MORNING BRIEFING
June 14, 2023

All About Earnings & Inflation

Check out the accompanying chart collection.

Executive Summary: Like the economy, earnings have been landing softly; revenues haven't landed at all. The S&P 500's Q1 results imply earnings weakness totally due to margin contraction as businesses battled fast rising costs. … Analysts see y/y earnings gains resuming in Q3 and Q4, for full-year earnings growth of 0.4% followed by 11.4% next year. … We see a U-shaped earnings recovery and are tweaking our estimates for S&P 500 revenues, earnings, margins, and the price index. Our year-end targets for the S&P 500 are 4600 this year and 5200 next. … Inflation continues to moderate nicely, which should stay the Fed's hand.

Earnings I: The Past. The Q1 earnings season is over, and the final numbers are in. They were better-than-expected results, which isn't surprising when the economy is growing. Worse-than-expected results tend to occur when the economy is falling into a recession. That the economy would fall into a recession has been a widespread concern—but not our outlook, as you know. So far, so good.

Today, let's review the results and then go back to the future by updating our forecasts for S&P 500 revenues per share, earnings per share, and the profit margin for 2023, 2024, and 2025. Then let's conclude with a discussion of the outlook for the S&P 500's forward earnings per share, forward P/E, and stock price index. Put on your diving suit:

(1) *Revenues.* S&P 500 companies' revenues per share edged down during Q1 from Q4's record high, but still rose 9.1% y/y (*Fig. 1* and *Fig. 2*). Inflation boosted the growth rate, as the GDP price deflator rose 5.3%; but the inflation-adjusted increase was still a solid gain.

(2) *Earnings.* S&P 500 earnings per share was flat compared to Q4's result but still down 3.0% y/y (*Fig. 3* and *Fig. 4*).

(3) *Profit margin.* We can calculate the S&P 500's profit margin by dividing the index's earnings by revenues (*Fig. 5* and *Fig. 6*). The margin edged up to 11.8% from 11.5% during Q4, but it was still down from the record high of 13.7% during Q2-2021.

The earnings recession has been quite modest so far, with two back-to-back quarters of modest declines on a y/y basis. There has been no revenues recession so far. The earnings weakness of recent quarters has been entirely attributable to the decline in the profit margin. This suggests that while business revenues kept pace with price inflation, profits were squeezed by rapidly rising costs. Wage inflation has been high, and productivity has been weak because of unusually high turnover in the labor market, with record-high quits and job openings in recent quarters.

Earnings II: The Present. The S&P 500 companies' actual Q1 earnings per share turned out to be down 3.0% y/y, which was better than the -7.5% expected by industry analysts collectively at the start of the earnings season (*Fig. 7* and *Fig. 8*). Currently (as of the June 8 week), industry analysts project that S&P 500 earnings will be down 8.1% y/y during Q2, followed by Q3 and Q4 y/y gains of 0.4% and 9.1%. Like the economy, earnings have experienced a soft landing, so far.

Currently, industry analysts are expecting the following y/y revenues and earnings growth rates: for 2023 (1.9%, 0.4%) and for 2024 (4.6%,11.4%) (*Fig. 9* and *Fig. 10*).

The S&P 500 profit margin forecasts implied by analysts' revenues and earnings estimates have been dropping for 2023, 2024, and 2025 since the start of this year (*Fig. 11*). The projections may be bottoming now, with the latest readings for the three years at 12.0%, 12.8%, and 13.6%. A bottoming of industry analysts' implied margin estimates would suggest they believe that the mini recession in earnings attributable to weakening profit margins is over. They'll be right if margins stop falling.

As you know, Joe and I are big fans of weekly S&P 500 forward revenues per share and forward earnings per share as great coincident indicators of the actual quarterly series for S&P 500 revenues per share and earnings per share (*Fig. 12* and *Fig. 13*). (Forward revenues and earnings are the time-weighted average of analysts' estimates for the current year and the coming year.) Forward revenues rose to yet another record high during the June 1 week, while forward earnings bottomed during the February 23 week and is up 3.0% since then through the June 1 week. The forward profit margin edged up during the June 1 week to 12.5% (*Fig. 14*).

Earnings III: The Future. Now let's turn to an update of our outlook for the S&P 500 companies' collective revenues, earnings, and profit margin.

Since earnings have had a soft landing so far rather than a hard one, we are expecting a U-shaped, rather than a V-shaped, earnings recovery. If we are surprised, then it's likely to be because the recovery is more robust than we are projecting. If so, that would be attributable to higher profit margins, boosted by technology-driven productivity gains. Let's think ahead:

(1) *Revenues.* We are projecting that revenues per share will increase 4.0% this year to $1,823 and 4.0% in 2024 to $1,896 (*Fig. 15*). (Our previous estimates were about the same at $1,825 and $1,875.)

(2) *Earnings.* We are projecting that earnings per share will be $225 this year and $250 next year (*Fig. 16*). That's been our forecast since last summer. (The final tally for 2022 was $218. We had been projecting $220.)

(3) *Profit margin.* Our projections imply that the profit margin will fall from 12.4% in 2022 to 12.3% in 2023 and rise back to 13.2% in 2024 (*Fig. 17*).

(4) *Forward earnings.* We are projecting that S&P 500 forward earnings per share will be $250 at the end of this year and $270 at the end of next year (*Fig. 18*). Those are what we expect the analysts' consensus earnings expectations then will be for 2024 and 2025. (At year-ends, forward earnings matches the analysts' projections for the upcoming year.)

(5) *Valuation & S&P 500 ranges.* Now let's apply forward P/E ranges of 16.0-20.0 to our forward earnings projections to derive target ranges for the S&P 500 (*Fig. 19*). The range for 2023 is 4000-5000 and for 2024 is 4320- 5400 (*Fig. 20*). Our year-end point estimates are 4600 by the end of this year and 5200 at the end of 2024.

We acknowledge that our valuation multiple ranges are high. However, they reflect our expectations that the MegaCap-8 stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) will continue to account for a significant portion of the market cap of the S&P 500 and that they will continue to be highly prized by investors.

Inflation: Still Moderating. May's headline CPI inflation rate continued to moderate, dropping to 4.0% y/y, the lowest reading since March 2021 and well below last year's June peak of 9.1% (*Fig. 21*). The comparable core CPI inflation rate has been stickier, falling to 5.3% y/y through May. We are sticking with our forecast that the headline PCED inflation rate will fall to 3.0%-4.0% by the end of this year.

We are also sticking with our position that the federal funds rate is restrictive enough at 5.00%-5.25% to moderate inflation without causing an economy-wide recession. We expect that the Fed will come to the same conclusion and leave the rate where it is through the end of this year.

CPI goods inflation was down to just 0.6% y/y during May, with durables unchanged and nondurables up 1.0% (*Fig. 22*). The 4.4% m/m increase in used car and truck prices seemed like an anomaly to us.

We are optimistic that the CPI services inflation rate will continue to moderate over the rest of this year. It was down to 6.3% and 4.3% with and without rent of shelter (*Fig. 23*). Rent inflation remains high, but the three-month annualized inflation rate has been declining for the past three months (*Fig. 24*).

Calendars

US: Wed: Headline & Core PPI -0.1%m/m/1.5%y/y & 0.2%m/m/2.9%y/y; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 5.25%; FOMC Economic Projections; IEA Monthly Report. **Thurs:** Retail Sales -0.1%m/m/2.2%y/y; Total & Manufacturing Industrial Production 0.1%/-0.1%; Capacity Utilization 79.7%; Business Inventories 0.2%; NY Empire State Manufacturing Index -16.0; Philadelphia Fed Manufacturing Index -13.5; Import Price Index -0.6%; Initial & Continuous Jobless Claims 250k/1.761m; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production 1.0%m/m/0.8%y/y; Germany WPI -1.0%m/m/-3.3%y/y; UK GDP 0.1%m/m/0.6%y/y; UK NIESR Monthly GDP Tracker; UK Industrial & Manufacturing Production -0.4%m/m/-1.7%y/y & -0.4%m/m/-0.9%y/y; China Retail Sales 13.7%y/y; China Industrial Production 3.8%y/y; China Unemployment Rate 5.2%; China NBS Press Conference; Japan Core Manufacturing Orders 3.0%m/m/-8.0%y/y; Australia Unemployment & Participation Rates 3.7%/66.7%; Australia Employment Change 15k. **Thurs:** Eurozone CPI -0.1%m/m/5.1%y/y; Eurozone Trade Balance €21.5b; Eurogroup Meetings; ECB Interest Rate Decision 4.00%; BOJ Interest Rate Decision -0.10%; Lagarde; Nagel. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): Back on February 2, the S&P 500 Value price index hit a record high for the first time in just over a year. At the same time, the S&P 500 Growth index remained in a deep bear market at 25.5% below its record high. That's the only record-high close so far this year for the Value index. As of Monday's close, the S&P 500 Value index is 1.4% below its February 2 record high, but has soared 21.3% from its September 30 low. The S&P 500 Growth price index has outperformed Value since February 2, with a gain of 8.7%, and is up 20.4% since its October 12 low; but it remains in a deep correction at 19.1% below its December 27, 2021 record high. Growth's underperformance relative to Value began on November 30, 2021 when their relative price index peaked at a record high. Since then, Value's price index has risen 7.2%, while Growth's is down 16.0%. Looking at their ytd performance through Monday's close, Growth is up 17.4%, well ahead of the 8.3% gain for the S&P 500 Value index. According to the consensus, Growth is expected to record slightly higher revenue growth (STRG) than Value over the next 12 months, but its earnings growth (STEG) is expected to lag Value's considerably. Growth has 3.4% forecasted for STRG and 3.7% for STEG, while Value has forecasted STRG and STEG of 3.3% and 10.2%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021 before tumbling 42% to a 33-month low of 17.6 on January 5. It was back up to a six-month high of 21.1 on Monday. Value's forward P/E fell 26% from 17.6 in January 2021 to a 30-month low of 13.0 on September 30, and since has risen to 16.6 as of Monday's close. Regarding their NERI readings, Growth's and Value's improved in May for a second month and were positive for the first time in 11 months. Growth's NERI improved to a 12-month high of 2.7% from -5.1% in April, while Value's rose to an 11-month high of 0.1% from -6.9%. Growth's forward profit margin forecast of 15.8% remains 3.3ppts below its record high of 19.1% in February 2022 and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 1.0ppt to 10.4% from its record high of 11.4% in December 2021.

US Economic Indicators

Consumer Price Index (*link*): The headline CPI rose only 0.1% in May, slowing from April's 0.4% gain, while the core CPI posted its third successive gain in May, of 0.4%, following gains of 0.5% and 0.4% the prior two months of the year. On a yearly basis, the *headline CPI* slowed to 4.0% y/y, the lowest since March 2021 and less than half of last June's 9.1% peak. Meanwhile, the *core prices* yearly rate remained at an elevated level, easing from 5.5% to 5.3% in May, close to its peak of 6.6% last September. Energy prices fell for the third time in four months, by 3.6% in May and 7.0% over the period, while food prices ticked up 0.2% after two months of flat readings. The rate for *consumer durable goods* was flat with a year ago in May after five months of negative readings, while the rate for *consumer* *nondurable goods* excluding food (-4.6 y/y) fell deeper into negative territory. The *services rate excluding energy* eased a bit for the third month to 6.6% y/y, after rising from 2.7% in August 2021 to 7.3% this February—which was the highest since summer 1982. *Food costs* (6.7 y/y) eased for the ninth month from last August's 11.4%, which was the fastest pace since April 1979. Within food, the rate for *food at home* (5.8) slowed steadily from 13.5% last August (the highest since March 1979); the rate for *food away from home* slowed slightly for the second month to 8.3% from March's 8.8%—which was the highest since the highest since fall 1981. *Energy costs* were below zero for the third month, slowing from last June's 41.6%—which was the fastest pace since April 1980—to -11.7% in May. Within energy, the rate for *fuel oil* plummeted to -37.0% y/y, down from last May's record high of 106.7%. The rate for *gasoline* prices fell 19.7% y/y, remaining in negative territory for the fourth successive month; it peaked at 59.9% last June (fastest since March 1980). The rate for *natural gas* prices fell below a year ago in April (-2.1) for the first time since August 2020, and fell further below zero on May (-11.0). It was at 38.4% last June, which was the highest since October 2005. The *electricity* rate eased to a 20-month low of 5.9% y/y in May; it peaked at 15.8% last August—which was the highest since August 1981. Within *consumer durable goods*, the rate for *new cars* rose 4.7% y/y, the lowest rate since May 2021, down from last April's near-record high of 13.2%, while the rate for *used cars & trucks* was -4.4% last month, up from February's -13.6% bottom—which was the lowest since November 1960. It was as high as 41.2% last February and at a record-high 45.2% during June 2021. The rate for *furniture & bedding* fell 0.5% y/y in May, the first negative reading since July 2020 and down dramatically from last February's record high of 17.1%, while the rate for *major appliances* was in double digits for the second month, by -10.0% y/y, down from its recent peak of 12.4% last March. Within *consumer nondurable goods*, the rate for *apparel prices* continues to hold around 3.5% the past few months, not too far from the 20-month low of 2.9% at the end of 2022; before that, it fluctuated in a 5.0%-5.5% range from last April through September. It was at a recent peak of 6.8% last March (the highest since the end of 1980). Within services, *owners' equivalent rent* remained at its record high of 8.1% again in March, while the rate for *rent of primary residence* dipped to 8.6% y/y, easing from 8.8% y/y in both March and April, which was the highest since fall 1981. These rates compare with recent lows of 2.0% and 1.8%, respectively. Meanwhile, the yearly rate for *lodging away from home* was at 3.4% y/y, down from 7.7% at the start of the year, heading back toward the recent low of 1.0% last July; it was at a record high of 25.1% in both March and February of 2022. Turning to medical care, the yearly rate for *hospitals'* (3.7) services picked up a bit for the second month, from March's 20-month low of 2.7%, though was down from the 4.4% rate at the end of 2022. The *physicians' services* (-0.1) rate continues to drop sharply from March 2021's 5.3% peak. Meanwhile, the yearly rate for *airfares* fell 13.4% y/y, its steepest drop since March 2021 and down from October's 43.0%, which wasn't far from the record high of 45.0% in September 1980.

NFIB Small Business Optimism Index (*link*): "Overall small business owners are expressing concerns for future business conditions," said NFIB Chief Economist Bill Dunkelberg. "Supply chain disruptions and labor shortages will continue to limit the ability of many small firms to meet the demand for their products and services, while less severe than last year's experience." May's *Small Business Optimism Index* (SBOI) increased 0.4 points to 89.4, the 17th consecutive month below the 49-year average of 98.0; the last time it was above the average was December 2021. In May, four of the 10 components increased, five decreased, while now is a good time to expand was unchanged at a net 3%. Plans to make capital outlays (+6ppts to 25%) was by far the biggest positive contributor to May's SBOI, followed by plans to increase inventories (+3 to -2), plans to increase employment (+2 to 19), and current inventory (+2 to -3). Contributing negatively were earnings trends (-3 to -26), sales expectations (-2 to -21), expected credit conditions (-2 to -10), current job openings (-1 to 44), and expect economy to improve (-1 to -50). Inflation (to 25% from 23%) reclaimed the top spot as small business owners' *single biggest business problem*, while quality of labor (unchanged at 24%) returned to the number two spot. Taxes (14), cost of labor (10), and government requirements (9) round out the top five biggest problems. The net percentage of owners raising selling prices continued to ease, sinking to a 26-month low of 32% in May from a near-record-high 66% last March, while the net percentage of owners *planning to increase selling prices* climbed to 29% after sinking to a 29-month low of 21% in April; it was at a record high of 54% during November 2021. A net 41% of owners reported *raising compensation* last month, up from 40% in April though down from 46% the first two months of this year; it was at a record-high 50% at the start of 2022. A net 22% of owners *plan to increase compensation* in the next three months, ticking up from April's two-year low of 21% but 10ppts below October 2022's 32%, which matched the record high posted the final two months of 2021.

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

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.