Weekly Commentary with Professor Jeremy J. Siegel

An Important Shift in Consumption Preferences?

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A critical development last week for the equity markets was the disappointing earnings that occurred at Walmart and further confirmed with a drop in earnings at Target. The equity market declines have thus far been largely explained and driven by higher discount rates lowering valuation multiples, while fundamentals and earnings at large remained robust.

These retailer earnings were a real miss and I am contemplating if the retailers just misestimated the shift from consumer goods preferred during lockdowns to services. I toured three different cities giving presentations last week and can report the demand for air travel is very robust with oversold planes in each of my flights. I have never seen this type of excess demand for travel—and this could signal an important shift in consumption preferences towards services.

The earnings misses also undoubtedly reflect higher gas prices and inflation crimping the purchasing power of lower income consumers at those retailers but there also appears to have been rare inventory issues and mis-estimation of what goods would be in higher demand.

There is concern margins will come under pressure. But almost 90% of companies reported earnings for the first quarter, and results as a whole, were quite solid. I believe earnings growth will remain robust in 2022, but an earnings deterioration is certainly a key risk for the market.

We are more than half-way through the second quarter and economists see this quarter's real GDP estimated to be +2.5%, not another negative GDP print like the first quarter. Inflation is still the most important underlying issue. Gas prices are at all-time records in nominal terms, although in real terms still slightly below their 2007 peak. Natural gas prices staying high will be a hit to consumers during the heating season.

We will be getting another M2 money supply figure this week, hopefully it continues to moderate as it did the last few months. But there is no question the Fed will be raising rates 50 basis points at the next two meetings—they welcome the tighter financial conditions that have come from the equity market declines and the higher mortgage rates that will surely slowdown the housing market. The Fed is not worried about a 30% decline in the Nasdaq—stocks would have to be a much further decline before it would cause any shift in the new inflation-fighting regime.

I believe we are getting closer to the bottom of this sell-off and we may be within 5% from the lows. Multiples have corrected and the market has appropriately reflected the reality of this Fed hiking cycle. With price-to-earnings (P/E) ratios of the S&P 500 now at 16-17x this year's estimated earnings-in a still very low real interest rate environment—these are values that should entice long-term investors.

Glossary

Basis Point: 1/100th of 1 percent.

Discount rate: The interest rate charged to commercial banks and other financial institutions for short-term loans they take from the Federal Reserve Bank.

Earnings: Refers to a company's profits in a given quarter or fiscal year. Earnings are a key figure used to determine a stock's value. A company's earnings are used in many common ratios.

Federal Reserve (Fed): The Federal Reserve System is the central banking system of the United States.

Fundamentals: Attributes related to a company's actual operations and production as opposed to changes in share price.

Gross Domestic Product (GDP): The sum total of all goods and services produced across an economy.

Inflation: Characterized by rising price levels.

M2 Money Supply: Contains all funds deposited in checking accounts as well as funds deposited in savings accounts and certificates of deposit. There are various ways to measure the money supply of an economy. This one is meant to broadly account for the majority of savings and checking accounts held by individuals and businesses across the economic landscape.

Multiple: A ratio that is calculated by dividing the market or estimated value of an asset by a specific item on the financial statements. The multiples approach is a comparables analysis method that seeks to value similar companies using the same financial metrics.

Nasdaq Composite Index: The market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange.

Price-to-earnings (P/E) ratio: The ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Valuations: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.