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MACROCOSM

Earnings Versus the Bubble

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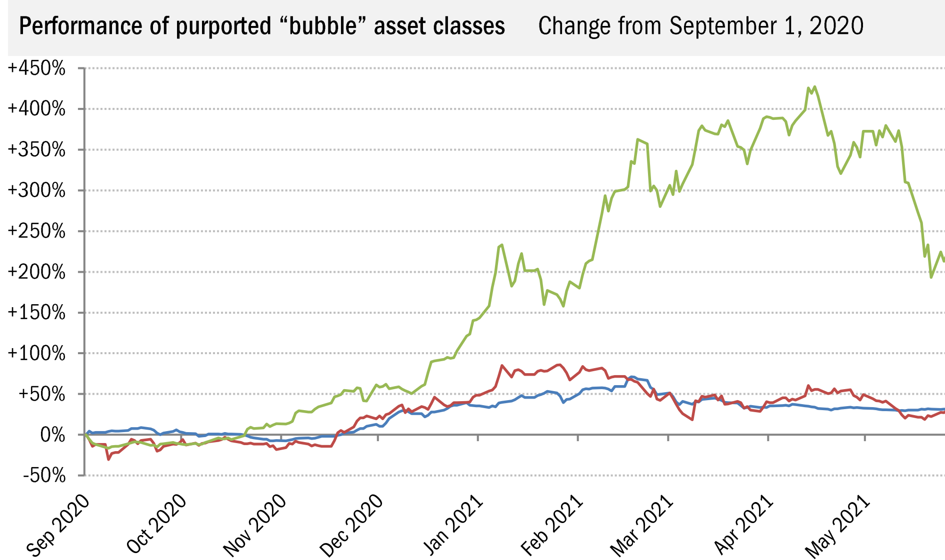
Donald Luskin

The rate of forward earnings upgrades has only been this high three times in history.

Supposedly overvalued US equities continue to hang in there. It looks like the S&P 500 is surviving its third minor correction of 2021. Stocks haven't had a healthy 10% correction since the one that ended September 24 last year. *It's quite remarkable, considering how many purported bubbles have burst* – the ones that were supposed to symbolize a general overvaluation, the ones that were supposed to bring down all risk-assets when they finally got their comeuppance. *SPACs, Tesla and Bitcoin have all had very substantial corrections* (please see the chart below, in which Bitcoin's ginormous rise and fall -- down 30% in a single day last week – makes Tesla's and the SPACs' merely large ones seem tiny).

Performance of purported "bubble" asset classes   Change from September 1, 2020



Source: Bloomberg, TrendMacro calculations

This is turning out not to be a bubble-bursting, but rather a healthy sector rotation against the backdrop of an earnings boom, and it has quietly been happening all year.

- There is a very strong negative correlation between sector performance in 2020 and performance in 2021 year-to-date (please see the chart on the following page).
- *It's not just that the mighty have fallen*. The consumer discretionary sector, second best last year, is tied for weakest performance this

Update to strategic view

US STOCKS, US MACRO: Supposedly overvalued equities are enduring their third mild correction this year, against the backdrop of violent corrections in purported bubble asset classes such as Bitcoin, Tesla and SPACs. Stocks were supposed to roll over when this happened, but they have not – it is turning out to be a healthy sector rotation and an earnings upgrade boom. S&P 500 sector performance has changed places year-to-date versus 2020, with last year's winners the weakest, and last year's losers the strongest. This earnings season is the fourth record-setter in a row, demonstrating that the consensus can't get optimistic enough. The upgrade rate of forward earnings has been elevated all year and is now at a near record. This reflects cyclical recovery combined with the emergence of a productivity boom. The probability of an earnings-damaging corporate tax hike is diminishing.

[Strategy dashboard]

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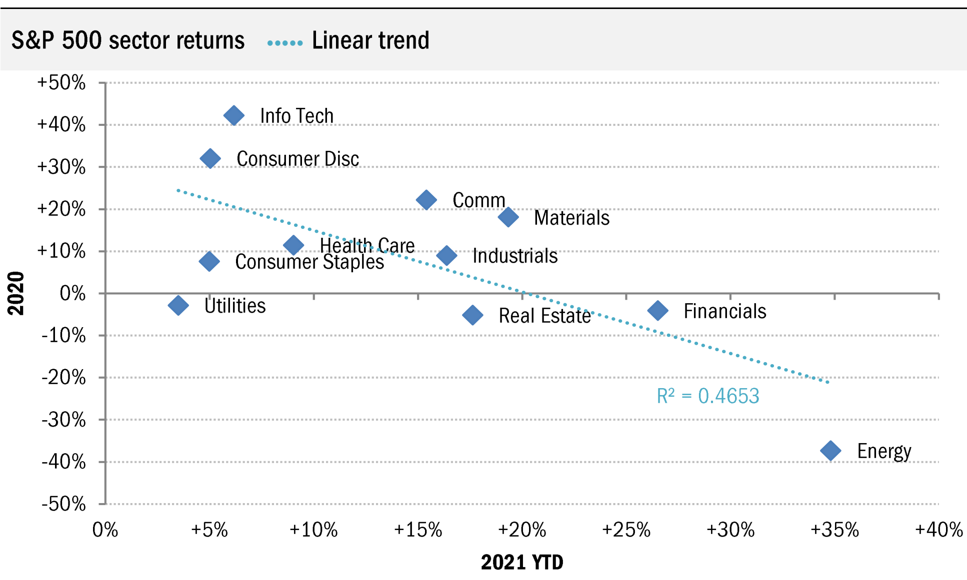
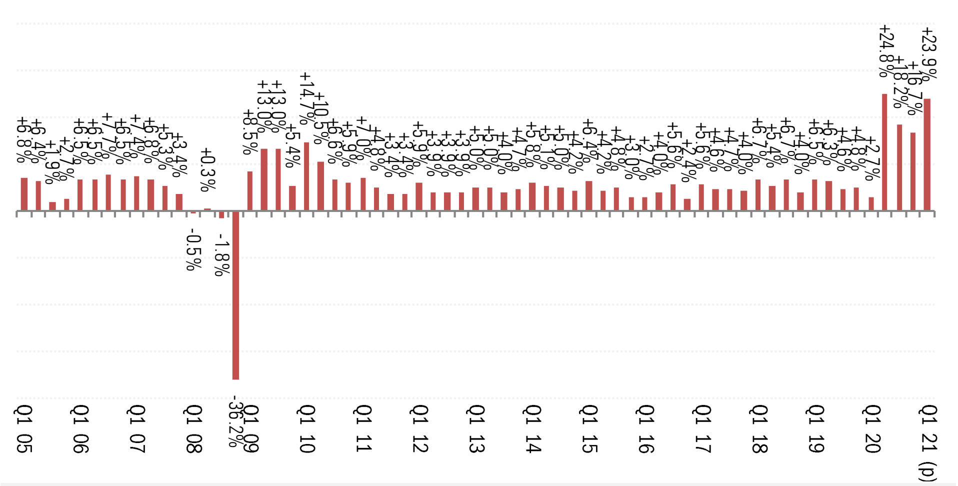


Source: Bloomberg, TrendMacro calculations

year, though still positive. Last year's number one, info tech, is third worst this year, though still positive also.

- *It's also that the meek have inherited the earth*. The two best performers this year, energy and financials, were the worst and third worst, respectively, last year.
- *This has been driven straightforwardly by the spectacular recovery in their forward earnings*. For example, forward earnings in the financial sector, last May, had been downgraded by $90 billion from the pre-pandemic highs, the worst loss for any sector in the S&P 500. Now a year later, they are $22 billion above.
- To be clear, last year's mighty sectors haven't exactly *fallen* – even the worst performers, consumer discretionary and utilities, are up respectably year-to-date. *All sectors have been buoyed by a year of continuous upside surprises in earnings performance as the V-*

S&P 500 earnings season surprise factor (by quarter of earnings)



Source: Bloomberg, TrendMacro calculations

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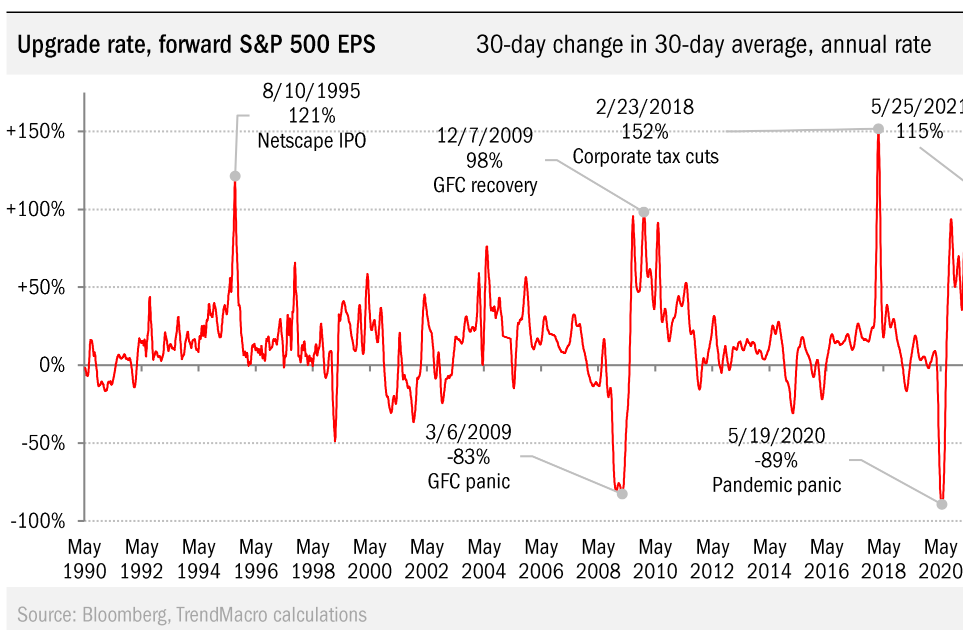
shaped recovery we alone predicted a year ago has indeed come to pass (see [“On the March Jobs Report, and Being in Recession (Whatever that Means)”] April 3, 2020).

- Across the S&P 500, we are now wrapping up the fourth pandemic earnings season (please see the chart on the previous page) and with an average beat of 23.9% it looks like it will be the second best in history – just behind Q2-2020’s 24.8%. Indeed, all four pandemic earnings seasons have exceeded any pre-pandemic ones. From Q2-2020’s record beat, Q3-2020 and Q4-2020 monotonically moderated. So it was something of a shocker to see Q1-2021 rise to challenge the Q2-2020 record – it shows that *even with a whole year of experience and valuations seeming to point to a lot of optimism, the reality is that Wall Street seems never to get optimistic enough when it comes to earnings*.
- *As a result, consensus year-ahead bottoms-up S&P 500 forward earnings are being upgraded at a furious pace* – presently 115% month-over-month at an annual rate (please see the chart below).

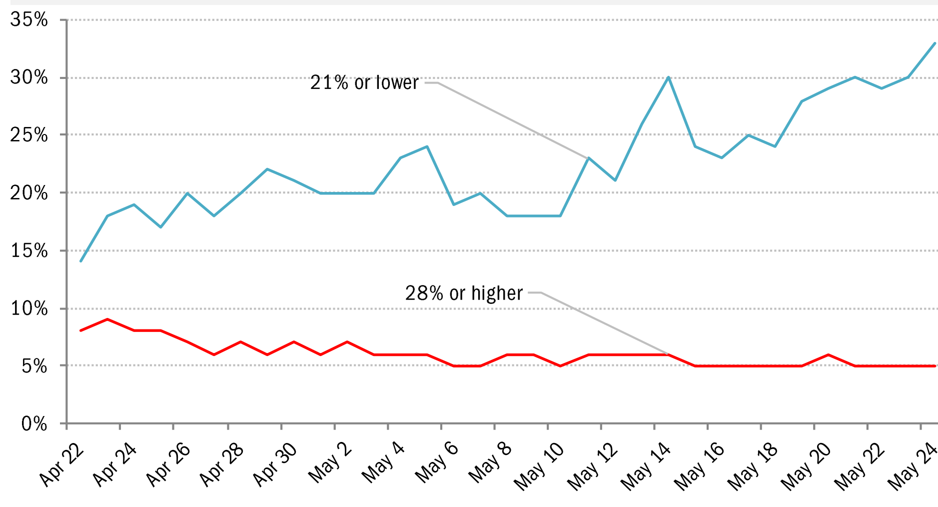


- This exceeds the 98% peak achieved in December 2009 in the aftermath of the Global Financial Crisis. That was not a transient peak. Upgrade rates in excess of 50% were sustained for about nine months. This time, in a similar business cycle recovery – but from an even deeper recession – it has only been five months so far. It’s not a transient peak either. Indeed, after five months, it just made a new high yesterday.
- The all-time record at 152% in February 2018 was a transient exogeneity, reflecting the sudden onset of the Trump-era corporate tax cuts that, by fiat, substantially increased after-tax corporate earnings.
- *Let us digress for a moment to note that President Joseph Robinette Biden, Jr. has proposed a set of corporate tax hikes that would reverse the 2018 cuts, and if implemented would have the reverse effect on earnings.* That is, earnings would have to be

downgraded, and we would likely see, at least transiently, the kind of downgrade rates we saw in the recession troughs of 2009 and 2020 (again, please see the chart on the previous page).

- When Biden proposed these hikes, we predicted that they would be significantly watered down or, indeed, not happen at all – and so far that is exactly what appears to be happening (see "On the Coming Corporate Tax Hikes" March 31, 2021).
- Within days, Democratic swing Senator Joseph Manchin (WV) let it be known that he didn't support the full proposed hike in the top marginal rate to 28%.
- Then 17 Democratic representatives from New York signed a letter insisting that any changes to the tax code include reinstatement of the federal deductibility of state and local taxes. All it takes is five Democrats to defect, and nothing can pass the House. *How about that – Biden's tax hikes blocked by Democrats who want tax cuts!*
- Europe is balking at Biden's proposal for the Organization for Economic Cooperation and Development to institute a global minimum corporate tax rate – a proposal designed to make higher US corporate tax rates less uncompetitive.
- And yesterday's lead story on the front page of the *New York Times*, of all places, covered the increasing recognition that stimulus already appropriated is so excessive that, if we really want to fund an infrastructure program, we can simply repurpose those stimulus dollars rather than hiking taxes to raise even more.
- No wonder market-implied probabilities in the political futures markets show only a small and diminishing chance of Biden's 28% tax rate being enacted – and a rising plurality chance that nothing will be done at all (please see the chart below).

Market-implied probability of top marginal corporate tax rate 2022



Source: Predict-It, TrendMacro calculations

- *So more than ever we stand by our original position that surging earnings don't face much of a potential tax shock, maybe none at all.*
- *Returning to the history of the earnings upgrade rate (again, please*

see the chart on page 3), the second-place record in August 1995 was transient, but endogenous. It coincides within a day with the history-making Netscape initial public offering, which signaled the immense value creation that was about to be undertaken with the commercial rollout of the Internet.

- All the prior peaks were followed by significant appreciation of equity prices. *We think the present situation combines elements of the 1995 and 2009 events – embodying both recovery from a deep recession trough (as in 2009) and the onset of a productivity wave (as in 1995)*.
- Make no mistake about it – we are experiencing the leading edge of a productivity wave. *Gross domestic product is virtually back to its pre-pandemic highs* (see "On Q1 GDP: Missed It By That Much!" April 29, 2021) *with 7 million fewer workers producing it* (see "On the April Jobs Report" May 7, 2021) *and 18% of them teleworking* (see "Data Insights: Jobs" May 7, 2021).
- Those unemployed workers are mostly in low-wage low-productivity service sector jobs, so when they come back to work, they will dilute the economy's average productivity compared to where it is today. Nevertheless, at that time*, the economy will be producing far more goods and services than pre-pandemic with the same number of workers – that is, by definition, a step-function upshift in productivity*.
- That won't be the end of it. Some of the 18% of presently employed persons currently teleworking will come back to the office – but some won't. The rigors of the pandemic experience have taught us many valuable lessons, including that we have options about how and where to work that we didn't previously know we had. We will selectively exercise some of those options – the ones we believe are profitable and productive.
- *Elevated productivity growth will continue for several years while we experiment with our options and learn from our successes and errors. We think the present surge in forward earnings upgrades reflects, in part, this future.*
- *Today's furious earnings upgrade rate can last longer, but not forever. How long it lasts and where it finally settles is not only a function of productivity going forward, but how much that productivity surprises the consensus.*
- *In our intuitive view, the wall of worry is so thick and steep we expect the surprises to continue to be on the upside. When the consensus finally gets its head around the idea that we are in a durable productivity-driven boom, we hope we'll detect it – because that's when the real correction happens.*

Bottom line

Supposedly overvalued equities are enduring their third mild correction this year, against the backdrop of violent corrections in purported bubble asset classes such as Bitcoin, Tesla and SPACs. Stocks were supposed to roll over when this happened, but they have not – it is turning out to be a healthy sector rotation and an earnings upgrade boom. S&P 500 sector performance has changed places year-to-date versus 2020, with last

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