February 22, 2022

Market Ethos

The latest market insights from Richardson Wealth

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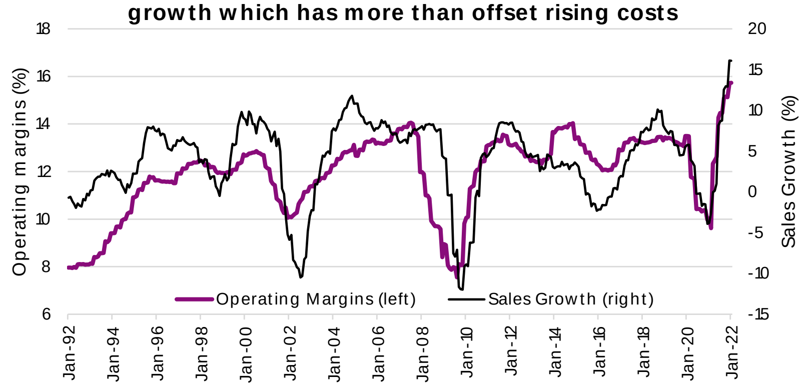
Great fundamentals, for now

Over the past few years, a common chorus has been that fundamentals just don't matter in this current market environment. It is all about the macro, the Fed's balance sheet, liquidity, money flows and performance chasing. We would agree with this assessment; fundamentals have taken a back seat to big macro. But now, with yields rising and liquidity being pulled back, fundamentals may start to matter more.

The good news is fundamentals for the equity markets are looking pretty good. We have just about completed the Q4 earnings season, and it was once again another great season – with over 80% of companies reporting, 78% beat earnings estimates and 70% beat top-line sales forecasts. Relative to Q4 2020, earnings are up a whopping 28% and sales are up 16%. That is fantastic growth and evidence that while costs are rising, top-line revenue growth is helping offset them. Companies are essentially passing on higher costs to the end consumer in case you hadn't noticed.

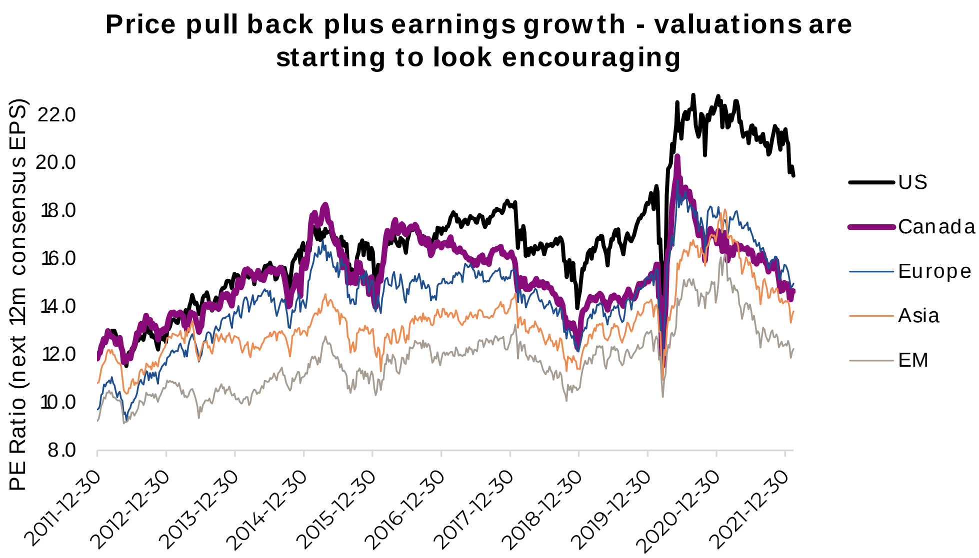
S&P 500 margins have jumped thanks to rising sales growth which has more than offset rising costs



Operating margins for the S&P 500 are higher than at any point over the past thirty years, as is sales growth. Because of the operating leverage within most companies, there is a solid relationship between sales growth and margins. Sales growth is benefiting, not just from good economic activity but inflation as well. Margin improvement has been rather pervasive, with 10 of 11 sectors enjoying improving margins in 2021. The one exception was utilities.

The TSX is enjoying similar trends of late, with strong earnings and sales growth with good margins. The fact is, 2021 was a stellar year for North American equities. As we have highlighted a few times, this was partly due to the pandemic changing consumers' and companies' behaviours.

Valuations provide more good news – if you combine the varying pullback in markets since the start of 2022 with the strong earnings growth, valuations are getting interesting. The S&P 500 is now trading just under 20x, its lowest since coming out of the pandemic-induced bear market. Canada is below 15x, which is below its long-term average. Looking at Europe, Asia, and Emerging Markets (EM), the valuation froth is no longer an issue. You can even make the argument that those markets look cheap.



But where does the buck go next?

One reason valuations have likely come back down is that the outlook for earnings growth is starting to lose pace. U.S. GDP is forecast to slow from 5.7% in 2021 to 3.7% this year and 2.5% next year. As a result, inflation is forecast to slow as well. Combine this with costs that are still likely rising, and you can imagine these record-high margins may be at serious risk of coming back down fast.

To give you an idea how fast this may decelerate, S&P operating earnings grew by over 60% in 2021. Sure, that was compared with 2020, but this growth is forecast to slow down to 9% in 2022. And that deceleration hits in Q1.

Investment implications

This year has a lot of significant macro events going on. Going back to the office appears to be one; central banks changing direction on stimulus and pivoting to tightening cycles is another. However, slowing growth does not seem to garner much attention. While not negative, slowing growth along with stimulus removal makes for a more challenging market. The second derivative effects can be quite important. Mark my words: it won't be long before people start talking about a 'hard' or 'soft landing.'

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist, Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.