Wentz Weekly

January 18, 2022

Will Profit Growth Continue to Support Valuations?

Wentz FINANCIAL GROUP

Investment management for your lifetime

Earnings season will ramp up this week with dozens of S&P 500 companies reporting before one of the busiest weeks of the quarter next week. The equity market has been trading at one of the highest valuations since coming out of the pandemic, but profits have been able to keep up with that, justifying the high valuations. As of last week, analysts are expecting 22% earnings growth for the fourth quarter and if that holds it would be a 48% increase in S&P 500 profits compared to 2020. This earnings season will be key to seeing if that can continue into 2022, in addition to management teams' thoughts about the headwinds that face the economy in 2022. The obvious one is inflation and how companies are overcoming higher costs, but also the lack of labor, supply chains issues, the ongoing pandemic, and tightening monetary policy.

Big banks typically kick off earnings season being some of the first companies to report on the previous quarter's results. If banks give us any indication on how the fourth quarter was then we would say very mixed. Loan growth, a key driver to growth for banks, remained stagnant in the quarter, perhaps because consumers are still flush with cash while costs were higher across the board for different reasons including higher compensation. Trading revenue, a large beneficiary since the start of the pandemic, was a weak spot with most seeing a decline. Offsetting these weak areas was strong investment banking as merger and acquisitions activity remained solid. As Raymond James notes, we have seen a pullback of around 4% prior to each of the past three earnings seasons. Banks results turned sentiment around in each of those instances as the market rallied through earnings, but this time around banks fell short of expectations. Earnings will need to continue to meet the high expectations to keep supporting these high valuations, either way we expect continued volatility along the way as we have seen through the first two weeks of the year

Jerome Powell reiterated in his renomination hearing he believes supply chain bottlenecks will ease this year and help cool inflation, but the Federal Reserve is ready to act if inflation last longer than what the Fed currently expects. As expected based on previous comments, the Fed is preparing to raise interest rates because the economy no longer needs the emergency support that was implemented during the pandemic. According to the CME FedWatch tool, the markets are pricing in a 94% chance the Fed will raise rates at its March meeting, well above its 46% probability one month ago. At its previous meeting, the Fed's "dot plot" indicated three rate hikes for 2022, but markets continue to pull forward expectations, now pricing in four rate hikes. This expectation is resulting in higher yields on the short end of the yield curve. The 2-year Treasury yields over 1.00% while the 10-year yield hit 1.80%, both hitting the highest levels since February 2020. The long-end of the curve has remained steady around 2% and we do not expect this to increase until the Fed begins discussing more in detail a runoff of its balance sheet which will have a bigger impact on longer dated bonds.

Sales at retailers and restaurants/bars slowed down in December, reflecting a slowdown in spending during the end of the holiday shopping season and the pickup in the spread of the Omicron variant. Sales fell 1.9% in the month compared to November and fell well short of the 0.1% decline expected. Our take is Americans did a majority of their holiday shopping much earlier in the season while the spread and unknown of the Omicron variant may have prevented consumers from going out. This follows two strong months of sales in October and November. For 2021, retail sales were 16.9% higher than 2020. Restaurants/bars, clothing and department stores, and retailers of electronics saw the largest year-over-year gains while grocery stores saw the lowest. Gasoline sales were 41% higher from a year ago reflecting higher oil prices. We expected a larger decline than the consensus and no one month makes a trend but we will be focusing more on how 2022 starts.

The Index of Consumer Sentiment, based on a monthly University of Michigan survey, was at 68.8 in January for its lowest level since coming out of the Great Financial Crisis in 2009. While sentiment on current conditions remains reasonable, consumers are becoming more worried about the future with the expectations index down to 65.9, falling from 74.0 a year ago. Much of the drop in sentiment relates to inflation. The Consumer Price Index released last week showed consumer inflation rose another 0.5% in December, another reading above expectations. Compared the same time a year ago prices accelerated from 6.8% in November to 7.0% in December for the largest annual increase since 1982. Stripping out food and energy prices the index rose 5.5% from a year ago, another multi-decade high. Businesses are seeing higher prices as well and the question is are they going to pass that cost on to the consumer by higher prices. The Producer Price Index rose 9.7% compared to a year ago, the highest in the data series. There is actual inflation and there is consumer's expectations on inflation. If consumers are expecting higher inflation in the months ahead, the Fed may feel more inclined to tighten monetary policy sooner and faster.

Company News

- Delta Airlines said the worst is behind the airline. The company said it is seeing "really robust" bookings starting President's Day weekend and forward. The company expects revenue to recover to 72%-76% of its 2019 levels, versus 74% of that level in the fourth quarter.
- Ahead of its presentation at the JPMorgan Investor Conference, Teladoc said its preliminary 2021 revenue was $2.03 billion, slightly above its $2.02 billion consensus estimate and almost double its revenue from 2020.
- Microsoft said it is acquiring video game maker Activision Blizzard for $68.7 billion, or approximately $95/share, for its largest ever acquisition. Microsoft said the deal will significantly expand its mobile gaming offerings. The move will make Microsoft the third largest gaming company by revenue (behind only Tencent and Sony).

The Week Ahead

It will be a holiday shortened trading week with the markets closed Monday for Martin Luther King Jr. Day. The economic calendar is light of releases with several manufacturing survey results through the week including the Empire State and Philly Fed survey indexes on Tuesday and Thursday, respectively, along with several housing reports including housing starts and permits Wednesday morning and existing home sales on Thursday. Earnings season ramps up this week with at least 37 S&P 500 companies reporting fourth quarter results. Notable releases include Goldman Sachs, Bank of America, and JB Hunt on Tuesday; UnitedHealth, Procter & Gamble, and United Airlines on Wednesday; American Airlines, Union Pacific, Netflix, and CSX on Thursday; and Honeywell and Schlumberger on Friday. After many comments from Fed members last week, a blackout period is now in place ahead of the next FOMC meeting on January 26.