Weekly Market Flash

Here Come the Earnings

October 14, 2022

Another month, another inflation report running hot. The Consumer Price Index report for September came out yesterday, topping economists' expectations for yet another month despite a welcome decline in energy prices. Food, shelter, medical services, new vehicles and transportation services all remain at elevated levels, leaving the market with a near-one hundred percent consensus that the Fed will once again raise rates by 0.75 percent when the Federal Open Market Committee meets next on November 2nd.

By the time that meeting takes place, we will have some initial intelligence on how companies are coping with higher inflation in terms of growth and profit margins. Third quarter earnings season kicks off today, and it is an important one. There is a sense in some corners of the market that earnings are the next "shoe to drop" in terms of negatively impacting stock price performance. Other corners of the market are more sanguine, arguing that expectations are already dismal and thus companies have a relatively low bar to clear to avoid undue negative surprises. For our part, we are less concerned about where the Q3 reported numbers come in relative to analysts' expectations, and more interested in what company management teams have to say about how their expectations going forward have, or have not, changed.

The Sales – Earnings Gap

One trend is already evident in the numbers: a widening gap between top line sales growth and bottom line net earnings growth. For the third quarter, sales are projected to grow by 8.5 percent from their levels twelve months ago. That estimate is only slightly lower than the 9.9 percent consensus estimate for Q3 sales made back on June 30.

The picture looks different down at the bottom line. Net earnings per share are expected to grow by just 1.4 percent, a vastly lower number than the 9.6 percent growth that analysts had forecasted back on June 30. Think about that: when the third quarter began in July, the expectation among the analysts who follow everything about these companies at an incredibly detailed level was that sales and earning would grow by roughly the same amount. In other words, neither reduced demand from their customers nor higher input prices from their suppliers (of materials, labor and other services) would have much of an effect on overall financial performance.

That picture is very different today. If sales growth does register in the high single digits, it most likely means that companies are still able to successfully offset somewhat lower levels of unit volume by passing on higher prices to their customers. But – not by enough to offset their higher input costs (that sharply reduced EPS growth estimate), meaning that profit margins are set to get measurably worse.

When Demand Turns

If you venture out to your local Home Depot or a popular restaurant in your neighborhood (or, say, catch a flight from DC to San Francisco), you will probably be able to collect plenty of anecdotal evidence in support of the near-term continuation of strong sales growth. People are still buying things – lots of things – despite having to pay more for these things than they did a year ago. This is why those inflation numbers are so persistently high despite what is by now a six month campaign by the Fed to bring consumer prices down. Monetary tightening by the Fed only works on the demand side of the equation. The central bank can't do anything about lockdowns in China, or the war in Ukraine, or supply chain malfunctions in Vietnam. Higher interest rates can only affect domestic demand, and so far that demand is only very slowly subsiding. Hence the low unemployment rate and relatively benign consumer confidence.

It is when the demand equation starts to turn that we are likely to see progress in lowering inflation. We are also almost sure to see weakening sales trends from the current high-single digit levels, since companies will run into much more resistance to higher prices from their customers, particularly for the many categories of highly discretionary items that fall into the category of want rather than that of must have. In fact there is already some early evidence of this: the one major category in the CPI basket of goods apart from energy to register a decline in yesterday's CPI report was apparel – broadly speaking a more discretionary category than, say, food, shelter or medical services.

We may get a further taste of this trend with the bank reports coming out today (not yet released as of the writing of this commentary). The major banks like JPMorgan Chase, Bank of America and Citi will have plenty to say about their consumer credit portfolios, including whether they are building up more reserves ahead of anticipated losses from defaults and delinquencies. This may be a good leading indicator as to what we can expect in the next three to six months.

Meanwhile, remember what we have said in recent commentaries: what is happening now in the economy and financial markets is cyclical. That does not mean it is immune from other extraneous X-factors, like the recent turmoil in the UK gill market. But the economic aspect of this – the inflation, the job market, all of it – is cyclical. And the thing about cycles is, they pass. This one will, too.

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