March 31, 2023

# MARKET SIGHT LINES

## Bank Troubles and Equity Earnings: An Inflection Point?

By Michael O'Keeffe, *Chief Investment Officer*

Over the last couple of weeks, we discussed real problems in the banking sector and how those troubles affect Federal Reserve (Fed) policy. My colleague Brian Gardner, Stifel's Chief Washington Policy Strategist, offered some initial thoughts on the regulatory response to these events. And Stifel's Chief Economist, Dr. Lindsey Piegza, shared her Economic Insight this week, going deeper into the Fed meeting and the prospect for slower future growth. Of course, as investors, we are well served to assess the investment implications for our portfolios going forward.

In this week's Sight|Lines, we unpack the fourth quarter 2022 earnings season, assess implications for 2023 earnings, and discuss the potential future impact of bank regulation changes on earnings growth longer term.

### THE TAKEAWAY: EARNINGS GROWTH SLOWED, BANK TROUBLES SIGNAL MORE HEADWINDS.

Equity earnings influence equity returns. Higher rates over the last year have eroded earnings, and bank troubles mean more earnings headwinds. In summary:

- Fourth quarter 2022 S&P 500 earnings fell compared to a year ago.
- S&P 500 earnings growth for the calendar year 2022 was more muted compared to earlier expectations.
- The 2023 S&P 500 earnings growth forecast remains modestly positive but has declined. The quarterly expectations show further declines in the first half, followed by recovery in the second half.
- But these bottom-up forecasts roll up the past work of individual stock analysts, which does not yet reflect the recent bank troubles. We should expect downward revisions, as seen from "top-down" analysts.
- We are at an inflection point, as increased regulation could serve as a headwind to future earnings.

Working through the recent bank troubles, a path to lower rates, and economic recovery will set the stage for recovering earnings growth and positive equity returns going forward.

### IN-DEPTH: 2022 EARNINGS GROWTH SLOWED, 2023 EARNINGS GROWTH HEADS LOWER, AND TIGHTER CREDIT AND MORE REGULATED BANKS MEAN LOWER FUTURE EARNINGS. WE ARE AT AN INFLECTION POINT.

Why do equity earnings matter? A company's earnings, and investor views about future earnings, drive stock performance. So, earnings are important. With the shift in monetary policy over the last year or so and the related economic slowdown, we've seen earning growth slow. Bank troubles likely mean tighter credit conditions and more bank regulations, which will put further pressure on earnings. Going deeper:

- 2022 S&P 500 earnings growth was more muted than expected at the beginning of last year:
  - Fourth quarter 2022 S&P 500 earnings fell 3.7, compared to a year ago, much lower than the 14.3% forecast at the beginning of 2022.

    - Five of the 11 sectors grew earnings in the fourth quarter compared to the previous year. The energy sector had the largest earnings increase (57.1%) while communication services had the largest decline (24.9%).
    - The calendar year 2022 earnings growth came in at 4.8%.
- For the full calendar year, eight out of the 11 sectors had earnings growth. Energy led the way with earnings growing 148.5%. Communication services earnings fell 19.7% in 2022, and financials earnings fell 17.8%. The S&P 500 earnings growth forecast for the full year 2023 remains modestly positive. The quarterly expectations show further declines in the first half, followed by recovery in the second half.
    - For the calendar year 2023, analyst forecasts combine for an earnings growth rate of 1.8%.
    - Those same forecasts project an earnings decline of 5.7% in the first quarter. If this happens, it will be the largest quarterly decline since the second quarter of 2020, when earnings fell 31.8% as the economy shut down during the pandemic.
    - The forecasts imply earnings growth rates of -3.8%, 2.9%, and 9.9% for the second, third, and fourth quarters, respectively, exhibiting recovery in the second half.
- But these bottom-up forecasts, which roll up the past work of individual stock analysts, do not yet reflect the recent bank troubles. We should expect downward revisions.
    - As a point of reference, analysts that specialize in a "top-down" approach, for example modeling the S&P 500 Index in its entirety, have been reducing their earnings forecasts given the challenges of the current environment. Many point to a decline in 2023 earnings versus 2022.
- The bank troubles of the last few weeks, triggered by higher rates and tighter financial conditions, mark a point in time, an inflection point, moving us toward tighter conditions in the near term and the headwinds of increased regulations in the long term.
    - Equity analysts will incorporate these effects as they revise their forecasts of future earnings.

Earnings growth drives equity returns. Recent equity market weakness reflects investor worries about the slowdown caused by hawkish monetary policy and tighter financial conditions. These worries and tighter conditions may well be amplified, given the influence of recent banking troubles. This will serve as a potential increased headwind to earnings growth.

## CONCLUSION

Over the last couple of weeks, we've experienced real problems in the banking sector and their effect on Fed policy. Brian Gardner, Stifel's Chief Washington Policy Strategist, expects a potential shift in regulations as a result. We are at an inflection point, where industry analysts must take into account these changes, which may well dampen equity earnings further, delaying a robust recovery in the stocks and the next bull market.

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