MORNING BRIEFING
November 14, 2023

Relevant Matters

Check out the accompanying chart collection.

Executive Summary: Today, we focus our observations on earnings, valuation, and inflation. … S&P 500 companies' collective Q3 earnings, forward earnings, and forward revenues all stand at record highs. But analysts' earnings estimates for future quarters have been dropping. … There's not always a neat inverse correlation between stock market valuations and bond yields. One reason: The MegaCap-8 stocks represent an outsized chunk of the S&P 500's P/E; but with less leverage than most companies, interest rates affect them less. … Our moderating inflation outlook suggests no more federal funds rate hikes this tightening round; we examine some of the data it reflects.

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

Strategy I: Record Earnings. As of Friday's close, the S&P 500 was 7.9% below its record high of 4796.56 on January 3, 2022. However, the composite's earnings per share is back at its previous record high.

Joe reports that the Q3-2023 earnings reporting season for the S&P 500 firms is over 91% complete. The quarter's blend of the actual and the remaining expected earnings results rose to $58.20 per share during the November 9 week, above its record high of $57.95 during Q2-2022 (*Fig. 1* and *Fig. 2*).

Here are a few more relevant observations on the recent performance of earnings and the outlook for them:

(1) The latest earnings recession lasted just three quarters, from Q2-2022 through Q1-2023. S&P 500 earnings per share fell 7.9% over that time. That compares to declines of 33.3%, 77.0%, and 28.4% during the earnings recessions of the Great Virus Crisis, the Great Financial Crisis, and the Tech Wreck from Q2-2000 through Q4-2001.

(2) The bad news is that industry analysts have been cutting their Q4-2023 earnings estimates since the start of the current reporting season for Q3 in response to cautious forward guidance provided by managements. During the week of November 9, analysts' consensus Q4 earnings-per-share estimate for the S&P 500 companies was down to

$55.39 from $58.14 the week of September 28.

(3) The analysts have also been lowering their Q1, Q2, and Q4 estimates for 2024 (*Fig. 3*). So the Q1 estimate is now $56.85, i.e., a bit below the record high. However, the final three quarters of 2024 are all still in record-high territory at $60.31, $63.73, and $64.48.

(4) The 2023 and 2024 analysts' consensus estimates for S&P 500 earnings per share are now $220.62 and $245.31. We are still using $225.00 and $250.00.

In our opinion, the stock market discounts the time-weighted average of consensus expected earnings per share during the current year and coming year. This weekly measure, a.k.a. "forward earnings," rose to a record $241.99 per share during the November 9 week, as it is converging toward the 2024 consensus estimate (*Fig. 4*).

(5) S&P 500 forward earnings per share tends to be a very good 52-week leading indicator of actual earnings per share (*Fig. 5*). The same can be said about the relationship between the weekly S&P 500 forward revenues series and the actual quarterly results (*Fig. 6*). Forward revenues rose to yet another record high during the November 2 week.

The S&P 500 forward profit margin bottomed during the week of April 7 at 12.4% (*Fig. 7*). It edged up to 12.5% during the November 2 week.

Strategy II: The Valuation Question. There tends to be an inverse relationship between the 10-year US Treasury bond yield and the forward P/E of the S&P 500 (*Fig. 8*). That's a well-known relationship. However, it doesn't always work as expected. The simple theory is that the higher interest rates are, the better alternative to stocks fixed-income securities become.

That inverse relationship might also be attributable to the fact that rising interest rates often lead to recessions, which have always been bad for stock valuations and earnings. If inflation is high and interest rates aren't high enough to bring it down, stocks might beat bonds because earnings tend to rise in that environment, while the purchasing power of interest payments is eroded by inflation.

In recent years, the MegaCap-8 stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) have been dominating the performance of the S&P 500, including its valuation multiple. They currently account for 27.5% of the market capitalization of the S&P 500 index and 51.4% of its Growth sub-index.

The collective forward P/E of the MegaCap-8 is currently 27.6. The S&P 500's forward P/E is 17.6 and 15.4 with and without the MegaCap-8. (FYI: Forward P/Es are simply the P/E calculated with forward earnings.)

In theory, the forward P/E of the MegaCap-8 stocks should be inversely correlated with the bond yield because the valuations of these and other Growth stocks tend to be even more sensitive to higher interest rates than those of the Value stocks. However, the MegaCap-8 stocks may be less vulnerable to high interest rates because these eight companies are less dependent on debt than most and have substantial cash flow.

In other words, the relationship between valuation multiples in the stock market and interest rates is a complicated one.

Inflation: Expectations & Oil Prices. The outlook for the economy and the financial markets in 2024 will depend largely on the path of inflation. In our projected scenario, the core PCED inflation rate falls to 2.0%-3.0% next year. It was 3.4% y/y through September.

That's a reasonable forecast, in our opinion. It is consistent with the FOMC's September *Summary of Economic Projections* (SEP) showing the core PCED inflation rate at 2.6% at the end of 2024, 2.3% at the end of 2025, and 2.0% at the end of 2026. According to the SEP, that would be consistent with the federal funds rate remaining at the current level through early 2024 with perhaps two 25bps cuts in the federal funds rate later next year.

Now consider the following relevant developments on the inflation front:

(1) *CPI.* The next big event on the inflation front is Tuesday's October CPI report. The Cleveland Fed's *Inflation Nowcasting* shows that the CPI headline and core inflation rates rose 0.1% and 0.3% m/m, respectively, during October. That puts the two up 3.3% and 4.2% on a y/y basis. These numbers confirm that inflation remains on a moderating trend.

(2) *Expectations.* Fed officials often have said that they also want to make sure that inflation is "well anchored." In other words, they want to see that inflationary expectations are low. So it was a bit unsettling that Friday's release of the consumer sentiment survey for the first half of November showed the one-year expected inflation rate jumped from 3.2% in September to 4.2% in October and 4.4% in early November (*Fig. 9*). The survey's five-years-ahead inflationary expectations rose from 2.8% to 3.2% over this same interval (*Fig. 10*).

On the other hand, on Monday, we learned that the comparable readings for October's consumer survey conducted by the Federal Reserve Bank of New York were 3.6% over the coming year and 2.7% over the next five years.

(3) *Oil*. The increase in the November consumer survey's inflationary expectations seems odd given that its year-ahead response tends to be highly influenced by the price of gasoline, which has been falling since early October. The recent weakness in gasoline prices reflects record-high crude oil field production in the US (*Fig. 11*).

Furthermore, Debbie and I seasonally adjusted the four-week moving average of gasoline consumed in the US (*Fig. 12*). It peaked this year at 9.7 million barrels per day (mbd) through May 1 and plunged to 8.4 mbd at the end of October.

Since the pandemic, consumer demand for gasoline has been more price elastic. That's because more people are working from home. With less need to commute to work, more driving is discretionary now. So when gas prices go up, people have the option of consuming less gas by driving less around their neighborhoods.

Calendars

US: **Tues:** Headline & Core CPI 0.1%/0.3%; NFIB Small Optimism Index; Real Earnings; IEA Monthly Report; Williams; Goolsbee; Jefferson. **Wed:** Headline & Core PPI 0.1%/0.2%; Retail Sales, Headline & Ex Gas & Autos -0.1%/0.1%; Business Inventories 0.3%; Empire State Manufacturing Index -2.60; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Barr. (FXStreet estimates)

Global: **Tues:** Eurozone GDP -0.1%q/q/0.1%y/y; Eurozone ZEW Economic Sentiment; Eurozone Unemployment Rate; UK Average Earning Including & Excluding Bonus 8.3%/7.8%; UK Unemployment Rate; Elderson; Japan GDP -0.1%q/q/-0.6%y/y; Japan Industrial Production 0.2%; China Retail Sales 7.0%y/y; China Industrial 4.3%y/y; NBS Press Conference; Mauderer; Lane; Enria; Gravelle. **Wed:** Eurozone Industrial Production -0.7%m/m/-6.3%y/y; Eurozone CPI; Germany WPI 0.2%; UK Headline & Core CPI 0.1%m/m/4.8%y/y & 0.4%m/m/5.8%y/y; UK Input & Output Prices 0.1%/0.1%; Japan Core Machinery Orders 0.9%m/m/-3.6%y/y; Australia Employment Change 18.0k; Australia Unemployment & Participation Rates 3.7%/66.7%; Haskel. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for two of these three indexes during the November 10 week. LargeCap's forward earnings rose less than 0.1% w/w to a new record high after first hitting that mark during the September 15 week (for the first time in 15 months, since June 2022). MidCap's dropped 0.6% w/w to 5.3% below its record high in early June 2022, and SmallCap's fell 1.8% w/w to 10.0% below its mid-June 2022 record. Through the week ending November 10, LargeCap's forward earnings has risen 7.1% from its 54-week low during the week of February 10; MidCap's is 3.1% above its 55-week low during the week of March 10; and SmallCap's is 4.2% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrend since mid-2022 has been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Forward earnings momentum remains near two-year lows but is steadily ticking higher now. The yearly rate of change in LargeCap's forward earnings has improved to 5.3% y/y from a 29-month low of -3.2% y/y during the June 23 week. Those levels compare to a record-high 42.2% at the end of July 2021 and, on the downside, to -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -0.6% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -4.4% y/y rate is up from a 32-month low of -12.9% in mid-June and 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 June of last year, but the 2023 estimate for the S&P 500 ticked higher during the Q1 and Q2 reporting seasons as analysts incorporated the strong earnings beats into their forecasts. During the Q3 season so far, they've kept the 2023 estimate little changed. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.2% and 11.2%), MidCap (-13.2, 11.8), and SmallCap (-7.7, 8.2).

S&P 500/400/600 Valuation (*link*): Valuations mostly ticked lower for these three indexes during the November 10 week. LargeCap's forward P/E was up 0.2pt w/w to 18.2 and is up from a seven-month low of 17.0 during the October 27 week. That's down from its 18-month high of 19.6 during the July 28 week. It's still up 3.1pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E dropped 0.1pt w/w to 12.8, but that's up from a 12-month low of 12.1 at the end of October. It's now 1.9pts below its 10-month high of 14.7 in early February and up 1.8pts from its 30-month low of 11.1 at the end of September 2022, 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 fell 0.1pt w/w to 12.1, but is up from a 12-month low of 11.3 the week before that and is now 2.2pts below its recent 12-month high of 14.3 in early February. It's up 1.5pts from its 14-year low of 10.6 in September 2022 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 29% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 34% discount is at a 23-year-low, which compares to a 22% discount during the March 10 week; that one 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 126th straight week; the current 6% discount is 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 estimate declines accelerated considerably for the three quarters through Q1-2023 before easing for Q2-2023. Looking at Q3-2023, the revisions pendulum turned slightly negative w/w in the usual performance right before the start of the earnings season ahead of the typical earnings surprise hook. They're forecasting that the S&P 500's earnings rose 3.9% y/y in Q3-2023. That's up from a 5.8% decline in Q2-2023, which likely marked the cyclical bottom for earnings growth. On a pro forma basis, they expect a y/y earnings gain of 6.3% in Q3, up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 11.6% y/y in Q3-2023, an improvement from the 3.6% gain in Q2-2023, the 1.6% decline in Q1-2023, and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q3-2023, unchanged from Q2-2023's count. However, that's up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected blended earnings growth rates for Q3-2023 versus their final earnings growth rates for Q2-2023: Communication Services (46.1% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (41.8, 57.0), Financials (22.7, 9.3), Information Technology (12.4, 5.0), Industrials (11.2, 15.7), S&P 500 ex-Energy (11.6, 3.6), Utilities (10.3, 0.6), S&P 500 (6.3, -2.8), Consumer Staples (5.5, 8.5), Real Estate (-5.4, -2.1), Health Care (-17.7, -26.7), Materials (-18.0, -26.4), and Energy (-33.0, -47.5).

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