MORNING BRIEFING
March 29, 2023

Churning Earnings

Check out the accompanying chart collection.

Executive Summary: The SVB debacle has depressed the S&P 500 Financials sector's market-cap share further below its earnings share. And the S&P 500 Bank Composite hasn't ever been this cheap relative to the S&P 500 (i.e., since the mid-1980s start of the data). We liked the Financials sector before SVB imploded and like it even more since, as the fallout we expect doesn't include systemic contagion and does include more M&A activity. … Also: While analysts have been cutting their 2023 earnings estimates for S&P 500 companies, the index's forward earnings increasingly reflects the higher 2024 estimates and has stopped falling. ... Also: Joe discusses some impacts of Standard & Poor's sector and industry reclassifications.

Strategy I: Hanging in There with Financials. Joe and I liked the S&P 500 Financials sector before Silicon Valley Bank (SVB) hit the fan. We like it even more now that the stocks are cheaper as a result of the SVB debacle. That's mostly because our economic outlook hasn't changed. We don't expect more bank runs, a credit crunch, and a recession. We believe that the rapid response by the Fed and the FDIC should avert any contagion. We do expect that banks will have to raise their deposit rates to avert disintermediation. That undoubtedly will squeeze the profit margins of many banks, especially the small community and regional banks. The result is likely to be lots of M&A activity aimed at cutting costs through consolidation. That would also benefit the S&P 500 Investment Banking & Brokerage industry.

Here are a few related developments to think about:

(1) *Regional banks.* Yesterday, Joe and I observed that industry analysts scrambled to cut their revenues and earnings estimates for the regional banks following the implosion of SVB on March 10. Investors responded accordingly, as the S&P 500 Regional Banks stock price index plunged 24.7% from March 9 through March 27 (*Fig. 1*). Industry analysts slashed their 2022 and 2023 earnings forecasts for the S&P 500 Regional Banks by 6.3% and 7.0% during the March 16 week. Investors lowered the industry's forward P/E from 8.3 on March 9 to 6.6 on Monday (*Fig. 2*).

(2) *Diversified banks.* The carnage was less intense for the S&P 500 Diversified Banks stock price index. It fell 5.6% from March 9 through Monday's close (*Fig. 3*). Analysts'

consensus earnings-per-share expectations for this industry actually rose 0.2% and 0.2% for 2023 and 2024 during the March 16 week. The industry's P/E has fallen less than the Regional Banks', from 9.1 to 8.5 (*Fig. 4*).

During the week ended March 15, deposits at large domestically chartered banks rose $67 billion. Deposits fell $120 billion at small domestically chartered banks and $45 billion at the US branches of foreign banks. The net outflow from all these banks was $98 billion during the March 15 week.

(3) *Money market mutual funds.* Benefitting from the deposit outflows were money market mutual funds (MMMF) that had net inflows of $238 billion over the two weeks through March 22 (*Fig. 5*). Over this period, institutional and retail MMMFs attracted $203 billion and $35 billion, respectively (*Fig. 6*).

(4) *Financials.* Industry analysts who cover companies in the S&P 500 Financials sector collectively reduced their earnings estimates for 2023 and 2024 by only 0.8% and 0.7% during the March 16 week (*Fig. 7*). From March 9 through March 27, the S&P 500 Financials stock price index fell 5.9% (*Fig. 8*). The sector's forward P/E dropped from 11.9 to 11.3 (*Fig. 9*).

The S&P 500 Financials sector's market-cap share (i.e., its share of the S&P 500's total market capitalization) was down to a relatively low 10.5% on March 16 versus the sector's earnings share of 16.1% (*Fig. 10*). The sector outperformed the S&P 500 during 2020's stock market rally and since then was a market performer, until it dropped in response to the SVB debacle (*Fig. 11*). The S&P 500 Bank Composite hasn't been this cheap relative to the S&P 500 since the start of the data in the mid-1980s (*Fig. 12*). S&P 500 Life & Health Insurance is also relatively cheap on this basis (*Fig. 13*).

Strategy II: Industry Analysts Awaiting Earnings Season. As the Q1 earnings reporting season in April and May approaches, industry analysts are still paring their estimates for the four quarters of 2023 (*Fig. 14*). They now expect to see a 7.4% y/y decline during Q1 followed by -5.8% in Q2, 2.1% in Q3, and 10.5% in Q4 (*Fig. 15*).

Nevertheless, S&P 500 earnings per share is still expected to be up 1.5% y/y for 2023 to $221.40 and 12.0% in 2024 to $248.03 (*Fig. 16*). As time passes, forward earnings—the time-weighted average of analysts' consensus operating earnings-per-share expectations for 2023 and 2024—is giving more and more weight to the 2024 estimate. As a result, it has stopped falling over the past three weeks through the March 23 week. It is currently

$227.55. At year-end, it will equal whatever the 2024 estimate will be at that time.

We believe that the upcoming earnings season will be especially important during the second and third weeks of April, when most of the big banks report their results. Their profits are likely to be depressed by increases in their provisions for loan losses. Given the recent banking crisis, even if bank managements aren't that concerned about loan losses, they might still want to show the banking regulators that they are being prudent. Then again, the Fed's weekly H.8 report on the assets and liabilities of commercial banks is still showing modest increases in their allowances for bad loans. They might prefer to downplay the impact of the banking crisis on their profitability to calm the nerves of their investors, or at least not to overdramatize it.

During the March 16 week, S&P 500 forward revenues rose to another record high (*Fig. 17*). The forward profit margin dropped to 12.3%, down from a record high of 13.4% during the June 9 week of 2022.

Accounting: S&P Changes GICS Classifications. On March 17, following the close of trading, Standard & Poor's and MSCI changed their GICS sector and industry classification schema. Such changes typically impact S&P 500 sectors' valuation, profit margin, and market-cap metrics. These were no different.

Two of the S&P 500's three largest-market-cap sectors—Financials and Information Technology—saw major impacts: Financials' size, valuation, and profit margin were boosted the most of any sector; those metrics mostly shrank for Information Technology. Also affected, albeit not by much, were the Consumer Discretionary, Consumer Staples, and Industrials sectors.

Here's a closer look:

(1) *Impact on market-cap share.* Financials' market cap soared by 25.9% due to the creation of a new sub-industry, Transaction Processing & Payment Services, in the sector. Overnight, the sector's market-cap weighting in the S&P 500 rose to 12.9% from 10.3%.

On the flip side, Information Technology's market cap fell by 10.9%, primarily due to the removal of the Data Processing & Outsourced Services sub-industry. Information Technology is still the S&P 500's largest sector even though the changes chopped its market-cap share to 25.9% from 29.0%.

Additionally, Consumer Staples' and Industrials' capitalizations rose by 6.5% and 4.7%, respectively, while Consumer Discretionary's dropped 4.5%. But these three sectors' combined market-cap shares rose by just 0.5ppt to 27.9%.

(2) *Processing the biggest change.* Information Technology's Data Processing & Outsourced Services sub-industry was transferred to the Industrials sector, but with only one of its prior 11 constituent companies. Of the remaining 10 companies, two were added to Industrials' Human Resource & Employment Services sub-industry and eight were moved to the newly created Transaction Processing & Payment Services industry housed in Financials—eight extremely profitable companies, by the way. Among the 11 firms moving out of Tech were two of the S&P 500's top 16 companies by market cap, Visa and Mastercard.

A recent *note* by Refinitiv's Tajinder Dhillon highlights how the GICS changes affect the profit margin and valuation metrics of Financials and Information Technology. Financials' forward P/E rises from 11.7 to 12.7 with the addition of the Transaction Processing & Payment Services sub-industry, which trades at a forward P/E of 21.1. But Financials' forward profit margin is most affected, rising, by Refinitiv's calculation, to 18.9% from 17.8%. That means Financials remains the S&P 500's second-most profitable sector. The changes take the forward margin of the most profitable sector, Information Technology, down to 21.8% from 22.6%. Its forward P/E rises, though, from 24.1 to 24.9.

(3) *What's in Financials' wallet?* The addition of Visa and Mastercard, the 10th and 16th biggest S&P 500 companies by market capitalization, account for 90% of the Financials sector's market-cap increase. On a float-adjusted basis, Visa steals Financial's top market-cap-share spot from Berkshire Hathaway, and Mastercard slides into the fourth spot behind JPMorgan Chase. According to Refinitiv, Visa and Mastercard have forward profit margins of 54.6% and 46.6%, well ahead of JPMorgan Chase's 27.1%.

(4) *What's in a name?* Most of the dozen-plus sub-industry name changes are minor and don't involve changes to constituent companies. However, a few of the renamed sub-industries bear little resemblance to their forebears. In Industrials, for example, Trucking was renamed "Cargo Ground Transportation." In Consumer Discretionary, Internet & Direct Marketing Retail (home to Amazon) became "Broadline Retail."

Consumer Staples' Hypermarkets & Super Centers industry is now "Consumer Staples Merchandise Retail." The renamed sub-industry—which had contained only Costco and Walmart—now houses three transferees from Consumer Discretionary's discontinued

General Merchandise Store's sub-industry: Dollar General, Dollar Tree, and Target.

(5) *A little history.* The impacts of this round of GICS changes pale in comparison to the upheavals of the 2016 and 2018 reshufflings.

In September 2016, Real Estate was carved out of Financials and elevated to sector status, which dropped Financials' market-cap share of the S&P 500 from 16% to 13%. The September 2018 round shifted sector weightings even more substantially. The stodgy Telecommunications sector, with just a 2% market-cap share, was reinvented as "Communication Services" with new players moved from Tech and Consumer Discretionary (including the entire Media & Entertainment industry). Overnight, the sector's market-cap share jettisoned back up to the 10% of its heyday a decade earlier.

Calendars

US: Wed: MBA Mortgage Applications; Pending Home Sales -3.0%; Crude Oil Inventories & Gasoline Production; Barr. **Thurs:** Real GDP & GDP Price Deflator 2.9% /3.5%; Core PCED 4.3%q/q; Corporate Profits; Initial & Continuous Jobless Claims 196k1.697m; Natural Gas Storage; Yellen; Barkin. (Bloomberg estimates)

Global: Wed: Germany Gfk Consumer Climate Index -29.0; France Consumer Confidence 81.0; Italy Unemployment Rate 7.8%; BOE FPC Meeting Minutes; European Central Bank Non-Monetary Policy Meeting; Mauderer; Mann; Schnabel; Balz; Gravelle. **Thurs:** Eurozone Economic Sentiment Indicator 99.8; Eurozone Consumer Confidence -19.2; Germany CPI 0.7%m/m/7.3%y/y; Italy PPI; Italy Unemployment Rate 8.0%; Spain CPI 0.7%m/m/3.8%y/y; Japan Unemployment Rate 2.4%; Japan Industrial Production 2.7%; ECB Economic Bulletin; Japan Retail Sales 5.8%y/y; China M-PMI & NM-PMI 50.5/54.2. (Bloomberg estimates)

US Economic Indicators

Consumer Confidence (*link*): Overall consumer confidence improved a bit this month, on an untick in expectations, though remains below the average level of 104.5 recorded in 2022. Consumer confidence edged up to 104.2 this month after falling the first two months of the year by 5.6 points, to 103.4 in February from December's 11-month high of 109.0.

The *expectations* component climbed 2.6 points to 73.0 in March after a two-month plunge of 13.0 points—from 83.4 in December to a seven-month low of 70.4 in February. It averaged 73.1 this quarter, down from 79.3 last quarter and 82.1 a year ago. Meanwhile, the *present situation* component dipped 1.9 points this month to 151.1, after soaring 14.7 points during the three months through February—to 153.0 from 138.3 in November. This measure averaged 151.7 during Q1, the strongest quarter since Q1-2020, and above last year's average of 145.7. *Current business conditions* deteriorated in March, with the percentage saying conditions were bad rising to 19.3% this month from 17.4% last month, while the percentage of consumers saying business conditions were good dipping slightly from 18.4% to 18.0% during the month. The *current labor market* also was slightly less favorable, with 49.1% of consumers saying jobs are plentiful, down from 51.2% in February, and 10.3% saying jobs are hard to get, on par with February's 10.5%. *Short-term business conditions* (six-month outlook) were slightly less pessimistic in March: 15.5% expected business conditions to improve, up from 14.6% in February, while the percentage expecting conditions to worsen fell from 21.6% last month to 18.5% this month—the lowest since September 2021. Consumers' assessment of the *short-term labor market* was slightly more positive, with the percentage of consumers expecting more jobs to be available six months from now moving up from 14.5% to 15.0% and 19.9% anticipating fewer jobs, down from 21.2% last month and 21.4% in January. Their *short-term financial prospects* were less upbeat this month, with 14.9% of consumers expecting their incomes to increase, up from 14.4% last month, and 13.6% expecting incomes to decrease, up from 11.6% in February.

Regional M-PMIs (*link*): Five Fed districts (New York, Philadelphia, Kansas City, Dallas, and Richmond) have reported on *manufacturing activity* for March; they show growth declined for the eighth successive month—and at a similar pace to February—deteriorating slightly to -13.7 from -11.9, posting its weakest reading since May 2020. Activity in the New York (to –24.6 from -5.8) region contracted at quadruple January's pace, while declines in the Philadelphia (-23.2 from -24.3) and Dallas (-15.7 from -13.5) regions were a close match to their February declines. Meanwhile, activity in the Richmond (-5.0 from -16.0) region declined at one-third February's pace, while manufacturing in the Kansas City area was at zero for the second successive month. *New orders* (-17.6 from -12.9) contracted for the 10th month, exceeding February's pace, with billings in the New York (-21.7 from -7.8), Philadelphia (-28.2 from -13.6), and Kansas City (-13.0 from -6.0) regions all contracting at a faster pace, while Dallas' (-14.2 from -13.2) virtually matched its February rate and Richmond's (-11.0 from -24.0) fell at half last month's rate. *Employment* (0.6 from 0.3) was flat in March, as hirings in the Philadelphia (-10.3 from 5.1) region swung from positive to negative and those in Dallas (10.4 from -1.0) from negative to positive. Meanwhile, New York (-10.1 from -6.6) factories cut jobs at a faster rate and those in Kansas City (18.0 from

11.0) hired at a faster pace. Richmond's (-5.0 from -7.0) factories cut jobs at a fairly steady pace.

Regional Prices Paid & Received Measures (*link*): We now have March's prices-paid and -received data for the five Fed regions—New York, Philadelphia, Richmond, Dallas, and Kansas City. (Note: The New York, Philadelphia, Dallas, and Kansas City measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.) The *prices-paid* measure in March continued to bounce around recent lows, easing a bit to 35.6 this month after accelerating a bit in February from a 26-month low of 35.4 from 40.3; it peaked at a record high of 90.2 during September 2021. Both the New York (41.9 from 45.0) and Dallas (20.3 from 25.1) regions saw price pressures ease a bit in March after tightening slightly in February, while Philadelphia's (23.5 from 26.5) slowed to a 31-month low this month. New York's gauge was at a record high of 86.4 during April 2022, while Dallas (84.1) and Philadelphia (83.6) both posted record highs in November 2021. Meanwhile, Kansas City's (30.0 from 26.0) measure accelerated this month, though remained considerably below its record high of 84.0 recorded during May and October of 2021, while Richmond's (to 62.4 from 79.0) slowed to a two-year low; it peaked at 150.1 last May. Turning to the *prices-received* measure, it eased for the fourth month, from 39.0 in November to a 27-month low of 21.3 in March; it was at a record high of 59.0 last March. Prices-received indexes were mixed: New York's prices-received measure eased to 22.9 in March after climbing from a two-year low of 18.8 in January to 28.4 in February; it was at a record high of 56.1 in March 2022. The Philadelphia measure moved down for the second month to 7.9 in March from 29.9 at the start of this year; it was at a record high of 65.8 in November 2021. Kansas City's eased to 13.0—the lowest since the end of 2020—it was at a record-high 60.0 in August 2021, while prices received in the Dallas (7.0 from 15.8) region rose at roughly half February's pace; it was at a record-high 51.3 during October 2021. Richmond's was little changed at 55.9 this month, down from its record high of 103.1 last June.

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