Market Perspective
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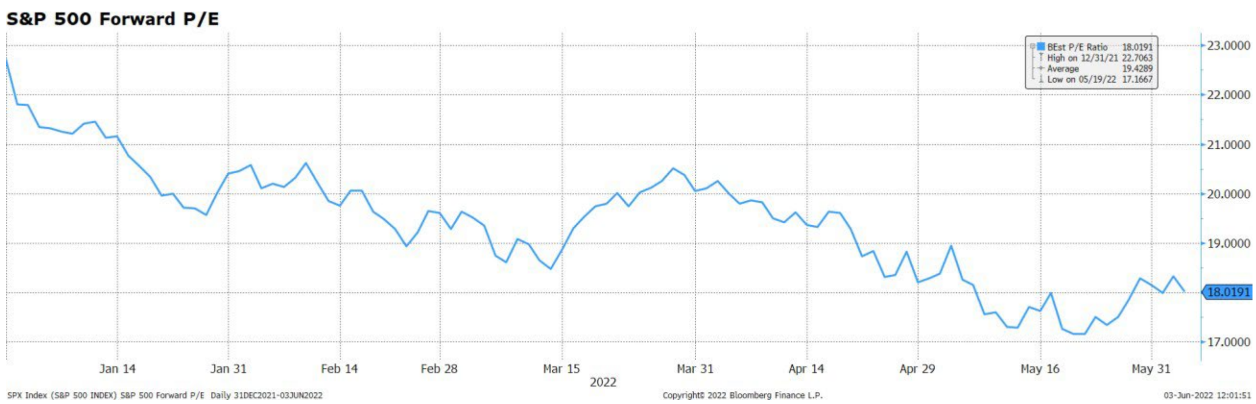
The Price/Earnings Ratio ("P/E") on a stock or an equity index has two distinct inputs; the price (numerator), as observed in the market and, generally, the "expected" earnings over the next year (the denominator). This latter input is derived by using the consensus estimates of the myriad of sell-side analysts.

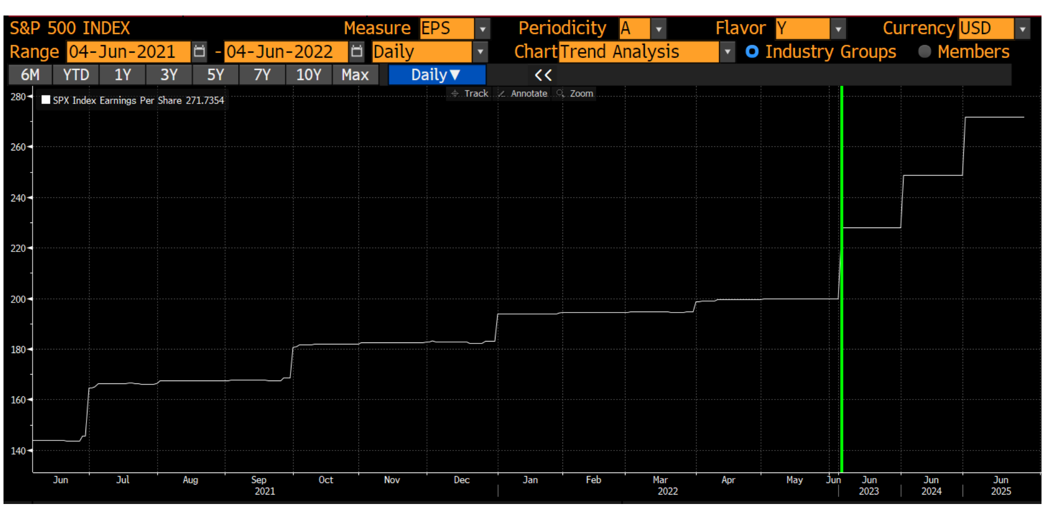
Since the beginning of the year, the "Forward P/E" on the S&P 500 has fallen from 22.8x to 18.0x.



What's important to know is that all of this decline is attributable to price declines, not earnings deterioration. Indeed, analysts are expecting a 14% growth in this year's earnings and 9% growth in each of the next two years.

The long-term average (since 1990) forward P/E is 16.7x, so it is tempting to believe that the decline in the market this year now has us near to average valuations. The only potential flaw in that logic is the degree to which those earnings expectations come true.

Here's a graph of earnings on the S&P 500 over the last year (left of the green vertical line) and then what the sell-side consensus suggests will be earnings over next three years.



So today's P/E is predicated on rather substantial earnings increases over the next couple of years. And, therin, lies the problem. While the decline in U.S. equity market values from January, 2022 – June, 2022 was primarily driven by a decline in overvaluations, we are now facing the prospect of a real decline in economic activity, resulting in a lower "E", and generating new pressure for market declines. Three months ago, I indicated that a key Wall Street indicator was flashing "recession". Today, that call is resonating among leading business people and investment strategists:

- BlackRock, Inc. Chief Executive Officer Larry Fink said he expects inflation to remain elevated for several years primarily because of snarled global supply chains. (June 2, 2022)
- Jamie Dimon, Chief Executive Officer at J.P. Morgan, warned investors to prepare for an economic "hurricane" as the economy struggles against an unprecedented combination of challenges, including tightening monetary policy and Russia's invasion of Ukraine. (June 1, 2022)
- Goldman, Sachs President John Waldron echoed Diamond's comments, indicating "This is among – if not the most – complex dynamic environments I've ever seen in my career. The confluence of the number of shocks to the system to me is unprecedented." (June 2, 2022)
- Sequoia Capital, one of the country's leading venture capital firms, convened a video call with its approximately 250 portfolio companies regarding the economy. Sequoia laid out the case for a long and drawn-out recession and instructed founders to "do the cut exercise" immediately, examining ways to conserve cash through eliminating or scaling back projects, R&D, marketing and other expenses. (May, 2022)
- Tesla Chief Executive Officer Elon Musk said the electric carmaker needs to cut staff by around 10%, noting he had a "super bad feeling" about the economy (June 2, 2022)

I have written in the past about the seeming unsustainability of ever-increasing corporate profit margins. However, there didn't seem to be a catalyst for a regression to the mean:

This has been particularly pronounced since the onset of the pandemic. Those optimistic analyst estimates are likely predicated on the continuation of outsized corporate profit margins.

So what might cause these margins (and corporate earnings growth) to come down? I could speculate about how inflation might not be passed-through, how inflation may result in demand destruction, how higher rates will slow housing, or how supply-chain disruptions may increase costs, etc. However, I would like to end this focus on prospective margins and earnings with the good work done by Bloomberg's independent research arm, Bloomberg Intelligence. Last week, the team released an outlook for margins of large cap stocks. I have attached that report. For those who just want the conclusion – profit margins are declining. Just remember, if projected margins don't hold up, neither will the earnings on which the forward P/E ratio is determined.

Finally, for those who wonder whether the market's recent decline has cured its over-valuation, I offer the following exhibit from Mark Hulbert's column in yesterday's Wall Street Journal. Hulbert's firm compiled eight different valuation measures and scored them from most undervalued to most overvalued at the market's mid-May low point. From my perspective, this still suggests overvaluation:

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Large Cap Margin Outlook: Spring 2022


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Margin Outlook Is Likely to Get Worse Before It Gets Better

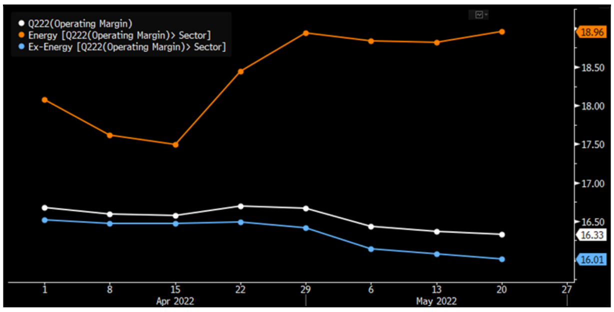
(Bloomberg Intelligence) -- All S&P 500 sectors except staples are still forecast to post operating-margin levels above pre-pandemic averages for fiscal 2022, an expectation that may prove challenging, particularly for companies with rising inventories and supply-chain exposure to China. Revisions are worsening, particularly for 2Q, while the outlook for 2H is now mixed. (05/24/22)

1. Energy Margin Can't Keep Market Forecast Afloat

Increases in energy operating-margin estimates are no longer offsetting the massive reductions being made to those in other S&P 500 sectors, with cuts continuing to deepen. Despite 2Q energy-profitability estimates rising 88 bps in the past eight weeks, total S&P 500 projections shrank 35 bps, with most of the decline occurring in the last four weeks.

Through April, 2Q margin estimates were flat for the S&P 500, with downward revisions in 17 of the 24 relevant industry groups, at an average of 33 bps. By May 20, the margin outlook for only one additional industry group (pharma) flipped negative, but the average cut widened to 74 bps. Major reductions were made to consumer services, retailing, household products and tech hardware in the past four weeks. (05/24/22)

2Q Operating Margin Estimates



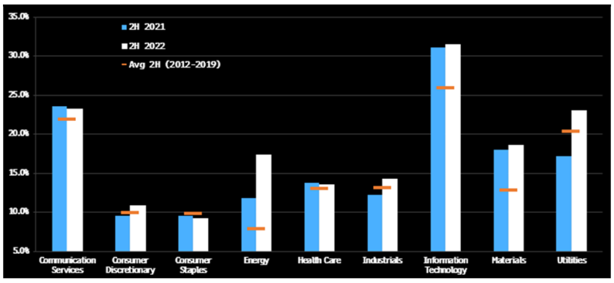
Source: Bloomberg Intelligence

2. Analysts Still Expect Some Margin Relief in 2H

Analysts have largely given up hope for recovery in operating margin in 2Q, but are still hanging on to the notion that the outlook will improve in 2H. Forecasts imply six of nine S&P 500 sectors will post operating-margin declines year-over-year in 2Q. However, by 2H, only three sectors are projected to post falling margins vs. 2H21 (health care, staples and communication services).

Consensus sees consumer staples as the hardest-hit sector in 2022, with margins falling short of pre-pandemic averages in 2Q and in the second half. For the full year, all sectors are expected to touch pre-Covid-19 average levels for operating margin except consumer staples, which is forecast to be more than 50 bps short. (05/24/22)

2H 2021 Operating Margins by Sector



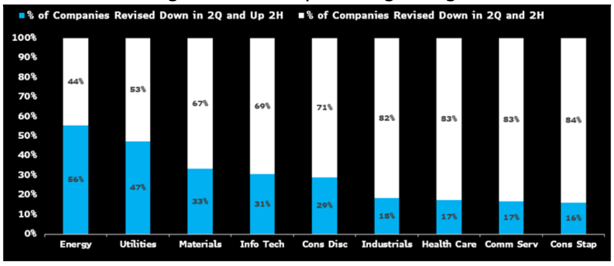
Source: Bloomberg Intelligence

3. Long-Term Margin Losers Starting to Surface

Near-term operating-margin forecasts are falling for most of the S&P 500, and analysts now expect a wide swath of the index not to recover much through the rest of the year. Over the past eight weeks, operating-margin forecasts for 2Q were cut on 69% of the S&P 500 companies tracked by BI, and on 61% for 2H. A quarter of the 277 corporations with a lowered 2Q outlook had a positive revision to 2H, implying analysts see the margin compression for this group as short term only. A third of discretionary, info tech and materials companies with 2Q margin reductions also recorded positive revisions to 2H forecasts.

Consumer staples, communication services, health care and industrials are expected to languish for longer, as over 80% of companies posted negative revisions to both 2Q and 2H in these segments.
(05/24/22)

8 Week Change in 2022 Operating Margin Estimates



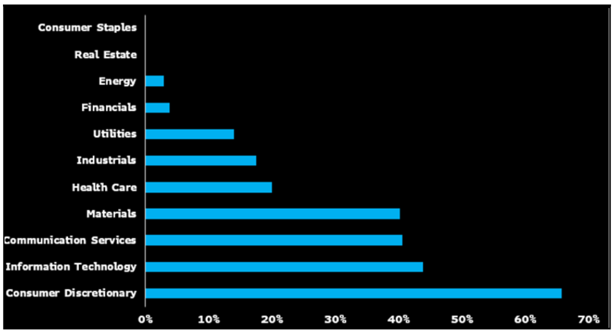
Source: Bloomberg Intelligence

4. China Exposure May Hurt Gross Margin Estimates

S&P 500 companies that disclose reliance on supplies from China may continue to see elevated pressure on gross margins. According to SPLC <GO>, 58 organizations in the index source a portion of their cost of goods sold from Chinese companies. Though only 12 of 60 in discretionary rely on Chinese suppliers, they make up 70% of the sector's market cap, and include some of the largest firms (Amazon.com, Tesla and Home Depot). Analysts trimmed gross-margin forecasts on 11 of those 12 corporations (92%) in the past eight weeks. Among consumer discretionary companies not reliant on China, less than half had cuts to the estimates.

Likewise, six of 28 materials companies cite Chinese suppliers. Five of the six (83%) had lowered gross-margin estimates, vs. only 22% of those that don't disclose Chinese company sourcing.
(05/24/22)

% of Market Cap With COGS Exposure to China



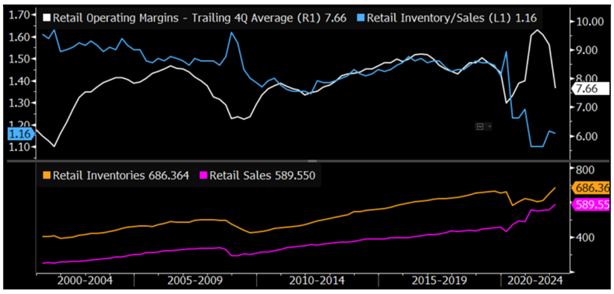
Source: Bloomberg Intelligence

5. Inventories Likely Next Thorn in Retail's Side

The outlook for retail margins took a mighty blow this earnings season, and evidence of building inventories may add even more pressure in the months ahead. The inventory-to-sales ratio for the retail economy hit its low midway through 2021 and coincided with the top in industry margins. The ratio appears likely to revert closer to norms as supply chains clear and the sales pace slows.

Thanks mostly to Amazon.com and Target, discretionary retail operating margin is now expected to be just 8.3% in 2Q, compared with expectations of 11% at the start of 1Q earnings season and more than 200 bps below year-ago levels. However, 14 of the 21 constituents in the discretionary retail industry recorded a drop in 2Q forecasts since the start of 1Q. (05/20/22)

Retail Inventory/Sales & Retail Operating Margins



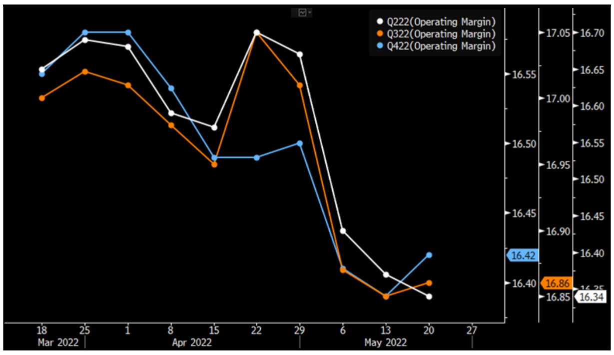
Source: Bloomberg Intelligence

6. S&P 500 Margin Forecasts Plummet

Though retail bore the brunt of operating-margin forecast weakness over the past week, the entire index has experienced a vicious downdraft in margin outlooks since late April. Over the past week, forecasts for the back half stabilized some, but since April 22, index margin estimates dropped 36 bps for 2Q, 19 bps for 3Q and 7 bps for 4Q.

Of the index's 402 relevant constituents, 261 (65%) recorded a drop in operating-margin estimates for 2Q since April 22, while 58% did the same for 3Q and 53% for 4Q. Consumer sectors are still the weakest, but seven of the nine sectors we track saw estimates fall for 2Q and 3Q (energy and materials were the outliers). (05/20/22)

S&P 500 Operating Margin Estimates



Source: Bloomberg Intelligence

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