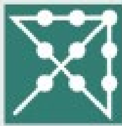

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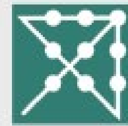

**MORNING BRIEFING**
**September 20, 2022**

## How's Business?

*Check out the accompanying chart collection.*

**Executive Summary:** Today we focus on business sales, showing how it relates to the key economic indicators that feed into our economic outlook and how it correlates with S&P 500 companies' aggregate and forward revenues, feeding into our stock market outlook. … For the economy, we forecast a "rolling recession"—a.k.a. "growth recession"—that depresses different industries at different times but avoids shrinking the overall economy. For the S&P 500, we estimate forward EPS of $215 this year, up 3.1% y/y, and $235 next year, up 9.3%.

**Strategy: Rolling Recession & Flat Earnings.** Debbie and I continue to watch numerous economic indicators so that we can regularly update our answer to the oft-posed question by investors, "How's business?" The answer today is that it is not so good but not so bad either. That's consistent with our rolling recession scenario for the economy.

In the past, many recessions that were attributable to tighter monetary policy tended to be hardest on the interest-rate-sensitive sectors, particularly autos and housing. That's where the biggest job losses occurred, and they quickly spread to most manufacturing businesses as goods producers scrambled to reduce their unintended inventory buildups and cut their capital spending. The services economy tended to hold up relatively well, and so did employment in most services industries.

The recession during 2001 hit technology industries hard when the sector's speculative bubble burst. The recession that occurred during the Great Financial Crisis depressed the housing, autos, and the banking industries when the subprime-lending bubble burst. So it weighed on employment not only in goods-producing industries but also in financial and real estate services.

The lockdown recession of 2020 didn't last very long in goods-producing industries because the lockdowns were lifted after only two months; but many services were forced by social-distancing regulations to curtail business. Manufacturers and distributors of consumer durable goods and the housing industry recovered very quickly and experienced remarkable booms in demand. But employment in the services economy remained depressed during the recovery.

The overall economy has been experiencing a growth recession so far this year, as real GDP edged down 1.6% and 0.6% (saar) during Q1 and Q2. The latest estimate from the Atlanta Fed's *GDPNow* tracking model shows real GDP growing just 0.5% during Q3. We've been characterizing the current economic experience as a "rolling recession," depressing different industries at different times without resulting in an official broad-based recession. (The GDPNow forecast will be updated this morning.)

The bottom line for the bottom line of corporate income statements is that earnings are likely to flatten rather than take a dive in our rolling recession scenario. Overall revenues may continue to grow, boosted by inflation, but profit margins will be squeezed. That should flatten earnings like a pancake.

The main rationale for our rolling recession forecast is that this time is different compared to previous monetary policy tightening cycles. In the past, these cycles ended when they triggered a financial crisis that quickly turned into a broad credit crunch, depressing most businesses—especially goods-producing ones—and causing an economy-wide recession.

Before we analyze the latest developments in various key industries, let's review the relationship between S&P 500 earnings and key macroeconomic variables:

(1) *Actual quarterly & weekly forward revenues.* S&P 500 revenues per share rose to a record high during Q2 (*Fig. 1*). Forward revenues per share—which is the time-weighted average of industry analysts' revenues-per-share estimates for this year and next year—is a great weekly coincident indicator of the actual quarterly revenues series. It rose to a record high during the September 8 week.

(2) *Aggregate revenues & business sales.* S&P 500 aggregate revenues includes the revenues of companies that produce both goods and services. Nevertheless, it is highly correlated with the monthly series on manufacturing and trade sales, which includes only goods producers and distributors (both wholesale and retail) (*Fig. 2*). Both series also are highly correlated with nominal GDP of goods. The growth rates of all three on a y/y basis are very close (*Fig. 3* and *Fig. 4*).

During Q2, nominal GDP of goods was up 11.3% y/y, while S&P 500 aggregate revenues was up 11.9%. During July, business sales of goods was up 12.5% y/y. The bad news is that inflation-adjusted business sales fell 1.5% y/y through June, while the price deflator for this category was up 16.2% (*Fig. 5* and *Fig. 6*).

Here are June's y/y percent changes in real business sales and their deflators for manufacturing (-2.4%, 18.4%), wholesale sales (1.8, 17.5), and retail sales (-4.1, 11.1) (*Fig. 7* and *Fig. 8*).

(3) *Actual per-share revenues, earnings, and the profit margin.* During Q2-2022, revenues per share rose 12.2% y/y, while operating earnings per share increased 9.8% (*Fig. 9*). Both set record highs, as the profit margin was 13.4% versus a record-high 13.7% a year ago (*Fig. 10*).

(4) *Actual quarterly earnings & weekly forward earnings.* S&P 500 forward earnings tends to be a good leading indicator of the S&P 500 companies' actual quarterly earnings, on an operating basis (*Fig. 11*). Forward earnings peaked at a record high of $239.93 during the June 23 week. It has edged down 0.7% since then through the September 15 week.

(5) *Bottom line on the bottom line.* Our rolling recession scenario implies that both forward weekly and actual quarterly operating earnings will stall at their recent record highs through the end of this year, and maybe through the first half of next year. If we were forecasting an outright recession for the economy, we would be much more bearish on earnings and the stock market; but we aren't doing so at this time. Instead, we are forecasting that earnings will be $215 per share this year, up only 3.1% from 2021 (*Fig. 12*). Next year, we are forecasting $235 per share, up 9.3% from this year.

(6) *Top down.* From a top-down macroeconomic perspective, we've noted that S&P 500 forward earnings, on a monthly basis, closely tracks the Index of Coincident Economic Indicators (CEI) (*Fig. 13* and *Fig. 14*). The CEI was up 2.1% y/y through July. In our rolling recession (a.k.a. growth recession) scenario, the CEI flattens around its current record high, as do S&P 500 forward and actual operating earnings.

**US Economy: Rolling Along.** Our business is a very simple one. Most of the variables we care about and need to forecast can go only up, down, or sideways. Forecasting the stock market is even easier. All we must do to forecast the S&P 500 stock price index is to forecast two variables, i.e., forward earnings for the S&P 500 companies as estimated by industry analysts and the forward P/E that investors will pay for those earnings. Forecasting these two variables is very easy to do. Getting them right is the hard part.

Today, we are working on getting the forward earnings piece right by getting our economic forecast right, particularly for the CEI. Let's examine the latest relevant indicators and assess whether they are likely to go up, down, or sideways:

(1) *Coincident Economic Indicators.* The CEI includes four economic indicators: payroll employment, real personal income less transfer payments, real manufacturing & trade sales, and industrial production (*Fig. 15*):

Payroll employment rose to a record high during August and is likely to continue to move higher in coming months since there are still lots of job openings. That's positive for personal income.

On an inflation-adjusted basis, however, wages and salaries in personal income have stalled as rapidly rising prices have continued to erode the purchasing power of rising wages.

Price inflation is boosting business sales of goods (and S&P 500 revenues), as we noted above, but these sales have stalled in real terms.

Industrial production edged down 0.2% during August after reaching a new record high in July and is likely to flatten out for a while, as unintended inventories have been increasing relative to sales (*Fig. 16* and *Fig. 17*).

As for the composite CEI, it rose 0.3% in July, to a new record high, and we project that it will remain around the high over the rest of this year.

(2) *Housing.* The major single-family housing indicators all have been going south as the mortgage rate has been on a due-north course since the start of this year. Since the start of this year, new and existing single-family home sales are down 38.5% and 25.0% through July.

Housing-related retail sales also are depressed. Real construction spending on home improvements is down 4.7% ytd through Q2. On the other hand, multi-family building permits and starts remain strong.

(3) *Auto sales and production.* Auto sales have been weak since last summer, mostly because production has been hampered by parts shortages. In other words, the auto industry has been in a recession already, attributable to supply-chain disruptions. But there is plenty of pent-up demand that should boost sales as production ramps up.

(4) *Government spending.* The pandemic unleashed a torrent of federal legislation to boost fiscal spending in coming months and years on public infrastructure, green projects,

semiconductor factories, and grants to fund state and local government spending. In addition, federal defense spending on weapons is likely to boom as inventories (depleted by the Ukraine war) are replenished.

(5) *Business spending.* Capital spending indicators have been weakening in some areas as economic growth has stalled. However, the "onshoring" of supply chains is likely to boost capital spending. So is a spending boom in the energy sector, particularly on LNG production and export facilities.

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## Calendars

**US: Tues:** Housing Starts & Building Permits 1.445mu/1.610mu; API Weekly Crude Oil Stocks. **Wed:** Existing Home Sales 4.70mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 3.25%; FOMC Economic Projections. (Bloomberg estimates)

**Global: Tues:** Eurozone Current Account €5.3b; Germany PPI 1.5%m/m/37.5%y/y; Canada CPI -0.1%m/m/7.3%y/y; Lagarde; McCaul; Beaudry; Bullock. **Wed:** UK Industrial Trends Orders -11; BOJ Interest Rate Decision -0.10%; European Central Bank Non-Monetary Policy Meeting; De Guindos; Beerman. (Bloomberg estimates)

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## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): Last week, forward earnings rose for a third straight week for LargeCap and for the first time in three weeks for MidCap, but SmallCap's fell for the first time in three weeks. For a 12th straight week, none of these three indexes had forward earnings at a record high. LargeCap's forward earnings is now 0.7% below its record high at the end of June. MidCap's is 0.3% below its record high in early June, and SmallCap's latest decline puts it 2.5% below its record high in mid-June. In the latest week, the yearly rate of change in LargeCap's forward earnings edged down to a 17-month low of 10.9% y/y from 11.0%; 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 eased w/w to a 17-month low of 21.3% y/y from 21.4%. 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 17-month low of 15.9% y/y from 16.2%. That's up from a 17-month low of 16.1% at the end of August and down from a record high of 124.2% in June 2021. It had been at 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 stalling or heading lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (8.3%, 8.0%), MidCap (16.1, 2.5), and SmallCap (10.8, 8.6).

**S&P 500/400/600 Valuation** (*link*): Valuations fell across the board for the fourth time in five weeks for all three of these indexes and were at nine-week lows. LargeCap's forward P/E fell 0.8pt to 16.3 from 17.1, which compares to a 16-week high of 18.1 in early August, a 26-month low of 15.3 in mid-June, and an 11-year low of 11.1 during March 2020. MidCap's forward P/E was down 0.6pt w/w to 11.9 from 12.5, which compares to a 16-week high of 13.2 in early August, a 27-month low of 11.1 in mid-June, a record high of 22.9 in June 2020, and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E gave up 0.4pt w/w last week to 11.5 from 11.9. That's down from a 16-week high of 12.8 in early August and up from its mid-June reading of 10.7, which was the lowest since it bottomed at a record low of 10.2 in November 2009 during the Great Financial Crisis. That compares to 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 27% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 109th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 30% 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 66th 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, and the declines have accelerated for Q3-2022. In the latest week, the Q3-2022 S&P 500 earnings-

per-share forecast remained steady w/w at $56.19, but is 5.5% below its $59.49 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken to 4.3% y/y on a frozen actual basis and 5.0% on a pro forma basis. That's down from Q2-2022's blended actual/estimate of an 9.9% y/y gain on a frozen actual basis and 8.5% y/y on a pro forma basis. Double-digit percentage growth is expected for just four sectors in Q3-2022, and y/y declines are expected for six. That compares to Q2-2022's count of four sectors with triple- and double-digit growth, three with a single-digit gain, and four with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q3-2022 versus their blended Q2-2022 growth rates: Energy (121.6% in Q3-2022 versus 296.7% in Q2-2022), Industrials (26.5, 31.6), Consumer Discretionary (17.5, -12.3), Real Estate (10.5, 13.0), Materials (4.8, 17.4), S&P 500 (5.0, 8.5), Information Technology (-3.3, 1.5), Consumer Staples (-2.9, 2.3), Health Care (-4.0, 8.7), Utilities (-7.1, -3.7), Financials (-9.1, -19.2), and Communication Services (-15.9, -20.3).

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## US Economic Indicators

**NAHB Housing Market Index** (*link*): "Buyer traffic is weak in many markets as more consumers remain on the sidelines due to higher mortgage rates and home prices are putting a new home purchase out of the financial reach of many households," noted Jerry Konter, NAHB's chairman, adding "In another indicator of a weakening market, 24% of builders reported reducing home prices up from 19% from last month." Homebuilder's confidence dropped for the ninth time this year, by 3 points in September and 38 points ytd, to 46—the lowest level since May 2020 during the height of the pandemic. (Any number below 50 indicates that more builders view sales conditions as poor than good.) All components continued their descents in September, with current sales (-3 points) once again posting the biggest decline this month, followed by future sales and traffic of prospective buyers which both edged down a point. Year-to-date, traffic of prospective buyers (-40 points to 31) posted the largest decline, followed closely by future sales (-39 to 46) and current sales (-36 to 54), with all falling to their lowest levels since May 2020. They were at record highs of 77, 89, and 96, respectively, during November 2020.

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