MORNING BRIEFING
August 10, 2022

Earnings & Productivity

Check out the accompanying chart collection.

Executive Summary: Why are industry analysts now slashing the estimates they had raised throughout the year's first half (even as the economy slowed)? … Why has productivity dropped to its weakest y/y rate since 1947? Is it returning to its pre-pandemic trendline? … Why has household formation suddenly rebounded? … How did landlords get so lucky as to find themselves in a "Golden Age"? … Today, we explain these economic anomalies, aided by recent data releases. … Also: With the economy in a growth recession and forward earnings starting to flatten, the valuation-led stock market rally might sputter for a while.

Strategy: Analysts Cutting Estimates. Industry analysts have been lowering their 2022 and 2023 earnings estimates for S&P 500 companies since the end of June. While the latest earnings reporting season—which ran from early July until about now—showed that their companies generally performed well during Q2, many managements provided cautious forward guidance during their calls with analysts. Let's have a closer look:

(1) *Q2 results to date.* So far, 87% of S&P 500 companies have reported revenues and earnings for Q2-2022. The revenue and earnings surprises are historically strong but near their lowest readings since the pandemic recovery began. Revenues are beating the consensus forecast by 2.8% and earnings by 6.0% (*Fig. 1* and *Fig. 2*).

The 435 companies that have reported Q2 earnings through mid-day Monday have a y/y revenue gain of 15.4% and a y/y earnings gain of 11.2%. These figures are bound to change as more Q2 results are reported in the coming few weeks, particularly from the struggling retailers.

(2) *Q2 and the next six quarters.* Better-than-expected results by some of the big-cap technology names last week caused Q2's blended earnings—i.e., including actual results and estimated ones—to jump during the first week of August (*Fig. 3*). At the end of June, just before earnings season began, analysts expected Q2 earnings to grow by 4.9% y/y. Now the blended growth rate is 8.9%. That's the good news.

The bad news is that analysts have lowered their estimates for each of the next six quarters

(*Fig. 4*). They've been doing so since the start of the current earnings season. So their 2022 and 2023 earnings estimates have been falling. As a result, forward earnings—which is the time-weighted average of analysts' consensus earnings-per-share estimates for the current year and coming year—peaked at a record high of $239.93 per share during the June 23 week, and is now down 1.3% to $236.74 during the August 4 week (*Fig. 5*).

(3) *Annual growth rate estimates.* As of the August 4 week, industry analysts estimated that 2022 and 2023 earnings per share will be $225.50 and $244.36, up 10.1% and 7.7% on a y/y basis (*Fig. 6*).

(4) *Back to the old normal.* Industry analysts typically lower their estimates for both revenues and earnings over time because their initial projections are too optimistic. We can see this tendency in the weekly "squiggles" charts for S&P 500 revenues and earnings starting in 2009 (*Fig. 7* and *Fig. 8*).

This time, after slashing their estimates for both revenues and earnings during the lockdown recession in March and April 2020, they scrambled to raise their estimates during the V-shaped economic recovery through the end of last year. Then during the first half of this year, economic growth stalled, yet the analysts continued to raise their estimates to new record highs. Some of that optimistic forecasting reflected higher-than-expected inflation, which boosted revenues estimates. It also boosted earnings estimates, as industry analysts assumed that profit margins would remain high because companies were successfully passing rapidly rising costs through to their selling prices.

(5) *Profit margin estimates falling fast.* During the current earnings reporting season, company managements have been guiding down analysts' expectations, particularly for profit margins. We derive the annual consensus estimates of the profit margins of the S&P 500 by dividing analysts' consensus earnings estimates by their consensus revenues estimates. The 2022 and 2023 profit margin estimates have dropped from 13.2% and 13.8% at the start of this year to 12.8% and 13.3% during the July 28 week (*Fig. 9*).

(6) *Our outlook.* In our Sunday, August 7 *QuickTakes*, we explained why the valuation-led stock market rally since June 16 might sputter for a while. It's mostly because forward earnings has probably started to flatten in recent weeks as a result of the economy's current growth recession. In addition, the S&P 500's forward P/E bottomed at 15.3 on June 16 and rebounded to 17.4 on Friday (*Fig. 10*). We reckon that the forward P/E will be range-bound between 15.5 and 17.5 for a while, especially if the 10-year US Treasury bond yield sputters around 2.50%-3.00% for a while, as we expect.

(7) *Feshbach's market call.* I checked in with our friend Joe Feshbach for his latest assessment of the action in stocks: "The market should continue to move higher. However, new buying should be put on hold. Narrowing breadth and improving sentiment raise the risks of a short-term pullback offering up lower prices."

US Economy: Why Is Productivity Falling? The pandemic certainly has disrupted and upset almost every aspect of our lives. That might explain the extraordinary drop in productivity during the first half of this year. The pandemic exacerbated pre-existing labor shortage problems. After the pandemic, companies might have concluded that labor shortages would persist and therefore have hoarded scarce workers without having enough for them to do, especially if supply-chain disruptions disrupted operations.

The recent productivity drop certainly challenges our thesis that chronic labor shortages will force companies to increase their capital spending on technology to boost the productivity of the available labor force. That's our story for the "Roaring 2020s," and we are sticking to it. We have a few more years before the end of the decade. Meanwhile, let's review the latest data, which were released yesterday:

(1) *Productivity.* Nonfarm business productivity fell 4.6% (saar) during Q2 following Q1's 7.4% plunge. It is a volatile series. Nevertheless, it was down 2.5% y/y through Q2, the weakest reading since the start of the data in 1947 (*Fig. 11*).

Keep in mind that productivity soared after the lockdown recession of 2020 by 10.3% during Q2 and 6.2% during Q3. The latest reading brings productivity back to where it was during the first half of 2020. So it should resume rising along its pre-pandemic trendline.

(2) *Statistical discrepancy.* Productivity is the ratio of nonfarm business output and total hours worked by labor. The numerator is based on GDP, which has been rising at a slower pace than gross domestic income. This suggests that GDP might eventually be revised higher, showing that both productivity and overall economic activity have been stronger than the preliminary data show.

(3) *Unit labor costs.* Then again, unit labor costs (ULC) jumped 9.5% y/y during Q2, the most since Q1-1982, as productivity plunged 2.5% and hourly compensation soared 6.7% (*Fig. 12*). The CPI inflation rate is highly correlated with ULC inflation, both on a y/y basis (*Fig. 13*). The former was up 9.1% through June.

US Households I: Golden Age Of Moving Out. Since the beginning of 2020, there's been a remarkably sharp drop followed by a remarkably quick rebound in the US household headship rate—i.e., the number of households divided by the number of adults in the population. This rebound has contributed to the huge increase in housing demand. Over this period, house prices and rents have soared to record highs.

America quickly lost 1.8 million households during September 2020, when the total fell to 125.5 million (*Fig. 14*). But by June of this year, the US had regained all the lost households and added 812,000 more! That's according to recent Census Bureau data.

A few years ago, it was generally expected that household formation would rise moving into the 2020s as many Millennials in their late 20s and early 30s moved out on their own after delaying "adulting." According to a 2021 *report* from the National Association of Realtors, the typical first-time home buyer was 33 years old. The pandemic temporarily dented household formation by Millennials, but it has quickly recovered. As the pandemic ended, as employment has increased, and as unmarried singles in the population have continued to rise, roommates have been parting ways.

Looking ahead, an erosion in affordability for both homebuyers and renters and the slowing growth in the population could pressure household formation. Slowing immigration in particular could offset any Millennials-led growth in household formation. That's important because household formation drives housing demand, rents, and prices! Already, the housing market has begun to turn south and is unlikely to recover in the foreseeable future, as we discussed in our July 27 *Morning Briefing*.

Here's more:

(1) *Living together during the pandemic.* Changes in the composition of living arrangements since 2019 show that at the onset of the pandemic, many adults living alone or with roommates abruptly moved in with older family members or with a spouse or partner. Additionally, some who were living with family members delayed moving out due to the health and financial concerns surrounding the pandemic. That's according to a May *FEDS Notes* piece written by two of the Fed's household economists.

(2) *Young adults moved in and out.* Gradually, the Fed economists wrote, the pandemic-induced changes in living arrangements have receded as the fraction of adults living with their original family and the fraction living with a spouse or partner have returned to pre-pandemic levels. The initial pandemic-onset-induced drop in headship rates was especially sharp for 16- to 30-year-olds who moved in with older relatives, but the trend for that group

has retraced some. Older Americans' headship rates have been relatively resilient.

(3) *More separations post-pandemic.* In a new development, more adults are living alone and fewer with roommates, boosting the headship rate. Because of the pandemic, people started spending more time at home and together, straining relationships. More than half a million roommate households separated in 2020, but that was below pre-pandemic levels, according to a July *analysis* of Census data from Apartment List. The percent of single persons in the civilian noninstitutional working-age population continued to rise from pre-pandemic rates above 50.0% after briefly falling below that level during the pandemic (*Fig. 15*).

Generational trends also may drive the growth in sole-person households. Baby Boomers made up 39% of sole-person households in 2020, and their share is likely to rise because of divorces and deaths of spouses/partners, wrote Freddie Mac in a *research* note last August.

(4) *Employment driving headship.* Likely, the ongoing recovery of the labor market has contributed to the rebound in headship rates, as headship is higher among the employed than unemployed, the Fed economists surmised. That's confirmed by our chart of the total households (as a percent of the working age population) and the Civilian Labor Force Participation Rate, which has dramatically improved, demonstrating labor market tightening, since the onset of the pandemic (*Fig. 16*). However, these drivers of the headship rate could be outweighed by weakening US population growth.

(5) *Population growth slowdown.* From 2010 to 2016, the number of adults in the US grew by 2.3 million per year, on average, the FEDS Notes article observed. But since 2016, population growth has slowed—to about 1.5 million in 2021—largely because of reduced immigration (*Fig. 17*). In recent years, actual immigration growth has come in far below the Census Bureau's low estimate.

(6) *Immigration the underlying offset.* Under Census' low immigration projection, the FEDS Notes piece highlighted, the adult population in 2030 would be about 5.5 million lower than would be expected assuming historically consistent immigration levels—implying roughly 2.75 million fewer households at the current headship rate. The lower headship rate suggests either many more vacant units by then and/or less housing construction, the Fed economists expect.

US Households II: Golden Age for Landlords. The post-pandemic era has been *called* the "Golden Age" for multifamily housing, and we think that's true, as we've often discussed.

Landlords have been a big beneficiary of household formation following the pandemic. Rental vacancy rates hit 5.6% during Q2, the lowest in over 30 years, according to Census Bureau data (*Fig. 18*). In turn, landlords have been afforded the opportunity to raise rents pretty darn high (*Fig. 19*). Generational trends also point toward greater growth of renters than homeowners. Consider the following:

(1) *Millennials & Boomers living alone.* Most younger adults moving out of their parents' homes after the pandemic are moving into rentals. Mostly that's because owning a home has become increasingly unaffordable. Seniors living on their own because of recent family circumstances also tend to rent rather than purchase a home. These trends are apparent in the Census data on post-pandemic household formation by renters versus homeowners (*Fig. 20* and *Fig. 21*).

(2) *Zoomers want to zoom into homes.* Generation Z, colloquially known as "Zoomers," will be the next generation to age into moving out. Nearly 90% of those born between 1997 and 2012 want to buy a home, and nearly half of them want to do it within the next five years, according to a *survey* by Rocket Mortgage. But desire and ability are two different things. Millennials think they have it tough, but Gen Zers are facing the steepest housing prices in years, especially relative to their starting incomes, *wrote* a Gen Zer for Next Advisor. Like Millennials, Gen Zers too are saddled with debt and limited savings. In other words, Gen Zers are likely to be doing Zoom calls out of their rentals as they age in place.

Calendars

US: Wed: Headline & Core CPI 0.2%m/m/8.7%y/y & 0.5%m/m/6.1%y/y; Wholesale & Retail Inventories 1.9%/0.9%; Federal Budget Balance -$76.5b; MBA Mortgage Applications; Crude Oil Inventories. **Thurs:** Headline & Core PPI 0.2%m/m/10.4%y/y & 0.4%m/m/7.6%y/y; Initial & Continuous Jobless Claims 263k/1.407m; Natural Gas Storage; IEA Monthly Report; OPEC Monthly Report. (Bloomberg estimates)

Global: Wed: Germany CPI 0.9%m/m/7.5%y/y; Italy CPI 0.4%m/m/7.9%y/y; RICS House Price Balance 60%. **Thurs:** China New Loans & Total Social Financing; . (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index exited a bear market last week. Since its June 16 low, when Growth was in a deep 31.5% bear market from its December 27 record high, it has surged 18.0% through Monday's close to 19.2% below its record. Value has risen 8.6% since its June 17 low to 9.0% below its January 12 record. It had been 16.2% below its record high. Still, Growth has tumbled 18.1% ytd, well behind the 7.7% decline for the S&P 500 Value index. Growth's price index relative to Value's peaked at a record high on November 30. Since then, Value's price index has dropped 1.4% while Growth's is down 16.1%. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) than Value over the next 12 months, but Value is expected to have higher earnings growth (STEG). Growth has forecasted STRG of 8.4%, but its STEG is lower at 6.8%. Value has forecasted STRG and STEG of 6.2% and 9.1%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and tumbled 40% to a 27-month low of 18.4 on June 16. It has rebounded 21% since then to 22.3 as of Monday's close. Over the similar time period, Value's forward P/E fell 24% from 17.6 to a 26-month low of 13.4, and has since risen 9% to 14.6. Regarding NERI, Growth's and Value's turned negative in July for the first time in 27 months. Growth's dropped to -2.4% from 1.8% in June, and Value's was down to -2.4% from 1.0%. Growth's forward profit margin of 18.5% is down 0.6ppt from its record high of 19.1% in mid-February and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 0.4ppt to 11.0% from its record high of 11.4% in December.

US Economic Indicators

Productivity & Unit Labor Costs (*link*): Productivity in the nonfarm sector continued to contract during Q2, falling 4.6% (saar) following a 7.4% drop during Q1, with output last quarter falling 2.1% (saar) as hours worked rose 2.6%. Versus a year ago, productivity is down 2.5%, with hours worked up 4.1% and output only 1.5% higher. Meanwhile, unit labor costs soared 10.8% (saar) during Q2 as the drop in productivity coupled with a 5.7% acceleration in hourly compensation pushed costs higher. On a year-over-year basis, unit labor costs soared 9.5%—the biggest yearly increase since Q1-1982—as hourly compensation climbed 6.7% and productivity fell. On both a quarterly and year-over-year basis, productivity can be volatile. We track the five-year growth rate of productivity, which slowed to 1.3% during Q2, still above its 0.5% trough during the final quarter of 2015. We still believe productivity growth is heading to 3.5%-4.5% by the second half of the decade.

NFIB Small Business Optimism Index (*link*): "The uncertainty in the small business sector is climbing again as owners continue to manage historic inflation, labor shortages, and supply chain disruptions," said Bill Dunkelberg, NFIB chief economist. "As we move into the second half of 2022, owners will continue to manage their businesses into a very uncertain future." July's Small Business Optimism Index (SBOI) barely budged from June's level—which was the lowest since January 2013, inching up to 89.9 last month after sinking from a recent high of 102.5 in June 2021 to 89.5 by June 2022. July's level was its sixth successive month below the 48-year average of 98.0. In July, six of the 10 SBOI components fell, while four increased. Current inventory (-3 ppts to 2%) was the biggest drag on the index, followed closely by expected credit conditions (-2 to -7), while the remaining four all edged down percentage point: current job openings (to 49%), capital outlay plans (22), earnings trends (-26), and sales expectations (-29). The percentage expecting the economy to improve (+9 to -52) was the biggest positive contributor to July's SBOI—but that was a bounce off June's record low of -61, with the remaining positive contributors small by comparison. Plans to increase inventories rose 3ppts to 1%, while expected credit conditions plans and hirings ticked up 2ppts and 1ppt to 20% and -7%, respectively. Last month, 37% of small business owners listed inflation as their biggest problem in operating their business—the highest since Q4-1979. The net percent of owners raising their selling prices on goods fell to 56% in July from 63% in June and a near record-high 66% in March. The report notes that while the decline is "significant, the net percent still raising prices is inflationary," with a net 37% planning price hikes, down from 49% in June. As noted above, labor shortages remained a problem, with nearly half of owners reporting they could not fill job openings. Meanwhile, 32% of owners reported that supply-chain disruptions had a significant impact on their business.

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