MORNING BRIEFING
August 3, 2022

US Earnings & European Gas

Check out the accompanying chart collection.

Executive Summary: Industry analysts finally have begun reining in their high earnings, revenues, and profit margin expectations. Their moves suggest that analysts collectively expect inflation to moderate but don't anticipate a recession. … Also: Europe may face a cold, dark winter—literally and economically—if Russia doesn't restore the natural gas flows to Europe that the EU depends on. Melissa presents a timeline of Russia's gas-depriving moves and the responses from government and gas futures markets. … And: Soaring energy prices are dampening European consumer and business sentiment, boding ill for GDP growth and corporate earnings prospects. The only EMU MSCI sector with unscathed earnings growth expectations is Energy.

Strategy: Analysts Are Shaving Earnings. Investors spent most of the first six months of this year worrying about a recession and selling stocks. They did so even as industry analysts raised their earnings estimates. Investors, apparently fearing that the analysts might be delusional, slashed the valuation multiples they were willing to pay for analysts' earnings estimates. Now that analysts finally have started to lower their earnings estimates, investors seem to have concluded that the economic outlook may not be as bad as they feared. So stocks have rebounded sharply since they bottomed on June 16.

Let's see what analysts have been up to recently:

(1) *Earnings.* Joe and I shaved our earnings estimates on July 5 (see that day's *Morning Briefing*). We reduced our S&P 500 operating earnings-per-share forecast for 2022 by $10 to $215 and for 2023 by $5 to $235 (*Fig. 1*). Industry analysts also have started shaving recently. Their comparable consensus estimates peaked at $229.57 and $251.99 during the week of June 16. They lowered them to $227.02 and $246.33 during the July 28 week.

(2) *Revenues.* S&P 500 revenues-per-share data for 2022 and 2023 consensus estimates are available with a one-week lag through the July 21 week. They remain on solid uptrends in record-high territory, though both flattened during the latest week (*Fig. 2*). We expect that they will continue to rise, boosted by inflation, as they have been doing for the past year. There's certainly still no sign that analysts are shaving their earnings estimates because they see a recession given their upbeat outlook for revenues.

(3) *Margins.* The main reason that analysts have been trimming their earnings estimates is that they have lowered their sights for profit margins, which we can tell because we impute the profit margins they expect simply by dividing their consensus earnings estimates by their consensus revenues estimates (*Fig. 3*). Nevertheless, their latest profit margin estimates, at 12.9% and 13.4% for this year and next year, are higher than our estimates of 12.3% and 12.5%—suggesting that they may have further shaving of margin and earnings estimates to do if our numbers are closer to the mark.

Of course, both their estimates and ours are too optimistic if a severe recession unfolds over the rest of this year and/or next year. During the Great Financial Crisis, the aggregate profit margin for S&P 500 companies fell into the mid-single digits. During the Great Virus Crisis, it fell into the low double digits.

(4) *Forward earnings.* Our projections for the S&P 500 price index are based on our projections for the forward P/E and forward E—i.e., the time-weighted average of the analysts' consensus earnings-per-share estimates for this year and next year. We are predicting that forward earnings will be $235 per share at the end of this year. During the July 28 week, it was down to $238.16 from a recent record high of $239.84 during the July 7 week (*Fig. 4*).

(5) *Quarterly earnings estimates.* Joe and I also track the weekly series of analysts' consensus estimates for the quarterly earnings of the S&P 500 companies for the current year and the coming one. Data through the July 28 week show that their estimate at the start of the Q2 earnings season remains close to the mark of around $55 per share for the quarter (*Fig. 5*).

However, since the annual consensus estimates peaked on June 16, analysts have shaved their Q3 and Q4 estimates by $3.07 altogether. At the same time, they've also been shaving their earnings estimates for each of next year's four quarters by $6.15 altogether (*Fig. 6*).

(6) *Revenues & earnings growth.* As noted above, there's no recession in analysts' consensus expectations for revenues. They've actually raised their expectations for 2022 revenues growth from 7.5% at the start of this year to 12.0% during the July 21 week (*Fig. 7*). The revenues boost from higher-than-expected inflation was undoubtedly the reason. However, their revenues growth estimate for 2023 is down to 4.2% from 5.3% at the start of this year. Apparently, they expect to see a moderation in inflation since we doubt that they are collectively anticipating a recession next year.

And what are they expecting for earnings growth? During the July 21 week, their earnings projections represented growth rates of 10.6% this year and 8.2% next year, which compares to their 8.7% and 10.1% projections at the start of this year (*Fig. 8*).

Europe I: Running Out Of Gas. The European Union's political leaders are accusing Russian President Vladimir Putin of using energy as a weapon of war because he has slowed the flow of Russian natural gas to Europe in what appears to be retaliation for the EU's war sanctions on his country. EU nations are preparing to reduce their dependence on Russian gas but likely won't be able to meet their needs this winter if Russia further slows gas flows or cuts them off entirely.

The EU's precarious gas situation could quickly turn into a crisis and a recession. Before reductions in deliveries to Europe of about 20% of previous capacity, Russia supplied about 40% of Europe's natural gas.

Here's a timeline of major recent developments related to the flow of natural gas from Russia to Europe:

(1) On June 24, Politico reported that Russia's state-run Gazprom has previously stopped or reduced deliveries to 12 EU countries in retaliation for Western sanctions against Russia over the invasion of Ukraine. Deliveries were halted to Poland, Bulgaria, the Netherlands, Finland, and Denmark. To compensate, the impacted countries are relying on alternative sources, including coal and nuclear-powered plants. That was after those Russia-*designated* "unfriendly countries" refused to pay for deliveries in rubles instead of the contractual euros or dollars.

(2) On July 11, Gazprom closed its critical Nord Stream pipeline gas flow to Europe, *claiming* force majeure for technical maintenance over a 10-day period. As promised, the energy major reopened the taps on July 21. Even before the maintenance period began, however, Moscow already had reduced the flow of gas through Nord Stream to about 40% of its capacity on June 14, the retroactive effective date of the contract clause. But a spokesperson for Germany's economic ministry *said* the reason for the maintenance was a replacement part that was meant to be used only from September onward.

(3) On July 19, Putin said that the Kremlin would keep good on its natural gas commitments to Europe, but at the same time *warned* of putting a squeeze on capacity due to Western sanctions.

(4) On July 20, the European Commission (EC) released a plan to push governments to prepare for a gas shortage this winter. The EC is aiming to get countries to voluntarily reduce their gas consumption by 15% by early next year. If countries do not abide by the timeline, the EC could force the reductions. Russian gas supplies to Europe in June were less than 30% of the average sent to the EU over the previous five years, the Commission said.

(5) On July 27, gas flows through the pipeline were further reduced to about 20% of the pipeline's capacity from an already low 40%, again with Gazprom *citing* maintenance issues. Ukraine President Volodymyr Zelenskyy said the move was equivalent to a "gas war" with Europe. Germany's economy minister said the maintenance "excuse" was a "farce." It is unclear whether this will be a temporary supply restriction or Gazprom will continue sending only 20% of supplies.

(6) On Monday, European gas futures jumped after Gazprom *announced* it had stopped sending natural gas to Latvia. Gazprom said it did so because of a "violation of the conditions for gas withdrawal" with no further details. Latvian officials *said* Gazprom's move would have little effect given that Latvia has already decided to ban Russian gas imports starting January 1, 2023.

(7) Bloomberg calculations *published* Monday showed that Gazprom's daily deliveries were down 22% in July from June. That was the lowest seen since at least 2014 even as daily flows to China set multiple records in July.

Europe II: Winter Of Their Discontent? European officials have said that Russia's squeeze on Europe's gas supply will result in a "clear cut" recession for the region. The latest economic indicators are already pointing in that direction. Energy prices are soaring and depressing consumer and business sentiment. Here are the latest updates on the European economy:

(1) *Energy leading CPI inflation to record highs.* In July, the Eurozone's flash CPI inflation rate jumped to a record 8.9% y/y (*Fig. 9*). The flash core rate (excluding food and energy) was 4.0%, also the highest on record looking back to 2000.

(2) *Energy prices leading.* Not surprisingly, energy prices led the way up for the headline number with a rate of 39.7% y/y, down only slightly from the record rate of 44.3% during March (*Fig. 10*).

(3) *European sentiment souring.* In July, the European Economic Sentiment Indicators (ESIs) for both the EU and Eurozone fell just below 100 for the first time since recovering from the pandemic (*Fig. 11*). So far, Europeans are not nearly as pessimistic about the economy as they were during the pandemic. But they could soon be if limited gas this winter plunges them into the cold and dark.

The overall ESI is derived from the industrial (weight 40%), service (30%), consumer (20%), construction (5%), and retail trade (5%) confidence indicators. Of the components, consumer sentiment fell most dramatically in July (*Fig. 12*). Consumers are most concerned over the next 12 months about the general economic situation, while their expectations about the job market remain strong (*Fig. 13*).

(4) *Real GDP to weaken.* The Eurozone's ESI does not bode well for real GDP growth, as the former tends to be a leading indicator for the latter. During Q2, the Eurozone's real GDP rose 4.0% y/y (*Fig. 14*). The ESI suggests that GDP growth could weaken significantly during the rest of this year and early next year.

(5) *European stocks drop.* The EMU MSCI index fell 16.2% (in local currency) from its record high on November 17 through Monday's close (*Fig. 15*). The index is trading at a low forward P/E multiple of just below 12.0, down from just over 18.0 in mid-2020 when pandemic lockdowns began to lift (*Fig. 16*).

Forward earnings continued to rise through the July 21 week. Leading the way in earnings growth expectations is the EMU MSCI's Energy sector, which makes sense given that Europe is becoming much more dependent on domestic energy firms than it was before the war. Forward earnings for most other sectors have either flatlined or edged downward through July 21.

The EMU MSCI sectors' forward profit margins also remain near recent record highs, led by the Energy sector with a record-high forward profit margin of 9.7%. That suggests that energy firms are having no problems passing the increases from rising costs through to their selling prices. That doesn't appear to be the case for companies in most other sectors, however, as their forward profit margins recently have turned downward. (See our *EMU MSCI Sectors*.)

Calendars

US: Wed: Motor Vehicle Sales; Factory Orders 1.2%; ISM NM-PMI 53.5; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; OPEC Meeting. **Thurs:** Trade Balance -$80.1b; Initial & Continuous Jobless Claims 259k/1.37m; Natural Gas Storage; Mester. (Bloomberg estimates)

Global: Wed: Eurozone, Germany, & France C-PMIs 49.4/48.0/50.6; Eurozone, Germany, France, Italy & Spain NM-PMIs 50.6/49.2/52.1/50.0/52.0; Eurozone PPI 1.0%m/m/35.7%y/y; Eurozone Retail Sales 0.1%m/m/-1.6%y/y; Germany Trade Balance, Exports & Imports €0.2b/0.7%/1.3%; UK C-PMI & NM-PMI 52.8/53.3. **Thurs:** Germany Factory Orders -0.8%; Japan Household Spending 0.2%m/m/15%y/y; Canada Trade Balance $4.8b; BOE Interest Rate Decision 1.75%; ECB Economic Bulletin; RBA Monetary Policy Statement; Bailey. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index has tumbled 19.0% ytd through Monday's close, well behind the 8.9% decline for the S&P 500 Value index. Since its June 16th low, when Growth was in a deep 31.5% bear market from its December 27 record high, it has surged 16.6% to 20.1% below its record. Value has risen 8.7% since its June 17 low to 8.9% below its January 12 record. It had been 16.2% below its record high. Growth's price index relative to Value's peaked at a record high on November 30. Since then, Value's price index has dropped 1.2% while Growth's is down 17.1%. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) than Value over the next 12 months, but Value is expected to have higher earnings growth (STEG). Growth has forecasted STRG of 8.8%, but its STEG is lower at 7.8%. Value has forecasted STRG and STEG of 6.3% and 9.4%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and tumbled 40% to a 27-month low of 18.4 on June 16. It has rebounded 18% since then to 21.7 as of Monday's close. Over the similar time period, Value's forward P/E fell 24% from 17.6 to a 26-month low of 13.4, and has since risen 9% to 14.6. Regarding NERI, Growth's and Value's turned negative in July for the first time in 27 months. Growth's dropped to -2.4% from 1.8% in June and Value's was down to -2.4% from 1.0%. Growth's forward profit margin of 18.5% is down 0.6ppts from its record high of 19.1% in mid-February and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 0.3ppt to 11.1% from its record high of 11.4% in December.

S&P 500 Q2 Earnings Season Monitor (*link*): With 57% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, the revenue and earnings surprises are the lowest since the pandemic recovery began. Revenues have beat the consensus forecast by 1.8%, and earnings have exceeded estimates by 5.4%. At the same point during the Q1 season, revenues were 2.1% above forecast and earnings had beaten by 6.8%. For the 296 companies that have reported Q2 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed from their Q2-2021 to Q1-2022 readings. Collectively, the companies have a y/y revenue gain of 14.4% and an earnings gain of 9.6%. Just 67% of the Q2 reporters so far has reported a positive revenue surprise, and 77% has beaten earnings forecasts. Markedly fewer companies have reported positive y/y earnings growth in Q2 (60%) than positive y/y revenue growth (80%). These figures are bound to change 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, rising inventories, and higher costs.

US Economic Indicators

JOLTS (*link*): June job openings fell for the third month since reaching a new record high in March (11.86 million), falling 605,000 in June and 1.16 million over the three-month period to a nine-month low of 10.70 million. There were 5.91 million unemployed in June, so there were 1.8 available jobs for each unemployed person that month. By industry, retail trade (-343,000), wholesale trade (-82,000), accommodations & food services (-81,000), construction (-71,000), and state & local government education (-62,000) recorded the largest declines, while health care & social assistance (+79,000) and finance & insurance (+31,000) posted the biggest gains. The number of quits fell for the third month, by a total of 212,000, but remains high at 4.24 million, only 273,000 below November's record high of 4.51 million; over the past seven months, quits has remained in a volatile flat trend just below its record high. Before the pandemic, quits hovered around 3.5 million. Many employers are raising wages and incentives amid a severe labor shortage, which gives workers confidence that they can get better pay elsewhere. Meanwhile, hirings sank for the fourth month, by a total of 458,000, to 6.37 million, after a 406,000 rebound in February. Hirings are up 714,000 since their recent bottom during December 2020.

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