MORNING BRIEFING
March 8, 2023

Profit Margin Recession?

Check out the accompanying chart collection.

Executive Summary: Today, we examine S&P 500 companies' revenues, earnings, and profit margins as reported for Q4-2022 and as estimated by industry analysts for 2023. Notably, Q4 revenues grew impressively to a record high, but inflation accounted for much of that. Operating earnings per share fell y/y, and just two S&P 500 sectors saw y/y earnings growth. Profit margins were squeezed by rising labor costs at a time of negative productivity growth. … While Q4 is behind us, its influence isn't: It has caused analysts to chop earnings expectations for all four quarters of this year. Current 2024 estimates may prove too low if they reflect a recession that never arrives.

Earnings I: Season's Greetings. The Q4-2022 earnings season is over. Joe reports that S&P 500 earnings data are out for the quarter. We weren't surprised by the top-line or bottom-line numbers. That's because we follow the weekly data series on forward revenues, forward earnings, and the forward profit margin. They continue to steer us in the right direction for assessing the near-term outlook for the comparable quarterly data (*Fig. 1*). (FYI: Forward revenues and earnings are the time-weighted average of analysts' current and coming years' consensus expectations, while forward profit margins are the imputed margins calculated from forward revenues and earnings.)

Consider the following:

(1) *Revenues.* There was no recession in S&P 500 revenues at the end of last year. The series was up 8.1% y/y to a record high (*Fig. 2* and *Fig. 3*). S&P 500 forward revenues has been stalled at a record high since October, though it managed to edge up to a new record high during the February 2 week.

In aggregate (i.e., not on a per-share basis), S&P 500 revenues rose 6.9% y/y. Again, this isn't surprising since nominal GDP increased 7.4% y/y during Q4 (*Fig. 4* and *Fig. 5*). Over this period, real GDP rose 0.9% y/y, while the GDP deflator increased 6.4%. So inflation has been a major driver of revenues over the past year.

By the way, the 1.2ppt spread between S&P 500 revenues per share and aggregate revenues suggests that buybacks are not significantly boosting revenues per share and

earnings per share. Indeed, the average spread between the two was only 0.1ppt per year on average since 2000 (*Fig. 6*).

(2) *Earnings.* The same goes for S&P 500 operating earnings per share and the comparable aggregate data series (using I/B/E/S data by Refinitiv). The average spread between the two was only 1.0ppt since 1995 (*Fig. 7*).

On a per-share basis, S&P 500 operating earnings fell 1.5% y/y during Q4 (*Fig. 8* and *Fig. 9*). That's the first negative reading since Q3-2020. It's also down 8.1% from the record high during Q2-2022.

(3) *Profit margin.* With Q4 revenues rising to a record high and Q4 earnings down from its record high, the S&P 500 operating profit margin fell to 11.6% last quarter, down from a record high of 13.7% during Q2-2021 (*Fig. 10* and *Fig. 11*). Economic recessions usually are the cause of margin squeezes, but that's not the case this time. This time, the margin has been squeezed by rising labor costs as hourly compensation has risen rapidly, while productivity growth turned negative last year, as we discussed in Monday's *Morning Briefing*.

In the past, companies typically would respond to labor-related margin squeezes by reducing their payrolls. That hasn't been happening this time. Labor shortages have caused employers to hoard labor and post lots of help-wanted signs, even now.

(4) *I/B/E/S vs S&P operating earnings.* 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), so I/B/E/S's earnings series is higher than S&P's earnings series.

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.

During Q4, I/B/E/S's operating EPS actual figure of $53.27 for the S&P 500 was 7.6% higher than S&P's operating EPS of $49.51. That's down from a recent peak difference of 23.6% during Q2-2022, 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

record-high $26.09 difference between S&P's and I/B/E/S's operating EPS actual for all of 2022's quarters. Despite this, the percentage difference between the two remains below past cyclical peaks (*Fig. 12* and *Fig. 13*).

(5) *S&P 500 sectors' revenues.* Six of the S&P 500 sectors had revenues at a record high in Q4-2022: Communication Services, Consumer Discretionary, Financials, Health Care, Industrials, and Information Technology. Revenues rose y/y for all but the Consumer Staples sector, which posted its first decline since Q1-2019. However, the y/y revenue growth rate decelerated q/q for all but the Financials sector.

Here are Q4-2022's y/y revenue growth rates for the S&P 500 and its sectors: Energy (18.7%), Utilities (17.9), Financials (15.9), Industrials (14.5), S&P 500 (8.1), Health Care (7.8), Consumer Discretionary (5.9), Communication Services (3.2), Information Technology (0.9), Materials (0.4), Consumer Staples (-0.3), and Real Estate (-0.5) (*Fig. 14*).

(6) *S&P 500 sectors' earnings.* With respect to earnings, just two of the 11 sectors posted a y/y gain in earnings in Q4-2022, using I/B/E/S's data. That's down from five sectors doing so during Q3-2022 and is a marked turnaround from Q4-2021, when earnings rose y/y for all but Utilities.

These are the y/y operating earnings growth rates during Q4-2022 for the S&P 500 and its sectors, according to I/B/E/S and S&P: Energy (56.7% according to I/B/E/S, 49.8% according to S&P), Industrials (41.3, 40.2), Real Estate (-1.9, -30.0), Consumer Staples (-0.5, 5.6), S&P 500 (-1.5, -12.7), Utilities (-1.6, 10.5), Health Care (-3.3, -0.8), Information Technology (-8.3, -14.2), Financials (-12.5, -36.7), Materials (-17.2, -28.2), Consumer Discretionary (-18.6, -28.6), and Communication Services (-27.2, -31.3) (*Fig. 15*).

(7) *S&P 500 sectors' profit margins.* Using the operating EPS from I/B/E/S, the quarterly profit margin improved q/q for three sectors: Consumer Staples, Industrials, and Information Technology. Among the remaining eight sectors with a weaker profit margin in Q4, only Consumer Discretionary managed to maintain a relatively high margin during the quarter, as most fell to their lowest levels in two years. The biggest laggards, Health Care and Utilities, saw their profit margins tumble to nine-year lows.

Here's how the profit margin ranked for the sectors during Q4-2022: Real Estate (26.7%), Information Technology (24.3), Energy (12.8), Financials (12.7), Communication Services (12.1), S&P 500 (11.6), Materials (10.5), Industrials (9.7), Health Care (9.5), Utilities (7.9), Consumer Staples (7.3), and Consumer Discretionary (5.9) (*Fig. 16*).

(8) *Write-offs.* Write-offs tend to accelerate during the last quarter of the year as companies clear the deck of their past misguided business decisions. This is reflected in the reported EPS released by S&P, and the latest quarter was no different. S&P's reported EPS of $172.24 for all of 2022 was 11.9% below its reported operating EPS of $196.09. While the write-off percentage is rising, for now it remains below the level during the Great Virus Crisis' cyclical peak of 20% in 2020 and the 84% record during the Great Financial Crisis in 2008-09 (*Fig. 17*).

Earnings II: Looking Forward. The stock market looks forward, not backward. Joe and I reckon that investors discount the outlook for earnings over the coming 12 months. That implies that the Q4-2022 earnings results are largely irrelevant. In fact, they are very relevant to the extent that the reported results influence analysts' expectations for earnings over the coming four quarters and the valuation multiples that investors are willing to pay for those earnings. Let's review the latest relevant data:

(1) *2022.* The Q4-2022 earnings results turned out to be about what analysts expected at the start of the earning season (*Fig. 18*). That's actually bad news, since there is almost always an upside "earnings hook" in the charted data as quarterly results come out better than was expected. The exceptions to this trend tend to occur during recessions. So far, the widely expected recession is a no-show.

(2) *2023.* Apparently, the actual Q4-2022 results and the guidance about 2023 provided during managements' recent conference calls were bad enough to cause analysts to cut their earnings estimates for the four quarters of this year (*Fig. 19*).

(3) *Forward earnings.* As a result, 2023 earnings per share is now expected to be up just 1.3% to $222 from $219 during 2022 (*Fig. 20*). However, 2024's earnings are expected to grow 12.0% to $248.

Forward earnings was $226 per share during the March 3 week. That's down 5.7% from its record high during the June 23 week of last year.

Keep in mind that forward earnings will converge to the 2024 consensus forecast at the end of this year, which may continue to fall over the rest of this year but should remain above the current reading of forward earnings. At the end of this year, the stock market will be discounting next year's consensus expectations.

We are thinking that there may not be much more downside to the 2024 estimate if it has

already discounted a recession that continues to be a no-show.

Calendars

US: Wed: ADP Employment 200k; Job Openings 10.5m; Trade Balance -$68.9b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; WASDE Report; Powell. **Thurs:** Initial & Continuous Jobless Claims 195k/1.675m; Natural Gas Storage; Barr. (Bloomberg estimates)

Global: Wed: Eurozone GDP 0.1%q/q/1.9%y/y; Eurozone Employment Change 0.1%q/q/1.5%y/y; Germany Industrial Production 1.5%m/m/-1.8%y/y; Italy Retail Sales 2.0%; UK RICS House Price Balance -49%; Canada Trade Balance 0$0.06b; BOC Rate Statement 4.50%; Japan GDP 0.2%q/q/0.8%y/y; China CPI 0.7%m/m/2.2%y/y; China PPI -0.5% y/y; Japan Leading & Coincident Indicators; Lagarde; Panetta; Dhingra. **Thurs:** France Nonfarm Payrolls 0.0%q/q/; Japan Household Spending 1.4%; Japan PPI -0.3%m/m/8.4%y/y; Japan Machine Tool Orders; BOJ Monetary Policy StatementRogers. (Bloomberg estimates)

Global Economic Indicators

Germany Factory Orders (*link*): Orders in January climbed for the second month since slumping to a 28-month low last November. *Manufacturing orders* climbed 1.0% in January, building on December's 3.4% surge, after declining three of the prior four months by 8.6%. *Foreign orders* expanded 5.5% in January and 7.6% over the two months through January, after plummeting three of the prior four months, by a total of 11.3%, to its lowest level since July 2020. *Foreign orders from outside* the Eurozone soared 11.2% in January after sliding four of the final five months of 2022 by 10.2%. Meanwhile, *foreign orders from within* the Eurozone sank 2.9% in January after a 10.7% gain and an 11.0% loss the prior two months. *Domestic orders* plunged 5.3% in January, reversing December's 5.3% gain; these orders had dropped 7.8% during the five months through November. *Versus a year ago*, total orders are down 10.9%, with domestic and foreign orders down 9.1% and 12.0%, respectively. Within foreign orders, billings were down 8.1% within the Eurozone and 14.2% outside the Eurozone. 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 (-19.5%, -1.7%, +3.7%),

intermediate goods (-10.3, -16.0, -9.3), consumer durable goods (-8.5, -15.5, -28.1), and capital goods (-6.7, -2.4, -16.8).

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