Super profits of 2021-2022: New norms or exceptional circumstances?

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IN A NUTSHELL

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4Q22 S&P EPS results are soft, but follow a tremendous profit boom

Investors remain focused on 4Q S&P earnings per share (EPS) results and 2023 guidance, but it's important to put such in the big picture context of what's been the greatest profit boom at the S&P 500 in its 75 history and probably for large US companies since the profit boom of WWI. About 40% of 4Q S&P EPS has reported and results are on track for about $54 of quarterly EPS. This is the first quarter of no y/y EPS growth since the 4 quarters of 2020 stricken by the pandemic. Moreover, this will be the second quarter of sequential S&P EPS decline from $58 in 2Q22 and $56 in 3Q22, despite seasonality and what's been healthy US gross domestic product (GDP) growth through 2022. Last week, US GDP reported 4Q at 2.9% q/q, albeit mostly inventory growth. However, this softening in profits and guidance for 2023 follows what was a 25% surge in S&P EPS from mid-2021 to mid-2022 from the record pre pandemic profitability of 2019.

Gauging what's normal requires looking at proper profitability metrics

Today's record S&P 500 profitability is much more than merely record high EPS in 2022. We expect S&P EPS to climb over time owing to inflation and more importantly the retention of earnings reinvested into these businesses at good returns on incremental capital. Thus, when we cite record "profitability" we are referring to margins, returns on capital, economic profits and observed real growth rates of profits relative to these driver norms and history. S&P net margins, Return on Equity (ROE), nominal and real EPS growth rates across the sectors paint a picture of record profitability nearly everywhere. Most notable is at Tech / Communications or all "digital" enterprises, but also at commodity producers, most manufacturers and the big box retailers of the S&P. Making for the highest net margins and ROE for the S&P 500 on record at 13%+ and 20%+.

The profit surge at digital is well known; while we expect a profit pause at these businesses in 2023, we think healthy growth still lies ahead afterward. Less appreciated profit surges are at industries that historically have been challenged to generate strong margins and returns. Including Energy, Materials, Auto, Semiconductors, some Retailers and some Industrials. Today, all of these and other sectors and key industries within them hit record net margins and ROE either in 2021 or 2022. A few notable exceptions are Aerospace at Industrials, still parts of travel and in-person Consumer Discretionary Services and Banks. However, Banks are generating some of the best profits, net interest margins and ROEs since the financial crisis on higher interest rates; as discussed in our previous Americas CIO View note. In this note, we take a closer look at the Energy sector and its 2022 profits.

Energy profits 2022 vs. 2020: Mother of cyclical profit swings

S&P Energy sector profits will likely finalize over $200bn in 2022. This compares to a low of -$5bn in 2020 and highs of $70bn in 2018 and $140bn in 2008. Our first cut at analyzing 2022 results, show the highest net margin, ROIC and ROE at Energy since 1995. A 2022E net margin of near 15% at Energy vs. prior highs of about 9.5% 2006-2007. A 2022E Return on Invested Capital (ROIC) and ROE of about 14% and near 30%, which were only briefly matched in 2006-2007 and exceed the S&P now. Oil prices surged in 2022, especially the first half, but we're observing the strongest profits relative to the oil price at the Energy sector in recent decades. The explanation is much about losses in 2020 causing cost cutting and deferred maintenance spending then swinging to big 2022 revenue gains on price surges across oil, natural gas and refined products. Oil prices will likely remain volatile, but we expect pressure on profitability relative to oil prices as maintenance operating expenditure (opex) and capital expenditure (capex) rebound. We note that capex/Depreciation & Amortization (D&A) was under 100% 2020-2022 vs. about 150% in the slow capacity growth years of 1990-2005 and 200% in the strong capacity growth years of 2006-2016. Since 2016, Energy capex has been in decline despite inflation, more regulations and transition prep. This supports prices, but maintaining current production will likely require a capex surge eventually. We expect Energy profits to decline at least 10% in 2023, followed by about 5% thereafter. Energy profits are 11% of S&P vs. 7.5% average 2009-2019 and 16% in 2007 and 20%+ early 1980s. But contribution to S&P profits is not a profitability metric. Steel, Rails, Utilities dominated profits a century ago and Financials, Tech, Health Care none.

Watching the results: 4Q EPS tracker and our S&P sector strategy

The S&P profit boom the past 12 years is attributable to globalization and digitalization with large S&P companies often leading the way on both. We see great promise at S&P Health Care companies leading the next decade of profit growth with medical innovation. But right now, we think investors expect too much of the S&P 500 as it faces world challenges. Valuations are demanding and S&P EPS growth could be flat the next couple of years.

Glossary

Amortization is an accounting term which refers to the periodical reduction of the book value of intangible assets (such as patents) or bank loans.

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

In relation to currencies, depreciation refers to a loss of value against another currency over time.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The net interest margin of a financial institution is the difference between the average interest rate paid and the average interest rate received by the institution.

An operating expenditure (opex) is an ongoing cost for running a product, business, or system. Its counterpart, a capital expenditure (capex), is the cost of developing or providing non-consumable parts for the product or system.

The Return on equity (ROE) is the amount of net income returned as a percentage of shareholders' equity.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Return on invested capital (ROIC) is a calculation used to assess a company's efficiency in allocating capital to profitable investments. The ROIC formula involves dividing net operating profit after tax (NOPAT) by invested capital. ROIC gives a sense of how well a company is using its capital to generate profits.

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