MORNING BRIEFING
May 23, 2023

Looking Forward To Better Earnings

Check out the accompanying chart collection.

Executive Summary: Our analysis of forward earnings—a good indicator for actual earnings over the next four quarters—suggests an April bottom. That jibes with our mid-cycle-slowdown thesis. … Many who expect a recession instead have been misled by the LEI's recession signaling. The LEI overrepresents the weak goods side of the economy and underrepresents the strong services side that's been keeping the economy afloat. … We think the forward profit margin, like forward earnings, has bottomed; margins have been improving for all but three S&P 500 sectors. … And: Still no credit crunch from the banking crisis. … Also: An update on bond market indicators.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Strategy I: Discounting the Future. The stock market discounts earnings over the next 52 weeks. How do we know this? Most industry analysts provide earnings estimates for the current year and the coming year. They might provide earnings estimates or earnings growth forecasts beyond that period, but investors aren't likely to have as much confidence in earnings forecasts beyond the next 52 weeks.

Of course, industry analysts don't forecast earnings on a 52-week-ahead basis. They forecast quarterly and total-year earnings for the current year and the coming year. However, forward earnings, which is the 52-week time-weighted average of the analysts' consensus estimates for the current and coming year (updated weekly), is actually a very good leading indicator of actual earnings over the coming four quarters (*Fig. 1* and *Fig. 2*).

Joe and I have the data for forward earnings monthly from September 1978 and the weekly data from March 1994. The monthly series divided by the CPI is a good leading indicator of the business cycle during economic expansions. Real forward earnings is a good coincident indicator of the business cycle during recessions (*Fig. 3*). It is highly correlated with both the Index of Leading Economic Indicators (especially during good times) and the Index of Coincident Economic Indicators (especially during bad times) (*Fig. 4* and *Fig. 5*).

Industry analysts tend to be optimistic about their companies during economic expansions. Collectively, they don't see recessions coming. When their companies confirm that a

recession is underway, the analysts scramble to cut their earnings estimates.

Real forward earnings peaked at a record high during May 2022, falling 8.0% through April, which was the first month the series rose since the peak. It is still 17.5% above its pre-pandemic record high. Might April have been the bottom for real forward earnings? Joe and I think so because the weekly series for nominal forward earnings bottomed during the February 9 week and is up 1.8% since then through the May 18 week (*Fig. 6*). The weekly series for forward earnings (currently at $229.94 per share) is converging toward the analysts' consensus earnings estimate for 2024 (currently $245.73), as always happens as a year progresses. Analysts' consensus estimate for 2024 has been falling, but it remains well above their consensus for 2023 ($220.07). (We expect to be updating our earnings forecast in the next few days after the Q1-2023 results are compiled by Standard & Poor's for the S&P 500.)

Real S&P 500 forward earnings was down 7.5% y/y through April (*Fig. 7*). We acknowledge that this sort of reading is consistent with early recession readings in the past. Nevertheless, if nominal and real forward earnings are bottoming now, that would be more consistent with our forecast of a mid-cycle slowdown, like the ones that occurred during the mid-1980s, mid-1990s, and from 2014-16.

In yesterday's *Morning Briefing*, we observed that the Index of Leading Economic Indicators (LEI), which has been falling since February 2023, is biased toward the performance of the goods side of the economy. The 10 components don't reflect the increasing importance of services. They tend to focus on the most cyclical sectors of the economy, particularly manufacturing and housing. Services in real GDP have tended to be less cyclical than goods in the past—with the notable exception of during the pandemic, of course.

Similarly, although S&P 500 forward earnings certainly gives plenty of weight to services, services providing companies in the index tend to be less cyclical than goods-producing ones. The usual relative stability of services earnings explains why the y/y growth rate of forward earnings closely tracks the goods-focused ISM manufacturing purchasing managers index (*Fig. 8*).

The same can be said about the S&P 500 forward earnings' close relationships with the growth rates of business sales and industrial production (*Fig. 9* and *Fig. 10*).

The goods side of the economy has been depressed since mid-2022 because consumers have pivoted from buying goods to purchasing services. So on balance, the economy has

continued to grow, supported by services and defying the recession heralders.

Strategy II: Is the Profit Margin Recession Over Yet? S&P 500 forward revenues per share remained near a record high during the May 11 week (*Fig. 11*). S&P 500 forward earnings per share peaked at a record high during the June 16, 2022 week and might have bottomed during the February 23 week of this year, down 5.9% from the peak. As noted above, it has been slowly rising since then. The forward profit margin of the S&P 500—which we calculate from S&P 500 forward revenues and forward earnings—peaked at 13.4% during the June 9, 2022 week. It fell to a low of 12.3% during the March 30 week of this year and edged up to 12.4% by the May 11 week.

Long story short, the recent earnings recession has been entirely attributable to a recession in the profit margin. Soaring commodity and labor costs squeezed margins. Both industrial commodity and petroleum prices have been falling since late last year (*Fig. 12*). Labor cost inflation seems to have peaked a few months ago (*Fig. 13*).

An analysis of the forward profit margins for the 11 sectors of the S&P 500 shows recent improving trends in Communication Services, Consumer Discretionary, Consumer Staples, Financials, Industrials, Information Technology, Materials and Real Estate (*Fig. 14*). Still falling are the forward margins of the Energy, Health Care, and Utilities sectors.

We think that the profit margin recession is over. If so, then the earnings recession should be over. The stock market may have started to discount this recent development in October of last year.

Credit I: Banking Crisis Update. So far, the banking crisis that started on March 8 with the deposit run on Silicon Valley Bank hasn't turned into an economy-wide credit crunch. Yes, we all know that the Fed's Senior Loan Officers Opinion Survey (SLOOS) shows that the banks have tightened their lending standards during the last two quarters.

However, the weekly bank loan series remains on an uptrend (*Fig. 15*). The series might have topped out at its recent record high of $12.2 trillion on March 15. It is down $49.2 billion through the May 10 week. Consumer and residential bank loans rose to record highs during the May 10 week (*Fig. 16*). Commercial and industrial loans and commercial real estate loans are starting to look toppy.

Credit II: Bond Drivers Review. Two of our favorite technical indicators for the 10-year Treasury bond yield are currently bullish. The yield tends to be highly correlated with the

ratio of the nearby futures prices of copper to gold (*Fig. 17*). The ratio suggests that the yield, which is currently 3.70%, should be much closer to 2.00%. We view the ratio as a risk-on versus a risk-off indicator.

The Citigroup Economic Surprise Index (CESI) is highly correlated with the 13-week change in the10-year yield (*Fig. 18*). The CESI fell from a recent peak of 61.3 on March 28 to 5.5 on May 19.

Notwithstanding these bond yield relationships, the yield has risen from a recent low of 3.30% on April 5 and 6 to 3.72% on Monday. Over this same period, the 2-year Treasury yield has risen from 3.79% to 4.29%. That's mostly attributable to better-than-expected March and April employment reports. In addition, a few Fed officials have opined that the Fed should continue to raise the federal funds rate or follow any pause in the rate-hiking with further hikes if necessary.

On the other hand, on Friday, Fed Chair Jerome Powell said that monetary policy is "restrictive." So Fed policy will be data-dependent and particularly dependent on inflation indicators. For those of us in the "Fed-should-pause" camp, he seemed to suggest that a pause in tightening is possible. He acknowledged that the banking crisis is bound to tighten credit conditions, reducing the need for the Fed to get more restrictive in its policy stance. That continues to be our position.

Calendars

US: Tues: M-PMI & NM-PMI Flash Estimates 50.0/52.6; New Home Sales 663k; Richmond Fed Manufacturing Index. **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Minutes; Yellen. (Bloomberg estimates)

Global: Tues: Eurozone, Germany, and France C-PMI Flash Estimates 53.7/53.5/52.3; Eurozone, Germany, and France M-PMI Flash Estimates 46.2/45.0/46.0; Eurozone, Germany, and France NM-PMI Flash Estimates 55.6/55.5/54.2; UK C-PMI, M-PMI, and NM-PMI Flash Estimates 54.6/48.0/55.5; Japan CPI; Nagel; Haskel. **Wed:** Germany Ifo Business Climate Index, Current Conditions, and Expectations 93.0/94.7/91.9; UK Headline & Core CPI -0.8%m/m/8.3%y/y & 0.8%m/m/6.2%y/y; UK Headline PPI Input & Output Prices 7.0% & 8.6%y/y; UK CBI Industrial Trends Orders; German Buba Monthly Report; European Central Bank Non-Monetary Policy Meeting; Bailey. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for just one of these three indexes and none were at a record high for a 47th straight week. During the May 4 week, all three had risen simultaneously for the first time in six weeks and only the third time since they peaked at record highs last June. However, all three are up from their lows during February and March. Through the week ending May 19, LargeCap's forward earnings rose 0.2% w/w to 1.8% above its 54-week low during the week of February 10. MidCap's fell 0.2% w/w to 2.1% above its 55-week low during the week of March 10, and SmallCap's fell 0.1% w/w to 0.7% above its 72-week low during the March 17 week. 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 4.2% below its record high at the end of June; MidCap's is 6.2% below its record high in early June; and SmallCap's is 13.0% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a 16th straight week and weakened to a 28-month low of -3.2% y/y from -3.1%; 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 -5.6% y/y is at a 31-month low, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's rate of -11.6% y/y is at a 31-month low, down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since last June, but 2023's estimates briefly ticked higher during the Q1 reporting season as analysts added the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (0.9% and 11.7%), MidCap (-9.7, 12.7), and SmallCap (-9.5, 14.5).

S&P 500/400/600 Valuation (*link*): Valuations ticked higher w/w through the May 19 week for these three indexes. LargeCap's forward P/E rose 0.2pt w/w to 18.2, matching its nine-month high of 18.2 during the April 28 week. 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 0.1pt to 13.1 from an eight-week low of 13.0 and is 1.6pts below its recent 10-month high of 14.7 in early February. It's now 2.0pts above its 30-month low of 11.1 at the end of September, which 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 rose 0.3pt to 12.8 from a 19-week low of 12.5 and remains 1.5pts below its recent 12-month high of 14.3 in early February. It's 2.2pts 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 is back down to a 28% discount relative to LargeCap's, matching its 23-year-low 28% discount last July. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 30% discount to LargeCap's P/E last week is not much improved from a 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest discount since August 2021. 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 a 101st straight week; the current 2% discount has weakened from 1% during the March 31 week. That 1% discount had been its lowest since July 2021 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. With over 94% of the Q1 earnings season complete, analysts expect the S&P 500's earnings growth rate to decelerate q/q for a seventh straight quarter in Q1-2023 to -3.2% y/y from -1.6% in Q4-2022 on a frozen actual basis. On a pro forma basis, they expect the y/y earnings decline to lessen in Q1-2023, to -0.2% from -3.2% in Q4-2022. Four sectors are expected to record positive y/y percentage earnings growth in Q1-2023, up from only two sectors doing so in Q4-2022. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2023 versus their final Q4-2022 growth rates: Consumer Discretionary (55.6% in Q1-2023 versus -15.6% in Q4-2022), Industrials (26.9, 41.4), Energy (20.9, 59.1), Financials (7.8, -8.9), Consumer Staples (-0.2, -2.5), S&P 500 (-0.2, -3.2), Real Estate (-7.7, -3.2), Communication Services (-9.0, -28.2), Information Technology (-9.4, -10.0), Health Care (-14.8, -2.7), Materials (-22.2, -20.4), and Utilities (-22.4, -4.6).

S&P 500 Q1 Earnings Season Monitor (*link*): With the Q1-2023 earnings season over 94% complete, this season is turning out to be a big improvement from Q4-2022's relatively weak showing. Then, the earnings surprise was the lowest since Q4-2008, and the revenue surprise the smallest since Q1-2020. Furthermore, the earnings surprise failed to outpace the revenue surprise in Q4-2022 for the first time since we began tracking that data in Q1-2009. With 471 of the S&P 500 companies finished reporting for Q1-2023, revenues are ahead of the consensus forecast by 2.3%, and earnings have exceeded estimates by 7.1%.

At the same point during the Q4 season, revenues were 1.8% above forecast and earnings had beaten estimates by 1.0%. Just 74% of the 471 Q1 reporters that have reported so far through Monday's close has reported a positive revenues surprise, while 77% has reported an earnings beat. Those are big improvements from their Q4-2022 readings of 68% for both revenues and earnings. However, their aggregate y/y revenue and earnings growth rates are little changed from their Q4-2022 readings. The collective y/y revenue gain for the 471 reporters so far has dropped to 4.2% from 5.9% at the same point in Q4-2022, and earnings are down 3.0% y/y from a 1.9% y/y decline in Q4-2022. During the 57 quarterly reporting seasons over the last 14 years through Q1-2023, y/y earnings growth has trailed revenue growth in only 15 of the quarters, and it did so again in Q1 for a fifth straight quarter. Significantly fewer companies are reporting positive y/y earnings growth in Q1 (60%) than positive y/y revenue growth (72%). These figures could edge down as more Q1-2023 results are reported from retailers in the coming weeks. We expect the y/y revenue growth rate to remain positive in Q1, but y/y earnings growth is likely to be negative for a second straight quarter.

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