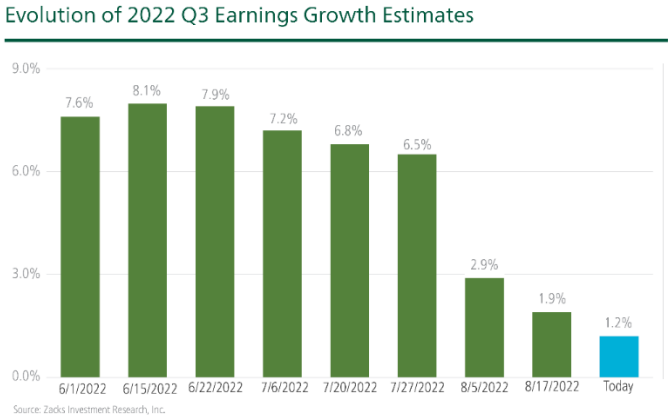
What Earnings Estimate Declines Mean for Markets

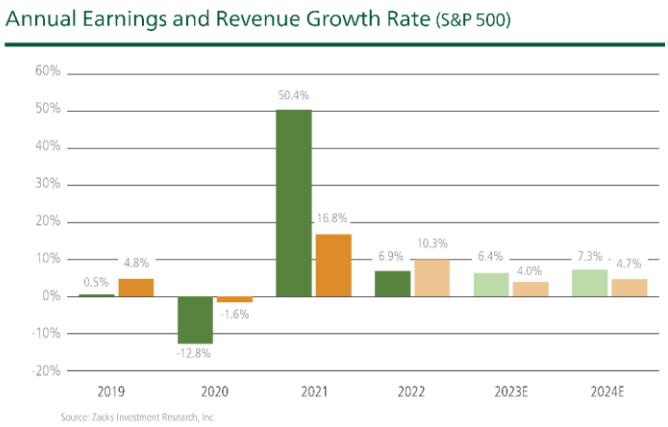
Earnings estimates for the second half of 2022 and full-year 2023 are marching lower. On July 1, earnings growth for S&P 500 companies was expected to be +7.6% for the third quarter. As I write, expected earnings growth has fallen to +1.2% for Q3, with the positive skew largely coming from big gains in the Energy sector. These are the biggest cuts (see chart below) to earnings estimates we've seen since Q2 2020, when analysts were scrambling to factor in the impact of the Covid-19 pandemic.[1]



Source: Zacks Investment Research

Q3 earnings estimates have been cut for 14 of the 16 Zacks' sectors over the past several weeks, with the biggest declines coming in Consumer Discretionary, Consumer Staples, Technology and Retail. Given the U.S.'s status as a service and consumption-based economy, these are key sectors where we generally don't want to see earnings coming down. It's also worth noting that nearly half of S&P 500 companies mentioned 'recession' on their post-earnings conference calls in Q2, which is far more than we see in a typical quarter.[2]

Earnings weakness is expected to persist in Q4 and into 2023, with estimates in decline for these periods as well. As you can see on the chart below, there is still a consensus that we'll see earnings growth this year and next – it's just much slower growth than was anticipated at the beginning of the year.



Source: Zacks Investment Research

Analysts and market participants have been factoring in the earnings impact of rising interest rates and sticky inflation, and how the two are coming together to possibly push the U.S. into a recession. Even a stronger dollar has many analysts worried, as it can adversely affect sales that multinationals make abroad. While caution over corporate profitability started to appear in earnest in Q2, it has hit stride over the last few weeks.

Investors who have been following these earnings trends or are perhaps reading about them now may be thinking: *this can't be good for markets going forward.* There is a growing sense that falling earnings and earnings estimates must mean falling stocks, which for some investors also means considering changes to portfolio positioning.

But that's not really how markets work. For one, U.S. stocks are already in a bear market, so weaker economic and earnings growth ahead is likely being priced into stocks now, at least to a degree. Consider what happened with earnings estimates in the early days of the pandemic. In the beginning of Q2 2020 – which was the last time earnings estimates fell by as much as they are falling now (see chart below) – analysts were slashing earnings forecasts to factor in the impact of the pandemic. But by the time earnings estimates started coming down, the bear market was already over:

Source: Federal Reserve Bank of St. Louis

Analysts are now starting to factor in the impact of higher rates on spending and earnings, but I would argue that the impact on markets has already been felt to a large degree. I would also expect the market to rally when expectations and sentiment about earnings and the economy are low and/or falling, which is what we've been seeing over the past few weeks. There's an old saying that "bull markets are born on pessimism," which is what I think investors should be looking for now.

Bottom Line for Investors

Earnings gloom is gaining steam in Q3, which is arguably helping U.S. corporations since falling expectations mean there is a lower hurdle to clear for companies to do better than expected. That's what we saw in Q2, when companies proved pretty resilient in the face of inflation and weaker growth, and the earnings season turned out to be better than expected (with stocks holding up over the summer months). We're likely to continue seeing estimates coming down in future weeks and months, but I don't see an action item for investors – much of this weakness is already priced in.

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. September 7, 2022. https://www.zacks.com/commentary/1977754/previewing-the-q3-earnings-season-as-estimates-slide

[2] Wall Street Journal. September 12, 2022. https://www.wsj.com/articles/sliding-earnings-forecasts-pose-next-test-for-markets-11662907853?mod=markets_lead_pos2

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- **Fed raises rates by 75 basis points**
- **The downstream effects of a softening housing**
- **Rise of retail sales**

Fed Raises Rates By 75 Basis Points and Increases Forecast for the Year

As expected, every member of the Federal Open Market Committee (FOMC) voted to raise the federal-funds rate by 75 basis points, to a range between 3% and 3.25%. The last time rates were this high was in 2008, during the Global Financial Crisis. Even though this rate increase was largely expected, equity markets sold off sharply as investors digested the central bank's new projections for interest rates by the end of the year and into 2023. Fed minutes showed a 4.4% median projection by FOMC officials for fed funds by the end of the year, which marked a substantial increase from the 3.4% forecast that existed in June. What was perhaps more meaningful to equity markets and short-term Treasury yields, however, was that the 4.4% projection was 25 basis points higher than traders were expecting, which registered as a negative surprise. Markets do not like negative surprises. With rates currently at 3% to 3.25% and projected to reach 4.4%, the implication is that the Federal Reserve will implement sizable rate increases at their November and December meetings, assuming that inflation data remains elevated throughout this time. There are two key pieces of economic data that have investors worried that inflation may not meaningfully abate in the near future: rapidly rising wages and rising prices outside of food and energy, signaling that inflation is broad-based.[1]

The Downstream Effects of a Softening Housing Market

The housing market in the U.S. continues to show signs of cooling off, with home sales falling for the seventh straight month. On the heels of Federal Reserve rate increases have been rising U.S. Treasury bond yields and mortgage rates, which recently crossed 6% for the first time since 2008. Worth noting, however, is that the housing market is softening from a relatively strong position, as the pandemic ushered in a housing boom that saw sales and prices soar to record levels. Even still, as the housing market cools off, there could be rippling effects throughout the economy, particularly for sales and revenues of companies that sell products home buyers need. Think furniture, washing machines, light fixtures, and other goods and even services that new homeowners need. The effects are already starting to be felt: according to the Commerce Department, furniture and home-furnishing store sales fell by 1.6% in August, and new layoffs have been reported. At electronics and appliance stores, sales have fallen by 5.7%.[2]

Economic Data Roundup Points to Slowing – But Not Imploding – U.S. Economy

Economic data in the U.S. has been tapering off, but has not shown signs of falling off a cliff. At least not yet. Retail sales in August were relatively good, rising 0.3% in August – a 0.2% faster pace than inflation's increase over the same period. However, looking more closely into the numbers shows that a bulk of the sales increase came from spending at auto dealerships, which may reflect higher prices for cars. Stripping out auto sales, retail sales were down 0.3%. Industrial production was also off by 0.2% in August, though manufacturing

output held its own and rose 0.1%. Finally, the jobs market continues to be the asterisk in an otherwise weakening economic landscape, with new claims for unemployment falling for the fifth straight week and the unemployment rate steady at a historically low 3.6%.[3]

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[1] Wall Street Journal. September 21, 2022. https://www.wsj.com/articles/u-s-treasury-yields-steady-ahead-of-fed-decision-11663770829

[2] Wall Street Journal. September 18, 2022. https://www.wsj.com/articles/home-goods-retailers-jolted-by-slowdown-in-housing-market-11663493404?mod=djemRTE_h

[3] Wall Street Journal. September 15, 2022. https://www.wsj.com/articles/us-economy-retail-sales-august-2022-11663185901?mod=djemRTE_h

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