Truist Advisory Services, Inc.

Market Perspective from the Investment Advisory Group

Earnings drop may be less than feared because of inflation

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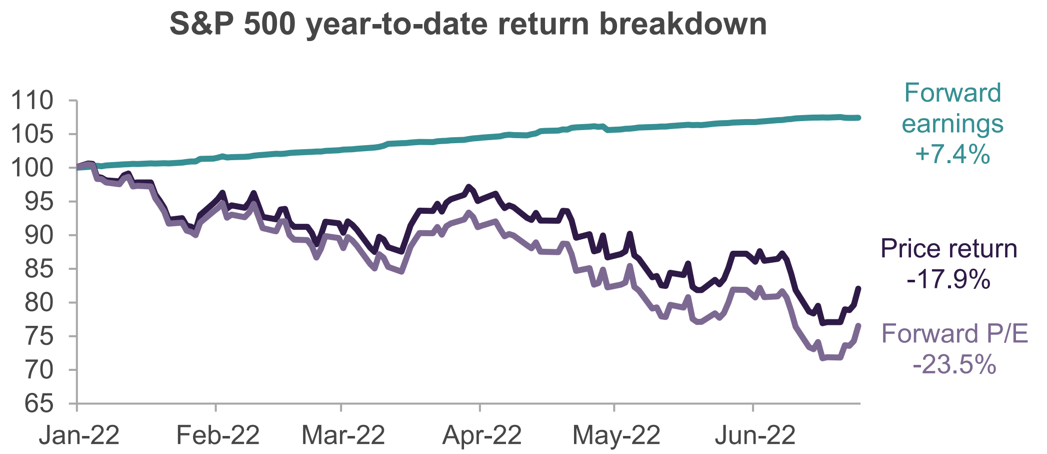
Highlights

- It's become a growing consensus on Wall Street that earnings are the next shoe to drop in the market.
- We agree that earnings estimates are likely to soften. However, our take is earnings are not likely to drop as sharply as some fear. A key to our differentiated view is the impact of inflation on sales and profits.
- While real GDP estimates have been revised sharply lower, nominal GDP estimates, which include inflation, have risen for 2022 and remain stable for 2023.
- History supports our point of view. The inflationary period of the 1970s had among the strongest earnings growth of any decade.
- As we move forward, a sharp breakdown in earnings from current levels would likely be accompanied by a sharp drop in inflation as well. Falling inflation would likely lead to some stabilization in market valuations and allow the Federal Reserve (Fed) to pivot from its current aggressive posture.

What happened

It's become a growing consensus on Wall Street that earnings, which have held up remarkably well this year, are the next shoe to drop in the market. The thinking behind this view is that the first part of the market decline was a reset in valuations from elevated levels, which has largely played out. Now, the next leg of the market decline will come from the effects of a slowing economy trickling down into earnings.

Market decline this year driven by lower valuations while earnings trends are still rising



Data source: Truist IAG, FactSet. Past performance does not guarantee future results.

Our take

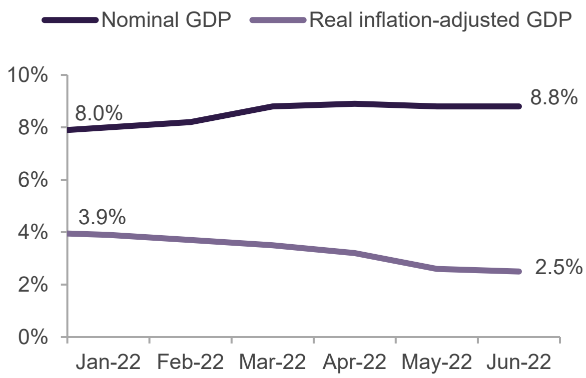
We agree that earnings estimates are likely to soften, consistent with the downward revisions in the economy's growth rate since the beginning of the year. However, our take is earnings are not likely to drop as sharply as some fear when looking at the average earnings drawdowns of close to 20% around previous recessions. **A key component of our differentiated view is the impact of inflation on sales and profits.**

Indeed, investors seem to be focused on earnings relative to slower "real" GDP, or inflation-adjusted, economic growth. That makes sense insofar as inflation has not been an issue over the past 20 years.

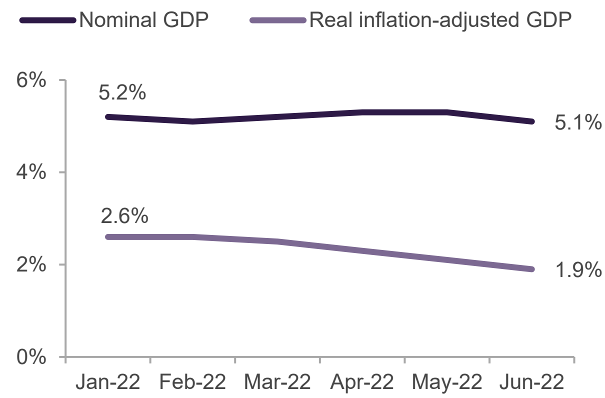
However, inflation matters when thinking about earnings. Notably, while real GDP has been sharply cut for 2022 and 2023 that is not the case for nominal GDP, which includes inflation. **In fact, nominal GDP for 2022 is currently estimated to be 8.8% vs. 8.0% at the beginning of the year, while for 2023, estimates of 5.1% have remained relatively stable, especially given the cut in real GDP estimates from 2.6% to 1.9%.**

While real GDP estimates have been revised sharply lower, nominal GDP estimates have risen for 2022 and remain stable for 2023 relative to where they began the year

Consensus estimates for 2022 GDP: Nominal vs. real



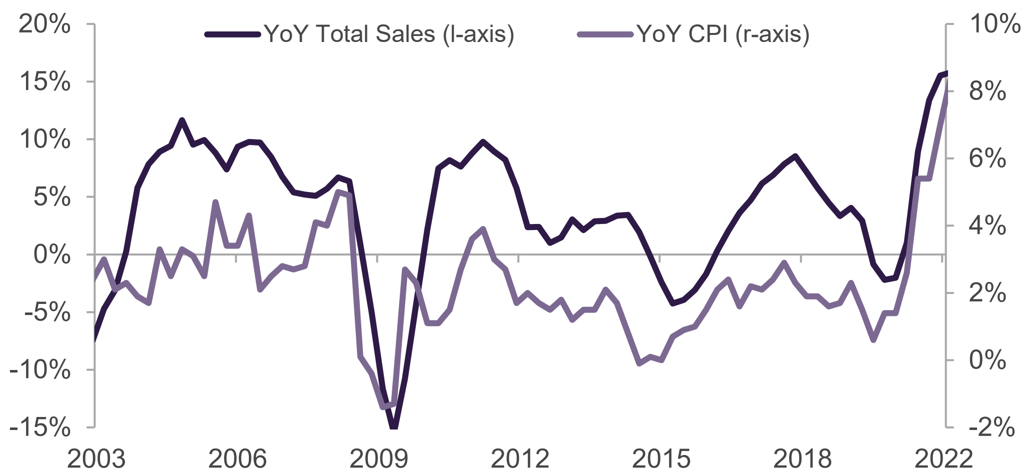
Consensus estimates for 2023 GDP: Nominal vs. real



Data source: Truist IAG, Haver, Blue Chip Consensus forecasts. Past performance does not guarantee future results.

Importantly, there has been **a relatively strong relationship with inflation and sales**

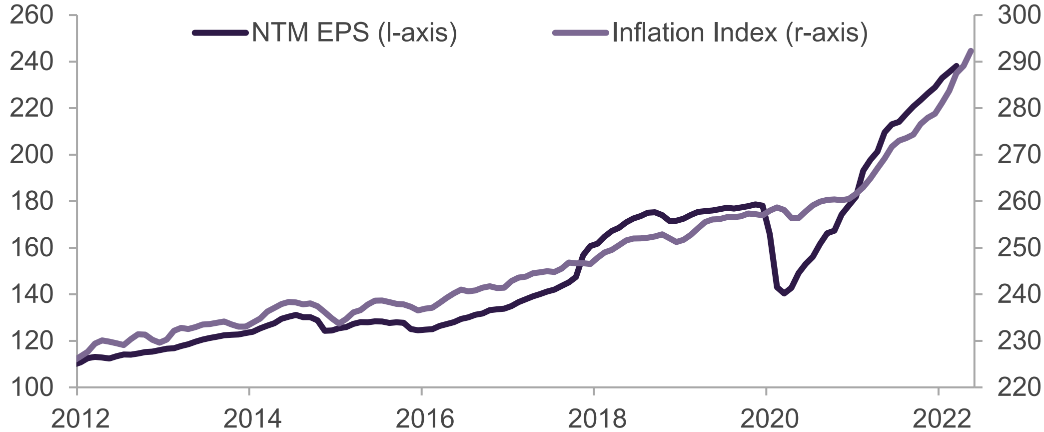
S&P 500 sales and inflation



Data source: Truist IAG, S&P Global, FactSet, Haver. Inflation represented by CPI-U. Data as of 3/31/22. Past performance does not guarantee future results.

And while each sector, industry, and company will have varying amounts of success in pushing higher inflation costs to the end consumer, stocks have tended to be a decent hedge to inflation given earnings in aggregate tend to rise alongside higher inflation.

S&P 500 forward earnings and inflation



Data source: Truist IAG, S&P Global, FactSet, Haver. Inflation represented by CPI-U.
Past performance does not guarantee future results.

History supports our point of view. The inflationary period of the **1970s had among the strongest earnings growth** of any decade (table below).

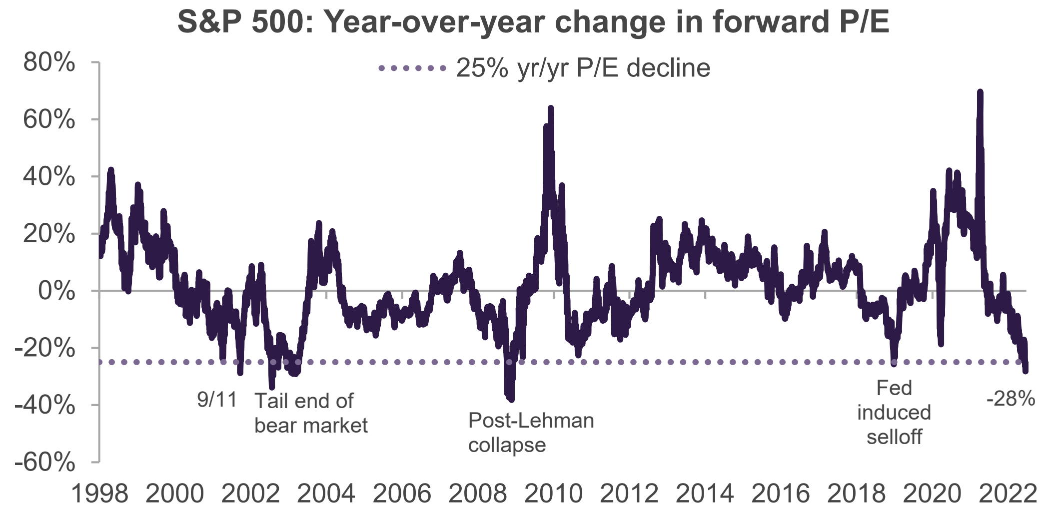
Sources of returns and macro environment by decade: 1970s had among best earnings and nominal GDP

	Sources of total return (%)				*Macro environment (%)*		
By decade	**P/E expansion/ contraction**	**Earnings**	**Dividends**	***Annualized total return (%)***	**Average inflation YoY**	**Annualized nominal GDP**	**Annualized real GDP**
1950s	9.4	3.9	5.1	19.4	2.1	6.9	4.3
1960s	-1.0	5.5	3.3	7.8	2.3	7.0	4.4
1970s	**-7.6**	**9.9**	**4.2**	**5.9**	**7.1**	**10.1**	**3.3**
1980s	7.2	5.0	4.4	17.6	5.6	7.8	3.1
1990s	6.9	7.8	2.5	18.2	3.0	5.6	3.4
2000s	-3.6	1.0	1.8	-0.9	2.6	4.0	1.8
2010s	0.5	10.7	2.1	13.6	1.8	4.0	2.2

Footnote: the 2010s superior earnings growth, despite weak economic growth, was more of a reflection of earnings rebounding from very depressed levels following severe write-offs during the global financial crisis.

Data source: Truist IAG, Morningstar, Haver. Prior to 4th quarter 1988, reported earnings are used for earnings and price-to-earnings calculations; otherwise, operating earnings are used. Inflation is represented by the Consumer Price Index – All Urban Consumers (CPI-U).
Past performance does not guarantee future results.

Instead, it was the higher inflation in the 1970s that led to a re-valuing of stocks downward that impacted the total return of stocks during that decade. Likewise, elevated inflation is a key reason for the steep reset in market valuations seen this year.



Data source: Truist IAG, FactSet. Past performance does not guarantee future results.

Bottom line

Today's note is meant to broaden the conversation. One of the reasons that stocks have historically been considered a partial hedge against inflation is because many companies have pricing power. This has historically shown up in the relationship between higher inflation and higher sales and earnings. Secondarily, many companies own hard assets. These assets are often revalued higher during inflationary environments.

As we move forward, a sharp break down in earnings from current levels would likely be accompanied by a sharp drop in inflation as well. Falling inflation would likely lead to some stabilization in market valuations and allow the Fed to pivot from its current aggressive posture. Conversely, if inflation stays elevated, earnings are likely to stay somewhat more resilient than expected, but valuations could see some further pressure.

This study does not change our overall neutral market stance (in that context we have been expecting a short-term rally that commenced last week). But this work provides a partial offset to the rising concern that the next shoe to drop is earnings.

Disclosures

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