# MORNING BRIEFING

**August 2, 2022**

## Valuation, M-PMI & Consumers

*Check out the accompanying chart collection.*

**Executive Summary:** Yesterday's M-PMI report jibed with our view that the US economy is in a growth recession with some sources of inflation abating—which is bullish for stocks. … Since we think the S&P 500 might have bottomed on June 16, we're raising our target ranges for its price index and forward P/E multiple while keeping our earnings expectations unchanged. … Also: The recent consumer spending and saving data paint a challenging picture: The "inflation tax" has sapped consumers' purchasing power, causing less saving and more borrowing to support essential spending. Consumer sentiment hasn't been so negative in nine years. Nevertheless, consumers should continue to pivot from buying goods to buying services.

**Strategy I: Tweaking Our Valuation Multiples.** In line with our view that the S&P 500 might have bottomed on June 16 at 3666, Joe and I are raising our target ranges for the index's forward P/E valuation multiples from 14.0-17.0 to 15.5-18.0 this year and from 15.0-18.0 to 16.0-19.0 next year.

We are sticking with our forward earnings forecasts of $235 per share for year-end 2022 and $255 per share for year-end 2023. As a result, our projected ranges for the S&P 500 stock price index are now 3642-4230 by the end of this year and 4080-4845 by the end of next year. (See our updated *YRI S&P 500 Earnings Forecasts*.) (FYI: Forward earnings is the time-weighted average of analysts' consensus earnings-per-share estimates for this year and next.)

Could the S&P 500 rise to a new record high of 4800 by the end of this year, rather than at the end of next year as we expect? These days, anything is possible, we suppose. However, during the July 21 week, forward earnings was $239. We are expecting it to be essentially flat over the remainder of this year assuming, as we do, that the current growth recession continues over the rest of the year.

For the S&P 500 to get to 4800 with our year-end forecast of $235 for forward earnings would require that the forward P/E jumps back to 20.4 from Friday's level of 17.2. If the current multiple remains unchanged at 17.2 by the end of the year, forward earnings would have to rise to $279 by the end of this year for the S&P 500 to hit 4800.

In other words, a new record high in the S&P 500 by the end of this year seems unlikely to us. It is more likely to happen by the end of next year. But we won't object if it happens sooner.

**Strategy II: Why Equity Investors Care About The M-PMI.** Yesterday's M-PMI report for July was fully consistent with our view that the economy is in a growth recession, supply-chain disruptions are abating, and unintended inventory accumulation is putting downward pressure on prices (*Fig. 1*). On balance, it was bullish for stocks. Consider the following:

(1) *M-PMI and S&P 500.* The S&P 500 on a y/y basis closely tracks the M-PMI (*Fig. 2*). The former was down 10.4% y/y during July. July's M-PMI reading of 52.8 suggests that the S&P 500 should be up by about as much.

Not surprisingly, the M-PMI is also highly correlated with the y/y growth rate in S&P 500 operating earnings per share (*Fig. 3*). So far, the former is consistent with a slowdown in the latter rather than a hard landing with negative y/y comparisons.

(2) *Production & new orders*. The M-PMI production index remained solidly above 50.0 during July at 53.5 (*Fig. 4*). However, the M-PMI new orders index dipped to 48.0, which is consistent with previous slowdowns rather than recessions.

(3) *Supply chains.* The M-PMI's supplier-deliveries and backlog-of-orders components both fell sharply to readings of 55.2 and 51.3, respectively, indicating that supply-chain disruptions are easing (*Fig. 5*).

(4) *Inflation indicator.* The M-PMI's prices-paid index dropped from 87.1 during March to 60.0 during July (*Fig. 6*). That's the lowest since August 2020. In the past, similar declines occurred during recessions, identified as such by the Dating Committee of the National Bureau of Economic Research. This time might be different if the current slowdown isn't bad enough to be counted as an "official recession."

**Consumers I: 'Inflation Tax' Flattens Real Incomes.** Over the past 12 months through June, personal income less government social benefits to persons, in current dollars, rose $1,346 billion to a record $17.9 trillion (*Fig. 7*). Over that same period, inflation-adjusted income (on a comparable basis) rose just $184 billion to $14.5 trillion. So in effect, the "inflation tax" reduced the purchasing power of pre-tax personal income by $1,162 billion.

A similar analysis of disposable personal income (DPI) shows that it rose $602 billion in current dollars and fell $498 billion on an inflation-adjusted basis. So the inflation tax reduced the purchasing power of DPI by $1,100 billion (*Fig. 8*).

In percentage terms on a y/y basis, real personal income with and without government social benefits fell 1.0% and rose 1.3% through June. On a m/m basis, they fell 0.3% and 0.2% during June. Real DPI fell by 0.3% m/m and 3.2% y/y through June. Any way that we slice and dice the data, the inflation tax has dramatically eroded the purchasing power of consumers over the past 12 months.

It's no wonder that the Consumer Sentiment Index (CSI), the Consumer Confidence Index (CCI), and the Consumer Optimism Index (COI) all show that consumers are very depressed (*Fig. 9*). The COI, which is the average of the CSI and the CCI, fell in July to the lowest reading since November 2013.

**Consumers II: Saving Less To Boost Spending.** In an effort to prop up their spending, especially on essentials, consumers have cut back on their saving and increased their borrowing. The personal saving rate fell from 9.5% last June to 5.1% this June (*Fig. 10*). Over this period, current-dollar personal saving fell $769 billion, while inflation-adjusted personal saving fell $718 billion (*Fig. 11*).

In current dollars, consumer revolving credit increased $131 billion over the past 12 months through May (*Fig. 12*). But again, on an inflation-adjusted basis, the real purchasing power of that borrowing increased by only $57 billion.

By saving less and borrowing more, consumers have managed to spend more but at a slower pace than during past periods when inflation wasn't eroding their purchasing power as much as it is now. Consider the following:

(1) *Real consumption.* Personal consumption expenditures (PCE) is up 8.4% y/y through June in current dollars but only 1.6% on an inflation-adjusted basis (*Fig. 13*). In other words, their nominal PCE has increased by $1,334 billion over the past 12 months to $17.1 trillion, but that's barely allowed them to increase their real spending—because of the inflation tax.

(2) *Pivoting from goods to services.* Over the past 12 months through June, real PCE on goods fell 3.0%, while real PCE on services rose 4.1%. Following the lockdown recession in early 2020 through mid-2021, consumers splurged on goods while most services were still unavailable. Now they've satiated their pent-up demand for goods and reverted to spending more on services.

(3) *Budget shares.* We can gain some additional insights into consumer spending by examining current-dollar spending categories as a percentage of DPI. Total PCE as a percent of DPI edged up to 92.1% during June, the highest since August 2008 (*Fig. 14*). This ratio is roughly the mirror image of the personal saving rate. (Personal saving equals DPI less PCE less personal interest payments less personal current transfer payments.)

From 2009 through 2019, consumers consistently spent between 9% and 10% of their DPI on durable goods. During the lockdown recession, this percentage plunged to 6.3%. Since then, it has rebounded to about 11.5%. Odds are that it will decline as the service percentage rises from 60% currently closer to the 62% pre-pandemic reading.

Spending on nondurable goods including groceries and gasoline had been on a downward trend from 1990 through 2019. Rapidly rising prices of food and fuel have forced consumers to spend 17.1% of their DPI on these essentials during June, the highest since March 2013 (*Fig. 15*). Similar trends have unfolded for the DPI share of clothing and footwear (*Fig. 16*).

Consumers have managed to pay for more of their essentials mostly by saving less and borrowing more, as noted above. That's disturbing. Even more disturbing is that many consumers might also be reducing the share of their DPI budgets spent on health care, which was down to 19.4% during June, compared to 21.2% before the pandemic (*Fig. 17*).

(4) *Nota bene.* Comparing nominal and real-time series is a bit like comparing apples and oranges because of indexing issues raised by using the price deflator. Nevertheless, the basic conclusions above make sense to us.

## Calendars

**US: Tues:** Job Openings 11.00m; API Weekly Crude Oil Inventories; Bullard; Evans. **Wed:** Motor Vehicle Sales; Factory Orders 1.2%; ISM NM-PMI 53.5; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; OPEC Meeting. (Bloomberg estimates)

**Global: Tues:** Spain Unemployment Rate; Spain Consumer Confidence; UK Nationwide HPI 0.5%; RBA Interest Rate Decision 1.85%; China Caixin NM-PMI. **Wed:** Eurozone, Germany, & France C-PMIs 49.4/48.0/50.6; Eurozone, Germany, France, Italy & Spain NM-PMIs 50.6/49.2/52.1/50.0/52.0; Eurozone PPI 1.0%m/m/35.7%y/y; Eurozone Retail Sales 0.1%m/m/-1.6%y/y; Germany Trade Balance, Exports & Imports €0.2b/0.7%/1.3%; UK C-

PMI & NM-PMI 52.8/53.3. (Bloomberg estimates)

## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): Forward earnings dropped for a third straight week for LargeCap and MidCap, but SmallCap's rose for a second week after dropping in two of the prior three weeks before that. However, none of these three indexes had forward earnings at a record high for a fifth straight week. LargeCap's has fallen in six of the past 13 weeks and is now 0.7% below its record high at the end of June. MidCap's has dropped in six of the past seven weeks and is 1.4% below its record high in early June. SmallCap's rose 1.1% w/w to 1.4% below its record high in mid-June. In what was an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 105 of the past 114 weeks, with the other down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings misses for Q1-2022 and Q2-2021, Walmart's Q1-2022 miss, and index changes last September and December. MidCap's forward earnings is up in 104 of the past 112 weeks, and SmallCap's posted 101 gains in the past 113 weeks. SmallCap had been steadily making new highs each week until mid-December. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 68.9% from its lowest level since August 2017; MidCap's is now up 138.0% from its lowest level since May 2015; and SmallCap's has soared 200.2% from its lowest point since August 2013. In the latest week, the rate of change in LargeCap's forward earnings fell to a 16-month low of 12.0% y/y from 16.4%; that's down from a record-high 42.2% at the end of July 2021 and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings dropped w/w to a 16-month low of 25.6% y/y from 27.9%. That's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate fell to a 16-month low of 26.8% y/y from 27.3%. It's down from a record high of 124.2% in June 2021 and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2021 to 2023 to improve instead of decline as is typical, but their forecasts are likely to head lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (9.1%, 8.5%), MidCap (13.0, 6.1), and SmallCap (12.7, 9.3).

**S&P 500/400/600 Valuation** (*link*): Valuations rose last week for all three of these indexes to their highest levels since late May. LargeCap's forward P/E rose 0.8pts to 17.3 from 16.5 a week earlier, which compares to a 26-month low of 15.3 in mid-June and a six-month high of 21.5 in early November. LargeCap's forward P/E also compares to an 11-year low of 11.1 during March 2020. MidCap's rose 0.6pt to 12.7 from 12.1, and is up from a 27-month low of 11.1 in mid-June. That's down from a 13-week high of 17.1 in early November. It had been at a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's gained 0.3pts, to 12.2 from 11.9 a week earlier. Its mid-June reading of 10.7 was the lowest since it bottomed at a record low of 10.2 in November 2009 during the Great Financial Crisis. That compares to a 13-week high of 16.1 in early November and its record high of 26.7 in early June 2020 when forward earnings was depressed. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 26% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 102nd straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% reading is near its biggest discount since February 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 59th straight week; the current 4% discount is up from a 9% discount in December but remains near its lows during 2000-01.

**S&P 500 Sectors Quarterly Earnings Outlook** (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022. In the latest week, the Q2-2022 earnings-per-share forecast rose 34 cents w/w to $56.09, and is now 0.3% above its $55.92 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 6.3% y/y on a frozen actual basis and 7.7% on a pro forma basis. That's down from Q1-2022's 11.6% y/y on a frozen actual basis and an 11.4% y/y gain on a pro forma basis. Double-digit growth is expected for just four sectors in Q2-2022, and four are expected to record a y/y decline. That compares to Q1-2022's count of seven sectors with double-digit growth, one with a single-digit gain, and three with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q2-2022 versus their Q1-2022 growth rates: Energy (286.6% in Q2-2022 versus 269.5% in Q1-2022), Industrials (30.0, 40.5), Materials (17.9, 46.3), S&P 500 (7.7, 11.4), Real Estate (10.4, 25.5), Health Care (7.2, 18.3), Information Technology (2.4, 14.6), Consumer Staples (1.0, 7.9), Utilities (-9.4, 24.6), Consumer Discretionary (-12.3, -27.9), Communication Services (-12.7, -2.8), and Financials (-21.7, -17.1).

**S&P 500 Q2 Earnings Season Monitor** (*link*): With 57% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, the revenue and earnings surprises are the lowest since the pandemic recovery began. Revenues are beating the consensus forecast by 1.8%, and earnings have exceeded estimates by 5.4%. At the same point during the Q1 season, revenues were 2.1% above forecast and earnings beat by 6.8%. For the 283 companies that have reported Q2 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed from their Q2-2021 to Q1-2022 readings. Collectively, the companies have a y/y revenue gain of 14.1% and an earnings gain of 8.5%. Just 67% of the Q2 reporters so far has reported a positive revenue surprise, and 77% has beaten earnings forecasts. Markedly fewer companies have reported positive y/y earnings growth in Q2 (60%) than positive y/y revenue growth (80%). These figures are bound to change as more Q2-2022 results are reported in the coming weeks. While we expect y/y growth rates to remain positive in Q2, we think revenue and earnings surprises will moderate q/q due to the slowing economy, rising inventories, and higher costs.

## US Economic Indicators

**Construction Spending** (*link*): A sharp drop in single-family home expenditures sent construction spending south in June. Total construction spending tumbled 1.1% in June after surging 9.1% during the eight months through May to new record high. Private construction spending contracted 1.3% from May's record high, while public construction spending dipped by 0.5% in June and by 1.1% over the past two months. Within private construction spending, residential investment slid 1.6%—the first decline since May 2020—after soaring 58.8% over the 24-month period from then through May of this year to a new record high. June's decline was driven by a 3.1% plunge in single-family construction spending from May's record high—the first decline this year and the steepest since May 2020. Meanwhile, multi-family construction remained in a volatile flat trend just below last May's record high, while home-improvement spending in June barely budged from May's record high, up 21.5% ytd and 33.0% y/y. Meanwhile, private nonresidential spending fell for the fourth successive month, by a total of 2.1%, though was 1.7% above last June's pace.

## Global Economic Indicators

**Global Manufacturing PMIs** (*link*): Global manufacturing activity in July sank to a two-year low, while business optimism dropped to a 26-month low. The JP Morgan Global M-PMI fell for the fifth time this year, from 54.3 in December to 51.1 in July, due to weakness in developed nations, where production volumes contracted (on average) for the second month; emerging markets saw output rise for the second month, mainly reflecting easing of lockdown restrictions in China during June. The M-PMI remained above the neutral mark of 50.0 for the 25th successive month; it peaked at 56.0 last May. In July, 15 of the 28 countries covered by survey were in expansionary territory, while 13 contracted. Here's how July M-PMIs ranked by country/region from highest to lowest: India (56.4), Australia (55.7), Netherlands (54.5), Brazil (54.0), Kazakhstan (52.8), Thailand (52.4), US (52.2), Japan (52.1), UK (52.1), Austria (51.7), Indonesia (51.4), Vietnam (51.2), WORLD (51.1), Malaysia (50.6), China (50.4), Russia (50.3), EUROZONE (49.8), South Korea (49.8), France (49.5), Colombia (49.5), Germany (49.3), Greece (49.1), Spain (48.7), Italy (48.5), Mexico (48.5), Turkey (46.9), Czech Republic (46.8), Myanmar (46.5), Taiwan (44.6), Poland (42.1). On the inflation front, the report noted that July saw both input-cost and output-charge inflation slow to 17-month lows.

**US Manufacturing PMI** (*link*): ISM's M-PMI showed manufacturing activity edged only slightly lower in July, as supply constraints continued to ease, though activity was at a two-year low. Meanwhile, there were further signs in July's report that inflation has likely peaked. The M-PMI (to 52.8 from 53.0) was little changed in July; it has been on a downward trend since peaking at 63.7 last March. July saw new orders (48.0 from 49.2) contracting for the second month and production (53.5 from 54.9) continuing to slow. In the meantime, inventories accumulated at the fastest pace since 1984, with the index up from 51.6 in April to 57.3 in July, raising concerns that this could lead to a continued softening in orders. There are signs that supply constraints are easing—with the measures for both supplier deliveries (to 55.2 from 78.8 last May) and backlog orders (51.3 from 70.6 last May) retreating to their lowest levels since 2020. On the inflation front, ISM's prices-paid measure eased in July for the fourth month, to 60.2 from 87.1 in March; it was at 92.1 in mid-2021—which was the fastest since the summer of 1979.

---

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306

Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102