MORNING BRIEFING
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On Political Cycles, Earnings Estimates & Fiscal Fatigue

Check out the accompanying chart collection.

Executive Summary: The stock market historically has performed well after midterm elections and during third years of presidential cycles, but none of these positive political cyclical trends will make much difference if inflation remains elevated, which would force the Fed to cause a hard landing of the economy. … Also: Analysts' earnings estimates are falling mostly because their expectations for margins are falling. We review the relevant data for the S&P 500 sectors. … And: How fiscal policy has contributed to the deficit and inflation.

Strategy I: The Next Political Cycle. Joe and I previously observed that the stock market has a strong tendency to perform well following midterm elections irrespective of the actual election outcome. Since 1942, during each of the 3-month, 6-month, and 12-month periods following each of the 20 midterm elections, the S&P 500 was up on average by 7.6%, 14.1%, and 14.9%. Of the 60 observations, only three of them were negative (*Fig. 1* and *Fig. 2*). But none of the 20 observed 12-month changes were negative!

However, there are too many factors that influence the stock market to show conclusively better performance under divided than unified governments. Nevertheless, it is widely believed that political gridlock is bullish for stocks in the US. The market is happiest when our constitutional system of checks and balances is working. Therefore, a divided government is preferable to a unified government when one party controls the White House and both houses of Congress. That all makes sense. However, gridlock may not be bullish this time if the government can't function because of extreme partisanship. We do expect nasty fights over the federal debt ceiling, for example.

By the way, in addition to the bullish midterm cycle, there is also the bullish third-year presidential cycle. The average return of the S&P 500 during the first, second, third, and fourth years of presidential terms (including both first- and second-term presidents from Roosevelt through Biden) was 6.7%, 4.3%, 13.5%, and 7.4%. The third year of presidential terms tends to be the best of the four-year cycle (*Fig. 3*, *Fig. 4*, *Fig. 5*, and *Fig. 6*).

None of these political cycles will matter if inflation doesn't moderate significantly in coming months. In this scenario, the Fed will be forced to raise interest rates higher for longer. The result could very well be a hard landing of the economy. That would certainly bring inflation down. But it would also push stocks deeper down into bear market territory.

Strategy II: Earnings Estimates Are Fading. Industry analysts have yet to get the recession memo. They are still estimating that S&P 500 revenues are growing. However, they've been reading the memo about the squeeze on profit margins from rising costs. As a result, many of them have been reducing their estimates for the profit margins of the S&P 500 companies they cover, as we can tell by deriving margin estimates from their revenues and earnings estimates. Let's update the data we've been following to keep track of these developments:

(1) *Forward revenues.* The weekly forward revenues per share of the S&P 500 dipped recently but remains on an upward trend through the last week of October (*Fig. 7*). This weekly series is a very good coincident indicator of actual S&P 500 quarterly revenues per share, so we use it to track the latter. There's no recession in the weekly series so far, which has been boosted by inflation, of course. It is up 10.7% y/y.

(2) *Forward operating profit margin.* The forward profit margin of the S&P 500 companies peaked at a record high of 13.4% during the June 9 week. It's been falling since then, down to a 17-month low of 12.8% during the October 27 week. It too closely tracks the S&P 500's actual quarterly profit margin. Based on the last two recessions, there is plenty of downside for the profit margin in a hard-landing scenario and less so in a soft-landing scenario.

(3) *Forward earnings.* The S&P 500's forward earnings per share peaked at a record high of $238 during the June 16 week. This series, which tracks the quarterly operating earnings per share of the S&P 500, is down 3.6% since then through the October 27 week. During the recessions of the Great Financial Crisis and the Great Virus Crisis, forward earnings dropped 39% and 21% from peak to trough.

(4) *Quarterly earnings estimates.* With over 88% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 2.2%, and earnings have exceeded estimates by only 3.7%. At the same point during the Q2 season, revenues were 2.7% above forecast and earnings had beaten estimates by 6.1%.

For the 437 companies that have reported Q3 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed from their Q2-2021 to Q2-2022 readings. The 437 reporters so far collectively has a y/y revenue gain of 12.0% but an earnings gain of only 5.2%, as higher costs are pressuring profit margins. Excluding Energy, S&P 500 revenue growth falls to 8.7% y/y from 12.0% and earnings growth drops to -3.2%

from 5.2%.

Industry analysts have been cutting their Q3 earnings expectations since the start of the Q2 earnings reporting season, as companies have been providing cautious guidance and continue to do so. As a result, the typical upward hook in actual earnings results is much more muted than usual during the current earnings season (*Fig. 8*). Meanwhile, the analysts continue to chop their expectations for Q4-2022 and all four quarters of next year (*Fig. 9*).

(5) *Annual earnings estimates.* While S&P 500 forward revenues per share has been climbing all year, the analysts' consensus estimates for revenues per share have flattened out for both 2022 and 2023 since August and June, respectively (*Fig. 10*).

The consensus earnings-per-share estimates for 2022, 2023, and 2024 have been falling since mid-year (*Fig. 11*). Here are the latest readings for them through the November 3 week: $220, $233, and $253. The latest reading for forward earnings is $231. With the S&P 500 currently around 3850, that implies that the forward P/E is around 16.6. That's more consistent with a soft landing than a hard-landing scenario.

(6) *S&P 500 sectors.* A look at the 11 sectors of the S&P 500 shows that their forward revenues are still rising in record territory for Consumer Staples, Energy, Financials, Health Care, and Utilities (*Fig. 12*). Stalling or heading downwards in recent weeks have been Communication Services, Consumer Discretionary, Industrials, Information Technology, Materials, and Real Estate.

In recent weeks, forward profit margins have stalled at relatively high levels for Energy, Financials, Industrials, and Real Estate (*Fig. 13*). They are falling among the other sectors.

On balance, slowing forward revenues growth and mostly flat and modestly falling forward profit margins are weighing on forward earnings (*Fig. 14*).

US Fiscal Policy: Biden's Contribution to Inflation. The Fed's latest *Minutes* doesn't mention the word "fiscal" even once. This is curious because the Fed's monetary policy mission to lower inflation runs counter to recent years' fiscal policy, the effect of which has been to boost inflation. So one would think the Fed would have an opinion on fiscal policy.

In any event, the one Fed governor who has *mentioned* fiscal policy in recent months is Fed Governor Lael Brainard. Interestingly, Brainard's take on monetary policy runs counter to Fed Chair Powell's, as we discussed in Monday's *Morning Briefing*. She is not as hawkish as he is.

Brainard may be right that a gentler approach to tightening ahead is best. That's not only because of the lagging effect that monetary policy has on inflation but also because fiscal policy is likely to become less stimulative and thus less inflationary over the coming months.

During President Joe Biden's tenure so far, about $4.8 trillion in excessively stimulative fiscal spending has poured into various sectors of the economy. The most significant tranche of spending released immediate funds in an indiscriminate manner to a large swath of the US adult population. Stimulus funds have acted like a jolt of espresso to household wealth and consumer spending, adding to the inflationary environment that the Fed now is trying to tame. Now that much of those funds already have been spent down by consumers, the US government is likely to run out of fiscal fuel while monetary policy is tightening. That's especially likely if the midterm elections result in more political gridlock.

Below, we examine the inflationary effects of Biden's big spending. It may very well lead to fiscal fatigue even as the stimulus wears off. Consider the following:

(1) *Spending under Biden.* The Committee for a Responsible Federal Budget (CFRB) has a helpful *infographic* on all the spending passed under Biden. It shows clearly that the spending, without much in the way of offsets, has added significantly to the deficit. Of the $4.8 trillion net deficit increase, the American Rescue Plan (ARP) enacted in March 2021 contributed the most, $1.9 trillion. Yet another significant spending bill passed into law under Biden was the Bipartisan Infrastructure Law, enacted in November 2021 and totaling $370 billion. Its purpose is to rebuild America's roads, bridges, tunnels, and other key transportation infrastructure.

The fiscal 2022 Omnibus bill also added $625 billion in discretionary spending to the budget to keep up with inflation. And net interest associated with the ARP is estimated to cost $700 billion. It all adds up to almost $5 trillion according to the CFRB.

For perspective, President Trump's additions to the debt added a historic $7 trillion. But $4 trillion of that was emergency spending related to Covid. Some say that Biden's nearly $2 trillion ARP represents emergency rescue spending as well; but we don't deem it as necessary as the Trump Covid outlay, since it added to the national debt at a time when the US economy already was coming out of Covid and growing. But the ARP certainly stimulated inflation.

(2) *American Rescue Plan inflates inflation.* Quick bursts of $1,400 were distributed to Americans with the government's third round of stimulus checks from the ARP in March 2021. At the time, annual inflation was just under 2.0%. Fast forward a year and a half to September 2022, and we see the highest inflationary increase in nearly 40 years (*Fig. 15*). Estimates from various university, Fed, and International Monetary Fund researchers (see *here*, *here*, and *here*) suggest that the ARP added around 3-4ppts to inflation.

Of the ARP's grand total $1.85 trillion, $900 billion of it was spent in 2021, with an immediate $400 billion injection directly into Americans' bank accounts. That jolted the already inflationary environment created by pandemic-related supply-chain difficulties and the Ukraine war. A case in point: Immediately after Americans received the stimulus checks, demand for new and used cars surged, overwhelming the short supply, and catapulted the CPI for those items (*Fig. 16*).

Was the ARP worth spiking inflation for? Sure, the spending came at a time of uncertainty when variants of Covid were spreading. But ARP also came at a time when millions of Americans who were out of work during the pandemic found employment.

(3) *Student debt relief adds to inflation.* Biden's student debt relief, enacted in several parts from April to August 2022, also freed up income that would have been used to pay down debt and increased household wealth by $20,000 for the biggest beneficiaries ($10,000 in debt cancelation and $10,000 in grants). Others received an extension on a pandemic-related repayment pause. In total, CFRB reports that the act canceled about one-third of all federal student debt.

While Biden's student debt aid did not add as much to inflation as ARP, according to estimates, the bump was still meaningful. Economist Jason Furman *estimated* that the Fed would need to raise interest rates by up to 75bps to counteract the debt from an inflationary perspective.

Counterarguments to the inflationary aspects of the student loan cancelation and relief were outlined in a recent *article* in *The Atlantic*. They say that much of the debt would have gone unpaid anyway and went to Americans under financial stress—but also acknowledge that only about 11% of debt was in default or arrears when the bill passed.

(4) *There's still lots of excess saving.* The Fed's study of excess savings *data* shows how much additional household savings was accumulated during the pandemic beyond what would have been saved under normal conditions (i.e., absent federal aid and assuming

consistent spending patterns) (*Fig. 17*). By Q3-2021, the Fed estimates that the stock of excess household savings amounted to about $2.3 trillion, after which it began to decline as spending picked up and fiscal support diminished. However, the stock of excess savings was still high, at about $1.7 trillion, by mid-2022.

The bottom line is that fiscal supports to Americans were inflationary and have not yet run out. But political gridlock suggests that as the fiscal high wears off, there won't be another round of fiscal extravaganzas.

Calendars

US: Wed: MBA Mortgage Applications; Wholesale Trade & Inventories 0.4%/0.8%; Crude Oil Inventories & Gasoline Production; WASDE Report; Williams. **Thurs:** Headline & Core CPI 0.6%m/m/8.0%y/y & 0.5%m/m/6.5%y/y; Initial & Continuous Jobless Claims 220k/1.475m; Federal Budget Balance -$90.0b; Natural Gas Storage; Baker-Hughes Rig Count; Williams; George; Waller. (Bloomberg estimates)

Global: Wed: UK RICS House Price Balance 20%; ECB Economic Bulletin; Bullock; Elderson; Haskel; Beerman; Wuermeling. **Thurs:** Italy Industrial Production -1.5%m/m/0.9%y/y; Japan PPI 0.6%m/m/8.8%y/y; ECB Economic Bulletin; Enria; Tenreyro; Ramsden; Macklem. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): As of Monday's close, the S&P 500 Value index was a whisker out of a 10% correction while the S&P 500 Growth price index was still in a deep 31.4% bear market. Growth's underperformance relative to Value began on November 30, 2021 when its price index peaked at a record high. Since then, Value's price index has dropped 2.2%, while Growth's is down 28.8%. Growth made a new low for the year on October 12, while Value remained above its September 30 bottom. At that October 12 low, Growth was down 20.1% from its recent high on August 15 to 32.8% below its December 27 record high. Value was down a lesser 14.6% on September 30 from its August 16 high to 19.2% below its January 12 record high. Looking at their ytd performance through Monday's close, Growth has tumbled 30.5% ytd, well behind the 8.5% decline for the S&P 500 Value index. Looking at the fundamentals, Growth is expected to deliver stronger revenue growth

(STRG) than Value over the next 12 months, but their earnings growth (STEG) is not far apart. Growth has 7.1% forecasted for STRG and 5.7% for STEG, while Value has forecasted STRG and STEG of 3.9% and 5.8%, 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. After rebounding to 23.3 in mid-August, it tested the June low with its 18.5 reading on October 12. It was back up to 19.0 on Monday. Value's forward P/E fell 24% from 17.6 in January 2021 to 13.4 on June 16. It made a new 30-month low of 13.0 on September 30, and has since risen to 14.4 as of Monday's close. Regarding NERI, Growth's and Value's were negative for a fourth straight month in October following 26 positive monthly readings. Growth's dropped to a 28-month low of -13.4% in October from -9.9% in September, and Value's was down to a 27-month low of -12.2% from -9.1%. Growth's forward profit margin of 17.7% is down 1.4ppts 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 0.6ppt to 10.8% from its record high of 11.4% in December.

S&P 500 Q3 Earnings Season Monitor (*link*): As the Q3-2022 earnings season approaches the finish line, the results to date indicate it's the poorest quarterly reporting season since Q1-2020 as assessed by the four surprise metrics we measure for both earnings and revenues. With over 88% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 2.2%, and earnings have exceeded estimates by only 3.7%. At the same point during the Q2 season, revenues were 2.7% above forecast and earnings had beaten estimates by 6.1%. For the 437 companies that have reported Q3 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed from their readings from Q2-2021 to Q2-2022. The 437 reporters so far collectively has a y/y revenue gain of 12.0% but an earnings gain of only 5.2%, as higher costs are pressuring profit margins. Excluding Energy, S&P 500 revenue growth falls to 8.7% y/y from 12.0% and earnings growth drops to -3.2% from 5.2%. Just 70% of the Q3 reporters so far has reported a positive revenue surprise, and 71% has beaten earnings forecasts. However, significantly fewer companies have reported positive y/y earnings growth in Q3 (58%) than positive y/y revenue growth (80%). These figures will change less markedly as more Q3-2022 results are reported in the coming weeks, but with a downward bias as retailers are more likely to miss forecasts and guide lower in this difficult economic environment.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): “Owners continue to show a dismal view about future sales growth and business conditions, but are still looking to hire new workers,” said NFIB Chief Economist Bill Dunkelberg. “Inflation, supply chain disruptions, and labor shortages continue to limit the ability of many small businesses to meet the demand for their products and services.” The report noted that 31% of owners recently reported that *supply chain disruptions* have had a significant impact on their business, with another 31% reporting a moderate impact and 27% a mild impact; only 10% reported no impact from recent supply chain disruptions. October’s *Small Business Optimism Index (SBOI)* dipped to 91.3 after climbing the prior three months, from 89.5 in June—which was the lowest reading since 2013 to 92.1 in September. The SBOI was below the 49-year average of 98 for the 10th consecutive month. In October, two of the 10 components of the SBOI improved while seven declined, and current job openings was unchanged at 46%. *Dragging the index lower* were plans to increase employment (-3ppts to 20%), sales expectations (-3 to -13), expect economy to improve (-2 to -46), expected credit conditions (-2 to -8), capital outlay plans (-1 to 23), current inventory (-1 to 0), and now is a good time to expand (-1 to 5). *Positive contributions* were recorded by plans to increase inventories (+2 to 2) and earnings trends (+1 to -30). *Inflation* continued to be small business owners’ single biggest problem in October, moving up for the second month from 29% to 33%, though the percentage is down 4ppts from July’s peak of 37% (which was the highest since Q4-1979). While inflation measures remained high, the percentage of owners raising selling prices eased to a net 50% last month, down from a near record high of 66% in March, while the percentage of owners planning to increase selling prices rose to 34% after easing from a near record high of 52% in March to a 20-month low of 31% in September. *Quality of labor* remained business owners’ second biggest problem, ticking up to a net 23% after easing from 26% in August to 22% in September; it was at a record high of 29% last November. A net 44% of owners report raising compensation, not far from the record-high 50% at the start of the year, while 32% plan to increase compensation in the next three months, up 9ppts from September’s 23% and the highest since October 2021.

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales, which excludes motor vehicles & motorcycles, rose for the first time in four months in September, climbing 0.4%, after no change in August and a 1.3% decline during the two months ending July. It’s down 2.6%

since reaching a new record high last June. Spending on *food, drinks & tobacco* continued its up-and-down pattern, rising 0.4% in September after falling 0.7% in August and rising 0.1% in July, while sales of *non-food products* excluding fuel rose for the second successive month, by 1.3% after a two-month drop of 2.2%; sales of automotive fuels slipped 0.6% in September after a two-month gain of 3.0%. Overall sales are down 0.6% y/y, driven by a 2.4% drop in food, drinks & tobacco, with nonfood products ex fuel (-0.3) basically flat; sales of *automotive fuels* climbed 3.7% over the period. Data are available for four of the *Eurozone's largest economies*, with only Italy (-0.1%) showing a decline, its third in four month for a total loss of 1.4%. Meanwhile, sales in Germany increased 0.9% after a 1.4% loss in August and a 0.5% gain in July, while sales in France rose for the second month, by a total of 1.2%, after a two-month loss of 2.4%. Italy posted its third decline in retail sales in four months, dropping 0.1% m/m and 1.4% over the period. Compared to a year ago, sales in Italy (-2.4% y/y) and Germany (-1.0), continued to contract, while sales in France (0.8) and Spain (0.2) held just above zero.

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