MORNING BRIEFING
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China, Earnings & FedNow

Check out the accompanying chart collection.

Executive Summary: China's government is mobilizing to shore up the country's struggling, debt-laden economy. New initiatives will facilitate home-buying, guarantee the debt of select private developers, make low-interest loans to banks, and provide financial backing for infrastructure projects. More may be needed. … Industry analysts still expect S&P 500 companies to log respectable earnings growth this year and next despite having lowered their sights for many. Jackie examines how and why estimates have been changing for various sectors and industries. … And better late than never: FedNow brings the instantaneous financial transactions that other countries enjoy to the US.

China: Time To Think Big. China's real estate market has crumbled over the past year, and so far the Chinese government has taken only incremental steps to staunch the bleeding. Until they open the floodgates, this drain on economic growth isn't going away. More than 30 developers have defaulted on their dollar-denominated debt. On Tuesday, Country Garden, considered among the strongest developers, reported that profits fell 96% y/y in H1-2022. And in more than 100 cities, people have stopped paying their mortgages on homes under construction or have threatened to do so.

Banks have started to show the impact, reporting large jumps in non-performing loans. China Construction Bank and Bank of China reported a 68% and a 20% increase in bad real estate debt during H2, an August 30 Reuters *article* reported. Nonetheless, the banks reported a net profit for the period. An S&P Global Ratings exec quoted in the article estimates that Chinese banks' nonperforming ratio in the property development sector will rise to around 5.5%-5.6% by year-end, more than double the year-earlier 2.6%. Regional banks could be even more exposed to nonperforming real estate loans than their national counterparts.

A real estate debacle isn't the only headwind China faces. It's still selectively locking down neighborhoods when Covid cases spike. Record heat and drought have forced the country to shut industrial plants in hard hit areas to preserve electricity for air conditioning. And the country is owed $1 trillion by struggling countries around the world who participated in China's Belt and Road initiative. In all, China's debt is expected to reach 275% of its GDP, according to an *estimate* by China's director of the National Institution for Finance and

Development. The country's leverage vastly overshadows even the US's sizable debt load, which equals 98% of GDP.

With the country's Q2 GDP having risen only 0.4%, China has been announcing new programs in rapid succession to bolster the economy in advance of the National Congress of the Chinese Communist Party on October 16 (*Fig. 1*). So far, the financial markets have only yawned in response. The China MSCI share price index has fallen 19.8% ytd through Tuesday's close, and the Shanghai-Shenzhen 300 is down 17.5% over the same period (*Fig. 2* and *Fig. 3*).

Here's a look at some of the economy-boosting steps the country has taken so far:

(1) *Lower rates.* Last week, China made buying a home more affordable by lowering the five-year loan prime rate (LPR)—a benchmark Chinese banks use when extending mortgages—by 0.15ppts to 4.3%, an August 22 *FT* *article* reported. This was the second time the rate was lowered in 2022, and one more cut is expected this year. The rate on the country's one-year loan prime rate was also cut, by 0.05ppts, to 3.65%; many commercial loans in China are based on this rate.

(2) *Debt guarantees.* The Chinese government is offering full guarantees on the domestic, yuan-denominated bond sales of six private Chinese developers: CIFI Holdings Group, Country Garden, Gemdale, Longfor, Seazen Group, and Sino-Ocean, an August 24 *WSJ* *article* reported. The guarantees don't apply to their dollar-denominated debt. These companies have been hurt by the downturn, but they are presumably the strongest developers in the market and are being helped by the government to ensure they survive the harsh property downturn. Shares of these developers rallied on news of the government guarantees.

The bond guarantees may open up a can of worms, however. By default, they reveal which developers the Chinese government doesn't believe are worth saving and may lead to even greater stress on those developers without government-guaranteed debt.

(3) *New cash.* The People's Bank of China will issue about Rmb200 billion of low-interest loans to state commercial banks. It's hoped that the banks will leverage the funds to provide Rnb1 trillion of loans to refinance stalled real estate projects, a July 27 *FT* *article* reported. Beijing-based Everbright Bank estimates that Chinese developers have suspended construction on as many as 8 million homes that require Rmb2 trillion ($292 billion) to complete. The problem is that many projects already have too much debt and may have

zero or negative value. They need new equity or a restructuring, not more debt.

Separately, Beijing has provided Rmb300 billion ($44 billion) to state-controlled banks in an effort to boost infrastructure projects and economic growth, an August 25 *WSJ* *article* reported. Beijing approved another Rmb200 billion ($29 billion) in new debt for power generation companies hurt by the extreme heat and drought and another Rmb20 billion to fight the drought and help in the nation's rice harvest.

(4) *Local government support.* Local government financial vehicles (a.k.a. LGFVs) have been raising funds from retail investors to back infrastructure projects, a July 16 *FT* *article* reported. In many cases, they are doing so because banks and institutional investors are no longer willing to lend to them. The practice is raising the question of whether the local governments in this situation are overleveraged and about to face a problem.

Beijing has sent high-ranking officials across the country "to demand local governments do more to stabilize growth, a rare move that may indicate the economy is in worse shape than official figures suggest," an August 29 *South China Morning Post* *article* noted.

Some areas have lowered housing down payments and eased some home-purchasing restrictions. The Zhengzhou city government set up a property relief fund to help developers finish their projects after residents who bought apartments threatened to stop making their mortgage payments.

Earnings: Analysts Fear Not. Although the S&P 500 is down 16.4% ytd through Tuesday's close, earnings for the companies in the index collectively will rise 9.6% this year and 7.2% in 2023 if analysts' estimates are on target. Next year's growth forecast certainly isn't heroic, but it's reassuring to know that it's in positive territory and has been revised downward only modestly since January 27, when it stood at 10.2% growth (*Fig. 4*).

Here are the growth rates implied by analysts' 2023 consensus earnings estimates for the S&P 500 and its sectors: Consumer Discretionary (36.2%), Industrials (17.3), Financials (13.3), Communication Services (12.9), Information Technology (7.7), S&P 500 (7.2), Utilities (6.1), Consumer Staples (5.9), Real Estate (0.1), Health Care (-0.5), Materials (-7.8), and Energy (-13.3) (*Table 1*). Let's take a look at how these estimates have moved this year:

(1) *Thank Amazon.* While the S&P 500 Consumer Discretionary sector's 2022 earnings estimates have been trimmed since the start of the year, its 2023 estimates have been

revised steadily upward (*Fig. 5*). The sector's anticipated improvement in 2023 owes much to Amazon, a member of the Internet & Direct Marketing Retail industry. Analysts forecast that earnings for the Internet & Direct Marketing Retail industry will rise more than 3,000% next year after declining a projected 96.5% this year (*Fig. 6*).

Amazon is expected to earn $0.10 a share this year, down from $3.24 in 2021. The company hit a rough patch this year: It built too much real estate, felt the impacts of higher fuel expenses and a strong dollar, and saw online product sales slow as consumers opted to spend more on services and less on stuff once Covid cases dropped sharply. Next year, however, the company is expected to return to form and earn $2.30 a share.

The Consumer Discretionary sector's earnings are also helped next year by the Hotels, Resorts & Casinos industry, which is recovering from losses suffered during the Covid lockdowns. The Auto Parts & Equipment industry's earnings also are forecast to climb in 2023, by 39.6%, giving the Consumer Discretionary sector a boost.

(2) *A tip of the hat to Boeing too.* The Industrials sector's earnings forecasts for both this year and next have held relatively steady since the start of this year. The sector's earnings are expected to soar 34.4% this year and 17.3% in 2023 (*Fig. 7*). Propelling such growth prospects are the following industries' expected earnings growth this year and next: Airlines (returning to a profit, 198.2%), Aerospace & Defense (30.0, 34.9), and Industrial Conglomerates (9.3, 20.0).

Boeing's earnings are expected to take flight now that deliveries of its 787 Dreamliner have resumed. The company's earnings—which contribute to those of the Aerospace & Defense industry—are expected to recover to $4.92 a share in 2023 from a $1.36 per-share loss this year.

The earnings of Boeing and other defense contractors also stand to benefit from the US Defense Department's need to replenish munitions and equipment being sent to Ukraine. Lockheed Martin's earnings are forecast to jump from $21.75 a share in 2022 to $28.11 in 2023; Raytheon Technologies' earnings are forecast to surge 19.4% in 2023; and General Dynamics' earnings are slated to jump 15.9% next year.

And General Electric's expected 68.4% jump in 2023 earnings boosts the Industrial Conglomerates industry's projected earnings growth.

(3) *Steady 2023 expectations.* Even though the Financials sector's 2022 earnings growth

forecast has declined gradually to -12.6%, its 2023 estimates have been relatively unscathed at 13.3% (*[Fig. 8]*). A similar pattern appears in the Communication Services sector: Its 2022 earnings growth has been slashed to a decline of 11.2%, but its 2023 earnings are expected to grow 12.9%, down slightly since the start of 2022 (*[Fig. 9]*).

(4) *No good news in ’22 or ’23.* Analysts have been slashing their 2022 and 2023 earnings estimates for the Consumer Staples, Health Care, and Technology sectors in recent months. Now they expect Consumer Staples’ earnings to grow 3.3% this year and 5.9% next, down from 6.3% and 7.9% expected at the start of 2022 (*Fig. 10*). Estimated 2022 earnings for the Health Care sector have dropped from a high of 8.4% on February 17 to a recent 4.9%. The 2023 estimate fell sharply in late 2021 and has been largely unchanged so far this year at -0.5% (*Fig. 11*). Earnings projections for the Technology sector both this year and next have been dropping since late April. At their peak in mid-May, Tech earnings for 2022 were expected to grow 13.4%; now just 10.0% growth is expected (*Fig. 12*). At their peak in late March, Tech earnings for 2023 were expected to grow 12.3%; that’s been trimmed to 7.7%.

(5) *Tough 2023 expected.* While analysts following Energy sector companies have been boosting their 2022 earnings estimates, they’ve been cutting their 2023 growth estimates. Next year’s forecast now calls for earnings to drop 13.3% versus -4.2% expected at the start of the year (*Fig. 13*). The same pattern—i.e., raised sights for this year and lowered sights for next—has been occurring for the Real Estate, Materials, and Utilities sectors (*Fig. 14*, *Fig. 15*, and *Fig. 16*).

Disruptive Technologies: Fed Catches Up, With FedNow. When Jackie and her husband bought their first home years ago, what was expected to be a simple transaction took a nightmarish turn, as the funds got stuck in limbo. “We’d transferred the money from a savings account into a checking account the day before,” she recounts, “and the transaction hadn’t yet settled. After much panic and many phone calls, the branch manager solved the problem, and we vowed to name our first child after her.”

Soon, such experiences will happen much less often because the Federal Reserve has announced that FedNow, its instant payment service, will launch for individuals and businesses perhaps as early as May 2023. Transfers will occur instantly, 24 hours a day, seven days a week, all year long between accounts at participating banks. It’s a move that helps the US catch up to other countries, like China and India, where real-time transactions are the norm.

Here are some of Jackie's observations about the new platform:

(1) *Who gets to play.* FedNow will be open to those who have an account with a participating bank. The more banking institutions that join, the more successful FedNow will be. Joining will require institutions to upgrade their systems to connect with the Fed's payments infrastructure.

"The time is now for all key stakeholders—financial institutions, core service providers, software companies, and application developers—to devote the resources necessary to support instant payments. This means upgrading back-office processes, evaluating accounting procedures to accommodate a seven-business-day week, arranging liquidity providers, deploying a new customer-facing application, and promoting instant payments for key use cases to customers," said Fed Vice Chair Lael Brainard in an August 29 *speech*.

FedNow competes with Real Time Payments (RTP), an existing system created by and largely used by large banks. Zelle runs on the RTP system. Smaller banks and thrifts encouraged the Fed to set up its own system so that they wouldn't be subject to RTP's rules and fees.

Notably, the FedNow system isn't open directly to retailers or fintech companies despite their requests to be allowed in. Fintech companies and retailers will need to access the system through a bank; only banks will benefit from direct access to the Fed system, as is the case now.

(2) *Consumers benefit.* FedNow will allow consumers to access the cash from their paychecks immediately upon deposit and eliminate high-interest payday loans. It may also eliminate or limit consumers' need to use a bank debit card, which often have fees. The instant transfer of funds may also reduce consumers' overdraft and late fees. Gig workers, like freelancers and Uber drivers, who can receive payments directly and instantly should also benefit from FedNow.

It remains to be seen whether the Fed can develop an app that's consumer friendly. One *flier* we saw explained that "all" that's needed for a person-to-person instant transfer is the routing number of the payment recipient's financial institution and his/her account number. Those aren't numbers that most people have memorized, but maybe it will be in the future.

(3) *Companies and banks benefit too*. FedNow instant payments could result in improved working capital for businesses. It could also reduce cash and check volumes, which would

reduce banks' costs, a PWC *primer* noted. And it would reduce the amount of funds banks owe each other, thereby reducing risk in the overall banking system.

Calendars

US: Thurs: ISM M-PMI & Price Index 5 2.0/55.5; 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. **Fri:** Nonfarm Payroll Employment Total, Private, and Manufacturing 300k/300k/20k; Average Hourly Earnings 0.4%m/m/5.3%y/y; Unemployment Rate 3.5%; Average Weekly Hours 34.6; Factory Orders 0.2%; Baker-Hughes Rig Count. (Bloomberg estimates)

Global: 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. **Fri:** Germany Trade Balance €4.8b; Germany Exports & Imports -2.3%/0.8%; Spain Unemployment Rate. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment (*link*): The BBR slipped this week for the second week, to 1.28, after advancing the previous six weeks from 0.76 to 1.64, which was the highest reading since early January. It was at 0.60 10 weeks ago, which was the lowest since the week of March 10, 2009's 0.56. Bullish sentiment fell to 38.4% after climbing the prior seven weeks by 14.6ppts (to 45.1% from 30.5%) over the period. Bullish sentiment was as 26.5% 10 weeks ago—which was the fewest bulls since early 2016. Meanwhile, bearish sentiment climbed for the second week to 30.1% this week after falling seven of the prior eight weeks by 16.6ppts (27.5 from 44.1). The correction count advanced to 31.5% after sinking in five of the prior six weeks from 31.0% to 25.3%—which was the lowest since early June. In the meantime, the AAII Sentiment Survey (as of August 25) reports optimism about the short-term direction of the stock market dropped to its lowest level this month, while pessimism rose back to an unusually high level. The percentage expecting stocks will rise over the next six months dropped 5.6ppts to 27.7% after rising to 33.3% the prior week—which was the highest since December 30, 2021 (37.7%). It remains below its historical average of 38.0%

for the 40th straight week. The percentage expecting stocks will fall over the next six months increased for the second week, by a total of 5.7ppts to 42.4%—with 5.2ppts occurring during the latest week. This followed five weeks of decline in the percentage expecting stocks to fall, from 52.8% to 36.7%, which was the lowest since March 31 (27.5%). The measure has been above its historical average of 30.5% for 39 out of the past 40 weeks, with the report noting that it's at an unusually high level for the 24th time in 32 weeks. (The breakpoint between typical and unusually high readings is currently 40.5%.)

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise for five of the 11 S&P 500 sectors, forward earnings rose for three sectors, and the forward profit margin rose for one sector. Nearly all of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Energy and Real Estate are the only sectors with forward earnings at a record high now. None of the sectors have forward revenues at a record high this week. All sectors now have forward profit margins that are below their record highs, but those of Energy, Industrials, and Real Estate remain closest to their post-pandemic highs. Energy still has forward revenues well below a record high, and Utilities' forward revenues and margin are lagging too. Only three sectors have posted a higher profit margin y/y so far during 2020: Consumer Staples, Tech, and Utilities; during 2021, all of the sectors but Utilities posted a y/y improvement. Seven sectors are expected to see margins decline y/y for full-year 2022, followed by four sectors in 2023. Here are 2022's decliners: Communication Services, Consumer Discretionary, Consumer Staples, Financials, Health Care, Information Technology, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (24.6%, down from its 25.4% record high in early June), Financials (18.4, down from its 19.8 record high in August 2021), Real Estate (18.4, up 0.1ppt w/w and down from its 19.2 record high in 2016), Communication Services (15.2, down 0.1ppt w/w and from its 17.0 record high in October), Utilities (13.9, down from its 14.8 record high in April 2021), S&P 500 (13.0, down from its record high of 13.4 achieved intermittently from March to June), Materials (12.9, down from its 13.6 record high in early June), Health Care (10.6, down from its 11.5 record high in early March), Industrials (10.3, down from its 10.5 record high in December 2019), Energy (12.2, down from its 12.3 record high in early August), Consumer Discretionary (7.4, down from its 8.3 record high in 2018), and Consumer Staples (7.2, down from its 7.7 record high in June 2020).

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise for five of the 11 S&P 500 sectors, forward earnings rise for three sectors, and forward profit margin rise for one sector. Nearly all of the sectors are below recent record highs in their forward revenues, earnings, and profit margins. Energy and Real Estate are the only sectors with forward earnings at a record high now. None of the sectors have forward revenues at a record high this week. All sectors now have forward profit margins that are below their record highs, but those of Energy, Industrials, and Real Estate remain closest to their post-pandemic highs. Energy still has forward revenues well below a record high, and Utilities' forward revenues and margin are lagging too. Only three sectors have posted a higher profit margin y/y so far during 2020: Consumer Staples, Tech, and Utilities; during 2021, all of the sectors but Utilities posted a y/y improvement. Seven sectors are expected to see margins decline y/y for full-year 2022, followed by four sectors in 2023. Here are 2022's decliners: Communication Services, Consumer Discretionary, Consumer Staples, Financials, Health Care, Information Technology, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (24.6%, down from its 25.4% record high in early June), Financials (18.4, down from its 19.8 record high in August 2021), Real Estate (18.4, up 0.1ppt w/w and down from its 19.2 record high in 2016), Communication Services (15.2, down 0.1ppt w/w and from its 17.0 record high in October), Utilities (13.9, down from its 14.8 record high in April 2021), S&P 500 (13.0, down from its record high of 13.4 achieved intermittently from March to June), Materials (12.9, down from its 13.6 record high in early June), Health Care (10.6, down from its 11.5 record high in early March), Industrials (10.3, down from its 10.5 record high in December 2019), Energy (12.2, down from its 12.3 record high in early August), Consumer Discretionary (7.4, down from its 8.3 record high in 2018), and Consumer Staples (7.2, down from its 7.7 record high in June 2020).

Global Economic Indicators

Eurozone CPI Flash Estimates (*link*): The headline CPI rate for August is expected to accelerate to yet another new record high of 9.1% y/y, up from 8.9% in July and 6.1ppts above last August's 3.0%. The rate was at -0.3% at the end of 2020. Looking at the main components, once again energy is anticipated to record the largest gain, though it is forecast to ease for the second month to 38.3% y/y in August after accelerating from 37.5% in April to 42.0% in June; it was at a record high of 44.3% in March. The rate for food, alcohol & tobacco is forecast to soar to a record-high 10.6% in August, having accelerated steadily from June 2021's 0.5%, while the rate for non-energy industrial goods is expected to pick up to a record-high 5.0%. The services rate is predicted to accelerate 3.8% y/y—the highest since spring 1994. Of the top four Eurozone economies, only Spain's (10.3% y/y) rate is above the Eurozone's expected rate of 9.1%, easing a bit from July's record high of 10.7%. Meanwhile, rates in Italy (9.0% y/y), Germany (8.8), and France (6.5) all were below the Eurozone's rate of 9.1%—though rates in Italy and Germany both reached new record highs, while France's eased a bit from July's 6.8% record high.

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