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Market Perspective
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In my Market Perspective last quarter, I examined the assumptions implied by analysts' projections that aggregate corporate earnings for companies comprising the Russell 3000 Index would increase over the next three years by double-digit growth rates (43%, 13% and 11%, respectively), thereby providing fuel for the continued rise in stock prices.

I contended that there are only three variables that affect the level of earnings. The first is Revenue. The second is the Operating Margin and the third is the Tax Rate. Using data from Bloomberg, I indicated that aggregate sales were only expected to increase 8%, 5% and 4% for the next three years, respectively. However, analysts were expecting Operating Margins on the Russell 3000 to increase from 9% in 2020 to 16% by the end of 2022. That would represent an all-time high for corporate profitability. I indicated we needed to consider risks to this forecast:

1. Modern-day Capitalism has a way of capping profit margins. If an activity is highly profitable, competition will develop. If it is a monopoly, regulators will cap returns.
2. The analysts' projected margin expansion assumes that all inflationary forces will be borne by the end consumers. We have many historical examples of where inflation was borne partially by the producers through lower margins. We know that we are going to have more inflation than recent history; the only question is whether it is transitory or persistent.
3. This is all based on rosy top-line growth. If robust economic growth does not persist for multiple years, the bottom-line earnings are at risk.
4. The tax rate is subject to political winds, which could pare back some of the 2017 tax cuts that brought the corporate tax rate down to 21%.

All told, this was a contrarian view.

I believe that having a perspective on likely earnings levels, in comparison to analysts' forecasts, is one of the most important data points in crafting a market outlook. This quarter, two highly respected independent research firms (Bloomberg Intelligence and BCA Research) made points that directly align with my concerns.

In August, Bloomberg Intelligence's Chief Equity Strategist, Gina Martin Adams, wrote: "Analysts and S&P 500 companies still expect strong EPS growth to extend in the near term, yet margin risks are starting to bubble to the surface as the pace of revenue growth slows and inflation pressures remain." She and her team went on to explain "The only area of evident concern in the [analysts' earnings] outlook appears to be margins. S&P 500 net income margin may have just peaked and is anticipated to fall in the near term before rising again to reach new highs by 1Q23. Near-term weakness is likely due to a combination of slower top-line gains—as revenue growth likely peaked in 2Q—and still persistent inflation."

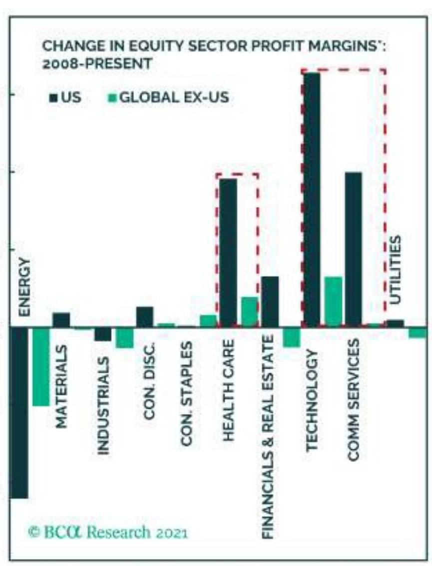
It is unclear what is giving analysts confidence to predict that profitability will be better in 2023 than 2022.

On October 1, the Bloomberg Intelligence team indicated that "Persistent inflation and policy risks remain the market's biggest concerns—sticky prices are already troubling margins."

Also on October 1, independent research strategy firm BCA Research published a white paper entitled: *The "Invincible" US Equity Market: The Longer-Term Outlook for US Stocks in Relative and Absolute Terms.* In it, they make several observations about why past market performance (since the Great Financial Crisis) may not be prologue for the coming decade. Two of these observations directly relate to earnings expectations:

- "Since 2008, US equity outperformance versus global ex-US stocks has not been driven by stronger top-line growth. Instead, it has been caused by a narrowly-based increase in profit margins, the accretive impact of share buybacks on the EPS of US growth stocks, and an outsized expansion in equity multiples. To a lesser extent, the dollar has also boosted common currency relative performance."
- "There are significant secular risks to these sources of US equity outperformance over the past 14 years. Elevated tech sector profit margins are likely to lead to increased competition and higher odds of regulatory action, leveraging has reduced the ability of US companies to continue to accrete EPS through changes to capital structure, relative multiples are not justified by relative ROE, and the US dollar is expensive and is likely to fall over a multi-year horizon."

BCA particularly makes the point that increased margins since 2008 in the US have been primarily due to larger technology/communications companies (and, to a lesser extent, healthcare), as demonstrated in the following graph. It appears regulatory forces could alter those trajectories:



* SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION), REFINITIV/IBES, AND BCA CALCULATIONS.

Why am I focusing on the technicalities of corporate earnings, rather than the macro forces of fiscal policy, the feuding politics of Washington DC, the monetary developments of the Federal Reserve, the implications of China's new focus on "Common Prosperity" or the continuing bloated valuations of US risk-assets? It is solely because it has been the extraordinary rise of expected earnings that has captivated investors over the last 18 months, while they have largely ignored macro risks. If that lynchpin fails, we should expect investors' love-affair with risk assets to suffer.