INVESTMENT STRATEGY INSIGHTS

Tracking the Decline

October 17th, 2022

Anticipating an Earnings Decline

- As earnings turn over, there may be further downside to this bear market, justifying an underweight to risk

Inflation Feeling Hot, Hot, Hot

- Persistently high inflation runs the risk of becoming embedded in the consumer psyche, warranting a stern Fed reaction

Tightening the (Monetary) Belt

- After a regimented rate hike campaign this year, expect the Fed to adopt a data-driven approach to further tightening

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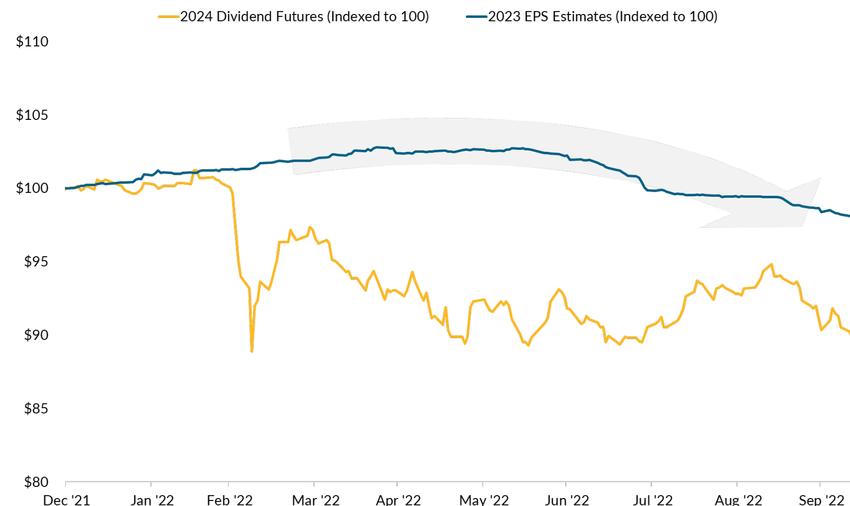
Tracking the Decline

Anticipating an Earnings Decline

- **Q3 Earnings Season.** Another earnings season kicked off last week, providing some of the first glimpses of profit trends for the second half of 2022. With almost 8% of companies reporting so far, the blended year-over-year earnings growth estimate for the S&P 500, which combines actual results with consensus estimates for firms that have yet to report, currently sits as 1.2%. The driving forces of growth are likely to remain inflation-sensitive sectors such as energy, industrials, materials and real estate.
- **Earnings Expectations Remain Stubborn.** Despite the economic uncertainty surrounding the Fed's campaign to cool inflation, earnings estimates have so far appeared relatively resilient. For example, consensus earnings per share for the S&P 500 in 2022 sits at $223, only marginally lower than its all-time high of $230. However, Glenmede's Leading Economic Indicator, which tends to directionally inform the path of corporate profits on a forward 6-month basis, has dipped into negative territory, suggesting there may be downside risk to earnings as the odds of recession rise.
- **Earnings Weakness Ahead?** It appears that there are growing risks to earnings estimates. For example, dividend futures appear to be rolling over, which is likely indicative of market expectations for the future direction of earnings. In addition, although they traditionally track relatively closely, there has been a divergence between reported profits of economy-wide corporations in the U.S. and companies in the S&P 500. This phenomenon historically occurs prior to earnings declines, a likely reflection of publicly-traded firms utilizing accounting to keep reported profits elevated before the storm.

As earnings turn over, there may be further downside to this bear market, justifying an underweight to risk

Chart of the Week:



Source: Glenmede, Bloomberg, FactSet Data through 10/12/22
Shown in the blue line is estimates for 2023 earnings per share for the S&P 500 Index. Dividend futures for 2024 are provided by Bloomberg. The S&P 500 is a market capitalization weighted index of U.S. large cap stocks. Actual results may differ materially from expectations. One cannot invest directly in an index.

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Inflation Feeling Hot, Hot, Hot

- **September CPI Print.** Last week's CPI report put yet another dent in the "peak inflation" narrative as inflation pressures continue to weigh on the U.S. economy. Core CPI (which strips out the more volatile food and energy components) increased at a relatively hot 0.6% month-over-month clip in September and marked the largest 12-month gain since 1982. Meanwhile, headline inflation rose 0.4% as another large jump in food prices helped push inflation higher last month.
- **Still-Sticky Inflation.** With another upside surprise to core inflation, the underlying detail of September's CPI report suggests that inflation may be looking increasingly sticky, particularly with the shelter component increasing 0.7% for the month. Medical care services, which is also one of the stickier pieces to CPI, grew 1.0% month-over-month, demonstrating that once those components begin to gather momentum, it can be difficult to slow them back down. This, in turn, risks inflationary factors becoming further entrenched and more difficult to rein under control.
- **No Fed Pivot Yet.** September's CPI report confirms that the Fed has a lot more work to do to satisfy its price stability mandate, on which it should remain hyper-focused in the near-term. This is likely to force the Fed to turn up the heat on its tightening campaign and follow through on a cumulative 125 basis points of rate hikes through year-end. This effort seeks to move rates firmly above neutral to mount a credible fight against inflation. All else equal, a faster pace of rate hikes and a higher terminal rate on fed funds increases the odds that a soft-landing gives way to recession in the U.S.

Persistently high inflation runs the risk of becoming embedded in the consumer psyche, warranting a stern Fed reaction

Tightening the (Monetary) Belt

- **One Step Closer to Neutral.** While estimates for the level of the "neutral" policy rate vary, Glenmede estimates that the fed funds rate now sits quite close to neutral and will meaningfully eclipse neutral with any subsequent rate hikes. Notably, futures market expectations for the fed funds rate by year-end rose to 4.5%, with a terminal funds rate of 4.9% by March of next year. It is important to note that 4%+ interest rates will sit firmly above the neutral level and should restrict the economy alongside inflation.
- **Follow the Fed.** With some foreign central banks seen as lagging the Fed's commitment to taming inflation, the widening gap in interest rate differentials between the U.S. and other nations is currently providing support for a stronger dollar. For multiple central banks overseas, the significant weakening of their currencies relative to the dollar can and has caused economic disruptions. In order to make their currencies more competitive, those central banks have and/or may have to raise rates to remain competitive as a destination for foreign capital.
- **Hiking With Caution.** After moving rates swiftly to neutral throughout the year, the Fed will likely adopt a more-data dependent approach to rate hikes going forward as it remains laser-focused on the price stability half of its dual mandate. Currently, that data is likely signaling that further tightening is needed to bring inflation back in the range of its 2% target. Walking the line, Fed Vice Chair Brainard noted in an interview last week that previous rate increases, together with anticipated further rate increases, will slow the economy in ways that can't be observed yet, further backing a "data dependent" approach.

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