MORNING BRIEFING
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Earnings Matters

Check out the accompanying chart collection.

Executive Summary: Industry analysts following S&P 500 companies collectively lowered their earnings sights for this year and next when they heard Q3 earnings reports. The past three weeks have brought a reprieve in the estimate cutting, but will Q4 earnings reporting season revive it? Our soft-landing economic forecast suggests forward earnings moving sideways, not dropping, through H1-2023. … Also: PMIs correlate with the growth rates of S&P 500 earnings and revenues, and the latest readings yield insights into consumer spending patterns and inflationary pressures. … And: There's no simple rule of thumb for when to over- and under-weight stocks of various capitalization sizes, but there are specific economic conditions that can guide the decision.

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Strategy I: Forward Earnings Have Stopped Falling for Now. The Q3 earnings reporting season caused industry analysts as a group to cut their earnings estimates for S&P 500 companies for Q4-2022 and each of next year's quarters (*Fig. 1* and *Fig. 2*). Now that the earnings season is over, their estimates for these five quarters have stabilized over the past three weeks. So have their consensus S&P 500 operating earnings estimates for 2023 and 2024 (*Fig. 3*). During the December 1 week, the former was $231.25, while the latter was $253.55. Likewise, S&P 500 forward earnings—which is the time-weighted average of the consensus estimates for this year and next year—has stopped falling over the past three weeks and is currently $230.41.

That's the most recent good news. The question is whether analysts will resume cutting their estimates early next year during the Q4-2022 earnings reporting season. The answer will largely depend on the economy, of course. Nominal and inflation-adjusted forward earnings follow the business cycle closely (*Fig. 4*). They track both the Index of Coincident Economic Indicators and the Index of leading Economic Indicators (*Fig. 5* and *Fig. 6*). The former rose to a record high during October, while the latter fell 3.8% over the past eight months, from its February record high through October.

As we look ahead to 2023, Debbie and I remain in the soft-landing camp, which would be consistent with forward earnings continuing to move sideways through the first half of next year. While it is widely feared that a recession might occur during the second half of next year (when consumers deplete their excess savings), we expect that economic growth will be recovering by then.

Strategy II: Purchasing Managers & Earnings. Among the timeliest economic indicators are the M-PMI and NM-PMI compiled by the Institute for Supply Management. They are highly correlated with the growth rates of S&P 500 revenues and earnings. November's data show that manufacturing is relatively weak but still expanding, while nonmanufacturing remains strong. This is the latest confirmation that consumers have been pivoting from spending heavily on goods to buying more services. Consider the following:

(1) *M-PMI.* The US manufacturing sector contracted in November, as the M-PMI registered 49.0%, 1.2 percentage points below the reading of 50.2% recorded in October (*Fig. 7*). A M-PMI above 48.7% over a period of time generally indicates an expansion of the overall economy. Therefore, the November M-PMI indicates the overall economy grew in November for the 30th consecutive month following contractions in April and May 2020.

(2) *NM-PMI.* In November, the M-PMI registered 56.5%, a 2.1-percentage point increase compared to the October reading of 54.4% (*Fig. 8*). The 12-month average is 57.2%, reflecting consistently strong growth in the services sector, which has expanded for 30 consecutive months. A reading above 50.0% indicates the services sector economy is generally expanding; below 50.0% indicates it is generally contracting. The survey's production index jumped by 9 percentage points to 64.7, the highest since last December.

(3) *Prices.* The M-PMI's prices-paid index registered 43.0%, down 3.6 percentage points compared to the October figure of 46.6%; this is the index's lowest reading since May 2020 (40.8%). While inflationary pressures are abating in manufacturing, they remain persistent in non-manufacturing. Prices paid by services organizations for materials and services increased in November for the 66th consecutive month, with the prices-paid index registering 70.0%, 0.7 percentage point lower than the 70.7% recorded in October. It was the fifth consecutive reading near or below 70% following nine straight months of readings above 80%.

The M-PMI and NM-PMI prices-paid indexes suggest that inflationary pressures have peaked (*Fig. 9* and *Fig. 10*). However, this is more clearly the case in the former than the latter.

(4) *Revenues & earnings.* The M-PMI is highly correlated with the y/y growth rate in S&P

500 operating earnings on a quarterly basis (*Fig. 11*). So the recent drop in the M-PMI below 50.0% suggests that earnings growth turned negative during Q4.

On the other hand, the NM-PMI suggests that S&P 500 earnings growth might have remained slightly positive during Q4 (*Fig. 12*).

Strategy III: LargeCaps vs SMidCaps. Often during past periods of tightening monetary policy, stocks with large market capitalizations tended to outperform those with small market caps. That's because tougher credit conditions would cause recessions, which were tougher on small companies than large ones.

On the other hand, speculative excesses drove the relative outperformance of the S&P 500 LargeCaps relative to the SMidCaps (a.k.a. the S&P 400 MidCaps and the S&P 600 SmallCaps) in the late 1990s and during the pandemic. When those bubbles popped, the former index underperformed the latter. In other words, there isn't any simple rule of thumb to judge when to overweight/underweight LargeCaps relative to SMidCaps.

This year sure has been a wild one in this regard. The sharp increase in interest rates increased the prospects of a recession, favoring the LargeCaps over SMidCaps. But the former stocks were overvalued and were hit hardest when rising interest rates weighed on their valuation multiples. In addition, tight monetary policy caused the dollar to soar, which has weighed more on the earnings of LargeCaps than SMidCaps.

Let's have a look at the latest developments:

(1) *S&P 500 equal-weighted vs market-cap-weighted.* So far this year through Friday, the S&P 500 equal-weighted index is down 8.6% compared to a decline of 14.6% for the market-cap weighted index (*Fig. 13*). The ratio of the two is the highest since June 2019 (*Fig. 14*). Early in bull markets, this ratio continues to advance, sometimes to new highs.

(2) *S&P 500/400/600.* Also slightly outperforming so far this year are the S&P 400 MidCaps and the S&P 600 SmallCaps (*Fig. 15* and *Fig.16*). They are down 9.4% and 11.2% ytd through Friday versus down 14.6% for the S&P 500 LargeCaps.

Calendars

US: Tues: Trade Balance -$79.1b; API Weekly Crude Oil Inventories. **Wed:** Nonfarm

Productivity & Unit Labor Costs 0.6%/3.1%; Consumer Credit $28.3b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: **Tues:** Germany Factory Orders -0.2; Canada Trade Balance $1.0b; China Trade Balance ¥79.1bAustralia GDP 0.1%q/q/6.3%y/y; RBA Rate Statement; Jochnick, Nakamura. **Wed:** Eurozone GDP 0.2%q/q/2.1%y/y; Eurozone Employment Change -0.2%q/q/1.7%y/y; Germany Industrial Production -0.6%; Italy Retail Sales -0.6%; UK Halifax Home Price Index -0.2%; Japan GDP -0.3%q/q/-1.1%y/y; Japan Leading & Coincident Indicators; Canada BOC Rate Decision 4.25%; Lane; McCaul; Panetta. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose for a third week following declines in seven of the prior eight weeks, but MidCap's was down for an 11th straight week and SmallCap's for a ninth. For a 23rd straight week, none of these three indexes had forward earnings at a record high. LargeCap's is 4.0% below its record high at the end of June and up slightly from a 36-week low in early November. MidCap's is at a 37-week low and 6.2% below its record high in early June; and SmallCap's is at a 38-week low and 7.4% below its record high in mid-June. Forward earnings momentum continues to fade. The yearly rate of change in LargeCap's forward earnings was down to a 21-month low of 4.1% y/y from 4.0% a week earlier; that's down from a record-high 42.2% at the end of July 2021 and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings fell to a 21-month low of 8.9% y/y from 9.3%. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's was down to a 23-month low of 2.1% y/y from 2.3%. That's down from a record high of 124.2% in June 2021. It had been at a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2022 to 2023 have been heading lower since June for both years. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (5.9%, 4.9%), MidCap (14.5, -3.1), and SmallCap (9.8, 1.8).

S&P 500/400/600 Valuation (*link*): Valuations ended higher last week for all three of these indexes. LargeCap's forward P/E rose 0.2pt to a 15-week high of 17.7, and is now up 2.6pts from its 30-month low of 15.1 at the end of September. That compares to a four-month high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.1pt w/w to an eight-month high of 13.7, up 2.6pts from a 30-month low of 11.1 at the end of September. That compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E also rose 0.1pt w/w, to an eight-month high of 13.1. That's up from a 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 22% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 120th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 26% reading is near its biggest discount since February 2001. SmallCap's P/E has been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 77th straight week; the current 4% discount is an improvement from its 9% discount in December 2021 but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. In the latest week, the Q3-2022 S&P 500 earnings-per-share blended actual rose 4 cents w/w to $56.03, and is now 5.8% below its $59.49 forecast at the start of the quarter. The S&P 500's blended Q3 earnings growth has weakened q/q to 4.0% y/y from 9.9% in Q2 on a frozen actual basis, and to 4.4% from 8.4% on a pro forma basis. Just four sectors have recorded double- and triple-digit percentage growth in Q3-2022, two have a single-digit gain, and five have y/y declines. That's little changed from Q2-2022's count, but analysts expect further deterioration in Q4. Looking ahead to Q4, a 0.6% y/y decline is expected for the S&P 500, with just four sectors expected to record positive y/y earnings growth and seven expected to decline. Here are the S&P 500 sectors' latest expected earnings growth rates for Q4-2022 versus their blended Q3-2022 growth rates: Energy (72.6% in Q4-2022 versus 140.8% in Q3-2022), Industrials (42.3, 19.7), Real Estate (6.8, 14.8), Utilities (4.5, -7.1), S&P 500 (-0.6, 4.4), Consumer Staples (-3.5, 1.3), Financials (-3.7, -16.4), Health Care (-6.4, 1.5), Information Technology (-8.3, -0.2), Consumer Discretionary (-14.3, 13.2), Communication Services (-20.8, -26.1), and Materials (-21.6, -8.8).

US Economic Indicators

US Non-Manufacturing PMIs (*link*): ISM's NM-PMI picked up a bit in November after slowing to its weakest reading since May 2020 in October. The NM-PMI climbed to 56.5 last month, after declining 8 of the prior 11 months, from a record-high 68.4 last November to 54.4 this October. Of the four components, the *business activity* (64.7) measure bounced back above 60.0, to its highest reading since last December, after slumping from 60.9 in August to 55.7 in October. Meanwhile, the *supplier deliveries* index sank to a 33-month low of 53.8 since peaking at 75.7 last October and November. The *employment* measure (51.5 from 49.1) moved back into expansionary territory in November, though has bounced around the 50.0 breakeven point most of this year. On the *inflation* front, the price index dipped to 70.0 in November after rising in October for the first time in six months, from a 20-month low of 68.7 in September to 70.7; it was at a record-high 84.6 in April.

Manufacturing Orders & Shipments (*link*): Factory orders climbed in October for the 12th time in 13 months, by 1.0% m/m and 13.2% over the period to its highest level since July 2014. Factory shipments rose 19 of the past 20 months, by 0.7% and 20.3% over the period to its highest level on record. Meanwhile, core capital goods orders and shipments continued to set new record highs, as companies have been attempting to boost productivity to compete with high inflation and a tight labor market. *Nondefense capital goods shipments excluding aircraft* (used in calculating GDP) has climbed every month but two since its April 2020 bottom, jumping 1.5% in October and 36.8% over the period. Meanwhile, *core capital goods orders* (a proxy for future business investment) has advanced during all but five months since April 2020, up 0.6% and 35.5% over the comparable periods. Machinery billings hit yet another new record high in October, with the industrial equipment component near record highs and construction equipment on an upswing. Meanwhile, orders for electrical equipment, appliances & components is stalled just below August's record high, with billings for household appliances at a new record high. Orders for motor vehicles & parts are on a steep uptrend, climbing to within 0.6% of September 2018's record high.

Global Economic Indicators

Global Composite PMIs (*link*): Global demand contracted in November for the fourth successive month, posting its sharpest decline since June 2020, with both the manufacturing and service sectors contracting at their fastest rates since mid-2020. The *C-PMI* moved lower for the fourth time in five months, from 53.5 in June to 48.0 in November, with the *NM-PMI* sinking for the second month, to 48.1, after rising from 49.3 in August to 50.0 in September, and the *M-PMI* remaining in a tailspin, falling nine of the first 11 months of this year from 54.3 at the end of last year to 48.8 last month. *Geographically*, the report noted that there was a broad slump in the developed economies, while performance in the emerging markets was mixed. Within the *developed economies*, the C-PMI for the US (46.4) showed a steeper drop last month, while activity in the Eurozone (47.8) contracted for the fifth successive month, with C-PMIs for Spain (49.6), Italy (48.9), Ireland (48.8), France (48.7) and Germany (46.3) all below 50.0. The UK's C-PMI (48.2) held at its weakest reading since January 2021, while Japan's (48.8) fell back into contractionary territory after a brief trip to expansionary territory in September and October. In the *emerging economies*, C-PMIs showed downturns were recorded in China (47.0) and Brazil (49.8), while India (56.7) showed an expansion and Russia (50.0) stabilized. Turning to *prices*, the report noted: "[O]ne positive influence of weak demand was the softening impact it had on prices and supply chain pressures." Rates for both input and output prices eased to 21-month lows, while the manufacturing sector saw the most favorable vendor lead times since January 2020.

Eurozone Retail Sales (*link*): Eurozone retail sales, which excludes motor vehicles & motorcycles, sank 1.8% in October after rising 0.8% in September—which was its first increase since March. Through the first 10 months of this year, sales have increased four times, decreased four times, and showed no change twice—for a ytd decline of 1.3%. Sales are down 4.0% since reaching its record high last June. Spending on *food, drinks & tobacco* continued its up-and-down pattern, sinking 1.5% in October after rising 0.6% in September and falling 0.7% in August, while sales of *non-food products* excluding fuel dropped 2.1%, more than reversing the 1.5% gain recorded during the two months through September. Sales of automotive fuels climbed for the third time in four months, by 0.3% m/m and 2.6% over the period. Versus a year ago, total sales were down 2.7%, driven by declines in food, drinks & tobacco and nonfood products (excluding fuel) of 3.9% and 2.6%, respectively, while sales of automotive fuel rose 2.5%. October data are available for three of the four of the Eurozone's *largest economies*, showing notable declines in Germany (-2.8%) and France (-2.7), following gains of 1.2% and 1.4%, respectively, while Spain eked out a 0.4% gain for the second straight month. Compared to a year ago, sales in Germany (-4.9% y/y) continued to contract, while sales in Spain (1.2) continued to expand; sales in France (-0.2) were flat with a year ago.

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