Farro Capital

Markets Commentary

25th Jan 2023

Reading the Tea Leaves

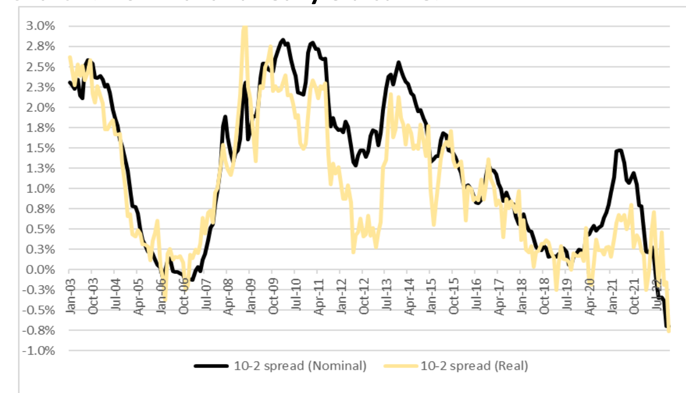
Gong Ci Fa Xai!

In our last market commentary, we highlighted that with improving global financial and growth conditions markets seem to be reaching an inflection point by transitioning from a recession to a global soft-landing scenario, but this same set up may also lead to higher-than-expected inflation, in turn causing the FED to hold rates higher-for-longer.

A picture speaks a thousand words.

Source: Andy constan @dampedspring

Chart 1: Nominal and real yield curve.



Source: FRED

Today we will touch upon earnings given the backdrop of hopes for a soft landing on one hand and an inverted US yield curve on the other. Currently both nominal and real 10-2 yield curves are inverted by ~70bps (see chart 1) and as history has it, an inverted yield curve has preceded every recession with a lead time of anywhere between ~8-18 months. Regardless of whether it turns out to be correct or not, what interests us as portfolio managers is what will be in the offing for earnings, with or without a recession.

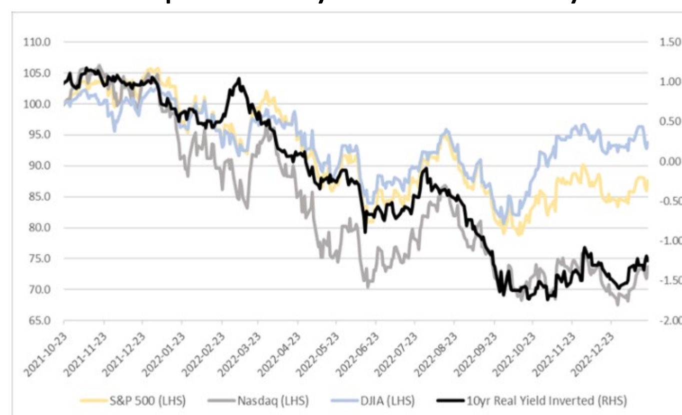
But first, let's try to eke out whether S&P already has seen a recession like drawdown, which may render this entire earnings discussion moot. At first glance, by looking at every peak-to-trough drawdown during US recessions since 1948, one could infer that Jan to October 2022 sell-off in US equities was already in line with the average of what has been seen in previous recessions (see table 1 below).

Table 1: S&P drawdowns in recessions.

Sell-off				Valuation		
Recession	S&P 500	Duration (months)	Recovery (months)	Peak P/E	Trough P/E	Decline in P/E
?	-28%	10	?	22.0	15.5	-27%
2020	-34%	1.5	6	19.0	13.5	-29%
2008	-57%	17	58	16.0	9.0	-44%
2001	-49%	26	57	25.0	14.0	-44%
1990	-20%	3	5	12.5	10.0	-20%
1981	-27%	19	5	8.0	6.5	-19%
1980	-17%	2	3	8.0	7.0	-13%
1974	-48%	19	61	17.0	8.0	-53%
1970	-36%	16	23	18.0	14.0	-22%
1960	-12%	15	4	18.0	17.0	-6%
1958	-20%	16	9	14.0	12.0	-14%
1953	-14%	8	6	11.0	9.0	-18%
1948	-28%	18	28	14.0	8.5	-39%
Base Rate	-30%	13	22	15.0	10.7	-27%

Source: S&P, Yardeni

Chart 2: US Equities broadly correlated with real yield.



Source: S&P, DJIA, Nasdaq

However, one should be mindful that this 2022 sell-off didn't have much to do with earnings, which held up well due to an inflationary environment. Yes, ex-energy, S&P EPS was down but aggregate EPS grew ~5% and most likely more in constant currency. Rather, the 2022 sell-off was driven more so by interest rate shock amid high valuation as bond-equity correlation converged towards +1 from Jan-Oct 2022 (see chart 2 above). Therefore, as

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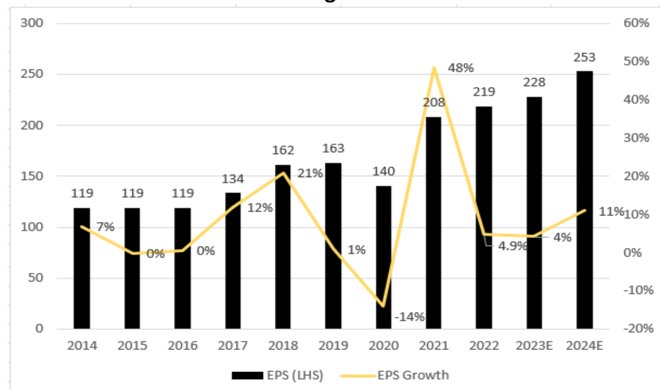
we move forward into 2023, it will be all about earnings and/or earning shock in case of a recession.

Let's first look at earnings estimates.

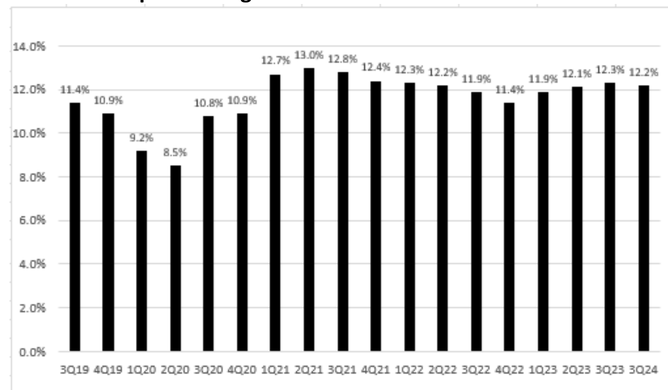
It's interesting that analysts' bottom-up estimates currently look benign despite all the gloom and doom out there. In 2023E, analysts are estimating ~4% EPS growth, with the majority coming in the 2H23 and margins improving in 2H23. For 2024E, analysts estimate EPS growth of 11%, which would translate into a 5-year EPS CAGR of 9.2% from 2019-2024. This compares to 5-year EPS CAGR of 6.5% from 2014-2019.

Chart 3: S&P EPS estimates and growth.



Source: Factset

Chart 4: S&P profit margin.



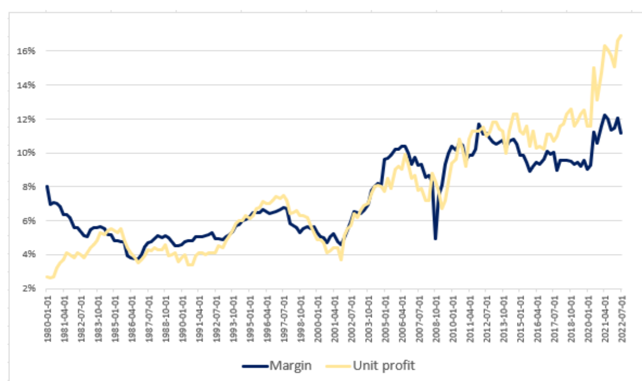
Source: Factset

The first key takeaway here is that EPS growth in 2023 is estimated to be just ok amid support from buybacks even as macro environment remains uncertain. Second, EPS growth for 2023 looks in sync with a growth hiccup scenario, not a recession. Third, while Covid turbo charged 2021 EPS growth and margins, operating leverage is estimated to have hit a permanent plateau that is expected to accelerate EPS growth in 2024. The big picture here is that S&P valuation may look expensive compared to history but not necessarily given its record profit margins.

Now let's imagine alternative scenarios.

In previous economic cycle transitions, unit profits usually stagnated and fell after reaching their previous high-water mark due to cost and liquidity pressures. However, in the current cycle, unit profits not only crossed previous high-water mark but also quickly reached their all-time high – a direct result of spending and pricing boost from huge government transfers (see chart 5 below).

Chart 5: Profit margins and Unit profits are at peak.



Source: FRED

Chart 6: Real growth indicators for non-financial firms.

Source: Federal reserve

If we look a bit at the long term: in the last 20 years, S&P profit margin has increased from 8-9% to 12-13% range, leading to outsized real earnings growth relative to real GDP (see chart 6 above). 1/3rd of this improvement has come from lower taxes and interest rates while the remaining 2/3rd from productivity gains due to globalization and market power. Profits have also become more concentrated: in 1995 top 100 firms had 50% share in total profits but as of 2015 top 100 profit share increased > 80%. What's telling is that in the last three years, Microsoft, Apple, Google & Amazon profits almost doubled.

As we move forward into 2023 and 2024, the question is whether we should expect more of the same for

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earnings in an era of high interest rates, de-globalization, tight labor markets and no further tax cuts? In that respect, the range of outcomes for earnings looks wide: i) recession may take time as wages catch up but inflation and interest rates may remain sticky in turn pressuring margins ii) recession is mild but earnings may still decline due to revenue and wage pressure iii) recession hits with FED overtightening followed by delayed easing which may trigger a deflationary episode and an earning shock, iv) recession is avoided, margins do not compress much, FED backs off and new cycle begins i.e., Soft landing (aren't analyst estimates already showing that with 11% EPS growth in 2024?).

Chart 7: Consensus expects margin to hold in the long run

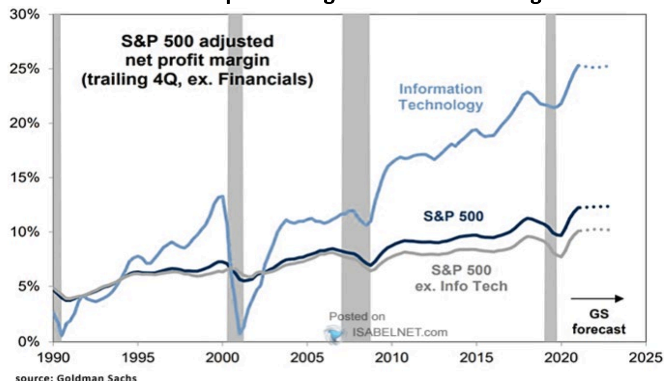

Chart 8: What kind of EPS decline we may see in the next recession?

Recession	Decline in EPS	Peak Margin	Peak PE	Peak Interest Rate	Cumulative Cuts
?	?	12.5%	22.0	?	?
2020	-14%	9.5%	19.0	2.5%	250bps
2008	-45%	10%	16.0	5.2%	500bps
2001	-23%	6.7%	25.0	6.5%	450bps
1990	-20%	5.0%	12.5	9.7%	375bps
1981	-13%	6.5%	8.0	19%	1000bps
1980	-3%	8.5%	8.0	17%	750bps
1974	-13%	7.7%	17.0	12%	650bps
1970	-8%	7.3%	18.0	9.0%	500bps
1960	-15%	6.8%	18.0	4.0%	225bps
1958	-20%	7.1%	14.0	3.5%	250bps
1953	-20%	6.4%	11.0	NA	NA
1948	-19%	9.0%	14.0	NA	NA
Base Rate	**-18%**				

Source: FRED, NASDAQ, S&P, FRED, Goldman Sachs

Conclusion

4Q22 earnings are in full swing with 40% of companies expected to report this week. So far both the number and magnitude of earnings and revenue beats are coming in below historical averages. Typically, in any given quarter, ~70% of companies beat earnings and revenues estimates. This is just how markets work, i.e., beats are expected. While beats are coming below historical avg, market sentiment was already not too rosy for 4Q22 earnings, so theme remains the same for earning season as for economy: not so good, not so bad data = not bad for markets.

That's because despite all the hue and cry about inflation/war/growth, markets seem to be looking ahead to better days: all major equity indices are sitting above 200 DMA along with 8 out of 11 global equity sectors. Meanwhile other than tech heavy Nasdaq, US indices seem to have de-linked from 10-year real yield since October (see chart 2). The gist is that markets are reaching an inflection point with divergence between central banks vs market expectations, soft data vs hard data, credit/equity markets vs Yield curve.

While in the short term, the next 1 week of data and policy thereafter shall decide where markets will be heading, beyond that it's all about earnings/margins.

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