MORNING BRIEFING
September 21, 2022

On Earnings & Central Banks

Check out the accompanying chart collection.

Executive Summary: S&P 500 forward earnings works well as a leading indicator of actual results during expansions and a coincident indicator of them during recessions; the same goes for forward revenues and forward profit margins. … Our takeaways from the three forward data series add up to a flat forward earnings outlook through early next year—a rosy viewpoint amid widespread recession trepidation. Our forward earnings and P/E forecasts together suggest a range-bound S&P 500 for the rest of this year. … Also: Melissa ferrets out the policy intentions of the ECB and BOJ.

Strategy: Flat Earnings Society. In yesterday's *Morning Briefing*, Joe and I explained that our rolling recession scenario suggests that S&P 500 forward earnings will be basically flat this year compared to last year. Forward earnings is the time-weighted average of industry analysts' consensus earnings forecasts for the current year and the coming year. So for example, at the end of each year, it is identical to consensus expectations for the coming year. At mid-year, it is equal to 50% of the current year's estimate and 50% of the coming year's estimate. And so on and so forth.

Last year, forward earnings peaked at a record $223.04 per share during the year's final week (*Fig. 1*). With so many people expecting a recession this year and next year, our prediction that forward earnings will be flat around that level through the end of this year and early next year is practically as fringe as the Flat Earth Society's beliefs. In a recession, forward earnings typically takes a dive as both forward revenues and forward profit margins drop (*Fig. 2*).

As we noted yesterday, the cycle in S&P 500 forward earnings is highly correlated with the Index of Coincident Economic Indicators (CEI) (*Fig. 3*). The former is also highly correlated with the Index of Leading Economic Indicators (LEI). We've found that forward earnings acts more like a leading indicator during economic expansions but more like a coincident one during recessions. In any event, forward earnings is available weekly with a one-week lag, while both the CEI and LEI are monthly and available with a one-month lag—so forward earnings is very useful to have.

Let's put the latest numbers in perspective:

(1) *Looking forward.* This year, S&P 500 forward earnings rose to a record high of $239.93 per share during the June 23 week (*Fig. 4*). It was down slightly to $238.23 during the September 15 week, not much above where it was at the end of last year. Industry analysts lowered their quarterly earnings forecasts for Q3-2022, Q4-2022, and all four quarters of next year during the latest earnings reporting season (*Fig. 5* and *Fig. 6*).

Yet forward earnings have held up relatively well because this time-weighted average is giving more and more weight to next year's earnings estimate, which remains above this year's estimate. During the September 15 week, the former for 2022 was $225.34, while the latter for 2023 was $243.46. As we approach year-end, this year's earnings will matter less and less, while next year's earnings will matter more and more.

(2) *Revenues rising, margins falling.* As noted above, during economic expansions, S&P 500 forward earnings can serve as a very good leading indicator of actual earnings over the coming year, and during recessions it makes a good coincident indicator of actual earnings. The same can be said about S&P 500 forward revenues vis-à-vis actual revenues and the forward profit margin vis-à-vis actual margins (*Fig. 7*).

The latest data through the September 15 week show that forward revenues remained close to its week-earlier record high. However, the forward profit margin peaked at a record 13.4% during the June 9 week, slipping slightly to 13.1% during the September 15 week. Inflation continues to boost revenues. Apparently, companies are finding it harder to pass their rising costs through to their selling prices, as evidenced by the weakness in the profit margin recently.

(3) *Homing in on the ranges.* We think it all adds up to a flattish outlook for forward earnings, consistent with our view that the stock market should be range bound with the S&P 500 between the June 16 low of 3666 and the August 16 high of 4305. That's the technical range we can see on a chart of the S&P 500.

Based on our forward earnings forecast of $235 per share at the end of this year and our target forward P/E range of 15.5-18.0, the arithmetic range for the S&P 500 is 3642-4230, which is consistent with the technical range (*Fig. 8* and *Fig. 9*). Next year, our range is 4080-4845 based on forward earnings of $255 and a forward P/E range of 16.0-19.0.

(4) *Let's get real.* The official CEI is based on four economic indicators measured in real terms. Above, we compared forward earnings to both the CEI and LEI. Let's do the same with monthly forward earnings divided by the CPI (*Fig. 10* and *Fig. 11*). The conclusion is

the same as using nominal forward earnings. The inflation-adjusted series is more like an LEI during recoveries and expansions, and more like a CEI during recessions. Real forward earnings peaked during May and has fallen each month since then through August.

(5) *Slicing & dicing.* Finally, let's have a quick look at the forward revenues, forward earnings, and forward profit margin of the 11 sectors of the S&P 500 (*Fig. 12*, *Fig. 13*, and *Fig. 14*).

We see that consensus forward revenues estimates for 2022 and 2023 are mostly rising with the notable exceptions of those for the Communication Services, Information Technology, Materials, and Real Estate sectors.

We see that forward earnings are flattening for all but the Energy, Real Estate, and Utilities sectors. Forward profit margins have been falling since the start of this year for all but Energy, Industrials, and Real Estate.

ECB: Whatever It Takes, Part *Deux*. Fed Chair Jerome Powell is not the only central bank chief on a mission to subdue inflation. European Central Bank (ECB) President Christine Lagarde is too. After raising the ECB's key interest rate by 75bps the week before last, Lagarde said: "[W]e are so far away from the rate that will help us return inflation to 2%."

Financial markets anticipate another 75bps hike at the ECB's October meeting as the ECB normalizes monetary policy to lower inflation. ECB Vice-President Luis de Guindos all but confirmed investors' interest-rate expectations in an *interview*. His message was that more hikes are coming. And that's with or without natural gas flowing into Europe from Russia.

(Breaking news: Lagarde further justified the ECB's thinking in a *speech* yesterday. "[W]e need to normalize policy, and be ready to adjust rates by as much as necessary to reach our inflation target in the medium term," she said, adding, "[M]oving faster [than 25 basis points] at the start of the hiking cycle clearly conveys our commitment to bring down inflation to our medium-term target.")

Consider more of what Guindos said:

(1) *Inflation.* Reducing inflation might be painful over the next few years, but the Eurozone's inflation level, running 9.1% y/y at its latest read, is already causing pain. ECB officials project that it will remain above their 2.0% target for quite a while. In 2024, under the baseline scenario, the ECB projects inflation averaging 2.3%. In the downside scenario, the

ECB projects inflation averaging 2.7% in 2024.

(2) *Uncertainty.* Regarding the European gas crisis brought on by Russia's war on Ukraine, "uncertainty is very high" because the war is still evolving: "We will be data-dependent and follow a meeting-by-meeting approach to set interest rates. … [But] more hikes might come in the next few months."

(3) *Normalizing.* Back in December, the ECB started normalizing monetary policy when the bank set an end date for its pandemic emergency purchase programme (PEPP) and the asset purchase programme (APP). But the bank's projections over the last year have underestimated inflation, putting ECB behind on raising rates—which has "happened not only at the ECB, but also in other international institutions."

(4) *Russia.* The ECB Vice-President said, "everyone has to understand" that the "slowdown of the economy is not going to take care of inflation on its own." In other words, the ECB will continue normalizing policy even if the gas crisis turns worse. "What we want to avoid is the sort of situation that we had in the 1970s, which also started with an energy shock followed by second-round effects that made things much worse."

(5) *Fiscal.* Lagarde has called on governments not to adopt measures that will fuel inflation. But many Eurozone countries are taking fiscal measures to aid households and businesses, as energy prices and inflation remain high. So the bank may be fighting not only inflation but also fiscal policy.

(6) *Fragmentation.* The ECB has prepared for the risk that some countries will need different monetary policy treatment than others. To address yield curves rising above the norm in certain countries, the ECB decided to flexibly reinvest redemptions under the PEPP and introduced the transmission protection instrument. But so far, the bank has not seen much fragmentation among countries in this respect.

(7) *Banks.* Higher interest rates will both boost European banks' profitability as well as raise their funding costs. The prospect of a dramatic economic slowdown could give rise to asset impairment and more defaults. Nevertheless, the capital and liquidity positions of European banks is solid.

(8) *Euro.* Negatively impacting the cost of energy in Europe, the depreciation of the euro could escalate inflationary pressures. But if the euro stopped depreciating, this could support the fight against inflation.

BOJ: Last Man Standing. By the end of its two-day meeting on Thursday, Bank of Japan (BOJ) Governor Haruhiko Kuroda and his board are anticipated to maintain negative interest rates, even as their global counterparts move to fight inflation. After the value of the yen came close to 24-year lows against the dollar last week, Kuroda indicated that direct intervention is on the table and could come swiftly and without warning, a Monday Bloomberg *article* observed. Here's more of what Bloomberg reported that Kuroda said:

(1) To stop the yen's recent slide, it would take massive interest-rate hikes that would break the economy. Even after its near low against the dollar, the BOJ continues to believe that a weak yen is positive for the economy so long as it's stable, according to people familiar with the matter.

(2) Japan is missing the robust wage growth that would indicate the sustainable inflation rates needed to justify interest-rate rises to normalize policy. So rates will stay "at their present or lower levels." The bank is expected to maintain its Yield Curve Control policy too, but for how long is questionable.

(3) Currently, the BOJ is holding short-term interest rates at -0.10% while enforcing a 0.25% cap on 10-year government debt. In the midst of the recent global bond selloff, the central bank had to spend 1.4 trillion yen ($9.8 billion) over just two days to buy bonds in order to defend yields.

Calendars

US: Wed: Existing Home Sales 4.70mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 3.25%; FOMC Economic Projections. **Thurs:** Leading Indicators -0.1%; Initial & Continuous Jobless Claims 218k/1.40m; Kansas City Manufacturing Index; Current Account -$260.6b; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: UK Industrial Trends Orders -11; BOJ Interest Rate Decision -0.10%; European Central Bank Non-Monetary Policy Meeting; De Guindos; Beerman. **Thurs:** France Business Survey 102; UK Gfk Consumer Confidence -42; Japan Core CPI 1.9% y/y; ECB Economic Bulletin; BOE Interest Rate Decision 2.25%; BOJ Press Conference; Fernandez-Bollo Tuominen. (Bloomberg estimates)

Strategy Indicators

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady last week at 13.1%. That's up from a 13-month low of 13.0% at the end of August, but remains 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 2.8ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues ticked down from its record high a week earlier, and forward earnings edged down to 1.1% below its record high in mid-June. Both had been steadily making new highs from the beginning of March 2021 to mid-June; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for growth and margins remained steady w/w as analysts await the Q3 earnings confession season. Forward revenues growth was steady w/w at a 23-month low of 5.7%. 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 0.1ppt w/w to a 24-month low of 7.5%. 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 0.4ppt to 12.8%. They expect revenues to rise 12.0% (unchanged w/w) in 2022 and 4.1% in 2023 (unchanged w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 9.6% in 2022 (down 0.1ppt w/w) and 7.1% in 2023 (down 0.1ppt w/w) compared to an earnings gain of 51.0% in 2021. Analysts expect the profit margin to drop 0.2ppt y/y to 12.8% in 2022 (unchanged w/w) compared to 13.0% in 2021 and to improve 0.3ppt y/y to 13.1% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E fell 0.1pt w/w to an eight-week low of 16.8. That compares to a 15-week high of 18.2 in mid-August and is up from a 26-month low of 15.8 in late June. That also 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 0.02pt w/w to a nine-week low of 2.19. That compares to a 15-week high of 2.38 in mid-August and is up from a 26-month low of 2.10 during June. That also 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 just three of the 11 S&P 500 sectors, forward earnings rise for five sectors, and the forward profit margin rise for four sectors. Nearly all of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Energy and Utilities are the only sectors with forward earnings at a record high now. Consumer Staples is the only sector with forward revenues at a record high this week, down from four in that club a week earlier. All sectors now have forward profit margins that are below their record highs, but those of Energy and Industrials remain closest to their post-pandemic highs. Energy still has forward revenues well below a record high, and Utilities' forward revenues and margin are lagging too. Only three sectors posted a higher profit margin y/y during 2020: Consumer Staples, Tech, and Utilities; during 2021, all of the sectors but Utilities posted a y/y improvement. Just four sectors are expected to see margins improve y/y for full-year 2022, followed by seven sectors in 2023. Here are 2022's gainers: Energy, Industrials, Materials, and Utilities. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (24.7%, 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 (18.2, down 0.1ppt w/w and down from its 19.2 record high in 2016), Communication Services (15.3, down from its 17.0 record high in October), Utilities (13.9, down from its 14.8 record high in April 2021), S&P 500 (13.1, down from its record high of 13.4 achieved intermittently from March to June), Materials (12.8, down from its 13.6 record high in early June), Health Care (10.6, down from its 11.5 record high in early March), Industrials (10.3, down from its 10.5 record high in December 2019), Energy (12.2, down from its 12.3 record high in early August), 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 was negative in September for a third month, as it weakened for the 12th time in 14 months. NERI fell to a 26-month low of -9.7% in September from -9.0% in August. It had been negative for 13 straight months through July 2020 due to the pandemic shutdown. The 23-month positive streak that ended in June 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. September's reading compares to a record-high 23.1% in July 2021 and an 11-year low of -37.4% in May 2020. Just two of the 11 S&P 500 sectors had positive NERI in September, unchanged from August and down from five in July. Five sectors had NERI readings at post-pandemic two-year lows during the month as seven had NERI weaken m/m. That's a minor improvement from August when seven sectors were at post-pandemic lows and all 11 sectors weakened m/m. Four sectors had NERI improve m/m in September: Communication Services, Consumer Discretionary, Financials, and Utilities. Among the lowest readings in September, Communication Services was negative for an 11th month, Consumer Staples for a seventh month, and Consumer Discretionary and Health Care for a sixth month. Here are the September NERIs for the S&P 500 and its sectors compared with their August readings: Energy (19.6% in September, down from 25.8% in August), Utilities (4.5, 2.8), Real Estate (-1.4 [17-month low], -0.6), Financials (-7.9, -9.4 [25-month low], -3.1), Industrials (-8.7 [26-month low], -7.9), S&P 500 (-9.7 [26-month low], -9.0), Health Care (-9.7 [27-month low], -9.3), Consumer Staples (-10.7, -11.5 [26-month low]), Information Technology (-11.7 [27-month low], -9.9), Consumer Discretionary (-17.2 [26-month low], -16.4), Materials (-19.9 [27-month low], -17.4), and Communication Services (-22.9, -23.4 [26-month low]).

S&P 500 Sectors Net Revenue Revisions (*link*): The S&P 500's NRRI weakened in September for a sixth straight month September and was negative for a second month following two years of positive readings. It has weakened m/m in 10 of the past 13 months, and dropped to a 26-month low of -5.5% from -5.1% in August. Before the just-ended 24-month positive streak, it had been negative for 21 straight months. That positive streak exceeded the prior 19-month streak during the cycle that ended October 2018, when NRRI reached a tax-cut-induced then-record high of 14.7% in March 2018. September's reading compares to a record-high 25.9% in August 2021 and an 11-year low of -35.8% in May 2020. Four of the 11 S&P 500 sectors had positive NRRIs in September, unchanged m/m; that's down from six with positive readings in July and all 11 during July-October 2021. Communication Services, Consumer Discretionary, Financials, and Utilities were the only sectors to have NRRI improve m/m. Five sectors had NRRI readings fall to post-pandemic lows during the month. Communication Services was negative for an 11th straight month, followed by Health Care at six months and Consumer Discretionary at five. Here are the September NRRIs for the S&P 500 and its sectors compared with their August readings: Energy (25.1% in September, down from 30.7% in August), Utilities (17.1, 16.4), Real Estate (10.0 [16-month low], 10.0), Consumer Staples (8.6, 11.6), Financials (-1.2, -3.4), Materials (-3.7 [26-month low], -2.2), S&P 500 (-5.5 [26-month low], -5.1), Industrials (-5.6 [26-month low], -5.2), Health Care (-9.1 [27-month low], -8.8), Information Technology (-12.2 [27-month low], -11.6), Consumer Discretionary (-14.5, -14.6 [26-month low]), and Communication Services (-19.1, -20.2 [26-month low]).

US Economic Indicators

Housing Starts & Building Permits (***link***): Housing starts unexpectedly rebounded in August, though building permits, a proxy for future construction, continued their slide, dropping to the lowest level since mid-2020. Housing starts jumped 12.2% last month to 1.575mu (saar) after tumbling 22.2% during the three months through July. Single-family starts rose for the first time in six months, climbing 3.4% to 935,000 units (saar) after a five-month drop of 25.5%. Meanwhile, volatile multi-family starts soared 28.0% to 640,000 units (saar) after an 11.0% loss and a 14.9% gain the prior two months. Building permits contracted for the fourth time in five months, plunging 10.0% in August and 19.3% over the period to 1.517mu (saar). Single-family permits haven't posted an increase since February, dropping 3.5% in August and 25.3% the past six months to 899,000 units (saar)—the lowest since June 2020. Multi-family permits plummeted 17.9% in August to 618,000 units (saar) after a two-month jump of 16.9%. In August, total housing starts were flat versus a year ago, while building permits were 14.4% below the August 2021 level. Last month, housing under construction rose to a record-high 1.702mu, while completions edged down to 1.342mu from 1.491mu in July. On Monday, NAHB released its August report on homebuilder's confidence, which showed that it dropped for the ninth time this year, by 3 points in September and 38 points ytd, to 46—the lowest level since May 2020 during the height of the pandemic.

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