

## US Strategy Snapshot

### Profit Margin Resilience on Display

**Bottom Line:** One of the major concerns plaguing investors in recent months has been the growing expectation that profit margins are too high and need to come down significantly given persistently elevated inflationary pressures and the resulting higher costs that companies face. The rally in US stocks since mid-June has only exacerbated these fears, based on our client conversations, with many predicting that a steep collapse in margins will ultimately be one of the primary catalysts for the market falling to new price lows before the end of the year. We disagree with that notion. We acknowledge that S&P 500 quarterly profit margins are set to fall year over year for the second straight quarter in Q2, but forecasts continue to imply resilient margins in the quarters ahead with sequential improvement. On a trailing-12-month basis, profit margins for S&P 500 companies are higher now versus the start of the year, while NTM profit margin projections have been holding up well, contracting just 23bps since the end of 2021 with 45% of the index exhibiting upticks in margin forecasts. From our lens, earnings and profit margins will certainly be important factors to monitor in the coming months, and while we are not necessarily ruling out the possibility of profit margins receding from current levels, we simply do not see signs yet of the sharp margin deterioration that many investors have been prognosticating.

#### Main Points:

- S&P 500 Quarterly Profit Margins Falling Y/Y, But Remain Above Average, With Upticks Expected in Coming Periods**
  - ✓ Yes, the S&P 500 is reporting a year-over-year decline in profit margins for the second consecutive quarter in Q2
  - ✓ However, forecasts are implying resilient margins in coming quarters with sequential improvements
- Trailing- and Forward-12-Month Profit Margins for S&P 500 Companies Still Holding Firm Despite Rising Inflation**
  - ✓ Current S&P 500 LTM profit margins are higher versus end of 2021, while NTM net margins have contracted just 23bps
  - ✓ Margin contraction should not be automatically equated to a significant drawdown in stock prices
- Almost Half of S&P 500 Index Have Exhibited Improvements in NTM Profit Margin Forecasts This Year**
  - ✓ While most S&P 500 sectors have lower NTM profit margin forecasts versus the end of 2021, only one sector has exhibited margin contraction of more than 80bps
  - ✓ Energy (86%), Industrials (55%), and Financials (55%) have the largest percentages of stocks showing improvements to NTM profit margins ytd, while Utilities (18%) and Consumer Staples (24%) have the smallest percentages.

#### Investment Strategy

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#### US Strategy – S&P 500 Targets

Price Target Model	2022E
DDM	4,925
Fair Value P/E	4,325
<b>Price Target</b>	<b>4,800</b>
EPS Target Model	2022E
Macro Regression	\$245
Bottom-Up Consensus	\$228
Normalized EPS	\$192
<b>EPS Target</b>	<b>\$245</b>
<b>Implied P/E</b>	<b>19.6x</b>

Source: BMO Capital Markets Investment Strategy.

#### US Strategy – Recommended S&P 500 Sector Weightings

Sector	Opinion	Tgt. Wgt.
Communication Services	OW	10%
Consumer Discretionary	MW	9%
Consumer Staples	MW	8%
Energy	MW	4%
Financials	OW	12%
Health Care	OW	15%
Industrials	UW	7%
Information Technology	MW	26%
Materials	MW	3%
Real Estate	MW	3%
Utilities	MW	3%

Source: BMO Capital Markets Investment Strategy.

OW: Overweight

MW: Market Weight

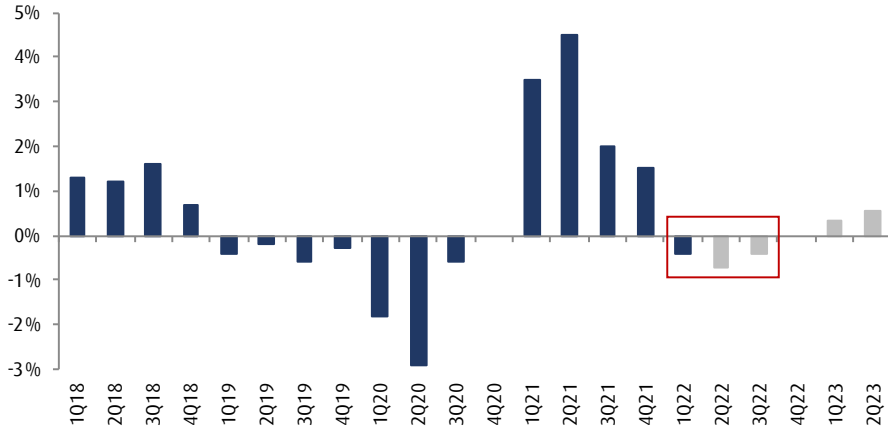
UW: Underweight

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## S&P 500 Quarterly Profit Margins Falling Y/Y, But Remain Above Average, With Upticks Expected in Coming Periods

### S&P 500 Quarterly Profit Margins Set to Fall Y/Y for Second Straight Quarter in Q2

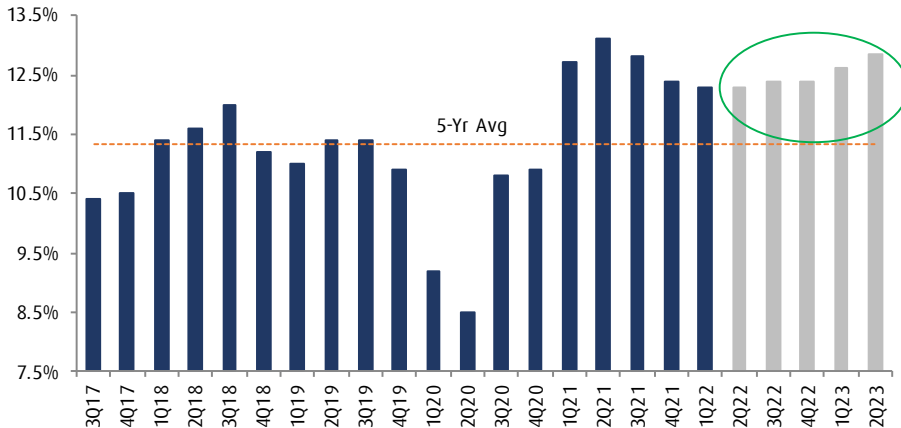
Year-to-Year Change in S&P 500 Quarterly Profit Margin  
gray bars represent consensus estimates



Source: BMO Investment Strategy Group, FactSet.

### Forecasts Implying Resilient Margins in Coming Quarters With Slight Improvements vs Q2

S&P 500 Quarterly Profit Margin  
gray bars represent consensus estimates

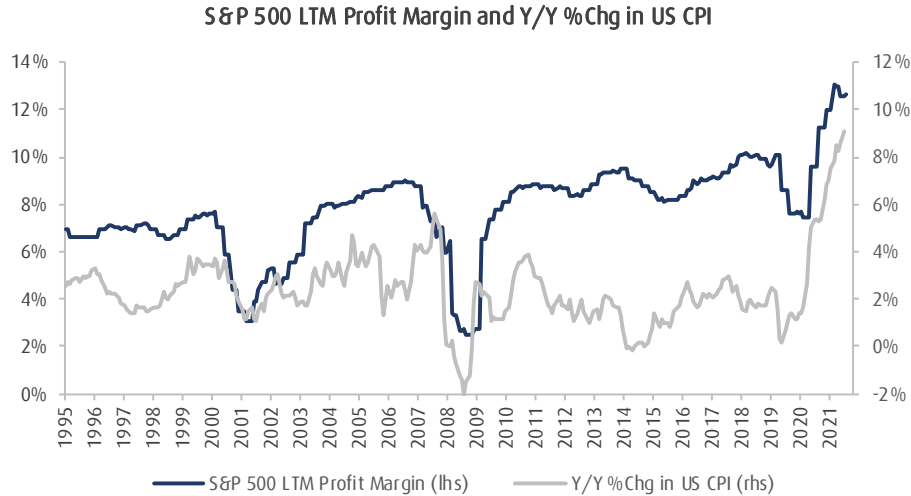


Source: BMO Investment Strategy Group, FactSet.

- The S&P 500 is reporting a year-over-year decline in profit margins for the second consecutive quarter in Q2 and is set to post another decrease compared to the year-ago quarter during Q3.
- That being said, it is important to put these numbers into perspective. A big contributor to the drop in profit margins has been the difficult comparisons to the elevated levels seen in 2021.
  - ✓ In fact, the 13.1% S&P 500 profit margins recorded in Q2'21 marked a record high for the index.
  - ✓ The current Q2 profit margins for the S&P 500 is tracking at 12.3%, which would be 100bps above the five-year average of 11.3% and flat versus Q1'22.
- Looking ahead, quarterly consensus profit margin forecasts for S&P 500 companies are implying slight margin improvements in the next two quarters and further upticks to 12.6% and 12.8% for Q1'23 and Q2'23, respectively.

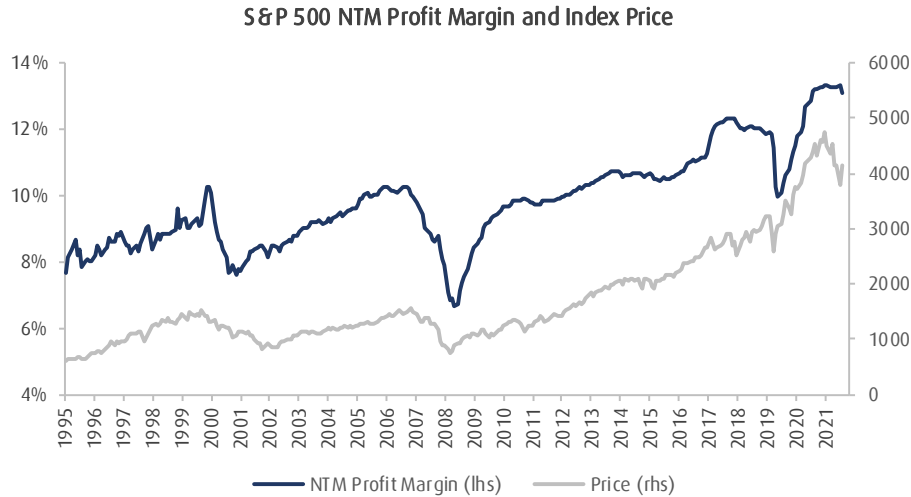
## Trailing- and Forward-12-Month Profit Margins for S&P 500 Companies Still Holding Firm Despite Rising Inflation

### S&P 500 LTM Profit Margins Have Held Firm Despite Rising Inflation



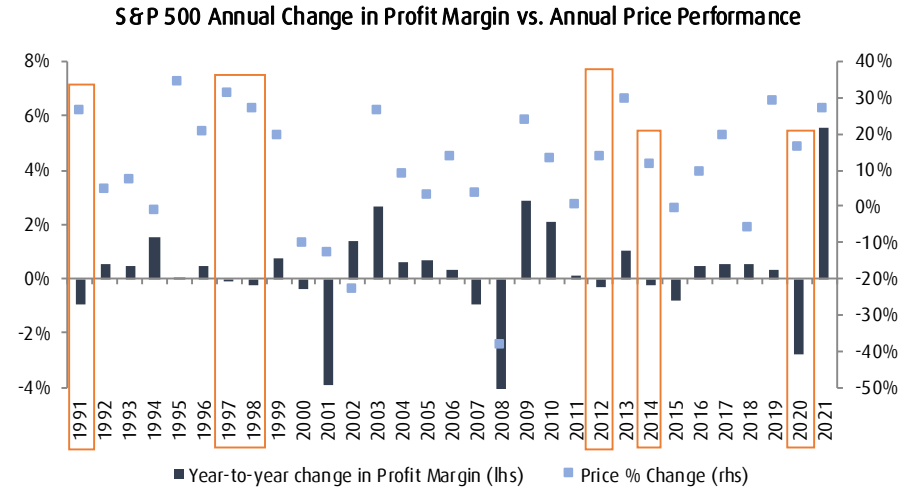
Source: BMO Investment Strategy Group, FactSet, Haver, BLS.

### No Significant Deterioration in NTM Profit Margin Forecasts Overall for SPX Companies



Source: BMO Investment Strategy Group, FactSet.

### Contracting Margins Do Not Necessarily Derail Market Price Performance

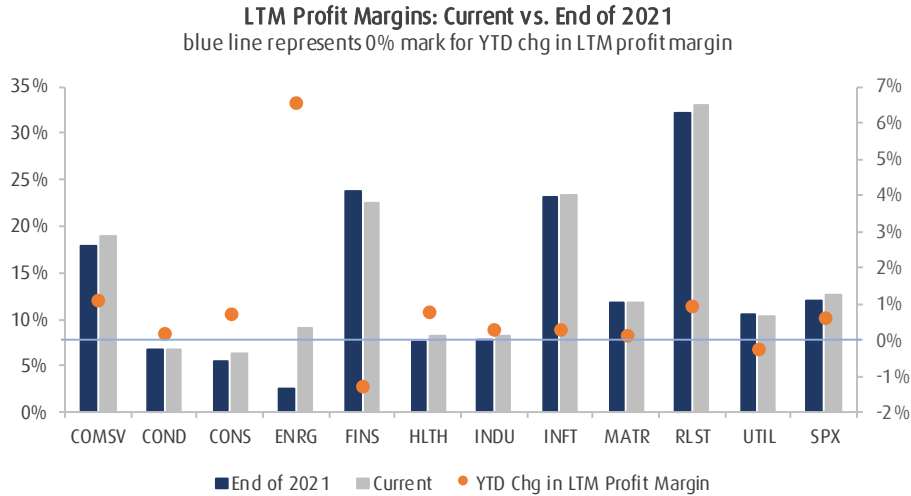


Source: BMO Investment Strategy Group, FactSet.

- Trailing-12-month profit margins for S&P 500 companies have held up well amid rising inflation. S&P 500 LTM profit margins have been rising over the past year even as y/y CPI has surged to 40-year highs with current margins still near record levels.
- US stock prices and valuations have de-rated as a result of this higher inflation and interest rate environment, but NTM profit margin forecasts have remained fairly stable throughout the past year, contracting just 23bps since the end of 2021. This suggests to us that analysts are more optimistic on the profitability outlook for S&P 500 companies and their ability to pass on higher costs than most investors.
- It is also important to note that even if S&P 500 net margins do end up contracting this year or in 2023, this contraction should not be automatically equated to a significant drawdown in stock prices, in our view.
  - ✓ For instance, we analyzed annual margin and performance trends in the S&P 500 since 1990 and found that the market logged double-digit percentage gains against a backdrop of falling profit margins (orange bars) in 6 of the 11 periods. On average, the annual S&P 500 price return during years when margins contracted was 6% with gains occurring in 7 out of 11 years.

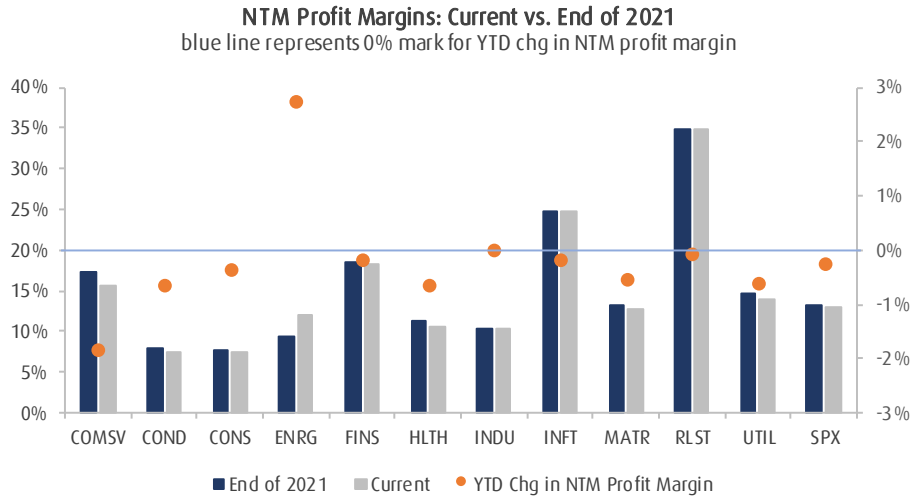
## Almost Half of S&P 500 Index Have Exhibited Improvements in NTM Profit Margin Forecasts This Year

### Most Sectors Have Higher LTM Profit Margins Currently Compared to End of 2021



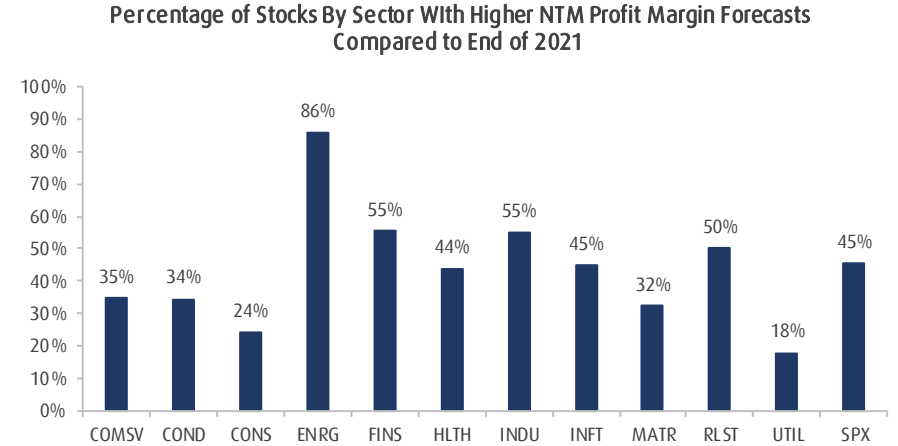
Source: BMO Investment Strategy Group, FactSet.

### Energy With Big YTD Uptick in NTM Net Margins, While COMS Has Displayed Notable Drop



Source: BMO Investment Strategy Group, FactSet.

### Nearly 50% of S&P 500 Companies Exhibiting YTD Improvements to NTM Profit Margins



Source: BMO Investment Strategy Group, FactSet.

- From a sector standpoint, current trailing-12-month profit margins for 9 of 11 GICS sectors are either in line or higher compared to those at the end of 2021.
  - Financials and Utilities have been the only groups to exhibit margin contraction ytd, while Energy has seen the biggest expansion this year.
  - LTM net margins for S&P 500 companies have improved by 60bps ytd.
- On a forward-looking basis, most sectors have seen their NTM profit margins contract versus the end of 2021, but the significant deterioration to forecasts that many investors and market pundits were predicting has not occurred.
  - Communication Services was the only sector that exhibited NTM net margin contraction of >80bps. Utilities NTM profit margins are 72bps lower versus the end of 2021, and Consumer Discretionary and Health Care margins are 63bps lower. NTM profit margins for Energy improved 280bps ytd, while those for Industrials and Real Estate have been essentially unchanged.
- NTM profit margins for the S&P 500 have contracted just 23bps compared to the end of 2021 with 45% of stocks in the index displaying margin expansion. Energy (86%), Industrials (55%), and Financials (55%) have the largest percentages of stocks seeing improvements to profit margins ytd, while Utilities (18%) and Consumer Staples (24%) have the smallest percentages.

## BMO Outperform-Rated Stocks That Fit the Theme

We screened the S&P 500 index for stocks exhibiting the biggest improvements to next-12-month profit margin forecasts since the start of the year.

The screening parameters are:

- Stocks in the S&P 500 index
- NTM profit margins higher than its forecast at the start of the year
- Ytd improvement in NTM profit margins falls in top quartile
- Rated Outperform by BMO Capital Markets Equity Research

### BMO Outperform-Rated S&P 500 Stocks Exhibiting Biggest YTD Improvements to NTM Profit Margins

Ticker	Company	BMO Rating	GICS Sector
ADI	Analog Devices, Inc.	OP	Information Technology
ALB*	Albemarle Corporation	OP	Materials
AMD	Advanced Micro Devices, Inc.	OP	Information Technology
AVGO	Broadcom Inc.	OP	Information Technology
CF*	CF Industries Holdings, Inc.	OP	Materials
COP	ConocoPhillips	OP	Energy
CVX	Chevron Corporation	OP	Energy
DVN	Devon Energy Corporation	OP	Energy
ENPH	Enphase Energy, Inc.	OP	Information Technology
EOG	EOG Resources, Inc.	OP	Energy
EXC	Exelon Corporation	OP	Utilities
HES	Hess Corporation	OP	Energy
HST	Host Hotels & Resorts, Inc.	OP	Real Estate
MCD	McDonald's Corporation	OP	Consumer Discretionary
MOS*	Mosaic Company	OP	Materials
MPC	Marathon Petroleum Corporation	OP	Energy
PFE	Pfizer Inc.	OP	Health Care
PSA	Public Storage	OP	Real Estate
PXD	Pioneer Natural Resources Company	OP	Energy
SLB	Schlumberger NV	OP	Energy

Source: BMO Capital Markets Investment Strategy, FactSet.

Rating Key, according to BMO Capital Markets Equity Research: OP: Outperform, Mkt: Market Perform, Und: Underperform, NR: Not rated by BMO Capital Markets Equity Research.

\* Covered by our Canadian affiliate BMO Nesbitt Burns Inc.

## Recent US Strategy Research Reports

Date	Title
<b>Comments, Snapshots, and Factor Focus Reports</b>	
7/27/2022	<a href="#">US Strategy Snapshot: Focus on Domestically Oriented Stocks Within Industrials</a>
7/21/2022	<a href="#">US Strategy Comment: Pick Your Spots Within Consumer Discretionary</a>
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6/23/2022	<a href="#">US Strategy Snapshot: Dissecting the Bear's Arrival and Its Implications</a>
6/15/2022	<a href="#">US Strategy Snapshot: Difficult Times Require Process and Discipline</a>
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5/30/2022	<a href="#">US Strategy Snapshot: Communication Services Barbell = Our Contrarian Overweight</a>
5/17/2022	<a href="#">US Strategy Snapshot: Still Bullish, With a Dose of Reality</a>
4/28/2022	<a href="#">US Strategy Snapshot: Charts to Consider as Market Slide Rolls On</a>
4/20/2022	<a href="#">US Strategy Comment: Preparing for the Second Derivative of Earnings Growth</a>
4/14/2022	<a href="#">US Strategy Snapshot: Sizing Up Small Caps and Mid-Caps</a>
3/31/2022	<a href="#">US Strategy Comment: Select Not Neglect When Evaluating Health Care</a>
3/24/2022	<a href="#">US Strategy Comment: Thematic Report – Industrial Renaissance is Upon Us</a>
3/15/2022	<a href="#">US Strategy Snapshot: Views From the Observation Deck</a>
<b>Monthly Reports</b>	
8/4/2022	<a href="#">US Strategy: US Chartbook – August 2022</a>
8/4/2022	<a href="#">US Strategy: US Factor Profiles – August 2022</a>
8/4/2022	<a href="#">US Strategy: US Multi-Factor Profiles – August 2022</a>
<b>Podcasts &amp; Videocasts</b>	
11/24/2021	<a href="#">Videocast: BMO Virtual Fireside Chat With Brian Belski – 2022 Year Ahead for the US &amp; Canada</a>
<b>Investment Strategy Snapshots and Special Reports</b>	
11/18/2021	<a href="#">Investment Strategy: 2022 Market Outlook - The Year Ahead for the U.S. and Canada</a>
<b>Canadian Strategy</b>	
<i>Please call or e-mail us to be added to our standalone Canadian Strategy research</i>	

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Buy	Outperform	53.6 %	18.6 %	52.0 %	56.4 %	59.5 %	57.7%
Hold	Market Perform	44.5 %	19.0 %	44.0 %	41.9 %	37.6 %	37.5%
Sell	Underperform	1.7 %	44.4 %	4.0 %	1.4 %	2.8 %	4.8%

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(S) = Speculative investment;

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