MORNING BRIEFING
October 6, 2022

On Earnings, JOLTS & Housing

Check out the accompanying chart collection.

Executive Summary: While S&P 500 forward revenues has hit successive record highs lately, the forward profit margin and forward earnings both peaked in June. Since then, forward earnings has been flat. We see more of the same for earnings given our expectation that economic growth will be close to zero in our growth recession scenario. … Also: One in three workers quit their jobs over the past year! But their ex-employers quickly rehired. We examine the reasons for the labor market's mind-boggling pace of job churn. … And: Home affordability challenges have sent the recently hot housing market into a deep freeze. Melissa traces the causes and the effects on homebuilders.

Strategy: Flat Earnings Society. We are expecting a growth recession in S&P 500 earnings because we believe that the economy has been in a growth recession since the start of this year. If economic growth is close to zero, S&P 500 forward earnings should be flat. That seems to have been the case since late June. Consider the following:

(1) *Revenues, profit margin & earnings.* Interestingly, so far, there is no sign of a recession in S&P 500 forward revenues per share, which rose to yet another record high during the September 22 week (*Fig. 1*). This weekly series closely tracks actual quarterly S&P 500 revenues per share, which likewise rose to a record high during Q2-2022. Revenues are getting a big boost from rapidly rising prices.

The weekly S&P 500 forward profit margin, which closely tracks the comparable quarterly series, peaked at a record high of 13.4% during the June 9 week. It edged down to a 14-month low of 13.0% during the September 22 week. S&P 500 forward earnings peaked at a record $239.93 per share during the June 23 week. It's been relatively flat since then at around $237 per share through the September 29 week.

(2) *Inflation-adjusted revenues & earnings.* Even on an inflation-adjusted basis, monthly S&P 500 forward revenues rose to a new record high during August (*Fig. 2*). While nominal forward revenues is up 11.6% y/y, real forward revenues is still up 3.7% (*Fig. 3*). However, this growth rate is likely to fall closer to zero. That's because it is highly correlated with the national M-PMI, which fell to 50.9 during September, the lowest reading since May 2020 (*Fig. 4*).

On an inflation-adjusted basis, forward earnings peaked at a record high during May (*Fig. 5*). It was down 1.5% through August. This series tends to be a good coincident indicator of the business cycle: If forward earnings is peaking, that could be an early sign of an impending hard-landing recession; if it simply stops climbing, that might signal a growth recession. The latter has occurred during past mid-cycle slowdowns of the US economy, and we think it is happening again.

(3) *Quarterly & annual consensus earnings forecasts.* How can it be that forward earnings isn't falling along with analysts' consensus earnings expectations for the last two quarters of this year and each of next year's four quarters (*Fig. 6* and *Fig. 7*)? They dropped during the September 22 week in response to FedEx's warning of recessionary forces in the US and abroad. They edged down during the September 29 week.

Of course, the recent downward revisions in the coming six quarters are reflected in the analysts' 2022 and 2023 earnings estimates at $223.72 and $241.83 during the September 29 week (*Fig. 8*). Forward earnings is the time-weighted average of the two and was $237.30 that week. It is converging toward the 2023 estimate at the end of this year, and will start giving weight to the 2024 estimate, which is currently $260.93, at the beginning of next year.

(4) *Our forecasts & theirs.* We are expecting S&P 500 revenues per share to rise to $1,750 and $1,875 this year and next, up 11.6% and 7.1% (*Fig. 9*). The analysts' consensus rose to $1,745.49 and $1,817.95 during the September 22 week. On the other hand, we expect that analysts will continue to lower their S&P 500 earnings estimates to our estimates of $215 and $235 for this year and next year (*Fig. 10*). That would be consistent with our flattish outlook for S&P 500 forward earnings (and actual earnings during the second half of this year and first half of next year) (*Fig. 11*).

US Employment: Churn To Earn (More). The labor market is remarkably dynamic. The pace of both hirings and quits is truly remarkable. Many people are quitting their old jobs to take new ones that pay more. The problem they face is that price inflation has been eroding most, if not all, of their wage gains. All that churning may also be weighing on productivity. Consider the following remarkable turnover in the labor market:

(1) *Working.* During the 12 months through August, payroll employment rose 5.8 million according to the monthly employment report (*Fig. 12*). That was only 3.8% of total payrolls during August (*Fig. 13*).

(2) *Hiring.* Over this same period, according to the JOLTS report, hiring totaled a whopping 78.0 million, or 51.1% of August's payrolls (*Fig. 14* and *Fig. 15*). That's right: Half of payroll employment was attributable to newly hired workers, i.e., hired over the past 12 months!

(3) *Quitting.* Over this same period, separations totaled 72.2 million (47.3% of payroll employment), consisting of 51.5 million quits (33.7% of payrolls) and 16.5 million layoffs (16.5% of payrolls) (*Fig. 16* and *Fig. 17*). That's right: A third of all workers quit their jobs over the past 12 months!

(4) *Job openings.* All this churning can partly explain why there are 1.7 job openings for every unemployed worker. Jobs open when workers quit. But the rapid pace of hiring suggests that jobs get filled quickly after opening.

(5) *Switching.* Some of this incredible churning in the labor market undoubtedly reflects workers' perceptions that the labor market is tight and that they can get paid more by switching jobs. They are right, according to the Atlanta Fed's wage growth tracker (WGT). During August, the wages of job switchers rose 8.4% y/y, while the wages of job stayers rose 5.6% (*Fig. 18*).

(6) *Eroding.* Meanwhile, the PCED inflation rate was 6.2% y/y through August. So in real terms, the WGT rose just 2.2% for switchers and fell 0.6% for stayers (*Fig. 19*).

US Housing I: Reversal Of Fortune. No longer are buyers lining up around the block at open houses. Homebuyer enthusiasm has been curbed by the Fed's aggressive interest rate hikes and quantitative tightening, driving up mortgage rates thus reducing affordability. But buyers aren't just wary of committing to higher mortgage payments than they can afford; they're also wary of purchasing a home poised to depreciate.

Depreciation is a real threat because sellers have been dropping home prices to attract reluctant buyers. In many US regions, home prices are flat with year-ago levels; and in some, they're down. In August, Realtor.com found that about 20% of sellers had dropped their asking price, *noted* CNBC, versus just 11% a year earlier. Redfin found that the average home sold for less than its list price for the first time in over 17 months during the four-week period ended August 28.

Affordability challenges dampen not only demand by causing buyer hesitancy; they also dampen supply by making sellers reluctant to list their home at a time of falling prices. As a result, Melissa and I expect continued affordability challenges to drive a further pullback in housing activity.

But notably, we don't expect home prices to freefall, as occurred during the Great Financial Crisis (GFC), because today's market is supported by more stringent lending standards, a persistent shortage of housing (since even before the pandemic), and the heightened importance of home in people's lives since the pandemic—especially when home doubles as a workplace.

(FYI: More than 60% of the increase in home prices from the start of the pandemic to November 2021 is attributable to the rise in work from home during the pandemic, *according* to San Francisco Federal Reserve Bank researchers. It's a trend that persists, with 30% of work still being done from home as of last month.)

How slow has housing activity gotten? One of the ugliest charts on the block right now shows the index for traffic of prospective buyers of new homes. It has continued to plunge from 71 at the start of this year to 31 during September (*Fig. 20*). Just as ugly is the chart showing the sharp declines so far this year in the Housing Market Index (for new homes) and the Pending Home Sales Index (for existing homes) (*Fig. 21*).

Consider the following:

(1) *Rising mortgage rates are busting the boom.* The single largest driver of the housing market right now is mortgage rates. Interest rates on a 30-year fixed mortgage crossed the threshold of 7.0% on September 30, the highest in the history of the data going back to 2004 (*Fig. 22*).

Mortgage rates took a momentary reprieve in July. After rising to 6.11% on June 21, rates fell back down to 5.26% on August 1 when the market briefly hoped for a less hawkish Fed. Rates could rise even further to 8.0% should an aggressive Fed not relent in the rate-hiking cycle. Currently, rates on a 30-year fixed-rate mortgage are at 6.86% as of Tuesday.

Mortgage applications for new purchases fell dramatically by 17% ytd through September 30 (*Fig. 23*). Since very few borrowers would benefit from refinancing, applications for these types of transactions fell 84% y/y during the last week of September—to its lowest reading since September 2000.

(2) *Buyers are affordability challenged.* Homebuyers today are looking at much different monthly mortgage payments than they were just a few months ago. For a $400,000 home,

the monthly mortgage payment would now be hundreds of dollars more than it was in January. Prices for existing single-family homes have come down some, yet still are 45% higher than they were pre-pandemic. Through July, the National Association of Realtors' (NAR) Housing Affordability Index, which is based on a 30-year fixed-rate mortgage, dropped to the lowest seen since July 2006 (*Fig. 24*).

Although mortgage rates have pressured home sellers to cut prices, home prices still are significantly higher than they were last year and before the pandemic. August's median existing housing prices (including houses, condos, and co-ops) fell 5.9% during the two months through August from June's record high $413,800, according to the NAR (*Fig. 25*). It was the largest two-month fall since September 2013. The y/y rate of increase slowed to 8% from 25% a year earlier (although it did remain an increase). Over the latest 24 months through May, the median existing single-family home price increased by 45%, slowing to 26% in August.

(3) *Prices decelerate with declining affordability.* Home prices cooled in July at the fastest pace ever as measured by the Case-Shiller Index (*Fig. 26*). From June to July, the national composite saw its first month-to-month price decline since February 2012. Because of a lag in how the index captures price data relative to when deals are done, July's reading might have been skewed upwards by temporarily lower mortgage rates.

(4) *Sales soften as the Fed marches on.* The NAR Pending Home Sales Index dramatically dropped through August from the record during mid-2020 when the Covid lockdowns were lifted. The index tends to be a leading indicator for existing home sales. Many sales agreements on existing home sales under contract were undone because mortgage rates had skyrocketed.

The recent weakness in sales largely reflects the surge in mortgage rates since the start of the year combined with the jump in home prices since the end of the lockdown recession in 2020. Total existing home sales (including single family homes and condominiums) plunged 26% since January to 4.8 million units (saar) during August, the slowest pace since May 2020 (*Fig. 27*). New home sales peaked at 1.04 million units (saar) during August 2020 and fell 34% to 685,000 units during August of this year (*Fig. 28*).

(5) *Thank goodness for tighter lending standards.* Fortunately, mortgage lending standards have been tightened significantly since the GFC. During Q2-2022, the percent of mortgages delinquent by 90 days or more remained at a record low of 0.5% (*Fig. 29*). The similar delinquency rate for home equity loans was 0.9%. Both were well below the delinquency

rates on auto loans (3.9%), student loans (4.6%), and credit cards (8.0%).

US Housing II: Homebuilders Are Flipping Out. The National Association of Homebuilders' latest survey of homebuilders reports weak traffic in many markets owing to the affordability challenges discussed above. The median yearly percent change in 12-month moving average of single-family prices for new homes fell 17.1% through August (*Fig. 30*). To bolster sales, more than a half of homebuilders have been offering incentives like home price cuts, help with closing costs, and free amenities, Robert Dietz of the National Association of Homebuilders recently *said*. Such incentives combined with elevated costs for labor and materials have pressured homebuilders' margins.

No wonder homebuilder sentiment is down. According to the National Association of Homebuilders Index, homebuilder sentiment fell 3 points in September to 46 (below 50 indicates negative sentiment) (*Fig. 31*). Given the weak margin prospects for new builds, it's not surprising that big homebuilders, including Lennar and KB, recently have announced dropping pending deals for new lots.

Calendars

US: Thurs: Initial & Continuous Jobless Claims 203k/1.345m; Natural Gas Storage; Waller; Mester; Cook; Evans. **Fri:** Payroll Employment Total, Private, and Manufacturing 250k/270k/20k; Average Hourly Earnings 0.3%m/m/5.1%y/y; Average Weekly Hours 34.5; Unemployment Rate 3.7%; Consumer Credit $24.5b; Wholesale Trade 0.4%; Baker Hughes Rig Count; Williams. (Bloomberg estimates)

Global: Thurs: Eurozone Retail Sales -0.4%m/m/-1.7%y/y; Germany Factory Orders -0.7%; Spain Industrial Production 4.8% y/y; UK Construction PMI 48.0; Japan Household Spending 0.2%; China M-PMI & NM-PMI; ECB Publishes Account of Monetary Policy Meeting; RBA Financial Stability Report; Macklem. **Fri:** Germany Industrial Production -0.5%; Germany Retail Sales -1.1%m/m/-4.3%y/y; Germany Import Prices 2.0%m/m/29.9%y/y; Italy Retail Sales; UK Halifax Price Index; Canada Employment Change 20k; Canada Unemployment Rate 5.4%; Japan Leading & Coincident Indicators; BOE Quarterly Bulletin; EU Leaders Summit; Ramsden. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The BBR sank further below 1.00 this week, dropping for the third week to 0.61 (the lowest since the June 21 week's 0.60), after rising from 1.00 to 1.15 the prior week. Bullish sentiment held steady at 25.4% this week (the fewest bulls since early 2016) after falling the prior two weeks from 32.4%. Meanwhile, bearish sentiment moved higher for the third week by 13.6ppts (to 41.8% from 28.2%), exceeding bullish sentiment for the third successive week, to its highest percentage since the June 21 week. The correction count dropped to 32.8% this week, after climbing from 38.6% to 40.3% last week, with bearish sentiment unseating correction as the largest group, where it sat the prior four weeks. In the meantime, the AAII Sentiment Survey (as of September 29) showed investors describing their six-month outlook for stocks as "bearish" remaining near record high levels, while the bullish sentiment percentage ranks among the 50 lowest in survey history. The percentage expecting stocks will rise over the next six months rose 2.3ppts to 20.0% after falling 8.4ppts (to 17.7% from 26.1%) the prior week, with optimism remaining below its historical average of 38.0% for the 45th consecutive week; it was unusually low for the fifth successive week and the 28th time in 39 weeks. The percentage expecting stocks to fall over the next six months was little changed at 60.8% after rising five of the prior six weeks, by 24.2ppts (60.9 from 36.7), with 14.9pps occurring during September 22 week. (It was the first time in the survey's history that pessimism was above 60% on consecutive weeks.) Bearish sentiment has been above its historical average of 30.5% in 44 of the last 45 weeks, and is at an unusually high level for the 29th time in 37 weeks. (The breakpoint between typical and unusually high readings is currently 40.6%.)

S&P 500 Q3 Earnings Season Monitor (*link*): The Q3-2022 earnings season is off to the poorest start of any quarterly reporting season since Q1-2020. With 3% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues have missed the consensus forecast by 0.4%, and earnings have fallen short by 4.1%. At the same point during the Q2 season, revenues were 1.4% above forecast and earnings had beaten estimates by 3.9%. For the 17 companies that have reported Q3 earnings through mid-day Wednesday, the aggregate y/y revenue and earnings growth rates have slowed from their readings from Q2-2021 to Q2-2022. The small sample of 17 reporters so far collectively has a y/y revenue gain of 12.8%, but an earnings gain of only 5.0%. Just 47% of the Q3 reporters so far has reported a positive revenue surprise, and 65% has beaten earnings forecasts. Furthermore, fewer companies have reported positive y/y earnings growth in Q1 (65%) than positive y/y revenue growth (94%). These figures will change markedly as more

Q3-2022 results are reported in the coming weeks. While we expect y/y growth rates to remain positive in Q3, we think the revenue and earnings surprises will deteriorate q/q due to the slowing economy, missed deliveries, higher costs, and currency translation.

US Economic Indicators

Merchandise Trade (*link*): The real merchandise trade deficit continued its narrowing trend in August after holding steady in May at -$116.6 billion. August's real trade deficit narrowed dramatically to -$99.0 billion from a record-high -$135.8 billion during March. Trade was a major drag on Q1 real GDP but was the biggest positive contributor during Q2; it's likely to contribute positively again this quarter. The *real merchandise trade deficit* averaged $101.1 billion the first two months of Q3, a big narrowing from Q2's average monthly gap of $115.5 billion and Q1's $122.4 billion. Real exports rose for the fifth time in six months, by 1.8% m/m and 10.3% over the period to another new record high, while real imports fell for the fifth successive month, by 0.5%m/m and 8.4% over the period. *Looking at exports,* real exports of industrial supplies & materials shot up 19.9% during the six months through August to a new record high, after sliding 8.0% the first two months of the year, while exports of nonfood consumer goods ex autos rebounded 6.3% in August, more than reversing the 4.6% drop during the two months through July, up 12.1% y/y. Meanwhile, capital goods orders ex autos remains on a volatile uptrend, climbing to its highest level since July 2019 in August, while auto exports remain in a volatile flat trend, dropping 7.7% in August. Foods, feeds & beverages' exports are moving sideways, but the swings are wide. *As for import trends,* the upswing in capital goods ex autos has stalled since reaching a new record high in March, while imports of nonfood consumer goods ex autos has tumbled 17.4% from its March record high. Real auto imports are on a volatile uptrend, picking up the past two months, while real imports of foods, feeds & beverages climbed back toward April's record high. Meanwhile, real imports of industrial materials & supplies has dropped 10.1% since its recent peak in March.

US Non-Manufacturing PMIs (*link*): ISM's NM-PMI was little changed from August's robust pace, while prices continued to ease from April's record rate. The NM-PMI inched down to 56.7 in September after climbing from 55.3 in June to 56.9 in August; the index was at a record high 68.4 last November. Of the four components, the new orders component (to 60.6 from 61.8) was just a above 60.0, while the business activity (59.1 from 60.9) gauge was just below 60.0. Supply bottlenecks continued to ease, with the supplier deliveries' measure dropping sharply from 75.7 in October and November to a 31-month low of 53.9 in

August. Meanwhile, the employment gauge moved up to a six-month high of 53.0 after bouncing around the breakeven point of 50.0 for several months. In the meantime, the price index eased for the fifth month since reaching a record-high 84.6 in April, slowing to a 20-month low of 68.7 in September.

Auto Sales (*link*): Auto sales is in a minor uptrend the past four months, climbing to 13.7mu (saar) in September from 12.9mu in May; it was at 15.2mu at the start of this year. Sales averaged 15.1mu for all of last year—with last year's sales reaching a high of 18.5mu and a low of 12.4mu. Domestic light-truck sales are hovering around 8.0mu the past four months, coming in at 8.2mu (saar) in September after falling from 9.4mu at the start of the year to 7.9mu in May. These sales were as high as 11.0mu last April. Meanwhile, domestic car sales continue to remain around 2.0mu, ticking up to 2.1mu (saar) last month—not far from the 1.4mu record low during the pandemic. Sales of imports are showing some signs of life, climbing to 3.3mu (saar) in September after falling from 3.8mu in January to 3.0mu in May.

Global Economic Indicators

Global Composite PMIs (*link*): Global demand contracted in September for the second month; however, the rate of decline eased slightly, with the report citing a marked easing in the downturn in the US and a return to growth in Japan. The C-PMI edged up to 49.7 after falling the prior two months from 53.5 in June to 49.3 in August—which was the first reading below the breakeven point of 50.0 since June 2020. The M-PMI dropped below the demarcation line between contraction and expansion for the first time since mid-2020 to 49.8 in September, continuing its steady downtrend since peaking at 56.0 last May. Meanwhile, the NM-PMI moved up to 50.0 last month after dipping below in August for the first time since June 2020. The report notes that C-PMIs showed downturns in the US (to 49.5 from 44.6), the UK (49.1 from 49.6), and the Eurozone (48.1 from 48.9)—with France (51.2 from 50.4) the only one among the Big Four Eurozone economies to show expansion. Meanwhile, activity expanded in Japan (51.0 from 49.4), Brazil (51.9 from 53.2), Russia (51.5 from 50.4), and Australia (50.9 from 50.2). By sector, growth was recorded in the consumer goods, business services, and financial services categories, while the consumer services, intermediate goods, and investment goods categories contracted. As for inflation, both input and output prices eased in September for the fifth month, with both price measures indicating their least notable increases in 18 months. That being said, both remained well above their long-run averages.

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