MARKET SIGHT LINES

A Hawkish Federal Reserve Means Lower Earnings Growth

By Michael O'Keeffe, *Chief Investment Officer*

The Federal Reserve's hawkish policy is intended to slow the economy, dampen demand, and cool inflation. We often observe higher rates and a slowing economy directly, with consumers spending a little less, workers having a tougher time finding a job, or small businesses struggling to survive. But as investors, we also assess capital market implications, and for stocks, that means gauging the impact of higher rates and a slowing economy on company earnings.

In this week's Sight|Lines, we assess weakening earnings growth and the impact on stock market performance.

THE TAKEAWAY: EARNINGS GROWTH IS WEAKENING, DRIVING STOCKS LOWER

Consensus earnings estimates, comprised of the work of individual industry analysts evaluating individual companies, help us understand how earnings growth is changing and the market implications:

- Since the start of the year, consensus earnings growth forecasts have fallen from 9.2% to 7.4% for 2022, 9.9% to 8.1% for 2023, and 11.2% to 8.5% for 2024, driven by higher rates and business slowdown.
- Weakening earnings have driven stocks lower, with the S&P 500 falling 19.7%, for example.
- Investors are debating whether earnings will weaken further and if stock prices already reflect such concerns, and it is likely too early to tell.
- As long-term investors, we should remind ourselves that timing a market bottom or a market top is quite challenging, and by remaining invested, we can participate in the market's recovery when it does happen.

IN DEPTH: THERE ARE HEADWINDS…AND SOME HOPE

By parsing the earnings data and observing industry trends, we can better understand the drivers of weakening earnings growth. Some observations:

- *More Slowing in the Second Half of 2022* – While we tend to put more weight on longer-term data, earnings growth is expected to slow in the third and fourth quarters.
  - For example, the third quarter 2022 earnings growth forecast was 10.8% on June 30 and today sits at 3.1%.
  - The fourth quarter 2022 earnings growth forecast has similarly fallen from 9.9% to 4.4%.

- *A Strong Dollar Can Be a Headwind* – The U.S. Dollar has strengthened meaningfully this year. About 40% of aggregate S&P 500 companies' revenue exposure comes from outside the U.S. And while many seek to hedge such currency risk, non-U.S. customers buying their goods or services with weaker currencies represent a headwind.
- *Company Surveys Signal Slowdown* – Purchasing Managers' Indexes (PMIs) are surveys of business leaders. A reading above 50 means expansion, and below 50 contraction. The ISM Manufacturing PMI has fallen from a recent high of 63.7 in March 2021 to 50.9 in September 2022. S&P 500 earnings growth tends to track this index reasonably well, and these recent results are consistent with the earnings growth slowdown.
- *Headlines Signal Slowdown* – Some media reports make these earnings pressures more relatable:
    - Many large retailers have reported slower sales, a buildup in inventory, and price-cutting programs to clear that inventory.
    - Consumers have shifted spending to higher-priced everyday items like gasoline and food and away from more discretionary goods like electronics, a negative for some companies.
    - Mortgage rates are higher, slowing the housing sector and impacting related companies.
    - Supply chains are easing enough for car dealers to rebuild inventory, just as higher rates make purchasing a car less affordable.
- *Some Hope: A Big One-Year Forecast* – Embedded in the work of the industry analysts mentioned above is, for most companies they analyze, a 12-month target price forecast. By rolling these forecasts up for S&P 500 companies, we observe a "bottom-up" estimate of a 29% price return for this index over the next year. While no one estimate is likely to be correct, this analysis tells us there is a very good chance that the market will be higher a year from now.

CONCLUSION

The Federal Reserve's hawkish policy has driven market interest rates higher, slowing the economy, dampening demand, but not yet cooling inflation. While we all often observe and experience a slowing economy directly, as investors we should also assess capital market implications. For stocks, this slowdown means lower earnings growth, which has driven the stock market's decline. Investors are debating whether earnings will weaken further and if stock prices already reflect such concerns. It is likely too early to tell, and as long-term investors, we should remember that timing the market is quite challenging, and by remaining invested, we can participate in the market's recovery when it does happen.

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