MV CAPITAL MANAGEMENT

Weekly Market Flash

A Mixed Take on Sales and Earnings

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The second quarter earnings season is winding down, with 435 companies on the S&P 500 having delivered their results as of this morning. If all the moving pieces of corporate financial performance could be boiled down to one simple phrase describing the market's reaction it would have to be this: Could have been worse. With the twin fears of prolonged inflation and economic downturn as a backdrop, investors and analysts were assuming the worst as company management teams teed up their quarterly earnings calls to share their views on what the coming months are likely to bring.

Sure enough, the general tenor in many of these calls was more downbeat than in recent prior quarters, but not dramatically so. The normal way these things go is that analysts have a consensus expectation for what they think a company's key numbers will come in at, and companies routinely beat the consensus (called an "upside surprise" or "earnings beat" in Street-speak). Typically, more than 70 percent of companies record earnings beats (which lends itself to some cynicism about how the game is played between companies and the analysts who cover them). This time the beat rate is in about the mid-sixties. While that is below the norm, it still means that more companies reported higher than expected earnings versus those who underperformed. Thus the mantra behind the market's recent upbeat mood: Could have been worse.

But there is much more to the story than the superficial takeaway headlines that tend to feed into stock market momentum trends. We have a few observations of our own about the good, the bad and the questionable as we sift through the Q2 numbers.

The Top Line

Here's a bit of good news: sales for S&P 500 companies grew by a brisk 13.6 percent from the second quarter of 2021 to the second quarter of 2022. Double-digit sales growth is generally something investors like to see – it means that whatever Company XYZ is selling, it sold substantially more this year than last year. But there is an important qualification to that bit of good news this year: the sales number, which is normally the top line of a company's income statement, incorporates inflation.

If Company XYZ makes, say, umbrellas, then its sales consist of the number of umbrellas sold (the volume) times the price of each umbrella. If it sells exactly the same number of umbrellas this year as it sold last year, but is able to raise the price of each umbrella by 10 percent, then its sales have grown by 10 percent in that year. That is exactly what we heard from many management teams on calls this quarter: volumes were slightly higher, flat or down, but price realizations were much higher as they passed inflationary costs onto their customers.

The Middle Lines

As you travel down the income statement you come to the various measures of profitability. EBIT – Earnings Before Interest and Taxes – is a good measure of a company's operating profitability. This number was also pretty decent for the second quarter: S&P 500 have companies reported EBIT growth of 13.2 percent thus far. Again – double digit growth is normally something to cheer. But let's think about this for a moment. If sales grew by 13.6 percent and operating profits grew by 13.2 percent, then profits

grew less than sales. Not by much, perhaps, but in the language of financial performance it means that operating profit margins (i.e. profits divided by sales) fell. That could mean different things to different companies, but the most likely go-to takeaway is that companies were not able to pass all of their own cost increases (e.g. raw materials, logistics, labor) onto their customers. This will be an extremely important trend to continue following in the months ahead leading to the third quarter reporting season.

The Bottom Line

Finally we come to what many like to call simply The Number: net earnings (usually expressed as earnings per share). Now, as a pure measure of financial performance net earnings is actually a pretty flawed number. All sorts of things that may have little to do with ongoing operations – one-off restructuring costs, legal settlements arising from litigation, adjustments reflecting technical accounting changes – these can all make the "bottom line" look very different from quarter to quarter.

Nevertheless, the buck stops here as they say. For the second quarter, the net earnings growth rate was 6.8 percent for the S&P 500. Again – nothing to sneeze at, but that reflects less than half the growth rate of top line sales. How much of this is related to some of those non-operating expenses and how much represents genuine margin deterioration is unclear at the aggregate level, but again is something that will demand closer attention as the second half of the year proceeds.

The Takeaway: Mixed

What we take away from our observations is that by the standard of corporate financial performance, we have no reason to believe we are in a recession today or likely to be in one soon (if anything, this view is reinforced by the jobs numbers which came out this morning, showing the strongest conditions in the labor market since the months right before the pandemic). Sales are up, companies are making money and staying ahead of what Wall Street analysts expect them to be earning.

In regard to the early evidence this quarter of profit margin deterioration, we should also remember that margins in recent quarters have been at historical highs. In an environment of inflation and slowing growth we shouldn't be too surprised that they are slipping. As long as the slippage is reasonably contained then we shouldn't have too much cause to worry, at least for the moment.

But consumer behavior is changing. Higher food and gas prices are forcing households to curb spending in other, more discretionary areas. There is clearly a limit as to how much additional capacity companies have to pass on their own inflationary costs downstream. What that limit is depends on a number of factors – not least of all, of course, on how much more inflation we have in store and how effective the Fed proves to be in bringing it down. Some indicators of long-term inflation have come down recently, notably break-even rates in five and ten year fixed income yields. But the Fed itself has been very clear this week that it still has a long way to go in getting to where it feels comfortable with inflation. More rate hikes are in the works. Meanwhile, we will be paying very close attention to those margin trends.

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