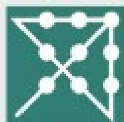
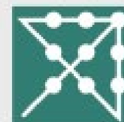


Yardeni Research



MORNING BRIEFING
July 12, 2023

Sunny Or Cloudy Earnings Season?

Check out the accompanying chart collection.

Executive Summary: We see reasons for optimism that upcoming inflation releases and Q2 earnings news will please stock investors. We expect to learn that inflation continues to moderate in response to monetary policy that's restrictive enough. And we expect Q2 earnings to be less bad than analysts are predicting. That's because analysts' estimates usually are too pessimistic at the start of reporting seasons and because the macroeconomic backdrop likely provided good revenue and earnings support. We look at some of the macro influences on specific industries. … And: Joe examines analysts' ever-changing earnings growth expectations through various lenses—by index, sector, and in the context of historical trends.

US Inflation: Moderating Expectations. Monday was a sunny day for stocks and bonds following a few stormy days. That's even though two Federal Reserve Bank (FRB) district presidents—Mary Daly, FRB-San Francisco and Loretta Mester, FRB-Cleveland—said that inflation remains too high and that more rate hikes will probably be necessary to bring it down. On the other hand, Raphael Bostic, president of FRB-Atlanta said the Fed's "policy right now is clearly in the restrictive territory." He is willing to be patient. We side with Bostic.

Monday's good news on the economic front was that the FRB-New York's survey of consumer expectations showed that the one-year-ahead inflationary expectations fell to 3.8%, the lowest since April 2021 and well below last summer's readings of more than 6.5%. The three-years-ahead expectations edged down to 3.0% (*Fig. 1*). The one-year-ahead expectations series has been tracking the PCED inflation rate very closely since early 2021 (*Fig. 2*).

The question is whether the next batch of inflation data will be sunny as well. The same question applies to the Q2 earnings reporting season, which starts this week. For now, Joe and I are inclined to have sunny dispositions. Let's see if we can keep them that way through this week's inflation releases and the next few weeks' earnings season.

US Earnings Season I: Low Expectations. The good news is that Q2 earnings expectations might be too negative for companies in the S&P 500/400/600 indexes (*Fig. 3*). Here are their actual Q1 and expected Q2, Q3, and Q4 y/y growth rates: the S&P 500 (-2.8%, -8.9%, -0.5%, 8.3%), S&P 400 (-7.2, -22.4, -5.7, 4.2), and S&P 600 (-3.0, -24.2, -

10.5, 3.5). During periods of economic expansion, analysts tend to be too pessimistic at the start of earnings season. We expect that will be the case again this time.

Now let's have a look at their annual forecasts:

(1) *Earnings.* Industry analysts are also still lowering their earnings estimates for S&P 500/400/600 for this year and for next year (*Fig. 4*). Here are their latest consensus expectations for earnings growth in 2023 and 2024: S&P 500 (0.5%, 11.7%), S&P 400 (-10.3, 13.0), and S&P 600 (-9.5, 13.5). The good news is that the forward earnings of the S&P 500/400/600 seem to be bottoming, as the higher expectations for next year's earnings are getting more weight day by day.

(2) *Revenues.* Interestingly, there's no recession in the analysts' consensus expectations for S&P 500/400 revenues, though the same cannot be said for S&P 600 revenues (*Fig. 5*). The forward revenues of the S&P 500/400 rose to new record highs during the June 29 week. The forward revenues of the S&P 600 has been moving sideways in record-high territory since early 2022.

(3) *Profit margins.* So the earnings recession of the past year has been relatively mild and attributable to falling profit margins rather than falling revenues (*Fig. 6*). However, in recent weeks the forward profit margins of the S&P 500/400/600 seem to be bottoming, which explains why forward earnings are doing the same.

(FYI: "Forward earnings" and "forward revenues" are the time-weighted average of analysts' consensus estimates for the current year and the following one. "Forward profit margins" are the margins calculated from forward earnings and forward revenues.)

US Earnings Season II: The Macro Environment. The weekly series for S&P 500 forward revenues is a very good coincident indicator of actual S&P 500 revenues (*Fig. 7*). Again, the former rose to a record high during the June 29 week.

Aggregate S&P 500 revenues is also highly correlated with business sales of goods and nominal GDP of goods (*Fig. 8*). There has been a growth recession among goods-producing industries since early last year. However, the S&P 500 also includes plenty of service-providing industries that have been doing very well. They've more than offset the weakness among the goods producers, which is why nominal GDP rose 7.2% y/y during Q1 to a record high.

So the macroeconomic environment should support the S&P 500's Q2 revenues at a record high. Let's briefly look at the macro variables that drive the revenues (and earnings) of selected industries:

(1) *Banking.* The Q2 earnings season starts off this week with the major banks reporting their results. Based on weekly data provided by the Fed, we know that loans and leases at the large domestic banks rose 3.0% y/y through the end of June (*Fig. 9*). We also know that allowances for losses increased 16.9% over the same period (*Fig. 10*). Banks undoubtedly responded to the banking crisis in early March by raising their deposit rates. That probably squeezed their net interest margins. Investment banking fees probably remained weak during Q2 given that the 12-month sum of new issues of US corporate bonds and stocks was $1.37 trillion, little changed from May's $1.30 trillion, which was the lowest since fall 2012 (*Fig. 11*).

(2) *Transportation.* The airlines and cruise ships are packed with tourists. The restaurants and Taylor Swift concerts are also packed. The service-providing industries that cater to consumers are booming.

The trucks and railcars that haul merchandise to be sold by wholesalers and retailers to consumers aren't doing as well, and their costs have gone up over the past year. Both the ATA truck tonnage index and intermodal container traffic have been weak lately, consistent with a growth recession in the goods-producing and distribution industries. Inflation-adjusted real consumer spending on goods has been flat since the second half of 2021 (*Fig. 12*).

(3) *Industrials.* Demand for civilian aircraft is booming. Orders for construction machinery are up 13.5% y/y through May to the highest reading since March 2008 (*Fig. 13*). They undoubtedly are getting a boost from the onshoring of manufacturing and public spending on infrastructure. Industrial machinery orders are down 6.4% y/y but should be rising soon, reflecting the boom in construction of manufacturing facilities.

(4) *Semiconductors & high-tech hardware.* The upturn in the forward earnings of the S&P 500 Semiconductors industry suggests that worldwide semiconductor sales have bottomed and should be on the rise over the rest of this year (*Fig. 14*). US industrial production of high-tech equipment rose to a new record high in May, led by an 11.1% y/y increase in computer & peripheral equipment output (*Fig. 15*).

(5) *Restaurants & retailers.* Restaurant sales are booming. Retail sales of food services & drinking places rose 8.0% y/y through May (*Fig. 16*). They now exceed spending on food

consumed at home. Retail sales excluding building materials and food services have been flat since the second half of 2021. Sales of warehouse clubs and super stores also were flat y/y in April. The same can be said for housing-related retail sales (*Fig. 17*).

US Earnings Season III: A Sweet & Sour Outlook. Joe has been tracking the analysts' consensus S&P 500's quarterly earnings forecast each week since the series started in Q1-1994. Each quarter typically begins with analysts cutting their estimates gradually until reality sets in during the quarter's final month, when some companies warn of weaker results. The combination of reduced forecasts for poorly performing companies and steady forecasts for companies quietly keeping good news close to their vests inevitably leads to an "earnings hook" in the charted data series, a.k.a. a positive surprise, when the results are released during the subsequent earnings reporting season.

During the strong recovery following the Great Virus Crisis (GVC), analysts scrambled to raise their forecasts for six straight quarters from Q2-2020 through Q3-2021, but they still didn't come close to the actual earnings. The S&P 500 recorded unusually high double-digit percentage earnings beats for the first time since the aftermath of the Great Financial Crisis (GFC). The tide turned after Q1-2022. But signs of a turnaround in the y/y growth rates are emerging amid a slower pace of estimate cutting.

I asked Joe to separate the good news from the bad news:

(1) *Less drastic estimate cutting.* After falling slightly during H1-2022, the pace of estimate declines throughout the quarter accelerated in Q3-2022, when it dropped 6.6%. The pace of declines remained elevated during Q4-2022 and Q1-2023 but has abated for Q2-2023. The Q4-2022 estimate was down 5.9% during the runup to its earnings season; the Q1-2023 estimate was down a nearly similar 6.2%. The Q2-2023 estimate has dropped just 2.5% in its slowest decline since Q2-2022.

Q2-2023's meager estimate decline marks a return to estimate cutting as usual. In the 105 quarters from Q2-1994 to the GVC in Q2-2020, the estimate fell during 90 quarters in the runup to earnings season, or more than 85% of the time. Half of the gains occurred following the GFC, when shell-shocked analysts mistimed the recovery.

Similarly, since the GVC, the quarterly estimate rose for six straight quarters through Q4-2021, before the earnings recovery began to run out of steam during H1-2022. Including Q2-2023, the quarterly estimate has now declined for six straight quarters.

(2) *Fewer sectors have falling estimates now.* Analysts had been too bullish and overestimated the length of the post-GVC boom in earnings, resulting in very broad quarterly earnings declines at the sector level during their runup to the earnings seasons through Q1-2023. At the peak of optimism in Q2-2021, nine of the 11 S&P 500 sectors had their quarterly estimate rise during the quarter. By Q1-2022, that count was down to five sectors (Energy, Financials, Real Estate, Tech, and Utilities) before dwindling to just one sector during Q3-2022 (Energy), Q4-2022 (Utilities), and Q1-2023 (Utilities). The broad sector declines have ended with the upcoming Q2-2023 season, with the Q2 estimate rising for four sectors (*Fig. 18*).

Among the four sectors, Industrials' Q2-2023 estimate has risen 2.9% since the end of Q1-2023, edging out Communication Services (2.8%) and well ahead of Tech (0.7) and Consumer Discretionary (0.3). Financials has held up surprisingly well despite the regional bank crisis in early March, while Energy's declines have accelerated.

Here's how much each sectors' Q2-2023 estimate changed over the course of the quarter: Industrials (2.9%), Communication Services (2.8), Tech (0.7), Consumer Discretionary (0.3), Utilities (-2.9), Financials (-3.1), Health Care (-4.4), Real Estate (-6.2), Consumer Staples (-7.3), Materials (-8.0), and Energy (-15.2).

(3) *More sectors to show y/y growth in Q2-2023, but Energy drags down the S&P 500.* Six sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors doing so in Q1-2023 and only two sectors in Q4-2022 (Energy and Industrials). With 26.6% expected y/y growth for Q2-2023, Consumer Discretionary is the only sector projected to be a double-digit percentage grower. A distant second is Communication Services (9.3%), followed by Industrials (6.7), Financials (5.4), Consumer Staples (1.9), and Utilities (1.6).

Despite the rising number of sectors with positive y/y growth, analysts expect the S&P 500's earnings growth rate to be negative on a frozen actual basis for a third straight quarter in Q2-2023, weakening to -8.9% y/y from -2.8% in Q1-2023 and -1.6% in Q4-2022. On a pro forma basis, they expect earnings to decline 5.7% in Q2-2023 following a surprising 0.1% gain in Q1-2023 and a 3.2% decline in Q4-2022.

Excluding the Energy sector, S&P 500 earnings are expected to decline just 0.7% y/y in Q2—the fifth straight y/y decline in this data series but less of a drop than the 1.6% decline in Q1-2023 and the 7.4% drop in Q4-2022. A strong surprise could result in positive y/y growth for the S&P 500 on a pro forma basis yet remain negative on a frozen actual basis.

Here are the five sectors expected to report a y/y earnings decline in Q2: Energy (-45.5%), Materials (-29.0), Health Care (-15.9), Real Estate (-4.9), and Tech (-3.0).

(4) *Y/y growth streaks: winners and losers.* The S&P 500 is expected to record its third straight quarter of y/y earnings declines in Q2-2023 on a frozen actual basis. The Industrials sector remains on a strong positive earnings growth path, with Q2-2023 possibly marking nine straight quarters of growth. Communication Services is expected to rise y/y in Q2-2023 for the first time in six quarters, but Materials and Tech are expected to mark their fourth straight y/y decline in quarterly earnings. However, a strong earnings beat could turn Tech's growth rate positive.

Calendars

US: **Wed:** Headline & Core CPI 0.3%m/m/3.1%y/y & 0.3%m/m/5.0%y/y; Real Earnings -0.1%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; WASDE Report; Mester. **Thurs:** PPI 0.2%m/m/0.4%y/y; Initial & Continuous Jobless Claims 249k/1.73m; Federal Budget Balance -$90.0b; Fed's Balance Sheet; Natural Gas Storage IEA Monthly Report; OPEC Monthly Report. (Bloomberg estimates)

Global: **Wed:** Germany Current Account Balance; Spain CPI 0.6%m/m/1.6%y/y; China Trade Balance; BoC Interest Rate Decision 5.00%; BoE FPC Meeting Minutes; BoE Stability Report; Kashkari; Lane; Bailey; Rogers; Macklem. **Thurs:** Eurozone CPI; Eurozone Industrial Production 0.3%m/m/-1/1%y/y; ECB Published Account of Monetary Policy Meeting; Germany Account Balance; UK GDP -0.4%m/m/-0.1%3m/3m; Headline & Manufacturing Industrial Production -0.4%m/m/-2.3%y/y & -0.5%m/mn/-1.7%y/y; UK NIESR Monthly GDP Tracker; UK Trade Balance -£15.8b; UK Credit Condition Survey; China NBS Press Conference; Waller. (Bloomberg estimates)

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Halfway through the year, small business owners remain very pessimistic about future business condition and their sales prospects," said NFIB Chief Economist Bill Dunkelberg. "Inflation and labor shortages continue to be great challenges for small business. Owners are still raising selling prices at an inflationary level to try to pass on higher inventory, labor, and energy costs." June's *Small Business*

Optimism Index (SBOI) increased for the second month, by 1.6 points in June and 2.0 points over the period, to a seven-month high of 91.0. That marks the 18th consecutive month that the index was below its 49-year average of 98.0, not having exceeded the average since December 2021. In June, five of the 10 components increased, four decreased, and one was unchanged (capital spending plans at a net 25%). Expect the economy to improve (+10ppts to -40%) and sales expectation (+7 to -14) were by far the biggest contributors to June's gain, followed by now is a good time to expand (+3 to 6), earnings trends (+2 to -24), expected credit conditions (+2 to -8). Contributing negatively were plans to increase employment (-4ppts to 15%), current job openings (-2 to 42), plans to increase inventory (-1 to -3), and current inventory (-1 to -4). Inflation (to 24% from 25%) and quality of labor (unchanged at 24) were tied at the top spot as small business owners' *single biggest business problem*, with taxes (15 from 14), cost of labor (8 from 10), and government requirements (8 from 9) rounding out the top five biggest problems. The net percentage of owners raising selling prices continued to ease, sinking to a 27-month low of 29% in June from a near-record-high 66% last March, while the net percentage of owners *planning to increase selling prices* climbed for the second month to 31% after sinking to a 29-month low of 21% in April; it was at a record high of 54% during November 2021. A net 36% of owners reported *raising compensation* last month, down from 41% in May and 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, matching May's percentage and a tick above April's two-year low of 21%. The percentage is 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.