MORNING BRIEFING
November 14, 2022

On Earnings & Inflation

Check out the accompanying chart collection.

Executive Summary: Economic recessions invariably produce earnings recessions, but earnings slowdowns and downturns can occur without economic recessions: Nominal GDP and revenues growth can stay strong as profit margins narrow, causing earnings growth to falter. That's what seems to be happening now, with the earnings weakness looking like that of a soft, not hard, landing. Whether that changes up ahead depends much on what happens to profit margins. … In this context, Joe discusses the latest earnings results for Q3, explaining how to interpret the results supplied by two different data providers. …And: A look at the components of October's CPI results, which cheered the stock market at the end of last week. ... Also: Feshbach sees trading range ahead.

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Strategy I: A Brief History of Earnings Recessions. One of our accounts recently asked us if a corporate earnings recession is possible without having an economic recession. Can a soft landing in the economy still result in a hard landing for earnings?

Normally, an economic recession will cause corporate revenues to fall along with nominal GDP. During recessions, profit margins get squeezed as unit costs increase relative to unit revenues. This one-two punch sends earnings into a recession. Arithmetically, it's possible that nominal revenues could continue to grow, especially during a period of high inflation, even as the profit margin gets squeezed so significantly that profits fall. To some extent, that describes the current situation. Revenues are growing along with nominal GDP, boosted by inflation. Profit margins are narrowing. And earnings are weakening, though they are doing so still more in line with a soft landing than a hard one.

Joe and I have been closely monitoring this scenario for the S&P 500. Let's analyze the available data:

(1) *Revenues & nominal GDP.* We have S&P 500 aggregate revenues data since Q1-1992 through Q3-2022 (*Fig. 1*). This series is highly correlated with total nominal GDP. It is also highly correlated with nominal GDP of just goods and business sales of goods. So far, there

is no recession in any of these series. Nor is there a recession in either inflation-adjusted S&P 500 revenues or in real GDP (Fig. 2).

(2) *Earnings.* While the revenues data compiled by S&P covers only the latest three recessions, the data provider does have a series for reported S&P 500 earnings per share starting in 1935 and covering 14 economic recessions (Fig. 3). Each economic recession was associated with an earnings recession. However, there have been mid-cycle slowdowns and declines in reported earnings per share without economic recessions. We can spot them in the early 1950s, the mid-1960s, the mid-1980s, and the mid-2010s. Almost all past bear markets in stocks were associated with both economic recessions and recessions in reported earnings (Fig. 4). The one exception was the bear market in 1987. And the jury is out on whether the current bear market will be associated with a soft or hard landing (or no landing at all!).

(3) *Profit margins.* Most past bear markets in stocks were associated with a decline in revenues and a decline in the profit margin. Again, the S&P data are limited because they start only in 1992. However, a useful profit margin proxy that starts in 1948 is the ratio of after-tax corporate profits in the National Income and Product Accounts divided by nominal GDP. It correlates well with the S&P 500 profit margin using either reported or operating margins (Fig. 5 and Fig. 6). The proxy has a cyclical pattern that tends to peak at the tail end of business cycles, i.e., during the booms that typically precede busts. It takes a dive and usually bottoms near the end of recessions.

(4) *The future.* So where do we go from here? Joe and I are able to anticipate the quarterly data on S&P 500 revenues, earnings, and the profit margin by tracking the weekly series on S&P 500 forward revenues per share, forward earnings per share, and the forward profit margin (Fig. 7). Again, we are limited by the data's start date, though forward earnings is available since 1979 and encompasses six recessions (Fig. 8). (FYI: "Forward" earnings and revenues are the time-weighted average of analysts' consensus estimates for this year and next; we calculate the forward profit margin from forward earnings and revenues.)

As we've recently observed, there is no recession in S&P 500 forward revenues so far through the November 3 week, though the series may have just started to peak. Forward earnings peaked at a record high during the June 16 week and was down 4.1% through the November 3 week. It's the drop in the forward profit margin from a record high of 13.4% during the June 9 week to 12.7% during the November 3 week that has weighed most on earnings.

So again, where do we go from here? In a soft-landing scenario, earnings may continue to be depressed by a falling profit margin, but revenues should hold up enough to result in a mid-cycle slowdown like the previous ones identified above. In a hard-landing scenario, both revenues and margins would cause a sharp drop in earnings.

(5) *Shades of gray.* Of course, there are lots of shades of gray. If the dollar is finally peaking, that should ease the pressure on the profit margin. On the other hand, interest costs are likely to squeeze margins. Chronic labor shortages are causing significant turnover in the labor market, which is driving up wages and weighing on productivity. The question is whether business managers will conclude that they must automate to boost their productivity and their profit margins. Onshoring should reduce costs over the long run but may boost them in the short run.

Strategy II: Q3 Results. Joe reports that S&P and I/B/ES have compiled Q3's data for S&P 500 revenues per share, operating earnings per share, and the operating profit margin. There are no surprises since Joe tracks the results daily during earnings reporting seasons. Nevertheless, let's review Q3's numbers:

(1) *Q3 revenues.* S&P 500 revenues rose 11.6% y/y during Q3 to a record high (*Fig. 9*). Growth was boosted by inflation. However, inflation-adjusted revenues increased 4.2% y/y during Q3, to a level just shy of its record high during Q4-2021 (*Fig. 10*).

All in all, that's an impressive performance considering that global economic growth slowed during the quarter and the dollar continued to soar. Aggregate revenues received a big boost from the S&P 500 Energy sector. Aggregate revenues rose 10.5% and 7.8% y/y with and without Energy (*Fig. 11*).

(2) *Q3 earnings.* Despite the solid increase in revenues per share, S&P 500 operating earnings per share according to I/B/E/S rose just 3.7% y/y during Q3 (*Fig. 12*). They are looking toppy, having edged down during Q3 (*Fig. 13*). According to S&P's data, S&P 500 aggregate earnings fell 2.5% and 11.2% y/y during Q3 with and without Energy (*Fig. 14*). The latter growth rate has been negative during the first three quarters of this year.

(3) *Q3 profit margin.* The operating profit margin of the S&P 500 remained relatively high at 12.7% during Q3 (*Fig. 15*). It is down from its record high of 13.7% during Q2-2021.

(4) *S&P, I/B/E/S, and write-offs.* By the way, S&P and I/B/E/S each have their own polling services. S&P adheres to a stricter in-house definition of operating earnings, while I/B/E/S

follows a consensus "majority rule" when deciding how to present a company's consensus forecast. The industry analysts polled by I/B/E/S typically follow companies on an adjusted earnings basis (i.e., EBBS or earnings excluding bad stuff, a.k.a. write-offs), which is higher than S&P's earnings series (*Fig. 16*).

For 2022, the major difference occurred during Q2 when Berkshire Hathaway had a particularly large "mark to market" accounting loss that was not recognized by I/B/E/S. This accounts for a major part of the $15 difference between S&P's and I/B/E/S's 2022 estimate, which puts I/B/E/S at a slight y/y gain and S&P at a y/y decline.

There's another minor difference between the two services' data. S&P's number, which it calls "Basic EPS," is slightly higher than I/B/E/S's "Diluted EPS." During Q2, the difference between the two was 1.0%.

We generally use the I/B/E/S data for quarterly operating earnings, especially because we use the data services' measure of forward earnings. In our opinion, the stock market discounts majority-rule operating earnings over the coming 12 months.

US Inflation: Peaking Euphoria. It was a moonshot for the stock market on Thursday following the release of a better-than-expected CPI report. The S&P 500 jumped 5.5%, and the Nasdaq soared 7.4%. The market might also have responded to news that Russia's military commanders announced another significant withdrawal, this time from Kherson in southern Ukraine, on Wednesday. Also on Wednesday, the Atlanta Fed's *GDPNow* tracking model reported that Q4 is up 4.0% (saar) so far. There were lots of earnings disappointments last week, but company managements are responding quickly to their misses by cutting their costs.

In any event, the big story was that the headline CPI inflation rate rose 7.7%. That was below the 8.0% that was widely expected. Consider the following:

(1) *Monthly changes.* Among the major CPI components that dropped m/m during October were utility piped natural gas services (-4.6%), used cars and trucks (-2.4), apparel (-0.7), and medical care services (-0.6).

(2) *Annual changes.* The headline CPI peaked this year at 9.1% y/y in June, falling to 7.7% in October. The core CPI peaked this year at 6.6% in September and fell to 6.3% last month. Core goods peaked at 12.3% in February and is now down to 5.1% (*Fig. 17*). On the other hand, services excluding energy has yet to peak, holding at 6.7% during October.

(3) *Durable goods.* We've been expecting that the durable goods CPI inflation rate would come down the soonest and the most this year. So far, so good: It peaked at 18.7% y/y in February (*Fig. 18*). It was down to 4.8% during October. The annualized three-month inflation rate was down to -1.2%, auguring for further declines in this CPI component's inflation rate.

(4) *Nondurable goods.* Harder to predict is the nondurable goods component of the CPI because it is dominated by food and energy prices, which tend to be volatile (*Fig. 19*). However, their annualized three-month inflation rates—at 8.8% and -21.4%—are below their annual inflation rates of 10.9% and 17.6%.

(5) *Services.* There's no peak yet in either owners' equivalent rent (OER) or rent of primary residence (*Fig. 20*). We all know why rent inflation is among the stickiest components of the CPI and why OER is a flawed measure.

We all just learned that the CPI services component includes a component that is even funkier than OER. It is health insurance. On a m/m basis, it was rising by 2.0% or over for the past seven months through September (*Fig. 21*). In October, it dropped 4.0%. (See "*Inflation Doves Want It Both Ways With Latest CPI Quirk*" in the November 10 *Washington Post*.)

Strategy III: Trader's Corner. Here is Joe Feshbach's latest call on the market: "Thursday's huge rally came off two monster high put/call ratios in a row. Tuesday's ratio was the highest I've ever seen. So the bearish bets built up big time in the short term. While the momentum from Thursday should carry the market a little higher, I do not believe this is the start of something big from here. First of all, 1000+ DJIA point moves in a single day are not characteristic of bull markets. Furthermore, market breadth continues to underperform price moves in the major averages as well as the put call ratio quickly showing widespread acceptance of the rally on Thursday and Friday. I believe the most likely scenario to develop here is a trading range market."

Calendars

US: Mon: OPEC Monthly Report; Williams; Brainard. **Tues:** Headline & Core PPI 0.5%m/m/8.3%y/y & 0.4%m/m/7.2%y/y; Empire State Manufacturing Index -7.00; API Weekly Crude Oil Inventories; IEA Monthly Report; Cook; Barr. (Bloomberg estimates)

Global: Mon: Eurozone Industrial Production 0.3%m/m/2.8%y/y; Japan GDP 0.3%q/q/1.1%y/y; Japan Industrial Production -1.6% y/y; China Industrial Production 5.2% y/y; China Retail Sales 1.0% y/y; China Fixed Asset Investment 5.9% y/y; China Unemployment Rate 5.5%; NBS Press Conterence; RBA Meeting Minutes; De Guindos; Wuermeling; Enria; Nagel; Macklem. **Tues:** Eurozone GDP 0.2%q/q/2.1%y/y; Eurozone Trade Balance -43.9b; Eurozone Employment Change; Germany ZEW Economic Sentiment -50.0; France Unemployment Rate 7.3%; France CPI 1.3%m/m/7.1%y/y; Spain 0.4%m/m/7.3%y/y; CPI UK Employment Change 3m/3m -155k; UK Unemployment Rate 3.5%; UK Average Earnings Including & Excluding Bonus 6.0%/5.6%; Canada Manufacturing & Wholesale Sale -0.5%/-0.2%; Japan Core Machinery Orders 0.7%m/m/7.4%y/y; Japan Tertiary Industry Activity Index 0.6%; Mauderer; Balz; Buch; Elderson. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index soared 6.1% last week for its third gain in four weeks and its biggest since late June. The index finished the week out of a bear market at 17.8% below its record high on December 27. The US MSCI ranked 25th of the 48 global stock markets that we follow in a week when 45 of the 48 countries rose in US dollar terms. The AC World ex-US index rose 7.4% for its biggest gain since November 2020, but ended the week still in a bear market at 22.6% below its June 15, 2021 record high as nearly all ex-US regions moved higher. EMU was the best performer with a gain of 9.4%, followed by EM Eastern Europe (9.2%), EAFE (8.4), and EM Asia (7.4). EM Latin America (-4.6) was the worst performing region last week, followed by EMEA (1.3), and BIC (3.1). The Netherlands was the best-performing country last week with a gain of 15.5%, followed by Korea (14.2), Sweden (12.8), Taiwan (12.8), and Ireland (11.4). Among the 29 countries that underperformed the AC World ex-US MSCI last week, Brazil's 8.9% decline was the biggest, followed by those of Argentina (-5.3), Morocco (-2.0), Norway (1.1), and Jordan (1.2). The US MSCI's ytd ranking fell one place w/w to 25/49. After lagging for much of year through July, the US MSCI's ytd decline of 17.4% is now less than the AC World ex-US's 19.1% drop. EM Latin America is up 5.8% ytd; it and EAFE (-17.9) are the only regions that have outperformed the AC World ex-US on a ytd basis. The laggards: EM Eastern Europe (-83.9), EMEA (-34.3), BIC (-28.0), EM Asia (-25.8), and EMU (-20.9). The best country performers so far in 2022: Turkey (53.4), Chile (24.8), Peru (15.6), Jordan (14.3), and Argentina (7.5). Apart from Russia—in which investors have lost 100.0% of their investment this year, as its MSCI index stopped pricing—here are the worst-performing countries ytd: Sri Lanka (-67.1), Morocco (-38.2), Pakistan (-38.0), Egypt (-37.0), and

Hungary (-36.7).

S&P 1500/500/400/600 Performance (*link*): All three of these indexes moved higher w/w for the third time in four weeks, and out of bear market territory. LargeCap rose 5.9%, better than the gains for MidCap (5.3%) and SmallCap (5.2). LargeCap finished the week at 16.8% below its record high on January 3; MidCap is 13.0% below its record high on November 16, 2021; and SmallCap is 16.0% below its November 8, 2021 record high. All 33 sectors moved higher for the week, up from seven rising a week earlier. LargeCap Tech and MidCap Tech were the best performers with gains of 10.0%, followed by LargeCap Communication Services (9.2), SmallCap Tech (8.2), and SmallCap Consumer Discretionary (8.1). SmallCap Consumer Staples was the biggest underperformer, albeit with a gain of 0.9%, followed by LargeCap Utilities (1.4), MidCap Consumer Staples (1.5), LargeCap Health Care (1.8), MidCap Financials (1.8), and SmallCap Utilities (1.8). In terms of 2022's ytd performance, LargeCap's 16.2% decline continues to trail those of MidCap (-10.9) and SmallCap (-12.1). Five of the 33 sectors are positive so far in 2022, up from three a week earlier. Energy continues to dominate the top performers: LargeCap Energy (69.4), SmallCap Energy (62.8), MidCap Energy (55.1), MidCap Consumer Staples (1.3), and SmallCap Materials (0.9). The biggest ytd laggards: LargeCap Communication Services (-37.8), LargeCap Consumer Discretionary (-29.8), SmallCap Communication Services (-29.5), SmallCap Real Estate (-27.9), and LargeCap Real Estate (-25.3).

S&P 500 Sectors and Industries Performance (*link*): All 11 S&P 500 sectors rose last week, and five outperformed the composite index's 5.9% gain. That compares to a 3.3% decline for the S&P 500 a week earlier, when three sectors rose and eight outperformed the index. Tech was the best performer with a gain of 10.0%, followed by Communication Services (9.2%), Materials (7.7), Real Estate (7.1), and Consumer Discretionary (5.9). The top three sectors posted their best weekly gains since April 2020. Utilities was the worst performer, albeit with a gain of 1.4%, followed by Health Care (1.8), Energy (2.0), Consumer Staples (2.4), Industrials (4.6), and Financials (5.7). The S&P 500 is down 16.2% so far in 2022, with seven sectors ahead of the index and just one in positive territory. The best performers in 2022 to date: Energy (69.4), Consumer Staples (-4.8), Utilities (-5.1), Health Care (-5.7), Industrials (-6.0), Financials (-8.4), and Materials (-10.3). The ytd laggards: Communication Services (-37.8), Consumer Discretionary (-29.8), Real Estate (-25.3), and Tech (-23.8).

S&P 500 Technical Indicators (*link*): The S&P 500 rose 5.9% last week and improved relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index moved back above its 50-dma after being below in eight of the prior 11 weeks.

However, it closed below its 200-dma for the 38th time in 41 weeks. It had been above its 200-dma for 81 straight weeks through early February. The S&P 500's 50-dma moved higher for the first time in eight weeks as the index rose to a 12-week high of 5.3% above its rising 50-dma from 0.8% below its falling 50-dma a week earlier. That compares to a recent 15-week low of 10.6% below at the end of September, a 23-month high of 8.7% above the index's rising 50-dma the week in early August, and a 27-month low of 11.1% below its falling 50-dma in mid-June. The index had been mostly trading above its 50-dma from late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index closed Friday at a 12-week high of 1.8% below its falling 200-dma, up from 7.7% below a week earlier, and compares to an 18-week high of 0.8% below in early August. It remains above its 26-month low of 17.1% below its falling 200-dma in mid-June. The latest reading is down sharply from 10.8% above its rising 200-dma in November 2021. That compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008. The 200-dma fell for a 28th straight week, but its pace of decline is slowing from its fastest rate since July 2009.

S&P 500 Sectors Technical Indicators (*link*): Eight of the 11 S&P 500 sectors are trading above their 50-dmas, up from six sectors a week earlier. Real Estate and Tech moved back above in the latest week, leaving these three sectors still below their 50-dma: Communication Services, Consumer Discretionary, and Utilities. At the end of September, all 11 sectors were below. Seven sectors now have a rising 50-dma, up from three a week earlier. The four sectors that still have a falling 50-dma: Communication Services, Consumer Discretionary, Real Estate, and Utilities. Looking at the more stable longer-term 200-dmas, Financials and Materials moved above in the latest week, joining Energy, Health Care, and Industrials in that club. For perspective, at the depths of the Great Virus Crisis in April 2020, Health Care was the only sector trading above its 200-dma. Energy and Health Care are still the only sectors with a rising 200-dma, unchanged w/w.

US Economic Indicators

Consumer Price Index (*link*): October's headline & core CPI yearly rates cooled considerably more than expected. The CPI rose 0.4% in October for the second month, after a 0.1% uptick in August and no change in July, while core prices rose 0.3%, half the gain recorded during September and August. The *CPI yearly rate* eased for the fourth month, from 9.1% back in June (the highest since November 1981) to 7.7% in September, while the core rate eased to 6.3% last month after accelerating from 5.9% in both June and July to 6.6% in September—which was highest since August 1982. Rates for both consumer durable goods and consumer nondurable goods excluding food are slowing, while the services' rate excluding energy remains on an accelerating trend, though held steady at 6.7% in October—with shelter costs particularly high. *Food costs* (10.9% y/y) eased for the second month from August's 11.4%, which was the fastest pace since April 1979. Within food, the rate for food at home (12.4) slowed from 13.0% in September and 13.5% in August—which was the highest since March 1979—while the rate for food away from home picked up to 8.6% y/y, the highest since fall 1981. *Energy costs* (17.6) continued to ease from June's 41.6%, which was the fastest pace since April 1980. Within energy, yearly rates eased virtually across the board, except for fuel oil, which picked up to 68.5% y/y in October, after slowing the prior four months from May's record-high 106.7% to 58.1% in September. The rate for gasoline prices eased to 17.5% y/y, down from June's 59.9% (fastest since March 1980), while the rate for natural gas prices slowed to a 15-month low of 20.0%—nearly half June's 38.4% (which was the highest since October 2005). The electricity rate slowed for the second month, to 14.1% y/y, from August's 15.8%—which was the highest since August 1981. *Consumer durable goods inflation* slowed for the seventh month, from 18.7% in February (highest since early 1940s) to an 19-month low of 4.8% in October. The rate for new cars (9.6) eased for the sixth month from April's near-record high of 14.2%, while the rate for used cars & trucks sank to 2.0%—the lowest since July 2020. It was as high as 41.2% this February and at a record high 45.2% during June 2021. The rate for apparel prices slipped to a 13-month low of 4.1% y/y after fluctuating in a range of 5.0% to 5.5% the prior six months. It was at a recent peak of 6.8% in March—which was its fastest rate since the end of 1980. The rate for furniture & bedding (8.3) is down from February's record high of 17.1%, while the rate for major appliances remained flat, down from its recent peak of 12.4% in March. *Consumer nondurable goods inflation* slowed for the fourth month, to 10.5% y/y, after shooting up to 16.2% in June, which was more than double June 2021's rate and the highest since the 1940s. *Services inflation* eased to 7.2% y/y last month after rising steadily from January and February 2021's 1.4% pace to 7.4% in September—which was the highest since the early 1980s. Within services, owners' equivalent and tenant-occupied yearly rates accelerated 6.9% and 7.5%, respectively, in October—up from recent lows of 2.0% and 1.8%—with the former at a new record high and the latter the highest since October 1982. Over the three months through October, the owners' equivalent rent rose 8.6% (saar) and tenant rent 9.2%—far exceeding their yearly rates. Meanwhile, the yearly rate for lodging away from home accelerated for the second month since bottoming at 1.0% in July to 5.9% y/y in October; it was at a record high of 25.1% in both March and February of this year. Turning to medical care, the yearly rate for hospitals' (3.4) services has been moving in a relatively flat trend, while the physicians' (1.8) services rate is down sharply from last March's 5.3% peak, though has moved up from its recent low of 0.8% this July. Meanwhile, the yearly rate for airfares held at 42.9% y/y in October—not far from September 1980s record high of 45.0%; the three-month rate has been negative the past three months.

Consumer Sentiment Index (*link*): Consumer sentiment tumbled 5.2 points in mid-November to 54.7 after climbing steadily from June's record low of 50.0 to 59.9 in October, with this month's drop erasing just over half the latest gains. The report notes, "Overall declines in sentiment were observed across the distribution of age, education, income, geography, and political affiliation, showing that the recent improvements in sentiment were tentative." The *present situation component* plunged 7.8 points this month to 57.8 after rebounding 11.8 points the prior four months, from 53.8 in June to 65.6 in October, while the *expectations component* fell 5.3 points the past two months to 52.7; it had jumped 10.7 points in August after a three-month slide of 15.2 points. Joanne Hsu, director of the survey, noted that "instability in sentiment is likely to continue, a reflection of uncertainty over both global factors and the eventual outcomes of the election." The *one-year expected inflation rate* rose for the second month by 5.1% this month after easing steadily from 5.3% in June to 4.7% in September. The *five-year expected inflation rate* climbed for the second month, back up to 3.0%, remaining in the narrow, though elevated, range of 2.9%-3.1% for 15 of the last 16 months.

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