As Good As It Gets?

"Earnings season" is well under way for the quarter ended September 30. So far, it's been a very strong one. With results for just about half of the S&P 500 in the books, 76% of companies have topped earnings expectations and 67% have beaten sales estimates. These "beat rates" are above historical averages. At the index level, earnings per share have risen nearly 40% over a year ago. But is this type of growth as good as it's going to get?

SO FAR, SO GOOD
Earnings Season Summary

Sector	Total Companies	Companies Reported	% Beat EPS (sorted)	% Beat Revenue	% Beat EPS & Rev
Real Estate	29	14	93%	86%	86%
Health Care	64	24	92%	83%	75%
Comm Services	27	10	90%	50%	50%
Financials	65	52	83%	79%	2%
Tech	75	30	80%	67%	63%
S&P 500	***505***	***245***	***76%***	***67%***	***45%***
Industrials	73	48	75%	56%	52%
Materials	28	12	75%	75%	67%
Discretionary	63	27	59%	48%	44%
Staples	32	17	59%	65%	53%
Energy	21	6	50%	50%	17%
Utilities	28	5	40%	80%	20%

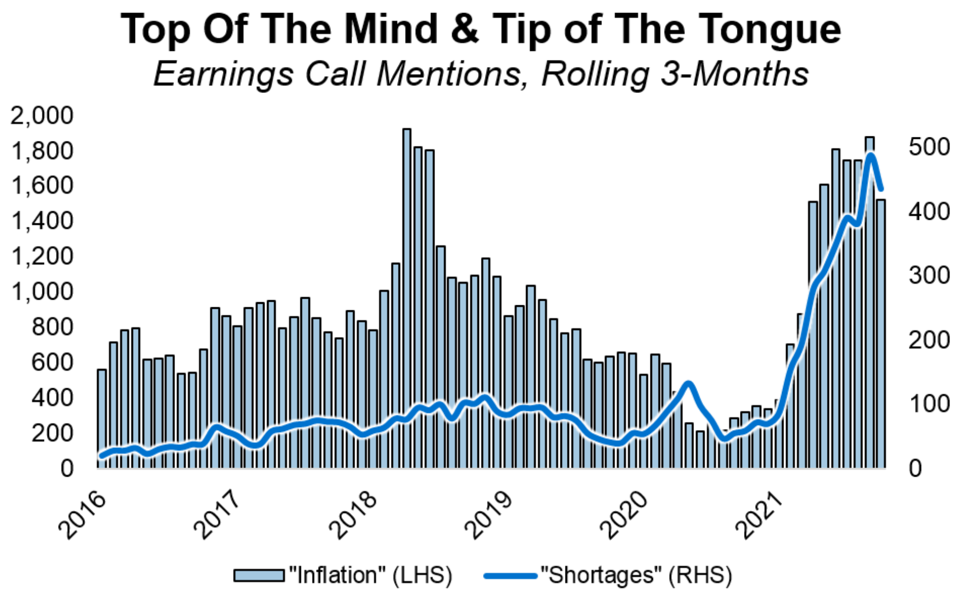
Source: Factset, FFWM Research. Data through October 28, 2021.

Many investors are saying "yes". While earnings should still grow on a year-over-year basis, it is unlikely that the recent pace of growth is sustainable. There are many reasons for this, chief among which is simply the passage of time.

Corporate America has been lapping shutdown levels of activity for the past two quarters. Going forward, it is going to be more difficult for companies to post explosive earnings growth compared to a year ago.

Also factoring into the slowing pace of earnings growth is that inflationary pressures, brought about by supply shortages and logistical bottlenecks, are building in the system.

The following chart illustrates how many times the terms "inflation" (bars) and "shortages" (line) have been mentioned in post-earnings conference calls for S&P 500 companies. While mentions of "inflation" similarly spiked in 2018, "shortages" has been mentioned at a record pace.



Source: Strategas, Bloomberg Transcript Analyzer for S&P 500 companies

What this chart highlights is how central inflation has become to the economic debate. For months, the Federal Reserve has insisted that inflationary pressures are "transitory" and will fade as the economy fully reopens. However, Fed officials never specifically defined what "transitory" meant, and now investors are beginning to question if inflation is going to hang around longer than expected.

From our vantage point, there are two forces driving the current rise in inflation. One force is widespread supply shortages caused by logistical bottlenecks. These shortages have caused costs to rise throughout the supply chain for many companies and industries. While this could result in price increases for the end consumer, these price increases are unlikely to persist in the future.

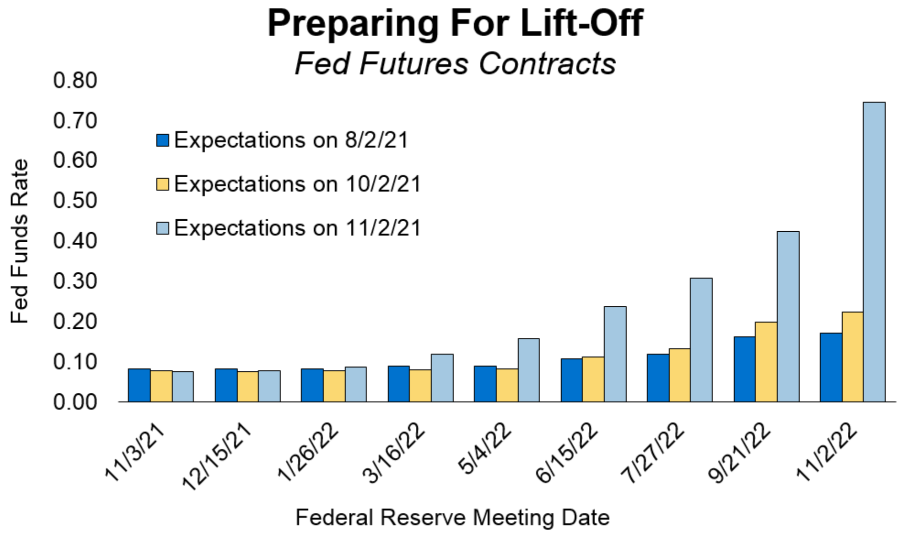
The other factor driving inflation higher is a labor shortage across many industries. Predicting how long these shortages will last is much more difficult. According to the Labor Department's most recent report, wages in the third quarter rose 4.2% from a year ago – the highest rate of increase since 1990.

These gains have been most acute in the leisure and hospitality industries (+7.6%), where labor makes up a relatively larger share of overall costs. Restaurant prices have increased 6.8% over the past year, the fastest rate since 1981 according to Labor Department data. For McDonald's company-owned restaurants, wages are up an average of 15% over last year.

The key debate for policy makers is how these two pressure points will resolve themselves. It is conceivable that price increases caused by supply shortages / rising transportation expenses / higher energy costs will work themselves out in fairly short order, assuming the economic impact of the pandemic continues to lessen. Wage pressures, however, could prove to be more problematic if workers don't return to the workforce. A continual shortage of eligible workers could generate an inflationary spiral, which would come at a bad time considering that corporate profit growth is slowing and US Gross Domestic Product only increased at an inflation-adjusted 2.0% rate in the third quarter.

All of this puts the Federal Reserve in a pickle. On the one hand, the Fed has already expressed a desire to begin "tapering" its monthly bond purchases by the end of this year, so that the "quantitative easing" program will be wrapped up by the middle of 2022. At that point, according to officials, the Fed would consider raising its benchmark Fed Funds Rate.

The market, however, has different ideas. As you can see in the chart on the next page, investors are predicting a much more aggressive Fed – perhaps as a result of inflation that turns out to be more persistent than the "transitory" variety that the Fed had been expecting.



Source: Bloomberg, FFWM Research

Depicted at right is the market-implied Fed Funds Rate for the next several Federal Reserve meeting dates (along the horizontal axis). The bars represent the market's best bet as to what the Fed's benchmark rate will be when those meetings wrap up. As you can see, over the past few months the market has been ramping up expectations for a more aggressive Fed. In fact, investors are now expecting the Fed to implement two 0.25% rate hikes twelve months from now.

This disconnect between Fed rhetoric and market expectations is what has Fed officials in a bind – and Federal Reserve Chair Jerome Powell is shouldering much of the responsibility to navigate the situation. If Powell pushes back on rising expectations too hard, inflation expectations could become unhinged and doubts about the Fed's ability to effectively control the situation will set in. On the other hand, if Powell doesn't push back at all, short interest rates could become unsettled as investors begin to price in earlier and more aggressive monetary policy tightening.

Potentially complicating things further is the fact that Powell's term as Federal Reserve Chair is set to run out early next year. Typically this close to the deadline, The President would have nominated someone for the post to allow the Senate to vet and confirm the candidate. The longer the Biden administration waits to present a candidate, the greater the uncertainty among investors. And as we've said before, investors hate uncertainty.

While the heightened focus on the Fed might be relatively new, our outlook and client positioning are largely consistent with where we've been. We continue to believe that the macroeconomic picture is one of higher growth and inflation. This "reflationary" environment has historically benefitted cyclical "value" stocks which should lead the market higher from here, though with the potential for some volatility along the way. In preparation, we recently trimmed our overweight allocations to riskier areas of the market in order to manage total portfolio volatility. Overall though, our client portfolios maintain their cyclical orientation.

Within equities, we previously increased our clients' exposure to larger, more developed international markets. We've continue to favor smaller companies in the US and have added targeted exposure to more cyclical and higher quality areas of the US large cap space. The recent rise in interest rates has caused these areas of the market to outperform on a relative basis over the near term. This just reinforces our position that cyclical "value" stocks should benefit more than expensive "growth" stocks.

In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. Within the alternative market segments, we continue to emphasize "real assets" (think commodities and real estate) as a hedge against the potential for higher inflation. We have also maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.