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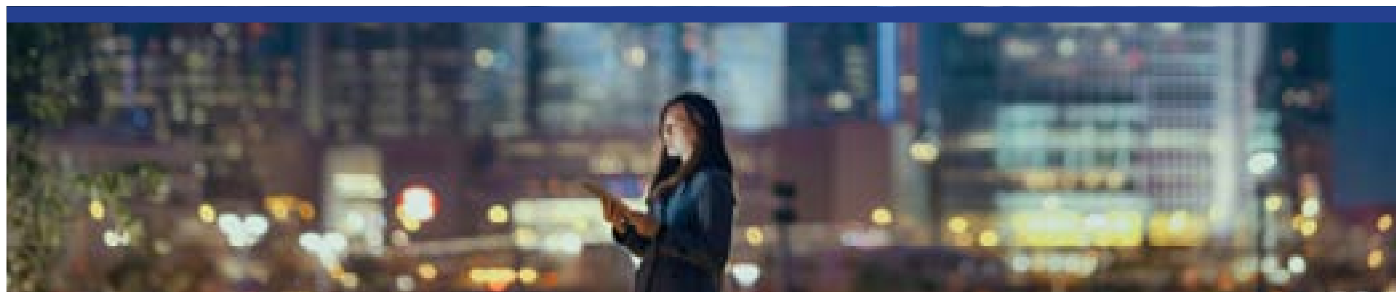

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CIO Strategy Bulletin

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Corporate Profits Still Matter

SUMMARY

- We fear that negative business cycle risks for markets remained underpriced even as analysts' estimates project a new record high for US corporate profits by the fourth quarter of 2023.
- Even after recent analyst downward earnings revisions for 2023, our own forecast for S&P 500 earnings per share (EPS) is about 10% below their full-year view.
- Some investors see either a swift return to or continuation of strong economic growth. Others believe that inflation will remain intransigent despite a Fed willing to continue on a rapid monetary tightening course to stop it. These views are inherently inconsistent with one another. Such is the state of this market, trying to balance contradictory signals.
- In our view, it may take some months before share prices fully reflect the lagged impact of past Fed tightening steps to discount the further weakening in business activity that we expect.
- The current unsettled market conditions suggest that our defensively positioned portfolios have the potential to hold value best. Our largest positions remain in the most reliable sources of return for portfolios: investment grade company dividends and coupon payments for the highest quality borrowers. By many measures, these yields are now the highest in 15 years or longer.

Corporate Profits Still Matter

We fear that negative business cycle risks for markets remained underpriced even as analysts' estimates project a new record high for US corporate profits by the fourth quarter of 2023.

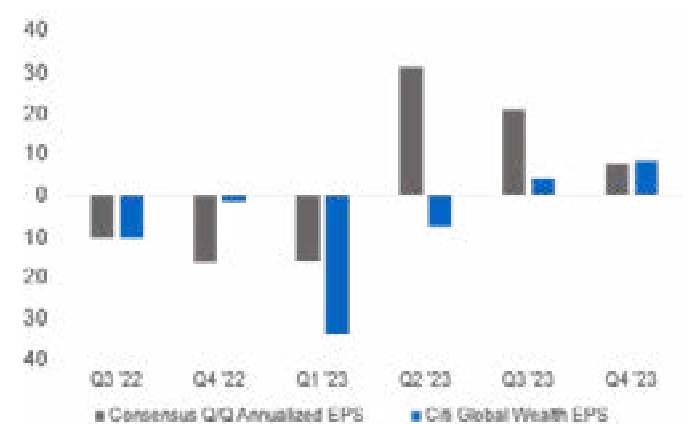
We do not believe that a full-blown recession in the US is underway, though the trend in US corporate earnings is downwards. While the majority of firms have beaten the "low bar" of analyst estimates for the final quarter of 2022, this obfuscates the negative trend that is forming. The 69% "beat rate" for the roughly 90% of S&P 500 firms that have reported earnings was the lowest in 12 years, apart from 1H 2020. These weak results from 4Q2022 have sent analyst revisions for 2023 lower. But not enough, in our view (**Figure 1**).

Earnings per share (EPS), a metric used for estimating corporate value, fell at a 14% annualized rate in the second half 2022 (**Figure 2**). EPS in the fourth quarter of 2022 were 4% below our own quarterly estimates. For the first half of 2023, we expect EPS to continue falling at roughly the same pace, leaving full-year 2023 EPS 10% below last year's.

Even after recent analyst downward earnings revisions for 2023, our own forecast for S&P 500 EPS is about 10% below their full-year view. So, who's likely to be more accurate? Analysts project the spring quarter EPS to rise 31% (on an annualized basis). This is actually the period when we think US economic activity measures will be declining most rapidly, as firms address high inventories by slashing production.

Figure 1: Net revisions to annual EPS estimates for the S&P 500

Figure 2: CGWI EPS estimates vs consensus



Source: Haver Analytics as of Feb. 24, 2023. Grey areas note recessions. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. **Figure 2**: Data are for S&P 500 operating EPS as reported by Factset. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Remember, Share Prices Lead EPS

Share prices lead EPS (**Figure 3**). Last year's almost 20% decline in share prices – coupled with surging interest rates – was indicative of where corporate profits would trend in 2023. Markets are more likely than not to price earnings declines, not rosy estimates. In our view, it may take some months before share prices reflect current economic conditions, reflecting further weakening in business activity (**Figure 4-5**).

Later in 2023, we expect markets to begin to focus on the recovery of 2024, when we expect a 5% EPS gain, strengthening into 2025 and beyond. But not before a reconciliation between real earnings and valuations.

It’s Hard to Be an Economist These Days

For many economists, the idea that the whole US economy has had a sudden, sharp acceleration at the start of 2023 seems implausible. Did US employers decide to double their hiring pace in January while simultaneously announcing the largest layoffs since the COVID shutdowns? And did US retailers, in fact, experience a sudden spending boom in January after reporting poor holiday sales (**Figure 6**)?

The Fed is using the positive economic data and “persistent” month-over-month inflation to justify ever higher short-term rates. Emphasizing lagging economic indicators that are calculated looking back 12 months ignores what’s happening now. Lagging residential rents – comparing today’s prices to those a year ago - appear to be steady or rising when rents have actually begun a meaningful downhill trend.

Here’s another example. Current demand for US labor reflects current production requirements. Residential homes started 12-18 months ago are being finished for delivery now. However, the surge in interest rates has caused a historically sizeable drop in home sales, with new housing permits and starts following sales lower (**Figure 7**). Construction employment across the industry will adjust to the much slower future production pace once housing units under construction are finished. While this isn’t the immediate condition for housing employment, it is the near future.

This dynamic will occur across many industries with high inventories. It will impact related services employment, too, as marketing, advertising, customer service and finance activities associated with industry are curtailed. All of this can occur even as certain sectors, like travel and tourism, still exhibit growth due to pent-up, Covid-related demand.

Be Aware of Seasonal Adjustments

The largest seasonal adjustments take place at extreme moments in the economy. Think of the hiring of extra retail staff for December holidays or summer employment at resorts. As **Figure 6** showed, the 16% drop in unadjusted retail sales for January was rather ordinary. In contrast, the 3% rise reported for the month after seasonal adjustment was stronger than 98% of all other months over the past 55 years. The same is true for the sudden 517,000 leap in net hiring in January. Of course, the “adjustments” are not mentioned when the press headlines are written.

Data bias exists in both directions. The severe slowing reported for the US economy in November/December data was also likely exaggerated downward.

Why Defensive Is Wise, for Now

Some investors see either a swift return to or continuation of strong economic growth. Others believe inflation will remain intransigent despite rapid US monetary tightening. These views are inherently inconsistent with one another. Such is the state of this market, trying to balance contradictory views and signals.

We still believe the worst of the bear market losses were felt in 2022. But the current unsettled market conditions suggest that our defensively positioned portfolios may hold the best value (see the Feb. 12 CIO Bulletin).

This is why we are emphasizing greater bond exposure as real US yields (+1.5% to 2.0% in TIPS markets) are historically attractive against our current backdrop. Investment grade corporate bond yields are high (5.8% for nominal long-term issues, greater for hybrid securities).

We are also maintaining our defensive equity exposures, with the most consistent dividend growers in the US market remaining our largest off-index position. Aside from “high quality” exposure, other areas we like are beaten down biotech and life sciences, energy (both old and new), defensive industrials, preferred stocks, and local Chinese equities.

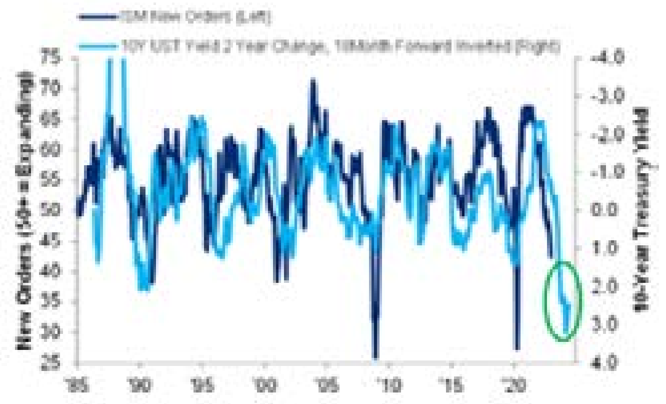
More generally, our largest positions remain in reliable sources of return for portfolios: investment grade company dividends and coupon payments for the highest quality borrowers. By many measures, these yields are now the most generous in 15 years or longer.

Figure 3: Global Equities (6-month lead) vs EPS Y/Y%

Source: Bloomberg and Factset as of Feb. 8, 2023. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

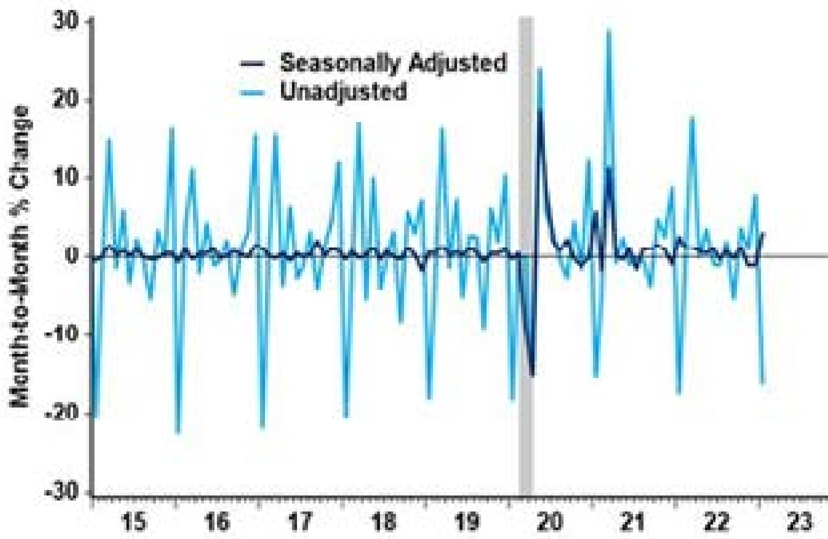
Figure 4: S&P 500 YY% vs ISM New Orders

Figure 5: Change in 10yr UST Yield (24 Months) vs ISM New Orders



Source: Haver Analytics as of Jan. 20, 2023. Note: Fig. 4 circle displays the equity decline has coincided with the drop in ISM new orders; Fig. 5 circle shows that the sharp rise in bond yields has historically been followed by a further decline in economic activity. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Figure 6: US retail sales: month/month % change before and after seasonal adjustment



Source: Haver Analytics as of Feb. 24, 2023. Grey areas are recession.

Figure 7: New single family home sales and single family building permits

Source: Haver Analytics as of Feb. 24, 2023. Note: grey areas are recessions.

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Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
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Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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