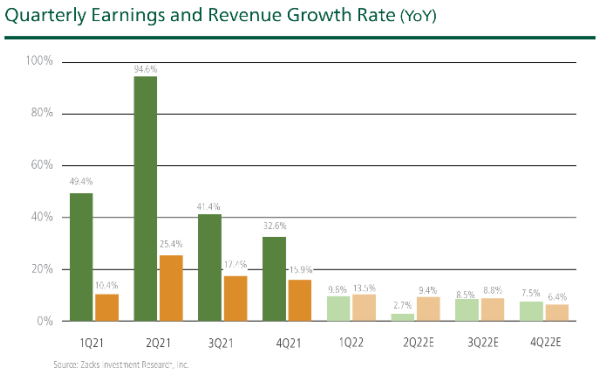
What You Should Know About Volatility, Earnings and Valuations

Earnings season is underway, and some high-profile misses in the retail sector arguably drove a fresh wave of volatility in the stock market. According to our colleagues at Zacks Investment Research[1], multiple factors were at play in these earnings misses: merchandising missteps, failing to read evolving consumer behavior, and a failure to fully factor the effect of rising costs. In other words, it's not necessarily the consumer that had a weak Q1 – just the companies serving them.

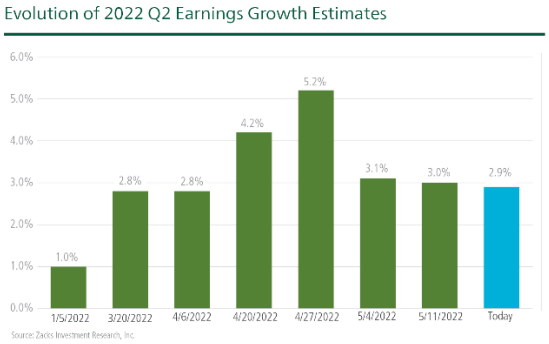
Indeed, in a survey conducted last fall by the Federal Reserve, Americans reported the highest level of financial well-being in 10 years, boosted by a strong jobs market with rising wages. Higher inflation and particularly rising food and gas prices likely dented this position in Q1 2022, but not so much that consumers are all of a sudden financially vulnerable. JP Morgan Chase reported last week that they expect credit losses to remain uncharacteristically low through 2023, and they are reporting strong cash balances among bank customers.[2]

Zooming out and looking at the Q1 earnings season as a whole, the total S&P 500 earnings are expected to be up +9.6% on +13.5% higher revenues. Companies are dealing with a challenging pricing environment and higher input and labor costs, but earnings are still going up.



It's also true that while the earnings picture has shifted around quite a bit in Q1 because of rising inflation, the war, and lockdowns in China, overall earnings growth estimates for Q2 2022 have not changed all that much. As you can see in the chart below, earnings estimate for

Q2 are actually higher today than they were at the start of the year, and they have settled at levels that were being forecast in early April:



To be perfectly fair, however, a good portion of overall earnings strength is coming from the Energy sector. The Q2 earnings estimates for the Zacks Energy sector have increased a staggering +78.5% since the start of January, and +41.7% since the beginning of April. And with an expected $49.9 billion in earnings in Q2, that would mark year-over-year earnings growth of +178.8%. The sector's full year earnings outlook is even more impressive, with the current aggregate earnings estimate of $182.3 billion, up +107.8% over 2021, and it has increased by an impressive +66.3% since the start of the year.

But it's not just Energy that is doing well in the current environment. We are also seeing nicely positive earnings revisions in Transportation, Basic Materials, Construction, Consumer Staples, and Autos. It is clear, in my view, that some areas of the economy are thriving with strong consumer demand and the benefits of pricing power, while other sectors are still trying to make adjustments to account for higher costs and shifting consumer behavior. Because again, it's not necessarily the consumer that's in a tough spot – it's companies trying to figure out how to efficiently meet demand and grow profits in the process.

Bottom Line for Investors

The earnings picture is shifting, but I am not seeing the glaring issues that seem to be reported daily in the financial media. In Q1, approximately 77% of S&P 500 companies reported a positive earnings-per-share surprise, which is very much in line with longer-term averages. And yet, companies that were surprised by the upside saw their shares decline in the two days following their earnings release, which is the opposite of what has happened historically. All told, the selling pressure amidst growing earnings has led to the S&P 500 having a forward 12-month P/E ratio of 16.4x, which is lower than the 10-year average.[3]

As a reminder to readers, no one can know when the market correction will run its course. Corrections (which I still believe this market action represents) can last weeks or months, with rallies giving way to sell-offs and the market often looks like it has no clear direction. But one thing we do know is that equity investors with goals of growth do not want to be on the sidelines when the correction does indeed end. Since 1974, the S&P 500 has jumped an average of +8% one month after a correction bottom, and more than +24% a year after a correction bottom.[4]

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Zacks.com. May 20, 2022. https://www.zacks.com/commentary/1927310/breaking-down-the-earnings-outlook-after-retailers-disappoint

[2] Wall Street Journal. May 23, 2022. https://www.wsj.com/articles/americans-reported-strong-personal-finances-late-last-year-fed-finds-11653317014

[3] Zacks.com. May 20, 2022. https://www.zacks.com/commentary/1927310/breaking-down-the-earnings-outlook-after-retailers-disappoint

[4] Charles Schwab. February 25, 2022. https://intelligent.schwab.com/article/stock-market-corrections-not-uncommon#:~:text=These%20occasional%20pullbacks%20have%20historically,than%2024%25%20one%20year%20later

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- **Fed minutes show urgency for raising rates**
- **Dividend-paying stocks are highly favorable**
- **Who won the U.S. – China trade war?**
- **A note on the China-U.S.-Taiwan risk**

What Last Week's Fed Minutes Tell Us

This week, market-watchers were eagerly anticipating the release of minutes from the Fed's May 3-4 meeting. Analyzing minutes is important for understanding the potential path of rate increases and as a means for understanding just how hawkish the Fed is. The verdict is that the Fed is prepared to take rates as high as needed to stem inflation pressures, which could mean additional 50 basis point increases at future meetings and also potentially raising rates high enough to intentionally slow the economy. The Fed has not raised rates by a half percentage point since 2000. This strategy is reminiscent of Fed Chairman Paul Volcker's monetary policy strategy in the 1980s when he deliberately caused a recession in an effort to tamp down the 'great inflation' of the late 1970s. Back in the 1980s, however, Chairman Volcker moved the fed funds rate past 20%, whereas today the fed funds rate sits at a range between 0.75% and 1%. In reality, comparing the two approaches is like comparing night and day. The Federal Reserve also made note in their May 3-4 meeting of their intent to begin shrinking their $9 trillion portfolio on June 1, which will remove a significant source of demand from the bond and mortgage securities markets. Upward pressure on mortgage rates and longer duration interest rates is to be expected, which could be a positive if it ultimately results in a steeper yield curve.[1]

Why Dividend-Paying Stocks are Being Favored

S&P 500 companies paid out a record $137.6 billion in dividends in Q1, and investors are taking notice – particularly as volatility continues. For years, investors have been flocking to the high growth, high valuation technology trade, which gained even more steam during the pandemic as the economy made a significant shift to digital everything. But as interest rates have moved higher and the growth outlook moderates, many of these high valuation names have experienced sharp selloffs as investors favor cash overgrowth. What's more, investors appear to be going a step further and favoring companies that are choosing to use cash reserves to pay out higher dividends versus opting to buy back shares. This shift demonstrates that investors again are favoring cash payouts now versus the prospect of profits later. The proof is in the pudding – the S&P 500 High Dividend index is up +3.6% in 2022 while the S&P 500 Buyback index is off -13%.[2]

Who Won the U.S. – China Trade War?

It's been nearly three years since the U.S. ratcheted up tariffs on Chinese imports, an action that escalated into a trade dispute and eventually a resolution that was supposed to see China buying more U.S. goods. It didn't happen. China fell 40% short of its commitment in Phase One of the trade deal to buy an additional $200 billion over two years, and reports of technology theft and unfair practices continue. For its part, China has not necessarily benefited from the trade dispute and resolution,

either. Economists note that Chinese companies that were hit with tariffs have spent less on research, reduced hiring, and exported less to America.[3]

A Note on the China-U.S.-Taiwan Risk

President Biden's trip to Southeast Asia this week in some ways reminded the world of another potential geopolitical conflict in the offing: a Chinese invasion of Taiwan. U.S. policy on Taiwan has been one of "strategic ambiguity" since Nixon's days, which has largely positioned the U.S. as an ally and arms supplier to Taiwan without defining what military action, if any, the U.S. would take to support it. In many ways, the Russian invasion of Ukraine is serving as a case study for how Western countries might respond to an unprovoked invasion of democracy like Taiwan, and President Biden's comments that the U.S. would consider defending Taiwan have perhaps served to have China grasp the full economic – and perhaps military – repercussions of an invasion. For markets, regional conflicts like the Russia-Ukraine war have not historically had a severe impact on the global economy or equity markets. But a conflict that involves the U.S. and China would, in our view. It's a risk to keep an eye on.[4]

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[1] Wall Street Journal. May 25, 2022. https://www.wsj.com/articles/fed-minutes-show-growing-urgency-for-tighter-monetary-policy-11653501768

[2] Wall Street Journal. May 24, 2022. https://www.wsj.com/articles/there-is-a-rush-for-cash-on-wall-street-11653364425

[3] Wall Street Journal. May 20, 2022. https://www.wsj.com/articles/who-won-the-u-s-china-trade-war-11653059611

[4] Wall Street Journal. May 24, 2022. https://www.wsj.com/articles/china-taiwan-relations-tensions-explained-11653322751

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