MORNING BRIEFING
November 30, 2022

2024 Is Coming!

Check out the accompanying chart collection.

Executive Summary: As 2023 approaches and progresses, it will be the 2024 outlook that the stock market increasingly will discount. Today, we examine the stock market equation P = P/E x E, with E representing S&P 500 forward earnings, in the context of both the consensus and our expectations for earnings and the economic backdrop next year and in 2024. … Also: The inverted yield curve is predicting neither a credit crunch nor a recession, in our view. This time, it may be anticipating a hasty retreat of inflation. That could mean that the yields on both the 2-year and 10-year Treasuries are peaking.

Strategy: Looking Forward to 2024. In Monday's *Morning Briefing*, we wrote that 2023 is coming. We compared our economic outlook to that of the consensus, as we perceive it, for next year. The main difference is that we are expecting a soft landing rather than a hard landing. In any event, 2024 will be increasingly relevant to the performance of the stock market next year. That's because investors and analysts look forward by 12 months when they invest in and analyze stocks.

We all know that the stock market equation is P = P/E × E. Joe and I believe that the stock market discounts analysts' consensus expectations for S&P 500 forward operating earnings (E), which is the time-weighted average of their current expectations for the current year and the coming year. The data are available weekly from I/B/E/S data by Refinitiv. We also reckon that the P/E based on forward earnings reflects the valuation multiple that investors are willing to pay for the analysts' forward earnings expectations. (Joe and I wrote a detailed 2020 primer on this subject, *S&P 500 Earnings, Valuation, and the Pandemic*.)

In this context, let's have a look at the outlook for the stock market equation not only for 2023, but also for 2024 since the market will be giving more weight to 2024 and less weight to 2023 as next year progresses. Consider the following:

(1) *S&P 500 quarterly, annual, and forward consensus earnings expectations.* During the latest earnings reporting season, for Q3-2022, industry analysts lowered their earnings estimates for Q4-2022 and all four quarters of next year (*Fig. 1* and *Fig. 2*). However, over the past two weeks through the November 24 week, they've stopped cutting estimates for

next year's four quarters.

The same can be said about their earnings-per-share estimates for all of 2022 (the consensus is $220.33 currently) and for all of 2024 ($253.30 currently) (*Fig. 3*). As a result, forward earnings per share edged up over the past two weeks to $230.20, which is now down 4.1% from its record high of $239.93 during the June 23 week.

We take some comfort in these recent developments because we are not expecting a plunge in forward earnings as typically occurs during a hard landing (*Fig. 4*).

(2) *Weekly vs quarterly S&P 500 fundamentals.* As we have often noted before, the weekly forward metrics for S&P 500 forward revenues, earnings, and the profit margin closely track their actual reported counterparts (*Fig. 5*). They are showing that forward revenues might have peaked at a record high during the week of October 13, falling 1.1% through the November 17 week. Forward earnings is down 4.1% from its record high during the June 23 week through the November 24 week, as noted above. We can use these two series to calculate the forward profit margin, which fell from a record high of 13.4% during the week of June 2 to an 18-month low of 12.7% during the November 17 week.

In our opinion, these recent developments are consistent with our soft-landing outlook (so far). In a hard landing, there would be much more downside in forward revenues and the profit margin, and therefore in earnings. That's not our most likely forecast—we assign it an admittedly high 40% subjective probability, with the other 60% assigned to a soft landing.

(3) *Our 2023 and 2024 forecasts vs the consensus for earnings.* Supporting our perception that a hard-landing scenario is the consensus outlook is the recent weakness in analysts' consensus revenue estimates for the coming two years (*Fig. 6*). Analysts tend to be optimistic. They don't turn pessimistic until they receive heads-up recession warnings from the companies they follow.

As of the November 17 week, the analysts were estimating that S&P 500 revenues will increase 11.6% this year, 2.6% next year, and 4.3% in 2024. We are currently projecting increases of 11.6%, 4.3%, and 2.7%. Their estimate for next year seems low for investors to use considering that inflation will remain above the Fed's 2.0% through next year. Then again, the analysts may be going over to the dark side and incorporating a hard(er) landing into their estimates than we are.

We are lowering our S&P 500 earnings estimates to reflect the pressure on the profit margin

that started earlier this year (*Fig. 7*). We are now projecting margins of 12.3% this year, the same for next year, and back up to 13.3% in 2024. The analysts have been shaving their estimates steadily since mid-June, and their current margin forecasts—imputed from their revenues and earnings estimates as of the November 17 week—are now 12.5%, 12.7%, and 13.3% for 2022, 2023, and 2024.

Our latest operating earnings-per-share estimates for these three years are $215, $225, and $250 (*Fig. 8*). Our 2022 estimate is unchanged, but 2023 is down from our previous estimate of $235. The analysts' latest consensus estimates are $220, $231, and $253.

(4) *Our 2023 and 2024 S&P 500 targets.* When we forecast our S&P 500 price index target ranges for the three years, we start by projecting where the forward earnings series is likely to be at the year-ends. Remember that forward earnings at year-ends is the same as the analysts' consensus projections for the following year. We are projecting forward earnings per share of $225, $250, and $270 for the current and next two years (*Fig. 9*). While $270 might seem awfully high right now, that's our projection for what analysts will expect at the end of 2024 that 2025 earnings will be. After all, 2025 is coming too.

Now all that's left to do is to project the forward P/E ranges for this year (15.0-18.0), next year (15.0-17.0), and 2024 (16.0-18.0) (*Fig. 10*). Our projections are consistent with a soft-landing scenario, not a hard-landing one.

Now here are our projections for the S&P 500 price ranges for the current and coming two years: 3642-4305, 4080-4845, and 4320-4860 (*Fig. 11*).

The bottom line is that even with our relatively optimistic economic and earnings outlook, it's hard to see the S&P 500 rising well into record territory over the next two years. That's mostly because the valuation multiple was so elevated at 21.5 when the S&P 500 rose to a record high of 4796.56 on January 3 of this year.

For a handy compilation of all the above, see *YRI S&P 500 Earnings Forecast*.

US Economy: The Yield Curve One More Time. Everyone seems to be obsessed with the inversion of the yield curve. We are too. It is still widely believed that such inversions are uncannily accurate predictors of imminent recessions. But that's not exactly the case, Melissa and I concluded in our 2019 study *The Yield Curve: What Is It Really Predicting?*: "In our opinion, the yield curve, first and foremost, predicts the Fed policy cycle rather than the business cycle. Our research confirms this conclusion, as does a recent Fed study.

More specifically, inverted yield curves don't cause recessions. Instead, they provide a useful market signal that monetary policy is too tight and risks triggering a financial crisis, which can quickly turn into a credit crunch causing a recession."

In other words, the yield curve predicts the impact of the Fed's policy cycle on the financial and credit cycle, and then on the business cycle. So what is it doing now? It doesn't seem to be predicting a credit crunch. Despite a bunch of financial crises in cryptocurrencies and the ARK, meme, and SPAC stocks, the credit system in general and the banking system in particular remain remarkably resilient. For the reasons we discussed in yesterday's *Morning Briefing*, we believe that the US economy is also resilient and can continue to grow notwithstanding the Fed's very aggressive monetary policy tightening cycle (so far). While we do see a soft landing for the economy next year, we don't see a hard landing, which apparently is the consensus view.

So what is the inverted yield curve really predicting this time if not a credit crunch and a recession? We won't leave you in suspense: In our opinion, it may be anticipating that inflation might moderate surprisingly quickly without a recession in 2023. If so, then it may also be predicting that the yields on both the 2-year Treasury note and the 10-year Treasury bond are peaking. Consider the following:

(1) *Fed cycle.* The Fed cycle can be easily depicted on a chart showing periods when the Fed raised the federal funds rate followed by periods when it lowered the rate (*Fig. 12*).

(2) *Financial and credit cycle.* Since 1960, more often than not, the end of the Fed's monetary policy tightening cycle coincided (i.e., caused) financial crises, which quickly morphed into economy-wide credit crunches (*Fig. 13*).

(3) *Business cycle.* Most of those credit crises triggered recessions, causing the Fed to start a monetary easing cycle (*Fig. 14*).

(4) *Yield curve and interest-rate cycle.* The yield curve, based on the yield spread between the 10-year Treasury bond and the 2-year Treasury note, has had a tendency to invert at the end of monetary tightening cycles and the beginning of easing ones (*Fig. 15*).

The 2-year Treasury note is a leading indicator for the federal funds rate (*Fig. 16*). During monetary policy tightening cycles, it tends to rise faster than the 10-year yield (*Fig. 17*). Data available since 1976 show that when the 2-year yield rises to match or slightly exceed the 10-year yield, the Fed's monetary tightening policy cycle is almost over.

Based on this past performance, we conclude that both the 2-year and 10-year yields might have peaked in late October. If that development can't be attributed to an impending credit crunch and recession, then that leaves only peaking inflation as the explanation for why this is happening.

Of course, this optimistic analysis could be obliterated should inflation remain persistently high or move even higher. In this scenario, the Fed's monetary policy tightening cycle would persist, sending both 2-year and 10-year yields higher. Stay tuned.

Calendars

US: Wed: Real GDP & GDP Price Index 2.7%/4.1%; Core PCED 4.5%; ADP Employment 200k; Job Openings 10.3m; Pending Home Sales -5.0%; Goods Trade Balance -$90.2b; Chicago Fed PMI 47.0; Wholesale & Retail Inventories; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; Powell; Cook. **Thurs:** Personal Income & Spending 0.4%/0.8%; Core PCED 0.3%m/m/5.0%y/y; Initial & Continuous Jobless Claims 235k/1.573m; ISM M-PMI & Price Index 49.8/47.5; Construction Spending -0.3%; Natural Gas Storage; Barr; Bowman. (Bloomberg estimates)

Global: Wed: Eurozone CPI Flash Estimate 10.4% y/y; Germany Import Prices -1.7%m/m/22.7%y/y; Germany Unemployment Rate 5.5%; France GDP 0.2%; France Consumer Spending -0.9%; France CPI; Spain Retail Sales; Italy GDP 0.5%q/q/2.6%y/y; Italy CPI 1.4%m/m/12.0%y/y; Japan Housing Starts -1.3%; Caixin M-PMI 48.9; European Central Bank Non-Monetary Policy Meeting; Pill; Noguchi. **Thurs:** Eurozone Unemployment Rate 6.6%; Eurozone, Germany, France, Italy, and Spain M-PMIs 47.3/46.7/49.1/47.0/45.6; Germany Retail Sales -0.6%m/m/-2,8%y/y; UK M-PMI 46.2; UK Nationwide HPI -0.3%m/m/5.8%y/y; Japan Household Confidence 30.3; Enria. (Bloomberg estimates)

Strategy Indicators

MSCI World & Region Net Earnings Revisions (*link*): Analysts' recent earnings revisions through November suggest a tad higher optimism about profits in EM Eastern Europe but increasing pessimism about profits in the rest of the world. The US MSCI's NERI was negative in November for a fifth month following 23 straight positive readings, falling to a 29-

month low of -14.0% in November from -12.4% in October. That compares to a post-pandemic high of 21.1% in July 2021 and an 11-year low of -36.9% in May 2020. The AC World ex-US MSCI's NERI was negative for a ninth month following 17 straight positive readings, as it dropped to a 28-month low of -5.9% from -3.5% in October. NERI was negative again in November for EM Asia and Emerging Markets. EM Latin America also weakened m/m but was positive for a ninth month. EM Eastern Europe turned slightly positive in November, but these regions turned negative m/m: EAFE, Europe, and Europe ex-UK. Here are November's scores among the regional MSCIs: EM Eastern Europe (0.8% in November, up from a 26-month low of -2.5% in October), EMU (0.4 [23-month low], 3.7), EM Latin America (less than 0.1, 0.7), Europe (-1.6 [26-month low], 1.1), EAFE (-1.9 [25-month low], 0.0), Europe ex-UK (-2.5 [26-month low], 0.5), AC World ex-US (-5.9 [28-month low], -3.5), Emerging Markets (-8.1 [28-month low], -5.5), AC World (-8.1 [28-month low], -5.9), EM Asia (-8.9 [29-month low], -6.1), and the US (-14.0 [29-month low], -12.4).

MSCI Countries Net Earnings Revisions (*link*): NERI was positive for 16/41 MSCI countries in November. That's the lowest count since September 2020 and down from 20 in October. It had peaked at 35/41 during May 2020, which nearly matched the record-high 36/41 from June 2004. That also compares to zero countries with positive NERI from April to June 2020. NERI improved m/m in November for 18/41 countries, up from 14/41 in October. These countries had relatively high NERIs in November: Belgium (14-month high) and the Philippines (11-month high), followed by Egypt, India, and New Zealand at nine-month highs. The UK has had positive NERI for 26 straight months, followed by Italy (25), Turkey (25), Austria (24), France (23), and Chile (22). New Zealand has the worst negative-NERI streak, at 26 months, followed by Hong Kong (18), China (15), Belgium (14), and Brazil (13). NERI flipped back into positive territory in November for the Czech Republic and Egypt. It turned negative m/m for six countries: Denmark, Finland, Greece, Ireland, Norway, and Spain. The highest NERI readings in November: Turkey (18.8%), Italy (8.8), Israel (7.5), France (5.9 [19-month high]), Portugal (4.7 [12-month high]), and Mexico (4.7). The weakest NERIs occurred this month in Taiwan (-15.5 [30-month low]), Peru (-15.2), Switzerland (-14.6), Hong Kong (-14.5), Canada (-11.8 [28-month low]), and China (-10.8).

AC World ex-US MSCI (*link*): This index is up 9.2% in local-currency terms so far in Q4 to a 10.7% decline ytd. In US dollar terms, the index is up a greater 13.7% so far in Q4 but has declined a substantially greater 18.4% for 2022 to date. Local-currency forward revenues has risen 17.2% since it bottomed in January 2021 and is just 0.4% below its record high in mid-October. Local-currency forward earnings is down 2.2% from its record high in early September but has soared 55.6% since it bottomed in July 2020. Revenues are expected to rise 12.9% in 2022 and 3.2% in 2023 following a 16.9% gain in 2021, and earnings are

expected to increase 13.8% (2022) and 2.1% (2023) after soaring 57.2% (2021). The industry analysts' sales forecasts imply short-term 12-month forward revenue growth (STRG) of 4.4% and short-term 12-month forward earnings growth (STEG) of 3.3%, compared to 4.1% and 10.0% before Covid-19 hit the news. These measures bottomed at -0.1% and -0.3%, respectively, during May 2020. The profit margin implied by analysts' earnings and revenue estimates calls for 9.2% in 2022 and 9.1% in 2023, compared to 9.1% in 2021. The forward profit margin forecast of 9.1% is down 0.2ppt from its record high of 9.3% during March but remains well above its 10-year low of 6.6% at the end of May 2020. The Net Earnings Revision Index (NERI) for the AC World ex-US MSCI was negative in November for a ninth straight month following 17 positive readings and weakened to a 28-month low of -5.9% from -3.5% in October. That compares to a 12-year high of 6.4% in July 2021 and an 11-year low of -23.9% in May 2020. The forward P/E of 12.0 is up from its 29-month low of 10.8 in mid-October. That compares to an 18-year high of 17.1 in February 2021 and its March 2020 low of 10.8. The index is at 20% discount to the World MSCI P/E, still near its record-low 22% discount during the first half of 2022.

Emerging Markets MSCI (*link*): The EM MSCI price index is up 6.3% in US dollar terms so far in Q4 to a 24.5% decline ytd. In local-currency terms, EM is up a lesser 4.5% quarter-to-date to a smaller ytd loss of 19.2%. Local-currency forward revenues has risen 10.9% since its bottom in January 2021 but remains 4.8% below its record high in May 2019. Local-currency forward earnings is up 26.2% since its bottom in June 2020 but is now 11.8% below its record high in early March. Revenues are expected to rise 12.4% in 2022 and 5.1% in 2023 after jumping 21.0% in 2021. That's expected to lead to an earnings gain of 7.6% in 2022 and 2.8% in 2023, following a 53.2% recovery gain in 2021. Forecasted STRG of 5.8% is down from April 2021's 11-year high of 12.6%, which compares to a five-year low of 3.6% at the end of April 2020. STEG has dropped to a 13-year low of 2.8% from a record high of 33.7% in December 2020. The implied profit margin is expected to drop to 7.3% in 2022 from 7.7% in 2021 and fall another 0.1ppt in 2023 to 7.2%. The forward profit margin of 7.1% is up from a four-year low of 6.1% at the end of May 2020 and compares to its 10.3% record high in December 2007. NERI was negative in November for a 13th straight month and weakened to a 28-month low of -8.1% from -5.5% in October. That compares to an 11-year high of 6.0% in February 2021 and an 11-year low of -18.7% in May 2020. Emerging Markets' forward P/E of 11.4 is up from a 30-month low of 10.2 in October, which compares to a record high of 16.3 in February 2021 and its March 2020 low of 10.1. The index is trading at a 24% discount to the World MSCI P/E. That's up from a 33% at the start of the year, which was its biggest discount since 2005.

EMU MSCI (*link*): The EMU MSCI price index has soared 16.0% in local-currency terms so

far in Q4 but has fallen 11.9% ytd. In US dollar terms, EMU is up a greater 23.1% so far in Q4 to a bigger ytd drop of 19.4%. Local-currency forward revenues is down 1.3% from its first record high since September 2008 and has risen 22.3% since its bottom in January 2021. Local-currency forward earnings is up 77.2% from its bottom in July 2020 to just 0.4% below its first record high since January 2008. Revenues are expected to rise 12.8% in 2022 after gaining 17.2% in 2021, but growth is expected to slow sharply to just 1.4% in 2023. That's expected to lead to an earnings gain of 17.9% in 2022 following a recovery gain of 75.2% in 2021, but drops to 2.4% in 2023. Forecasted STRG of 2.3% is down from a record-high 8.3% during April 2020, but that's up from an 11-year low of -0.9% during April 2020. STEG has dropped to 3.6% from a record high of 47.4% in December 2020, but that's up from a record low of -6.7% in April 2020. The implied profit margin is expected to rise from 8.4% in 2021 to 8.8% in 2022 and 8.9% in 2023. The forward profit margin of 8.9% remains near a 13-year high, which compares to a 12-year low of 6.0% at the end of July 2020 and its 9.1% record high in October 2007. EMU's NERI was positive in November for a 23rd month after 27 straight negative readings and leads all developed regions but dropped to a 23-month low of 0.4% from 3.7% in October. That compares to a record low of -35.9% in May 2020 and is down from a record high of 15.2% in September. EMU's forward P/E of 11.9 is up from a 29-month low of 10.2 in mid-October, which compares to a record high of 18.3 in July 2020 and a slightly lower 10.2 in March 2020. The index is trading at a 21% discount to the World MSCI P/E, which is near September's 11-year low of 25% and among its worst readings since 2001.

China MSCI (*link*): The China MSCI price index is the sixth-worst performer of the 49 MSCI countries so far in Q4, with a decline of 0.9% in local currency terms. Its 31.6% ytd decline ranks as third worst of the 49 countries. Local-currency forward revenues has risen only 1.6% since its five-year low in June 2021 and is now 36.4% below its record high in October 2014. Local-currency forward earnings is 3.1% below its June 2020 Covid-low to a five-year low and is now 20.4% below its record high in June 2018. Revenues are expected to rise 10.0% in 2022 and 7.1% in 2023 after surging 19.3% in 2021. That's expected to lead to earnings gains of 7.5% in 2022 and 14.9% in 2023, following a 9.2% increase in 2021. Forecasted STRG of 7.2% is down from an 11-year high of 13.5% in April 2020, but that's up from a five-year low of 5.0% at the end of April 2020. STEG has dropped to 14.3% from a 10-year high of 18.6% during December 2020, which compares to a four-year low of 8.0% in April 2020. The implied profit margin ranks as one of the lowest in the world; it's expected to remain unchanged y/y at 4.3% in 2022 and to rise to 4.6% in 2023. The forward profit margin of 4.5% is down from a record high of 5.2% in July 2021 and now matches its pandemic low of 4.5% in May 2020. NERI was negative for a 15th straight month in November and dropped to -10.8% from -7.1% in October. That compares to a 23-month low

of -11.7% in May and ranks as sixth worst among the 41 MSCI countries that we follow. China's forward P/E of 10.0 is up from a seven-year low of 8.5 in late October. That compares to 12.1 at the start of the year and its March 2020 pandemic-low of 10.5. The index is trading at a 33% discount to the World MSCI P/E, up from a 22-year low discount of 46% in mid-March.

US Economic Indicators

Consumer Confidence (*link*): "Consumer confidence declined again in November, most likely prompted by the recent rise in gas prices," noted Lynn Franco, senior director of economic indicators at The Conference Board. "Inflation expectations increased to their highest level since July, with both gas and food prices as the main culprits. Intentions to purchase homes, automobiles, and big-ticket appliances all cooled. The combination of inflation and interest rate hikes will continue to pose challenges to confidence and economic growth into early 2023." Consumer confidence fell for the second month, by a total of 7.6 points to 100.2, after a two-month jump of 12.5 points. The *present situation* component fell 1.3 points this month, coming on the heels of an 11.5-point plunge in October, falling to a 19-month low of 137.4 this month—more than erasing the 10.5-point jump during the two months through September. Meanwhile, the *expectations* component fell for the second month, by a total of 4.1 points to 75.4—retaining 70% of the 13.9-point gain during the two months through September. *Current business conditions* were mixed: The percentage of consumers saying business conditions were good rose from 17.7% to 18.2%, while the percentage saying conditions were bad rose from 24.0% to 26.7%. As for the *current labor market*, 45.8% of consumers said jobs were plentiful this month, up from 44.8% last month, while 13.0% said jobs were hard to get, unchanged from October. *Short-term business conditions* (six-month outlook) remained pessimistic: The percentage of consumers expecting business conditions to improve rose slightly from 19.6% in October to 19.9% this month, while 22.7% expect conditions to worsen, down from 24.3% last month. The *short-term labor market* deteriorated: The percentage of consumers expecting more jobs to be available six months from now fell from 19.5% to 18.6%, while the percentage anticipating fewer jobs rose from 20.8% to 21.4%. As for their *short-term financial prospects*, the outlook was troublesome, with 17.2% of consumers expecting their incomes to increase, down from 19.6% in October, and 16.6% expecting their incomes to decrease, up from 15.2% last month.

Global Economic Indicators

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Indexes (ESI) for both the EU and Eurozone increased in November for the first time since February. The EU and Eurozone's ESIs both rose a point this month to 92.2 and 93.7, respectively, after to falling to 91.2 and 92.7 in October—their lowest levels since November 2020. They peaked at 116.7 and 118.0 last October. ESIs among the *six largest EU economies* were mixed, with Italy's ESI (+4.1 points to 99.3) posting a solid gain, while ESIs in the Netherlands (+1.2 to 91.7) and Germany (+1.1 to 92.2) were also in the plus column, though to a lesser extent. Meanwhile, ESIs fell in Spain (-1.7 to 96.4) and France (-1.6 to 94.6) while Poland's (+0.3 to 88.8) was broadly flat. *By sector*, industrial confidence in the EU fell further into contractionary territory, dropping 10 of the 11 months since reaching a record high of 12.8 at the end of last year, plunging to -3.2 in November—after slipping below zero in September for the first time since January 2021. Services confidence edged up to 2.4 this month, after sliding every month but one from its recent peak of 18.1 last October to an 18-month low of 2.2 this October. Meanwhile, consumer confidence increased for the second month, to -25.8, after plunging to a record low of -29.3 in September. Construction confidence continued to hover around zero, while retail trade confidence was little changed at -6.7, down from +5.0 in February.

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