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Weekly Commentary

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By Hubert Marleau

The Message From Corporate America

Submitted October 22, 2022

A few weeks ago in the early days of September, I argued that corporations would likely report better earnings than generally expected and broadcast by the press. My thesis was based on observations collected from ISM reports, prints from the Bureau of Labour statistics and the Kalesky-Levy equation.

Price Received Versus Price Paid: Invariably lost in the internals of the ISM reports, the stats have nonetheless consistently shown that the spread between prices paid by businesses and prices received has not narrowed.

Real Cost of Labour: Although wage inflation has picked up in a broad-based manner through 2021, real inflation-adjusted wages have tended to be flat or falling across many industries. This is an important aspect of the current profit conjecture. Lower real wages affect profitability because they lower firms' real costs.

The Kalesky-Levy Equation: This is an accounting identity that shows where profits come from. Profits = Investment +Dividend + Buybacks - Personal Savings + Trade Balance + Government Budget Deficits. Knowing this axiom gives investors a leg up in predicting earnings. While I recognize that the smaller government budget deficits are burdening profits, dwindling personal savings and trade deficits have adequately compensated for the fiscal drag.

In this regard, it appears that companies have sufficient pricing power and sales growth to keep their businesses profitable. Here is what Yardeni Research has to say about this: "Recent downward revisions in the coming 6 quarters are reflected in analysts'2022 and 2023 earnings estimates at 223.72 and 241.83. Forward earnings are the time-weighted average of the two and was 237.30 this week. It's converging toward the 2023 estimate at the end of this year, and will soon start giving weight to the 2024 estimate, which is currently $260.93 at the beginning of 2023."

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Thus far, the earnings season is going well. The S&P 500 bounced handsomely off a crucial bottom as investors concentrated on earnings rather than inflation, interest rates, geopolitics and economic slowdown. Their confidence having been skinned by volatility, they are now trying to find a justifiable P/E equilibrium. Interestingly, they have the means to do this because the average equity fund manager surveyed by the Bank of America is holding more cash as a percentage of their portfolio than at any point since April 2001. In other words, they are in a position to buy stocks whose valuation metrics are reasonable and earnings performance acceptable. Indeed, a stream of mostly upbeat corporate reports from diverse companies has partially characterized the week. As of Friday's close, 88 companies in the S&P 500 had reported earnings, with 75% of them coming in higher than expected. For example, Netflix, BofA, JPM, Pepsi, P&G, Lockheed, JNJ, United Airlines, Lam Research, Procter and Gamble, IBM, Intuitive Surgical, Interactive Brokers, CRM, Abbott Laboratories, AT&T, Travellers, Baker Hughes, Schlumberger, and ASML Holdings, all topped revenue and profit estimates.

What is particularly uplifting is that all the major indices are now above their high of last Thursday's extraordinary upside reversal day. Traders, who tend to have a pro-risk stance, consider this week's session as a confirmation of the reversal day. If it had not been for the nasty run-up in bond yields, the stock market would have fared very well, in which case the street should expect more follow-through buying until resistance is met around 4000, where another tug of war between bulls and bears exists. The risk-reward outlook for the stock market is not favourable enough, however, to sustain a turnaround to the previous high of 4797 for the S&P500. For that, we need to wait until 2023.

Indeed, there is still serious anxiety surrounding the hawkish rhetoric of central banks and the rise in geopolitical tensions. It's not that the market is getting batches of bad news out of a majority of its companies; but the strength of the corporate sector reinforces the case for more official interest-rate increases. Federal Reserve officials, Patrick Harker, Neel Kashkari and James Bullard each gave speeches emphasizing that they will actively raise rates for a while longer to slow the economy, but may stop doing so in 2023. Treasury yields across the curve are now comfortably above 4.00%, while yields on 10-year U.S. government debt rose to 4.23%, and the 2-year yield, which is sensitive to short-term rate expectations, increased to 4.61%, its highest since July 2008.

Nevertheless, I'm not buying the proposition that the six-week 100 bps surge in government bond yields was entirely a function of higher inflation expectations. First, the loss of adequate liquidity in the treasury market, (which is related to lack of well capitalized market makers). Second, the enormous size of government bond issuance and quantitative tightening has raised the question about who will buy U.S. Treasuries if liquidity is withdrawn from the market. Third, the decline in the US money supply is accelerating. It fell an annualized

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2.78% over the past 3 months and was down 1.96% over the past 6 months. According to Macro Strategy Partnership, the scale of the fall is no longer just noise, but very serious.

As a matter of fact, the Conference Board's leading economic index and the forward swap market confirmed this week that the Fed is having its desired effect on the economy. The index fell 0.4% month-over-month in September, after a 0.3% drop in August. Swaps are predicting a 5.5% drop in inflation from 8.2% to 2.7%. The IMF has boldly forecast that inflation will turn back to normal levels (around 2.5% annually) within a year. In this regard, the widely anticipated capitulation may occur outside of the market but in the hard inflation number. Interestingly Nick Timiraos, known on Wall Street as the Fed Whisperer, wrote in the WSJ that the Fed's rate-setters will raise the policy rate another 0.75% on November 2, but will likely tame future hikes.

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