 11 during July-October 2021. Five sectors had NRRI readings at post-pandemic lows during the month. Consumer Staples and Energy were the only sectors to have NRRI improve m/m, up from just one rising in June. Communication Services was negative for a ninth straight month, followed by Health Care at four months and Consumer Discretionary at three. Here are the July NRRIs for the S&P 500 and its sectors compared with their June readings: Energy (40.6% in July [11-month high], up from 39.7% in June), Real Estate (19.6, 24.9), Consumer Staples (18.6 [9-month high], 15.3), Materials (17.5, 24.6), Utilities (16.2, 18.1), Industrials (4.8, 9.6), S&P 500 (1.7 [24-month low], 5.0), Information Technology (-2.7 [24-month low], 0.8), Financials (-4.8 [24-month low], 2.2), Health Care (-6.4 [24-month low], -4.4), Consumer Discretionary (-7.0 [24-month low], -4.7), and Communication Services (-19.4 [24-month low], -16.7).

S&P 500 Q2 Earnings Season Monitor (*link*): With 10% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, revenues have beaten the consensus forecast by 1.2%, and earnings have exceeded estimates by a well-below-recent-trend 4.1%. At the same point during the Q1 season, revenues were 1.4% above forecast and earnings 9.1% above. For the 48 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 6.7% and an earnings decline of 8.2%. Just 71% of the Q1 reporters so far has reported a positive revenue surprise, and 81% have beaten earnings forecasts. Markedly fewer companies have reported positive y/y earnings growth in Q1 (58%) than positive y/y revenue growth (79%). 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 Q1, we think revenue and earnings surprises will moderate q/q due to the slowing economy, missed deliveries, and higher costs.

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