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Market Ethos

The latest market insights from Richardson Wealth

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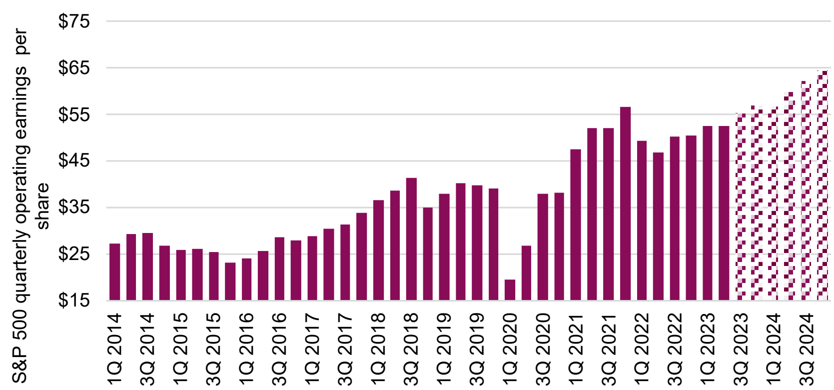
Making sense of consensus: Economists vs analysts

Here we are again, closing out Q2 earnings season for the U.S. and Canadian equity markets. The S&P 500 is now over 84% complete and keeping with standard practice, has seen positive surprise rates of about 80%. As inflation has continued to be a positive for corporate earnings combined with an economy that keeps on chugging along, it's a decent earnings season. Q2 S&P 500 earnings are sitting at about $52, roughly flat with last quarter and up a little from Q2 2022.

Earnings have held in well, and based on estimates are poised to accelerate



Source: S&P, Purpose Investments

On an optimistic note, based on current estimates earnings are poised to start to accelerate in the coming quarters. The positive economic growth and weaker USD has resulted in analysts remaining a bit more upbeat. Of course. the big question will be the economy. There is no denying that the stock market and the economy have a very loose relationship, often moving in opposite directions at times. However, earnings and the economy have a much stronger relationship. So, these estimates really come down to the direction of the economy.

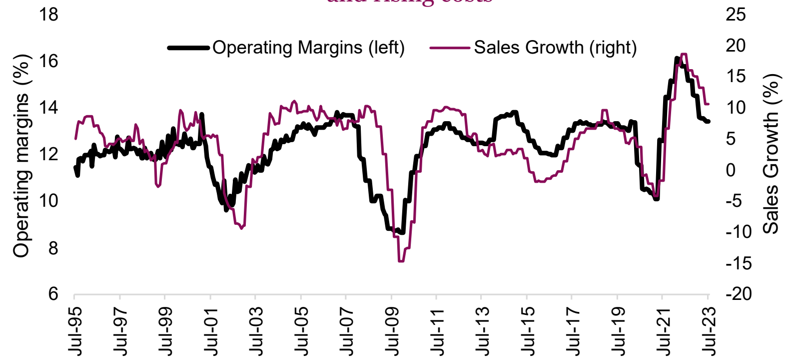
So, everything is looking good right? Not so fast. These are bottom-up analysis forecasts that are, let's just say, influenced rather heavily by individual company guidance. Companies are usually pretty optimistic about the future. Even if the CFO is worried about a slowing economy, do they bake that into their guidance or do they rely more on what is happening today? Since forecasting the economy is not easy or accurate, most extrapolate today into tomorrow. Especially if today is a good news story.

Here is where things don't really add up. From the data above, earnings are about to start expanding at about a 10% growth rate compared to levels from a year ago. Meanwhile, economist consensus forecasts for the U.S. economy have real growth – 1.6% in 2023 and slowing to 0.8% in 2024. That trend is slowing, not accelerating. Now this is real growth, meaning it is adjusted for inflation. And earnings are nominal, so inflation is actually a positive. But here too, things don't add up. Inflation, which you would add on top of real economic growth, is forecast to be 4.1% in 2023 and slowing to 2.5% in 2024. Add these up, and economists predict nominal GDP growth of 5.7% in 2023 (1.6+4.1) and 3.3% in 2024 (0.8+2.5). That is deceleration, not acceleration.

Now this is pretty loose math. Companies have operational and financial leverage that can magnify changes in economic activity as it makes its way to the bottom line. Markets are leveraged. But with higher interest costs and rising wages, these leverage multipliers are likely diminishing. This is evident in corporate margins which have been steadily falling.

Let's throw another twist into the economist vs analyst disagreement. The economy is largely driven by consumer spending, yet the stock market is more tilted to business spending. As a result, corporate earnings are actually more sensitive to manufacturing and other more cyclical parts of the economy, regardless of what the consumer is up to. As a result, PMI (Purchasing Managers Index) has a long history leading the trend in corporate earnings growth. In fact, earnings growth trends in six months match pretty well with PMI surveys today (we pushed PMI to the right by six months in this chart). The bad news is PMI keep going down, not good for earnings growth.

S&P 500 Margins are falling due to falling sales growth and rising costs

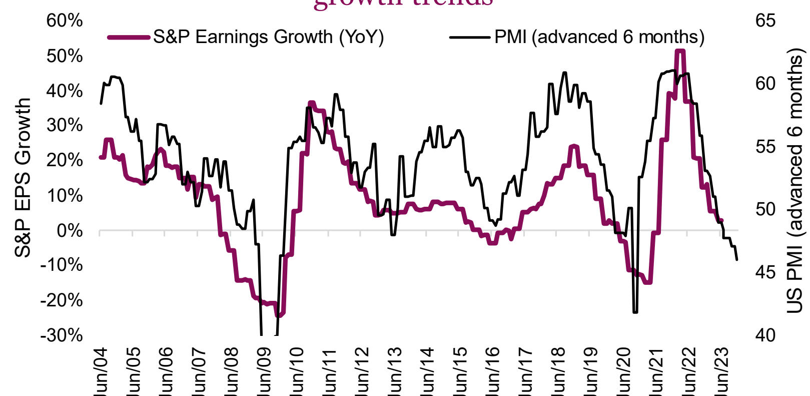


Source: Bloomberg, Purpose Investments

Final thoughts

There are other factors that influence S&P 500 corporate earnings such as the global economy, changes in the U.S. dollar, etc. However, clearly we are faced with a situation where consensus analysts are optimistic about the future of corporate earnings while the views from economists paint a much more tempered path forward. Who is right and who is wrong? Only time and the path of the economy will tell. But hats off to analysts for being more correct so far in 2023.

Manufacturing activity often leads corporate earnings growth trends



Source: Bloomberg, Purpose Investments

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.