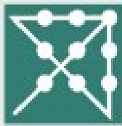
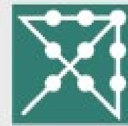
 **Yardeni Research** 

MORNING BRIEFING
March 22, 2023

Looking Ahead To Earnings Season

Check out the accompanying chart collection.

Executive Summary: Industry analysts and company managements have an optimism bias that blinds them to encroaching recessions. So when a recession looms, forward earnings' reliability as an indicator of actual earnings to come falters. … While analysts have been cutting their 2023 and 2024 earnings estimates for S&P 500 companies since last summer, their expectations for next year are still higher than for this year. As long as that remains the case, forward earnings, which have been declining since last summer, soon should stop falling and start moving higher unless a recession happens. … And: S&P 500 earnings growth ex Energy sector could turn positive in Q2 as Energy de-energizes.

Strategy I: Looking Ahead vs Looking Forward. Joe and I were going to title this *Morning Briefing* "Looking Forward To Earnings Season." But that would imply that we are expecting lots of positive surprises. In our lexicon, the word "forward" often refers to our focus on analysts' consensus expectations for S&P 500 operating earnings per share over the next 12 months (or 52 weeks), calculated as the time-weighted average of their latest earnings forecasts for the current and coming years. More often than not, forward earnings suggests an upbeat story since it is driven by the upward trend in economic activity (Fig. 1 and Fig. 2).

Indeed, forward earnings tends to be a good leading indicator of actual earnings when the economy is expanding (Fig. 3 and Fig. 4). However, industry analysts collectively never see recessions coming; then when a recession arrives, they must scramble to lower their earnings estimates. That's because they have an optimistic bias about the companies they follow. In addition, their expectations are heavily influenced by the guidance they receive from company managements, who also tend to have a positive bias.

The inherent optimism of industry analysts can be seen in our Earnings Squiggles, which track their annual earnings expectations on a monthly and weekly basis (Fig. 5 and Fig. 6). More often than not, analysts tend to be too optimistic during economic expansions; then their forecasts have to be lowered as the actual results come into view. Nevertheless, in this case, S&P 500 forward earnings may continue to rise as long as analysts' consensus estimate for the coming year continues to exceed the one for the current year.

Strategy II: Pre-Season's Greetings. Industry analysts have been lowering their earnings estimates for 2023 and 2024 since mid-2022. Their estimate for 2024 has exceeded their estimate for 2023 even as both were declining (*Fig. 7*). Forward earnings peaked at a record-high $239.93 last year during the week of June 23. It has been falling since then but stabilized recently at $227.30 during the March 16 week. The latest estimates for 2023 and 2024 are $221.63 and $248.43. There's plenty of room for forward earnings to converge with a higher 2024 estimate by year-end, even if that estimate is shaved some more, as long as forward earnings doesn't take a recession-induced dive. Here's more:

(1) *Q1-2023.* The analysts' consensus expectations for Q1-2023 was $50.84 during the March 16 week (*Fig. 8*). That's down 7.3% y/y (*Fig. 9*). It's also down 5.9% since the start of this year, mostly because managements guided down their expectations for Q1-2023.

Q2's earnings are currently expected to be down 5.8% y/y, then up 2.2% in Q3 and 10.4% in Q4 based on I/B/E/S data by Refinitiv through the March 16 week.

(2) *NERI.* The analysts' net earnings revisions index (NERI) for the S&P 500 has been in negative territory since July of last year through March of this year (*Fig. 10*). Negative readings tend to occur during recessions. They also occur during mid-cycle slowdowns like those in the mid-1990s and from 2014-16.

The NERI for the S&P 500 Financials sector has also been negative since July last year. As a result of the banking crisis, it is likely to go deeper into negative territory for the next few months (*Fig. 11*).

The recent drop in oil and gas prices is also likely to weigh on the results of S&P 500 Energy. The sector's NERI turned negative during December (*Fig. 12*). It is likely to remain negative in coming months if the prices of oil and natural gas remain depressed.

(3) *Financials.* The results and guidance of the S&P 1500 Financials sector are likely to be depressed by increasing provisions for loan losses. The banks will want to show their regulators that they have enough set aside in reserves to cover losses if the banking crisis worsens. Melissa and I have been monitoring the weekly data on such allowances (*Fig. 13*). It's been rising slowly since late 2022 through the latest data for the March 8 week, just before SVB hit the fan. We expect it will jump in coming weeks.

(4) *Profit margins.* While S&P 500 forward earnings has been falling since last summer, forward revenues has been rising to new record highs through the March 16 week (*Fig. 14*).

Both are excellent weekly indicators of their comparable quarterly series for actual revenues and earnings (*Fig. 15*). They imply that the S&P 500's forward profit margin might have continued to narrow during Q1-2023. It peaked at a record 13.4% during the week of June 9, 2022, falling to 12.3% during the March 16 week. Labor costs have been squeezing margins, causing some companies to pare their payrolls.

(5) *Sectors.* I asked Joe to calculate the latest (as of March 21) analysts' consensus expectations for the y/y growth rates of Q1-2023 revenues and earnings for the S&P 500 and its 11 sectors (*Table 1*). Here are the results: S&P 500 (1.6%, -4.6%), Communication Services (-2.5, -13.5), Consumer Discretionary (5.9, 29.2), Consumer Staples (3.4, -4.1), Energy (-4.7, 15.9), Financials (9.4, 5.9), Health Care (1.0, -18.7), Industrials (5.6, 42.3), Information Technology (-3.5, -11.1), Materials (-8.5, -33.7), Real Estate (4.7, -8.0), and Utilities (1.9, -9.1).

Strategy III: De-Energizing Earnings. The Covid-19 pandemic and its resulting economic shutdown caused profits to quickly reverse to losses beginning in 2020 for a few select S&P 500 industries such as Hotels and Casinos. But the entire S&P 500 Energy sector was hit by the closure. The sector suffered heavy losses during Q2-2020 due to the shutdown and during H2-2020 due to the slow reopening of the economy. The cratering of oil demand forced energy companies that were unable to shut off their drilling and pipeline taps to store crude in anchored tankers, repurposed as floating oil-storage facilities.

Following the reopening of the global economy, the slimmed-down and more-productive S&P 500 Energy sector benefitted from oil prices that were higher than before the pandemic. Their results contributed to the S&P 500's y/y revenue and earnings growth in a big way from Q2-2021 to Q4-2022.

Now this seven-quarter tailwind that had been boosting the S&P 500's y/y revenue and earnings growth rates is about to become a headwind. The Energy sector's positive contribution to the S&P 500's revenue growth is expected to end in Q1-2023, and the sector should be a drag on the index's revenue growth for the rest of the year (*Table 2*). On the earnings front, Energy's positive contribution to the S&P 500's y/y earnings growth is expected to linger for another quarter before the sector's impact turns negative beginning in Q2-2023.

The overall S&P 500's y/y earnings growth rate had turned negative in Q4-2022 for the first time in two years but had already been negative on an ex-Energy basis for two quarters beginning in Q2-2022. Based on analysts' current forecasts, the S&P 500's ex-Energy

earnings growth rate is expected to be negative again for a fourth straight quarter in Q1-2023, before turning slightly positive in Q2.

Analysts' estimate revisions for the Energy sector have turned decidedly negative in recent months. In the March data released on Tuesday, Energy's NRRI (Net Revenues Revision Index) was negative for a third straight month, and its NERI (Net Earnings Revisions Index) was negative for a fourth month. Both readings deteriorated sharply m/m to 33-month lows, and Energy's NRRI and NERI were the lowest of all 11 S&P 500 sectors' readings. (See our "*Stock Market Indicators: Net Revenue & Earnings Revisions By Sectors*.")

As for the broad S&P 500 index, its NERI reading of -7.3% in March was steady m/m and up from December's 30-month low of -15.6%.

The recent drop in energy prices suggests more downward-revision pain ahead for the S&P 500 Energy sector. But this bad news for Energy is good news for other sectors, particularly their profit margins. Sectors and industries that were hammered by high fuel and transportation costs after the pandemic ended will benefit from lower energy prices.

The S&P 500's forward profit margin peaked at a record-high 13.4% during the June 9, 2022 week, when Energy's was at a then-record-high 11.8% (*Fig. 16*). Energy's forward profit margin continued rising for another six months before peaking at a record-high 12.8% during the November 24, 2022 week, when it briefly exceeded the S&P 500's forward profit margin for three weeks and for the first time since March 2009.

Both since have fallen from record highs during 2022 to new post-pandemic lows through the March 16 week. The S&P 500's forward profit margin is now down 1.1ppts to 12.3%, and Energy's has slipped 1.0ppt to 11.8%. Energy's forward profit margin is now below the S&P 500's again, where it has lingered for much of the past 20 years.

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Interest Rate Decision 4.75%-5.00%. **Thurs:** Initial & Continuous Jobless Claims 197k/1.684m; New Home Sales 650k; Kansas City Manufacturing Index; Chicago Fed National Activity; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: UK Headline & Core CPI 0.6%m/m/9/9%y/y & 0.8%m/m/5.7%y/y; UK PPI

Input & Output 0.2%m/m/12.0%y/y & 0.2%m/m/12.4%y/y; UK CBI Industrial Trends Orders -15; Lagarde; Panetta; Mauderer; Balz; Nagel; Lane. **Thurs:** Eurozone Consumer Confidence -18.3; UK Gfk Consumer Confidence -36; Japan Core CPI 3.1% y/y; Japan M-PMI 48.2; BOE Interest Rate Decision 4.25%; BOE Inflation Letter; EU Leader Summit; Balz; Wuermeling; Mann. (Bloomberg estimates)

US Economic Indicators

Existing Home Sales (*link*): Existing home sales in February rose for the first time in 13 months, soaring 14.5% to 4.58mu (saar)—the largest monthly gain since July 2020—following a 12-month plunge of 36.9%, from 6.34mu last January to 4.00mu this January. "Conscious of changing mortgage rates, home buyers are taking advantage of any rate declines," noted Lawrence Yun, NAR's chief economist. "Moreover, we're seeing stronger sales gains in areas where home prices are decreasing and the local economies are adding jobs." *Single-family* sales skyrocketed 15.3% to 4.14mu (saar) last month after a 12-month slide of 36.1% to 3.59mu in January, which was the lowest level since November 2010. *Multi-family* sales jumped 7.3% in February to 440,000 units (saar), following no change in January, after plummeting 10 of the prior 11 months by 43.1% to 410,000 units. *Regionally*, sales in February rose in all four regions—three by double digits on a m/m basis but all below year-ago levels. Here's a tally: West (+19.4% m/m & -28.3% y/y), South (+15.9 & -21.3), Midwest (+13.5 & -18.7), and the Northeast (+4.0 & -25.7). The *median existing home price* fell 0.2% y/y to $363,000 in February, ending a streak of 131 consecutive months of year-over-year gains—the longest on record, as prices climbed in the Midwest (5.0% y/y) and South (2.7) and fell in the Northeast (-4.5) and West (-5.6). Total *housing inventory* at the end of February was 980,000 units, unchanged from January but up 15.3% y/y from last February's 850,000 units—with unsold inventory at 2.6 *months' supply* at the current sales rate, down from January's 2.9 but up from last February's 1.7 months. "Inventory levels are at historical lows," noted Yun. "Consequently, multiple offers are returning on a goods number of properties."

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