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INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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Moderating Earnings, Rising Rates, and the 2022 Stock Market

A glance at the title of this week's column may ring some alarm bells. If earnings are expected to moderate while interest rates (and inflation) rise, wouldn't this pose some pretty stiff headwinds for stocks?

I'll expand on this question more below, but I think the short answer is: "yes and no." Let's first take a look at where Q4 2021 earnings stand as of early February.[1]

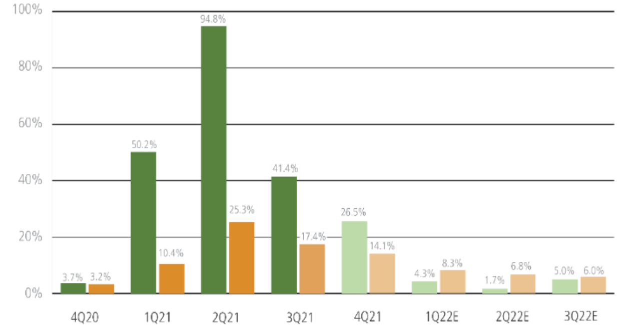
According to researchers at Zacks Investment Management, the picture emerging from the Q4 earnings season is one of continued strength and momentum. The proportion of companies beating consensus revenue estimates is tracking above what we saw from this group in the preceding earnings season, with earnings beats nearly the same.

Through early February, we had Q4 2021 results from 278 S&P 500 members, and total earnings were up +30.2% from the same period last year on +16% higher revenues. 78.4% of the companies reporting beat earnings-per-share and revenue estimates, pretty much in-line with longer-term averages.

Projecting out over the next few weeks, total S&P 500 earnings for Q4 are expected to be up +25.6% from the same period last year on +14.1% higher revenues. These are solid prints, and are largely better-than-expected given the well-known headwinds of cost pressures, logistical bottlenecks, and the labor impact from the Omicron variant. If anything, the real struggle companies are facing is being able to keep up with a historically high-demand environment.

Of course, these are all backward-looking figures, and what matters to stock prices in 2022 is where earnings are headed – not where they've been. And it's plain to see in the chart below that the pace of earnings growth is set to decelerate in the coming quarters:

Quarterly Earnings and Revenue Growth Rate (YoY)



Source: Zacks Investment Research, Inc.

Now I can revisit the question of rising interest rates and moderating earnings, and what it means for stocks. The basic premise investors need to understand is this: rising interest rates make future earnings less valuable. When risk-free bond yields (which I will refer to as the discount rate) are close to zero, investors will pay more for a company with high earnings and strong projected future earnings, i.e., growth stocks. This helps explain why many high-flying tech names trade at such high multiples.

However, when the discount rate starts to rise, those future earnings are worthless to an investor. In the past few weeks, bond yields have risen to their highest level since 2019, which helps explain the concurrent sharp selloff in many high valuation stocks, particularly in the tech sector. If the discount rate is rising, and an overvalued company even hints at weaker-than-expected earnings, it probably spells trouble.

Not all stocks necessarily feel the headwinds of a rising discount rate, however. Value stocks – which on a relative basis are cheap based on measures like book value and price-to-sales ratios, often look more attractive in a challenging rate and earnings environment. After all, we know stocks have historically done very well early in rising rate environments – it's just about knowing where the quality is.

Bottom Line for Investors

We remain positive in our earnings outlook for 2022, and we see the overall growth picture steadily improving particularly as labor issues associated with Omicron start to ease. Looking ahead, many reporting companies so far have offered reassuring, if not altogether positive guidance for the year.

Interest rates are also on the rise, however, which means the future earnings of high valuation stocks will be looked at more critically. This environment could pose challenges for 'growthy,' high multiple corners of the market while making value companies look more attractive by comparison.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Zacks.com. February 2, 2022. https://www.zacks.com/commentary/1861723/a-strong-and-resilient-earnings-picture-amid-market-volatility

IN FOCUS THIS WEEK

- **U.S. trade deficit's new record**
- **Higher inflation**
- **Rising interest rates and its impact on savers**
- **Stronger job market**

U.S. Trade Deficit Soars to Record

The U.S. balance of trade measures how much the country imports versus how much it exports. A trade deficit indicates more imports than exports, and a trade surplus indicates the opposite. In 2021, the U.S. trade deficit hit a new all-time high of $859.1 billion, having increased 27% from last year. Some believe that trade deficits are negative since the country is buying far more goods and services than it is selling. But that is not necessarily the case – what matters is *total trade*, which gives the most accurate indication of whether economic activity, on the whole is increasing. It is – U.S. exports also soared last year by 18.5%, reaching $394.1 billion. As the U.S. economy continues to rebound from the pandemic and expand further, total trade is rising – a good sign. Robust global demand for goods like computers, furniture, apparel, energy, and food are driving trade activity higher.[1]

Inflation Pushes Even Higher, to a 40-Year High

Inflation keeps going up. In January, the consumer price index (CPI) jumped at a 7.5% annual rate, which placed it at a 40-year high. For the last five months, inflation has been running at a 5% annual rate or higher, as continued strong demand bumps up against supply constraints and labor shortages. Every month, the CPI rose 0.6% from December to January, consistent with the monthly increase from November to December. Breaking down the inflation figures, it was the usual suspects driving prices higher. Used-car prices soared 40.5% in January from a year ago, and energy prices also continue to chart higher with a barrel of crude oil topping $90 a barrel. Food prices also increased 7% year-over-year in January, the largest increase since 1981. Inflationary pressures are expected to wane as supply constraints ease and as consumers shift spending to services from goods, but it may be a few months still before inflation rates come down.[2]

Are Rising Interest Rates Good News for Savers?

Not necessarily. The Federal Reserve has telegraphed their plans to increase the fed funds rates likely a few times in 2022, and many savers were hoping that would also mean earning higher deposit rates at banks. But that may not be the case. Generally speaking, banks will raise the interest they pay on deposits when they are trying to build up cash reserves, which they can in turn use to finance loan activity. But in the current environment, banks are not strapped for cash – at all. Because of bank reserve requirements in the aftermath of the 2008 Financial Crisis, combined with Americans' boosting savings in the pandemic due to stimulus checks, banks are flush with cash. Total deposits at U.S. commercial banks stand at $18.1 trillion, which is substantially higher than the $13.3 trillion they had on hand before the pandemic in early 2020. As it were, banks have little incentive to raise the interest rates they pay on deposits, at least for now.[3]

The Jobs Market is Even Stronger Than Many Thought

As has often been the case in the last few months, the U.S. jobs numbers as originally reported were way off. The Bureau of Labor Statistics changed its estimate for how to account for seasonal patterns as part of monthly employment, given the effects of the pandemic. The result has been a substantial underreporting of job growth in the U.S. economy. Employment in January grew 467,000 from December, which was three times Wall Street's official consensus. But the big revision came from the November and December 2021 figures. December job growth was revised from 199,000 to 510,000, while November was changed from 249,000 to 647,000. The Omicron variant certainly led to snags in the labor market with people out sick in January, but the job growth over the previous few months has been staggering and adds to an overall strong 2021. The labor force expanded by 1.2 million in December, and labor force participation ticked up to 62.2%, the highest rate since early 2020.[4]

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[1] Wall Street Journal. February 8, 2022. https://www.wsj.com/articles/economic-recovery-pushes-2021-u-s-trade-deficit-to-record-level-11644328979?mod=djemRTE_h

2 Wall Street Journal. February 10, 2022. https://www.wsj.com/articles/us-inflation-consumer-price-index-january-2022-11644452274?mod=hp_lead_pos1&mod=hp_lead_pos1&mod=hp_lead_pos1

3 Wall Street Journal. February 9, 2022. https://www.wsj.com/articles/dont-expect-rising-interest-rates-to-boost-your-savings-account-11644402600?mod=djemRTE_h

4 Wall Street Journal. February 4, 2022. https://www.wsj.com/articles/an-american-labor-market-mystery-11643976005?mod=djemRTE_h

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