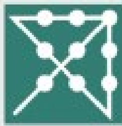

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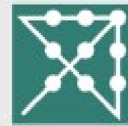

MORNING BRIEFING
August 31, 2022

Earnings Matter

Check out the accompanying chart collection.

Executive Summary: Will the rolling recession—which we believe is occurring now in the US economy—steamroll corporate earnings growth? Our economic outlook suggests that earnings growth could turn negative, but not by much and not for long. … We think August's M-PMI will be telling, suggesting that both this index and S&P 500 earnings growth are getting closer to bottoming. … And: Melissa looks under the hood of the auto manufacturing industry, still challenged globally by parts-supply problems and still short on inventory. … Also: A look at various factors driving rising EV sales.

Strategy: The Earnings Growth Cycle. We all know that the earnings growth cycle peaked during Q2-2021, when the y/y growth rates of S&P 500 revenues and earnings peaked at 21.8% and 88.5% (*Fig. 1* and *Fig. 2*). Naturally, both growth rates were lower, at 12.1% and 9.5%, one year later, i.e., in Q2-2022. The pressing questions now are: Will they soon turn negative? And if so, how negative?

The answers depend on the outlook for the business cycle, of course. We think that the current growth recession will continue through the second half of this year. Debbie and I are forecasting that real GDP, which fell 1.0% (saar) during H1-2022, will edge up by only 1.5% during H2-2022 (*Fig. 3*). We see the headline PCED inflation rate falling from 6.3% y/y in July to 4.0%-5.0% during the second half of this year and 3.0%-4.0% during 2023 (*Fig. 4*).

As we discussed in yesterday's *Morning Briefing*, we think that the economy is experiencing a rolling recession that is weakening different sectors of the economy at different times. In the past, most traditional recessions were caused by tight monetary policy that triggered a financial crisis, which caused a widespread credit crunch and a full-blown recession. Inverted yield curves tended to anticipate that chain of events. This time we believe there is ample liquidity in the financial system to avert a financial crisis that could morph into a credit crunch.

In our economic scenario, earnings growth does turn negative but not by much and not for long. Consider the following:

(1) *Earnings forecasts: ours & theirs.* We are anticipating that earnings growth will be -5.4%

y/y and -3.8% during Q3 and Q4. For the entire year, we are predicting earnings of $215 per share, which would be a flattish 3.1% increase from 2021 (*Fig. 5*). Next year, we are projecting a 9.3% increase in earnings per share to $235. The consensus estimates of industry analysts during the August 25 week were $225 and $244 this year and next year. In other words, their latest projections show no downturn during the second half of this year. (See Table 1 in *YRI S&P 500 Earnings Forecast*.)

The analysts' earnings estimates for this year and next year peaked at the end of June and have been converging toward our estimates since then. During the Q2 earnings reporting season, the actual result beat the consensus estimate for S&P 500 earnings at the start of the season by 4.4% (*Fig. 6*). Nevertheless, company managements provided cautious guidance for the rest of this year and all of next year. So the analysts shaved their estimates for the remaining two quarters of this year and all four quarters of next year (*Fig. 7*).

The good news is that now that the earnings season is over, analysts seem to have stopped shaving their estimates for the next six quarters. As a result, their earnings estimates for 2022 and 2023—as well as forward earnings, which we derive by time-weighting their annual estimates—stopped falling during the August 25 week (*Fig. 8*). Let's see what happens during the Q3 earnings season, which starts in early October (just before Halloween).

(2) *Revisions.* So we are clearly past the peak in the earnings growth cycle. The question is: How close are we to the bottom? In our outlook, earnings should start growing again during Q1-2023. For now, we can see that analysts are revising their estimates downward, which is what happens past the peak on the way to a trough in the earnings cycle. So for example, the S&P 500's net revenues revisions index (NRRI) was -5.1% during August, the first negative reading since July 2020 (*Fig. 9*). The net earnings revisions index (NERI) was -9.0% during August, following a -1.9% reading during July, which was the first negative reading since July 2020 (*Fig. 10*).

Furthermore, our forward earnings breadth index (FEBI) for the S&P 500 fell to 60.8% during the August 26 week, down from last year's peak of 89.8% during the June 4 week and the lowest reading since July 24, 2020 (*Fig. 11*). During the past three recessions, FEBI fell below 50.0%.

(3) *Macro picture.* Interestingly, the national manufacturing purchasing managers index (M-PMI) is highly correlated with the y/y percent change in the S&P 500 (*Fig. 12*). That's because the M-PMI is also highly correlated with the growth cycles of both S&P 500

revenues and earnings, as well as with both NRRI and NERI (*Fig. 13*, *Fig. 14*, *Fig. 15*, and *Fig. 16*).

We will get August's reading for the M-PMI on Thursday. Based on the five regional business surveys we track, we expect that it fell from 52.8 in July to just below the 50.0 level, indicating an economic contraction, in August (*Fig. 17*). The question is: Will that mark the bottoms in the M-PMI and the S&P 500's earnings growth cycles? Probably not, but we are getting closer to those bottoms, in our opinion.

Autos I: Not There Yet. In the past, auto market recessions have coincided with rising interest rates. This time, autos sales and production are depressed because of supply-chain problems and parts shortages, especially related to semiconductor parts. Sales and production have recovered some from levels during the thick of the pandemic, however. With the inventory shortages, customers are having to order a vehicle and wait months for delivery, often paying above sticker price.

Inventory levels are still well below demand levels, which continue to be elevated by pent-up demand as buyers have held onto their older models waiting for new car prices to fall. Before delving into some of the global auto industry's market dynamics, let's look at a few big-picture indicators for the domestic auto market:

(1) *Softish auto sales.* Domestic auto & light-truck sales plunged during September 2021 to a recent low of 8.9 million units (saar) because of supply disruptions (*Fig. 18*). Sales then recovered to a recent high of 11.5 million units during January. But sales since then have stalled around 10.5 million units, as shortages have persisted. (August data will be released tomorrow afternoon.)

(2) *High auto prices.* It has not been easy to afford a used car, let alone a new one, these days. Average estimated transaction prices for new vehicles have increased to about $48,000 from near $37,000 in early 2019, according to Cox Automotive's July industry *report*. But used auto price inflation has cooled recently as the availability of new cars has picked up. The CPI inflation rate for used autos has come back to Earth after rising at a rate just above 40% y/y during mid-2021 and then again early this year, falling to 6.6% through July (*Fig. 19*). New-car price CPI inflation has continued to rise during the pandemic years, to 12.6% y/y through July; this compares with a normal y/y rate near zero from at least 2012 through 2019.

(3) *Low inventories.* But demand still well exceeds supply, as reflected in rising prices for

new vehicles and the industry's inventory-to-sales ratio, which remained around half a month's supply during H1 (*Fig. 20*). In the past, auto dealers typically had 2.5 months' worth of inventory on their lots.

(4) *Production pending.* Cars don't last forever, and owners holding onto old ones will have to replace them at some point. Manufacturers are ramping up production as recent supply-chain difficulties are now abating. Domestic motor vehicle output dropped sharply from a July 2020 peak of 11.9 million units (saar) to a September 2021 low of 7.7 million units (*Fig. 21*). It was back up at 11.0 million units during July.

(5) *More borrowing.* Folks who are purchasing vehicles are borrowing more to do so as auto prices have surged (*Fig. 22*). Eventually, rising interest rates could bring demand and supply for autos into better balance, driving prices down. For now, borrowers are proving able to carry the more expensive debt at higher loan values, as shown by auto loan delinquency rates that are near historical lows according to the New York Fed's Q2 *Household Debt and Credit* *report*.

Autos II: What's Plaguing Production? Globally, auto parts shortages have continued to plague auto manufacturers following the pandemic. Production has improved around the world but remains depressed relative to where it was before the virus lockdowns hit supply chains. Here are a few reasons why:

(1) *China's plagues.* Persistent authoritarian lockdowns on the Chinese people after most countries have eased Covid lockdowns have continued to pressure global auto supply chains. Also, China's Sichuan region recently experienced a severe drought that's led to production cuts and plant closures for auto parts and semiconductors.

(2) *Russia-Ukraine war.* Russia's war on Ukraine certainly has not helped European auto production, especially as those two nations produce critical materials for auto production.

(3) *Semis dysfunctional.* Since the onset of the pandemic, the semiconductors supply chain has been strained. Even now that supply is flowing more normally for some types of semiconductors, getting the right product mix and kits remains challenging for auto manufacturers. Chips used in crypto mining rigs, PCs, and smartphones are starting to look oversupplied, but those are not the chips that automakers need to build cars, Wolf Street pointed out in a recent *note*.

Autos III: EVs Ruling The Road. Under the hood of the auto market, a divergent trend is

evident: The shortages are much more prevalent among fuel-efficient cars than gas-guzzling ones. Electric vehicles (EVs) are leading segment sales by far, according to the Cox report cited above (see page 8 chart!). Among EV brands, Teslas led sales ytd through July; gas-guzzlers like Rams and Dodges saw sales fall. Many more days' supply of Rams and Dodges are available than of Subarus.

The vehicles with the largest y/y price increases through July are alternative-fuel cars, while those with the smallest price increases are pickup trucks, *research* dated August 9 from iseecars.com found. Fiscal policy is providing incentives for purchasing "greener" autos. Here are a few of the latest updates:

(1) *US funds EV manufacturing*. Signed into law in August, the Biden administration's Inflation Reduction Act will provide $20 billion in loans and $2 billion in grants to auto manufacturers to retool and build green friendly auto plants in the US.

Likewise, the Chips & Science Act will provide $50 billion toward the construction of semiconductor chip manufacturing, research and development, and workforce development.

(2) *California cans gas cars.* California has adopted regulations that are taking the gas out of the market for ICE (internal combustion engine) vehicles and putting the pedal to the metal for EV models. It's leading among states in the transition to fuel-efficient vehicles, having passed a law banning the sale of new gas-powered cars by 2035.

(3) *Pump prices driving EV sales.* Russia's war on Ukraine has wreaked havoc for the energy markets, increasing the cost to drive gas-powered cars. Frustrated by high gas prices, many consumers are opting for fuel-efficient vehicles.

(4) *But are EVs ready for prime time?* While EVs may be catching on, they're also catching fire. Reports have it that *hundreds of vehicles* have caught fire this year in the world's largest EV market, China. That's way up from last year's number of such incidents. The car fires are largely due to fires at EV charging stations. EVs have a way to go before they can be truly sustainable rides.

Calendars

US: Wed: MBA Mortgage Applications; Chicago PMI 52.0; Crude Oil Inventories, Gasoline Production; Mester. **Thurs:** ISM M-PMI & Price Index 52.0/55.5; Initial & Continuous Jobless Claims 248k/1.44m; Nonfarm Productivity & Unit Labor Costs -4.5%/10.7%; Motor Vehicle Sales 13.3mu; Construction Spending -0.4%; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Eurozone Headline & Core CPI 9.0%/4.0% y/y; Germany Import Price Index 1.5%m/m/29.4%y/y; Germany Unemployment Change & Unemployment Rate 28k/5.5%; France GDP 0.5%q/q/4.2%y/y; Italy CPI 0.6%m/m/8.1%y/y; Japan Household Confidence 29.4; Japan Housing Starts -4.1%. **Thurs:** Eurozone, Germany, France, Italy, and Spain M-PMIs 49.7/49.8/49.0/48.0/48.5; Eurozone Unemployment Rate 6.6%; Germany Retail Sales -0.4%m/m/-6.5%y/y; Italy GDP 1.0%q/q/4.6%y/y; UK M-PMI 46.0; UK Nationwide HPI 0.1%m/m/8.9%y/y.(Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index fell back into a bear market last Friday, while the Value index moved closer to correction territory. Through Monday's close, Growth has fallen 8.2% from its recent high on August 16 to 22.8% below its December 27 record high. Value is down 4.6% from its August 16 high to 9.8% below its January 12 record high. Looking at their ytd performance, Growth has tumbled 21.7% ytd, well behind the 8.5% decline for the S&P 500 Value index. Growth's underperformance relative to Value began on November 30 when its price index peaked at a record high. Since then, Value's price index has dropped 2.2%, while Growth's is down 19.8%. 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 8.0%, but its STEG is lower at 6.8%. Value has forecasted STRG and STEG of 5.4% and 7.9%, 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. After rebounding to 23.3 in mid-August, it was down to 21.4 on Monday. Over the similar time period, Value's forward P/E fell 24% from 17.6 to a 26-month low of 13.4, and was down to 14.5 on Monday from mid-August's high of 15.2. Regarding NERI, Growth's and Value's were negative for a second straight month in August following 26 positive monthly readings. Growth's dropped to -8.4% from -2.4% in July, and Value's was

down to -8.6% from -2.4%. Growth's forward profit margin of 18.3% is down 0.8ppts 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

Consumer Confidence (*link*): Consumer confidence in August increased for the first time in four months, with current conditions improving for the first time since March, while expectations improved for the first time since April—with the latter posting its biggest monthly gain since March 2021.Lynn Franco, senior director of economic indicators at The Conference Board notes, "Purchasing intentions increased after a July pullback, and vacation intentions reached an 8-month high. Looking ahead, August's improvement in confidence may help support spending, but inflation and additional rate hikes still pose risks to economic growth in the short term." The Consumer Confidence Index rebounded more than expected, to 103.2, in August after sliding from 108.6 in April to a 17-month low of 95.3 in July. It peaked at 128.9 last June. Expectations rebounded 9.5 points this month, to 75.1, after falling six of the first seven months of the year by 29.8 points to 65.6—which was its lowest reading since March 2013. (The report notes recession risks still persist, with August's reading below 80.0.) Meanwhile, the present situation component climbed 5.7 points to 145.4 after a four-month slide of 14.1 points to 139.7—which was the weakest since April 2021. In August, consumers' appraisal of current business conditions was more favorable, with the percentage of consumers saying business conditions are good (to 19.2% from 16.3%) rising and the percentage saying conditions are bad (23.2 from 24.2) falling. Consumers' assessment of the labor market was mixed, with the percentage saying jobs were plentiful (48.0 from 49.2) and the percentage saying jobs were hard to get (11.4 from 12.4) both moving lower. Meanwhile, consumers were more optimistic about short-term business conditions this month, with the percentage of consumers expecting conditions to improve (to 17.5% from 13.3%) rising, while the percentage expecting conditions to worsen (22.3 from 26.2) falling. Consumers expected a slight improvement in short-term financial prospects, with the percent of consumers expecting their incomes to increase (15.8 from 15.3) slightly higher and the percentage expecting a decrease (14.5 from 15.5) slightly lower. Consumers were optimistic about employment, with the percentage expecting more jobs to be available (17.4 from 15.1) higher and the percentage expecting fewer jobs (19.3 from 21.1) lower.

JOLTS (*link*): July job openings climbed 199,000 to 11.24 million after falling the prior three months from a record high of 11.86 million in March to 11.04 million by June. There were 5.67 million unemployed in July, so there were 2.0 available jobs for each unemployed person that month. By industry, job openings increased in transportation, warehousing, and utilities (+81.000), arts entertainment, and recreation (+53,000), federal government (+47,000), and state & local government education (+42,000); openings fell 47,000 in durable goods manufacturing. The number of quits dropped for the fourth month, by a total of 270,000, but remains high at 4.18 million, only 331,000 below November's record high of 4.51 million. Before the pandemic, quits hovered around 3.5 million. Many employers are raising wages and incentives amid a severe labor shortage, which gives workers confidence that they can get better pay elsewhere. Meanwhile, hirings sank for the fifth month, by a total of 450,000, to 6.38 million, after a 406,000 rebound in February. Hirings are up 722,000 since their recent bottom during December 2020.

Global Economic Indicators

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Indexes (ESI) for the EU and Eurozone continued to slide in August, with ESIs for both the EU (-1.0 points to 96.5) and Eurozone (-1.3 to 97.6) falling to their lowest levels since January 2021 and February 2021, respectively. The EU's ESI is down 19.7 points since its recent peak of 116.2 in October, while the Eurozone's is 20.4 points lower than its 118.0 peak last July. ESIs dropped in five of the six largest EU economies, with Spain (+0.8 point to 97.9) the one outlier. The Netherland's ESI (-4.8 to 94.5) posted the biggest decline, followed by Germany (-2.5 to 97.2), France (-1.8 to 99.8), Poland (-1.8 to 90.8), and Italy (-1.2 to 100.2). For the overall EU at the sector level, industrial confidence continued to slide, falling from a record high of 12.9 at the end of last year to 0.4 in August, its lowest reading since February 2021, while services confidence dropped to a 15-month low of 8.5 this month after hovering in a flat trend around 13.4 the first half of this year. Meanwhile, consumer confidence showed signs of stabilizing, climbing a point to -26.0 after tumbling 22.8 points from -4.2 in June 2021 to a record-low -27.0 this July. Retail trade confidence showed little change, ticking up to -5.8 after dropping 11.2 points—from 5.1 in February to -6.1 (the weakest since March 2021)—in July. Construction confidence also held steady this month, ticking up 0.4 point to 1.4, after a five-month slide of 6.8 points to a 15-month low of 1.0.

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