MORNING BRIEFING
February 7, 2023

Earnings & Valuation

Check out the accompanying chart collection.

Executive Summary: While earnings recessions usually don't occur without economic recessions, recent data suggest a possible decoupling. Analysts have been lowering their earnings estimates, and a recession in forward earnings could occur if forward margins decline faster than forward revenues grow. Yet we see no recession ahead in the broad economy—or in earnings—but a soft landing, with real GDP growth approximating 1.0% during the first half of this year and 2.0% during the second half. … Also: Valuations have been rebounding across the board for S&P indexes since October 12, surprisingly so for the S&P 500 and its Value index. Comparatively low valuations in overseas stock markets have begun luring global investors.

Strategy I: Earnings. While economists are debating whether the economy is heading for a recession, investment strategists are debating whether earnings are heading for a recession. Aren't the two debates really one and the same? S&P 500 companies' collective reported earnings per share always falls during economic recessions, based on quarterly data that start in 1935 compiled by Standard & Poor's (*Fig. 1*). The same can be said about S&P 500 operating earnings per share based on quarterly data since Q1-1993 and Q1-1988 compiled by I/B/E/S and S&P, respectively (*Fig. 2*).

It might be different this time, however: Earnings could fall without an economy-wide recession. This may be happening now, as S&P 500 operating profit margins have been falling faster than S&P 500 revenues are increasing. The quarterly data are available only through Q3-2022. Q4-2022 data will be available soon after the end of the current earnings season.

We do have weekly data on S&P 500 forward revenues, forward earnings, and the forward profit margin through the January 26 week, which show that this time might be different (*Fig. 3*). These three forward stock market metrics each closely tracks their comparable quarterly actuals. (Each is the time-weighted average of industry analysts' forecasts for the current year and the coming year.)

Before we have a closer look at the data, let's review our forecast for the economy and S&P 500 earnings and proceed from there:

(1) *Our GDP forecast.* We remain in the soft-landing camp on the economic outlook. What we see ahead for this year can also be described as a "growth recession" or a "mid-cycle slowdown." Real GDP should grow around 1.0% (saar) during H1-2023 and around 2.0% during H2-2023 (*Fig. 4*). We are expecting inflation to moderate to 3.0%-4.0% this year based on the headline PCED (*Fig. 5*).

(2) *Our S&P 500 earnings forecast.* We tend to update our S&P 500 earnings projections after the ends of earnings seasons. Currently, we are estimating that S&P 500 revenues per share will be up 4.3% in 2023 and 2.7% in 2024 (*Fig. 6*). Not surprising is that S&P 500 aggregate revenues is highly correlated with nominal GDP (*Fig. 7*). The same can be said about the inflation-adjusted versions of these two variables (*Fig. 8*). So there's no recession implied in our outlook for revenues.

We are currently estimating that S&P 500 operating earnings will be up 4.7% this year to $225 per share and 11.1% next year to $250 (*Fig. 9*).

(3) *Industry analysts' estimates.* Again, while we aren't projecting a hard landing for earnings, we are aware that industry analysts have been cutting their earnings estimates for 2023 and 2024. In response to Q4's earnings reporting season, they have been reducing their estimates for each of this year's quarters and for next year (*Fig. 10* and *Fig. 11*).

Nevertheless, as of the February 2 week, the analysts collectively still were projecting an increase this year of 2.3% to $224.31 and an increase of 11.2% next year to $249.52. Those estimates are consistent with a mid-cycle slowdown in earnings this year and better growth next year.

(4) *Forward metrics.* As noted above, the S&P 500's forward metrics are high-frequency weekly indicators of their comparable quarterly series. Forward revenues has stalled in recent weeks in record-high territory (*Fig. 12*). That's consistent with a soft landing of the economy for now.

Forward operating earnings is down 5.5% from its record high during June 23, 2022 through the February 2 week of this year (*Fig. 13*). Again, that is more consistent with the slowdowns during the mid-1980s, early 1990s, and mid-2010s than the previous five hard landings associated with bear markets, when forward earnings dropped 21% on average.

All the weakness in forward earnings since mid-2022 is attributable to the decline in the forward profit margin (*Fig. 14*). The latter dropped 7% since rising to a record high of 13.4%

during the June 9 week of 2022. It was down to 12.5% during the January 26 week of 2023. Margin estimates were simply too high for this year and next year (*Fig. 15*). That's normal: Industry analysts have a consistent tendency to be too optimistic about margins even during good times. It is recessions that clobber profit margins.

(5) *Bottom line.* We don't anticipate a hard landing for earnings because we don't expect an economic recession, which would hammer both revenues and the profit margin. The latter has been under pressure, but we don't expect it to go much lower.

Strategy II: Valuation. Last year's bear market was mostly attributable to a plunge in earnings valuation multiples in response to soaring interest rates and fears that the Fed's aggressive tightening of monetary policy might cause a recession. Let's review what has happened to valuation multiples recently:

(1) *LargeCaps & SMidCaps.* The forward P/E of the S&P 500 fell from 22.5 at the start of 2022 to a low of 15.1 on October 12 (*Fig. 16*). We thought that low would hold, and so far it has done so. The surprise is how quickly the multiple rebounded to 18.2 on Friday of last week.

We aren't as surprised about the dramatic rebound in the forward P/Es of the S&P 400 MidCaps and S&P 600 SmallCaps over the same period from 11.5 to 14.7 and from 10.8 to 14.3. They were awfully cheap on October 12.

(2) *Growth & Value.* Also rebounding dramatically has been the forward P/E of the S&P 500 Value index from 13.2 on October 12 to 17.2 on Friday (*Fig. 17*). The ratio of the forward P/Es of the S&P 500 Growth to the S&P 500 Value indexes fell from a high of 1.88 late in 2021 (just before the bear market) to 1.11 at the beginning of January 2023, the lowest since late 2009 (*Fig. 18*).

Some of the bounce in Value's valuation multiple since late last year was attributable to the annual rebalancing of the Growth and Value indexes. After the close of trading on December 19, Standard & Poor's released its new constituents for its various S&P Growth and Value indexes based on its annual recalculation of the growth and value scores for companies in the indexes. Their scores determined which companies appear in the Growth and Value indexes, which appear in both indexes (in a weighted fashion), and which companies meet the stricter criteria for inclusion in the Pure Growth and Pure Value indexes. Meeting the criteria to appear in both indexes were 135 of the S&P 500 companies, including half of the MegaCap-8 stocks: Alphabet, Amazon, Meta, and

Microsoft.

(3) *MegaCap-8.* The MegaCap-8 collectively still accounts for 21.7% of the S&P 500's market capitalization (*Fig 19*). That's down from a record high of 26.4% during the November 19 week of 2021. Their share of S&P 500 Growth's market cap is down from a high of 50.9% at the end of February 2022 to 41.1%. Some of that drop is attributable to the rebalancing mentioned above.

At the end of last week, the forward P/E of the MegaCap-8 was up 1.4pts w/w to a five-month high of 26.4 (*Fig. 20*). The S&P 500's forward P/E was 17.8 with them and 16.4 without them a week earlier.

(4) *Stay Home vs Go Global.* Global investors have been scrambling to invest more in overseas stock markets than in the US market because the outlook for the global economy has improved, while valuation multiples remain (relatively) cheap outside of the US. Joe and I have recommended doing so through mid-2023, after which we will reassess our position.

In the past, the forward P/E of the All Country World ex-US MSCI closely tracked the forward P/E of the S&P 500 Value index (*Fig. 21*). The spread between the latter and the former has widened since early 2021, especially since the rebalancing last December. On Friday, the forward P/E of S&P 500 Value was 17.2, while that of the rest of the world collectively rose to 12.8 from a low of 10.6 at the end of September last year.

During the last week of January, the forward P/Es of the major MSCI indexes were US (18.1), Japan (12.7), EMU (12.5), Emerging Markets (12.3), and UK (10.3) (*Fig. 22*).

Calendars

US: Tues: Trade Balance -$68.5b; Consumer Credit $24.0b; API Weekly Crude Oil Inventories; EIA Short-Term Energy Outlook; Powell; Barr. **Wed:** Wholesale Sales & Inventories -0.3%/0.1%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; WASDE Report; Williams; Barr; Waller. (Bloomberg estimates)

Global: Tues: Germany Industrial Production -0.6%; Spain Industrial Production; UK Halifax House HPI -0.8%m/m/-0.3%y/y; Japan Leading Index 95.0; Schnabel; Ramsden; Pill; Macklem. **Wed:** France Non-Farm Payrolls 0.2%q/q/; Italy Retail Sales -0.8%; UK RICS House Price Balance -45%; Australia Building Approvals; Elderson; Balz. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for a fourth straight week for all three of these indexes as analysts' revision activity remains elevated following the release of Q4 results. Through the week ending February 2, LargeCap's forward earnings dropped to a 53-week low and is down in 13 of the past 18 weeks. MidCap's fell to a 49-week low and has dropped in 18 of the past 20 weeks. SmallCap's was down to a 65-week low and is down in 16 of the past 18 weeks. For a 32nd straight week, none of these three indexes had forward earnings at a record high. However, forward earnings remains on a modest downtrend for these three indexes compared to their deep declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is 5.5% below its record high at the end of June; MidCap's is 7.7% below its record high in early June; and SmallCap's is 10.3% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings turned negative w/w, falling to a 23-month low of -0.2% y/y; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of 2.2% y/y is at a 24-month low, down from a record high of 78.8% in May 2021, and compares to a record low of -32.7% in May 2020. SmallCap's rate of -2.7% y/y is at a 26-month low, 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 2023 have been heading lower since June. Here are the latest consensus earnings growth rates for 2022, 2023, and 2024: LargeCap (5.4%, 2.3%, and 11.2%), MidCap (15.3, -6.2, 12.0), and SmallCap (5.0, 1.5, 14.7). Blurb (link): Content here.

S&P 500/400/600 Valuation (*link*): Valuations rose w/w through the February 3 week to multi-month highs for these three indexes. LargeCap's forward P/E gained 0.3pt to a nine-month high of 18.2. It's up 3.1pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.5pt to a 10-month high of 14.7. That's up 3.1pts from a 30-month low of 11.1 at the end of September and 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 soared 0.8pt w/w to a 12-month high of 13.5. That's 3.7pts above its 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. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's

P/E relative to LargeCap's has improved from a 23-year low 28% discount last July to a 20% discount, which is its best reading in 20 months. SmallCap's discount has improved from a 21-year low of 32% last April to 22% last week; that's it lowest discount in 18 months. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for an 86th straight week; the current 3% discount is the lowest in five months and an improvement from its 20-year low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. Analysts expect the S&P 500's earnings growth rate to weaken q/q in Q4 to -1.1% y/y from 4.0% in Q3 on a frozen actual basis and to -2.7% from 4.4% on a pro forma basis. Just four sectors are expected to record positive y/y percentage earnings growth in Q1-2023 and Q4-2022, down from five sectors doing so in Q3. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2023 versus their blended Q4-2022 growth rates: Consumer Discretionary (34.1% in Q1-2023 versus -12.1% in Q4-2022), Energy (20.2, 60.3), Industrials (19.8, 40.7), Financials (5.8, -10.7), Consumer Staples (-1.1, -2.8), Real Estate (-5.5, 7.3), Utilities (-8.7, 5.5), Communication Services (-9.7, -27.2), Information Technology (-11.2, -9.5), Health Care (-14.8, -2.7), and Materials (-27.9, -20.1).

S&P 500 Q4 Earnings Season Monitor (*link*): With the Q4-2022 earnings season passing the halfway mark, it's off to a poor start as assessed by the four surprise metrics we measure for both earnings and revenues. Revenue and earnings surprises are deteriorating q/q due to the slowing economy, higher costs, and currency translation. With nearly 51% of S&P 500 companies finished reporting for Q4, revenues are ahead of the consensus forecast by just 0.8%, and earnings have exceeded estimates by only 1.2%. The surprises are tracking to be the weakest since Q4-2008 for earnings and since Q1-2020 for revenues. At the same point during the Q3 season, revenues were 1.3% above forecast and earnings had beaten estimates by 2.9%. For the 254 companies that have reported Q4 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings of Q2-2021 to Q3-2022. The collective y/y revenue gain for the 254 reporters so far has slowed from double-digit percentage gains in the prior seven quarters to 5.2%, and earnings are down 1.8% y/y as higher costs and increased loan-loss provisions continue to pressure profit margins. Just 65% of the Q4 reporters so far has reported a positive revenue surprise, and 69% has beaten earnings forecasts. Those are the weakest readings since the Great Virus Crisis in H1-2020. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q4 (61%) than positive y/y revenue growth (71%). These figures will change markedly as more Q4-2022 results are reported in the coming weeks. While we expect y/y revenue growth rates to remain positive in Q4, earnings are expected to decline for the first time since Q2-2020.

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales, which excludes motor vehicles & motorcycles, fell a larger-than-expected 2.7% during the final month of 2022, the biggest decline since March 2020, following a 1.2% increase from October's 1.5% shortfall. Sales fell 2.8% during the 12 months through December. Spending on *food, drinks & tobacco* fell for the fourth time in five months, sinking 2.9% m/m and 4.7% over the period, while sales of non-food products excluding fuel dropped for the second time in three months by 2.6% in December, following a 2.0% gain and a 1.8% loss the prior two months. Meanwhile, sales of *automotive fuels* rose 2.3% in December and 2.8% the last two months of last year. Over the 12 months through December, only automotive fuels (6.0% y/y) was in the plus column—foods drinks & tobacco (-6.9) and *non-food products ex fuel* (-0.6) were in the red. December data are available for three of the four of the *Eurozone's largest economies*, and show sales in Germany contracted for the second time in three months, down 5.3% m/m and 6.1% over the period, while France saw a three-month slide of 2.4% during the final months of 2022. Spain saw its first decline in retail sales in five months in December, slumping 1.4%, after a four-month gain of 4.8%. Compared to a year ago, sales in Germany contracted 6.6%, while sales Spain rebounded 4.6%; sales in France (-0.5%) were basically flat with a year ago.

Germany Factory Orders (*link*): Orders in December rebounded 3.2%, after declining three of the prior four months by 8.6%, boosted by gains in domestic orders and foreign orders from within the Eurozone. *Domestic orders* jumped 5.7% at the end of 2022, after plunging 7.8% during the five months through November. *Foreign orders* expanded only 1.2% in December after plummeting three of the prior four months, by a total of 11.3%, as *foreign orders from outside* the Eurozone dropped four of the final five months of 2022, by 3.8% in December and 10.9% over the period. Meanwhile, *foreign orders from within* the Eurozone rebounded 9.8% after sinking 11.0% in November and 17.6% during the four months ending November. Total orders fell eight of the 12 months through December by 10.1%. Here's a look at the movements in domestic orders, along with the breakdown from both inside and outside the Eurozone, for the main industry groupings, respectively, versus a year ago: consumer nondurable goods (-25.1%, -4.8%, +15.9%), intermediate goods (+4.0, -10.5, -10.7), consumer durable goods (-8.1, -9.4, -19.3), and capital goods (-20.2, -5.7, -11.9).

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102