MORNING BRIEFING
September 20, 2023

What's Up With Earnings?

Check out the accompanying chart collection.

Executive Summary: Today, we examine the flight paths of S&P 500 companies' revenues, earnings, and profit margins through Q2's earnings season. … Forward revenues per share rose to a record high the week before last, and analysts project revenues growth more than doubling next year to nearly 5%. … Forward earnings rose to a record high last week; it does a good job of predicting the earnings outlook during economic expansions. … The forward profit margin has edged up since bottoming in March, after dropping from last year's record high. … All things considered, we're sticking with our upbeat earnings forecasts and S&P 500 price targets for now.

Earnings I: The Revenues Story. Joe reports that S&P has released Q2 revenues data for the S&P 500. S&P also compiles comparable earnings series. While for our purposes, Joe and I prefer to monitor the operating earnings-per-share data compiled by I/B/E/S, let's review the S&P data, starting with revenues then proceeding to earnings:

(1) *S&P 500 revenues per share & inflation*. There has been no recession in S&P 500 revenues per share since the first half of 2020, when the pandemic lockdowns caused a 14.6% drop in this series from Q4-2019 through Q2-2020 (*Fig. 1*). Back then, it bottomed at $315.61 per share. Since then, it is up 46.4% through Q2-2023 to a record $462.16 per share.

S&P 500 revenues per share was up 7.1% y/y through Q2-2023 (*Fig. 2*). Of course, business sales have been boosted by rapidly rising inflation since late 2021. Inflation-adjusted S&P 500 revenues (using the GDP deflator) is up 25.9% since it bottomed in Q2-2020 and up 3.4% y/y through Q2-2023 (*Fig. 3*).

While S&P 500 revenues per share rose 7.1% y/y, aggregate revenues rose 6.1% y/y (*Fig. 4*). Joe derives the latter by multiplying S&P 500 revenues per share by the S&P 500 divisor for each quarter.

(2) *S&P 500 aggregate revenues & business sales of goods.* In current dollars, the trend and the cycles in S&P 500 aggregate revenues closely track those of nominal GDP (*Fig. 5*). Interestingly, they track business sales of goods (a.k.a. manufacturing shipments plus

wholesale and retail sales) much better, even though S&P 500 revenues includes the sales of both goods and services (*Fig. 6*). That's because the business cycle is usually more pronounced for producers and distributors of goods than providers of services.

The y/y growth rate in business sales of goods closely tracks the y/y growth rate of S&P 500 revenues (*Fig. 7*). The former is a monthly series. So it is usually a good leading indicator of the quarterly revenues series. It hasn't been so good since the second half of last year. That's because the rolling recession in the goods sector has been more than offset by strength in services. The monthly series was down 1.2% y/y through July, while S&P 500 aggregate revenues was up 6.1% during Q2.

Not surprisingly, the y/y growth rate in aggregate revenues closely tracks the y/y growth rate in nominal GDP of goods (*Fig. 8*). The former has been tracking better with the latter than with business sales of goods recently.

In the past, there wasn't much of a correlation between the growth rates of aggregate revenues and nominal GDP of services, which was much less volatile than the growth rate of nominal GDP of goods (*Fig. 9*). Of course, since the pandemic, the services sector has been much more volatile than usual and more closely correlated with aggregate revenues.

(3) *S&P 500 revenues per share and forward revenues.* A much better coincident indicator of quarterly S&P 500 revenues per share is weekly S&P 500 forward revenues per share (*Fig. 10*). The series is monthly from January 2004 through December 2005, then weekly. It doesn't catch every zig and zag in the quarterly series, but it certainly gets the trends and cycles right. It rose to a record high during the September 7 week.

Forward revenues per share is a time-weighted average of industry analysts' estimates for the current and the coming years' S&P 500 revenues (*Fig. 11*). As of the September 7 week, industry analysts expect that S&P 500 revenues per share will increase 2.2% this year, 4.8% next year, and 5.3% in 2025 (*Fig. 12*).

Earnings II: The Earnings Story. As noted above, in our work we tend to focus on S&P 500 operating earnings per share as reported by I/B/E/S rather than S&P. The big difference between the S&P and I/B/E/S measures of operating earnings per share is that the former determines which one-time items to exclude (or include) from reported earnings, while the latter is based on majority rule. In other words, it is based on the industry analysts' consensus on operating earnings, which tends to be the same as the operating numbers reported by the companies in their quarterly filings.

That allows us to calculate the weekly series on S&P 500 forward operating earnings using the analysts' consensus earnings estimates for the current and the coming years. Now let's have a look at the latest earnings data:

(1) *Earnings per share*. S&P 500 operating earnings per share edged up 2.7% q/q during Q2, suggesting that earnings bottomed during Q1 (*Fig. 13*). On a y/y basis, it was still down 5.4% during Q2 (*Fig. 14*). But these comparisons should start to turn positive over the final two quarters of this year.

(2) *Forward earnings per share.* S&P 500 forward earnings rose to a record high during the September 14 week (*Fig. 15*). It closely tracks the actual quarterly operating earnings data as reported by I/B/E/S. The weekly forward series tends to lead the quarterly actual one by about a year (*Fig. 16*). So it is a great predictor of the outlook for earnings during economic expansions. However, it consistently fails to anticipate recessions. If you agree with us that a recession isn't very likely over the next 52 weeks, then the prospect for earnings is bright over this period ahead.

(3) *Annual consensus earnings estimates and growth rates*. During the week of September 14, industry analysts estimated that earnings per share will be $221.37 this year, $247.94 next year, and $278.28 in 2025 (*Fig. 17*). They are expecting earnings per share to grow 1.1% this year, 11.6% next year, and 12.5% in 2025 (*Fig. 18*).

Earnings III: The Profit Margin Story. The weakness in earnings in recent quarters has been attributable to the decline in the S&P 500 profit margin per share since revenues have been trending upward to new record highs (*Fig. 19* and *Fig. 20*).

The quarterly profit margin peaked at a record high of 13.7% during Q2-2021. It peaked last year at 13.4% during Q2. It then fell to 11.5% during Q4-2022. It edged up to 11.8% during Q2.

The forward profit margin peaked at a record 13.4% during the June 9 week last year. It bottomed at 12.3% during the March 30 week this year and edged up to 12.7% during the September 7 week.

Earnings IV: Their Forecasts & Ours. Joe and I promised to revisit our earnings outlook following the release of Q2's results. We thought we might have to lower our projections, which have been among the most optimistic on Wall Street. We've decided to stay with them for now. Consider the following:

(1) *Revenues*. Joe and I are predicting that S&P 500 revenues per share will increase 4.0% this year, 4.0% next year, and 3.9% in 2025 (*Fig. 21*). We obviously are not expecting an economy-wide recession this year, though we did increase our subjective odds of one before the end of next year to 25% from 15% on Monday. Industry analysts have been raising their S&P 500 revenues-per-share estimates in recent weeks, and they almost match our projections.

(2) *Earnings*. The same can be said about their estimates for S&P 500 earnings-per-share and ours (*Fig. 22*). We are sticking with $225 this year (up 3.2% y/y), $250 next year (up 11.1% y/y), and $270 in 2025 (up 8.0% y/y).

(3) *Profit margin*. Industry analysts also recently have been raising their profit margin forecasts (implied by their earnings and revenues forecasts), which now are up to our forecasts (*Fig. 23*). We are projecting 12.3% this year, 13.2% next year, and 13.7% in 2025. Our optimism is substantially based on our view that productivity growth is likely to rebound over the rest of the decade.

(4) *Forward earnings.* Again, we are happy to report that S&P 500 forward earnings per share has risen to a record high of $240.28 during the September 14 week; it's getting closer to our year-end estimate of $250 (*Fig. 24*). Our year-end forward earnings estimates for 2024 and 2025 are $279 and $290.

(5) *S&P 500 valuation.* Joe and I expect the S&P 500 forward P/E to range between 16.0 and 20.0 through the end of 2025 (*Fig. 25*). The historically high upper end of the range assumes that the MegaCap-8 stocks will continue to account for about 25% of the S&P 500's market capitalization, and that they will continue to sport high valuation multiples.

(6) *S&P 500 price targets*. Applying these valuation ranges to our forward earnings projections yields the following S&P 500 stock price index ranges: 2023 (4000-5000), 2024 (4320-5400), and 2025 (4640-5800) (*Fig. 26*).

For those of you who prefer point estimates, here are our year-end forecasts for the S&P 500: 2023 (4600), 2024 (5400), 2025 (5800).

Calendars

US: **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed

Interest Rate Decision 5.50%; FOMC Economic Projections. **Thurs:** US Leading Indicators -0.5%; Philadelphia Fed Manufacturing Index -1.0; Existing Home Sales 4.10mu; Initial & Continuous Jobless Claims 225k/1.695m; Natural Gas Storage. (FXStreet estimates)

Global: **Wed:** Germany PPI 0.2%m/m/-12.8%y/y; UK Headline & Core CPI 0.7%m/m/7.1%y/y & 0.7%m/m/6.8%y/y; UK PPI Input & Output Prices 0.2%/0.2%; UK House Price Index 1.5; Schnable; Jochnick; Panetta; Enria; McCaul; Elderson; Mauderer. **Thurs:** Eurozone Consumer Confidence -16.5; France Business Survey 97; Nagel; UK Gfk Consumer Confidence -27; UK BoE Interest Rate Decision 5.50%; UK BoE Inflation Letter; BoJ Interest Rate Decision -.10%; Lagarde; Schnabel. (FXStreet 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. It continued to make new highs through the end of July at the same that the Growth index was recovering from a deep bear market to a correction. As of Monday's close, the S&P 500 Value index is 3.6% below its July 31 record high; but has soared 24.7% from its low on September 30, 2022. The S&P 500 Growth price index is down a lesser 2.4% since July 31, but remains in a deep correction at 16.5% below its December 27, 2021 record high and has risen a slightly lesser 24.2% from its October 12, 2022 low. 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 9.3%, while Growth's is down 13.2%. Looking at their ytd performance through Monday's close, Growth is up 21.1%, double the 10.5% 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 5.2% forecasted for STRG and 9.0% for STEG, while Value has forecasted STRG and STEG of 3.8% and 10.6%, 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 an 11-month high of 22.4 on July 31 before dropping 1.3pts to 21.1 by Monday's close. Value's forward P/E has been more stable, falling 26% from 17.6 in January 2021 to a 30-month low of 13.0 on September 30, 2022, and then rising to a 25-month high of 17.5 on July 19. Value has fallen 1.0pt since then to 16.5 as of Monday's close. Regarding their NERI readings, Growth's and Value's have been positive since May following 10 months of negative readings, but was relatively unchanged m/m in August. Growth's NERI was flat at a 15-month high of 3.4% in August, while Value's edged up to a 17-month high of 2.1% from 2.0%. Growth's forward profit margin forecast of 16.1% remains 3.0ppts below its record high of 19.1% in February 2022, but that's up from a 32-month low of 15.6% during the April 20 week and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 0.9ppt to 10.5% from its record high of 11.4% in December 2021; that compares to a 24-month low of 10.2% during the March 30 week.

US Economic Indicators

Housing Starts & Building Permits (***link***): Housing starts tumbled in August, while building permits were a surprise on the upside. Housing starts last month plunged 11.3% to 1.283mu (saar), following July's downwardly revised gain of 2.0% (from 3.9%), led by a 26.3% decline in *multi-family* starts to 342,000 units (saar)—the lowest level since May 2020. Multi-family starts have tanked by 40.1% the past three months. Meanwhile, *single-family* starts sank 4.3% last month to 941,000 units (saar), following a 5.7% gain and an 8.1% loss the prior two months. Multi-family starts have plunged 27.3% ytd, while single-family starts have increased 6.1%—helped by a 19.5% surge during May. *Building permits* jumped 6.9% in August to 1.543mu (saar) and are up 14.0% since its recent bottom of 1.354mu during January of this year. *Single-family permits* haven't posted a decline so far this year, climbing 2.0% in August and 26.9% ytd to 949,000 units (saar). Meanwhile, *multi-family permits* rebounded 15.8% in August to 594,000 units (saar), after sliding four of the prior five months by 25.2%. *Homebuilders' confidence* has taken a hit recently, falling in September for the second straight month and sinking 11 points over the two-month period to 45; this was the first time in five months that it dropped back below the key breakeven measure of 50, coinciding with the bounce in mortgage rates above 7%. Confidence previously had jumped 25 points over the first seven months of this year to 56.

Global Economic Indicators

Eurozone CPI (***link***): The CPI rate for August eased to 5.2%—the lowest since January 2022 and down from last October's record high of 10.6%. Looking at the main components, *energy* fell 3.3% y/y, its fifth negative reading in six months, up from July's -6.1%, which was the weakest since December 2020. It posted double-digit yearly gains from April 2021 through February of this year. It peaked at a record high of 44.3% last March. The rate for *food, alcohol & tobacco* slowed for the fifth month to 9.7% y/y after accelerating steadily from June 2021's 0.5% to a record high of 15.5% this March. The rate for *non-energy* industrial goods eased for the sixth month to 4.7% y/y from February's record-high 6.8%. Meanwhile, the *services* rate eased to 5.5%, from 5.6% y/y in July—which was the highest since fall 1992. Of the *top four Eurozone economies*, Germany (6.4% y/y), France (5.7), and Italy (5.5) showed rates above the overall Eurozone's 5.2% rate; while Spain's (2.4) rate was below that—and indeed one of the Eurozone's lowest—it did accelerate for the second month from June's 1.6%. Here are the record-high inflation rates and dates they were achieved for the four countries: Germany (11.6%, October 2022), Italy (12.6%, October & November 2022), France (7.3%, February 2023), and Spain (10.7%, July 2022).

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