Basis Points – January 26, 2023

westwoodgroup.com/weeklyblog/basis-points-january-26-2023/

Above the Fold

Early Earnings Reports Show More Dramatic Fed Impact

Markets breathed a sigh of relief late last year as third-quarter earnings results, though certainly not strong, did not reflect the "earnings cliff' so many had feared. Unfortunately, the most recent quarter may do little to keep those worries at bay. By the end of this week, we should have Q4 earnings results from 28% of S&P 500 companies, and so far, results and the overall tone, in many cases, are painting an increasingly grim picture. Though it's still early in the reporting season, corporate leaders, on average, are lowering their earnings growth trajectory at an even sharper rate. In other words, many still believe that investors' expectations for earnings potential are still high, given the softening demand, persistent cost pressures and obviously the Federal Reserve's hyper-hawkish interest rate perspective.

It's important to point out that this tempering of expectations is normal during periods of economic contraction in order to prevent big earnings "misses" in future reports. What we find moderately concerning is the rate of earnings "beat" percentages in the quarter, versus expectations. So far, less than 68% of the companies that have reported were able to top analyst expectations. In all of 2021 and Q1 2022, that number was close to 83% on average. What makes the beat ratio even more telling this quarter is that expectations are already low, with a -7.4% decline in earnings expected (quarter-over-quarter) on just a 4% increase in revenues. Procter & Gamble's -6% decline in sales volumes speaks to weakness at the consumer staples level, while Discover Financial's fairly strong report also offered a warning that households may begin to experience difficulty paying back debt in the coming months.

Three Things

Rental Market Looks Increasingly Shaky

Coming off nosebleed levels, America's rental market is cooling quickly. According to Zillow, rent prices came down nearly 50 basis points in November, and other datasets point to even deeper declines in December. November's drop was the largest since Zillow began tracking data in 2015, and many believe rent rates have further to go as they are still far higher than they were at the start of the pandemic, averaging $2,008 per month. Falling rent rates could trigger more selling and/or price declines in investment properties as they become less viable economically. This pressure could accelerate pricing pains already reverberating through much of the housing market.

Microsoft Revenue, Cloud Momentum Slow

The legacy tech giant just reported its slowest sales growth in more than six years as cloud and software demand softened globally. In the fourth quarter, Microsoft posted just a 2% revenue increase as its net income fell 12%. CEO Satya Nadella cited growing global macroeconomic concerns as the main reason its customers reduced spending. The company's Intelligent Cloud business, which includes its Azure cloud-computing business, grew at a respectable 18% to $21.51 billion, while Azure itself actually expanded by 31% in the quarter. Unfortunately, those data were tempered by a warning from CFO Amy Hood, who noted slowing in the entities starting in 2022, with additional deceleration likely in 2023.

Treasuries Extend Their Rally

The benchmark 10-year U.S. Treasury note extended its 2023 rally after the Bank of Japan maintained its cap on bond yields Wednesday. If Japanese bonds rise in yield, some investors might have sold other bonds (like U.S. Treasuries) in order to chase Japanese yield. But Treasury yields have been mostly on the decline since September as domestic economic data continues to deteriorate. Since the data points to an increased risk of recession and perhaps a peak in interest rates, investors flock to safe havens such as Treasuries and money markets. The buying frenzy has picked up steam recently as reports on weakening retail sales, slowing industrial production and declining supplier prices helped support a less-hawkish Fed (and thus Treasury prices).

In the Know

It Was AT&T That Proposed Its Own Breakup

Though government agencies can block mergers and acquisitions, it's extremely rare for U.S. authorities to force a company to completely break its business up once established. For Google, it's now been served with two antitrust lawsuits in just over two years and the latest seeks a breakup of Google's online advertising business. The last time the government succeeded in splitting a company into separate divisions was the 1982 breakup of AT&T into the "baby bells" and other entities. What some don't know is the breakup was actually AT&T's idea after fearing it would lose a filing that began some six years earlier. The reality is that government breakups are often threatened, but rarely fully executed … with only a few completed in history, including Standard Oil and American Tobacco.