MORNING BRIEFING
October 12, 2022

The Most Widely Anticipated Recession In History

Check out the accompanying chart collection.

Executive Summary: Some areas of US economy are thriving while others flounder, and several looming challenges signal tough times ahead. JPMorgan Chase's CEO yesterday said a recession is coming. Our assessment is that a rolling recession is already here and should linger well into next year. … We're raising our Q3 forecast for real GDP and lowering our Q4 one. … Notably, small business owners remain depressed, with inflation topping their worry list even as they're forced to exacerbate it. … Also: Industry analysts have been continuing to lower their earnings sights; we may do the same for S&P 500 earnings this year and next depending on the strength of Q3 earnings results.

US Economy I: The Recession Is Coming! Debbie and I have said it before: "The next recession may be the most anticipated recession of all times." We have a reason to say it again: Jamie Dimon, the CEO of JPMorgan Chase yesterday said a recession is coming.

Dimon acknowledged that the US economy is "actually doing well," but he thinks it could be in a recession within six to nine months. Among Dimon's major concerns are inflation, interest rates, quantitative tightening, and Russia's war in Ukraine. "These are very, very serious things which I think are likely to push the US … in[to] some kind of recession," Dimon said. He added that Europe is already in a recession.

Those are all valid points. Here's our assessment of the economy's recession prospects:

(1) *Rolling recession adds up to growth recession.* We agree that the US economy is actually doing well even though we think it has been in a "rolling recession," hitting different industries at different times, since the start of this year. So rather than a hard landing, we think we are already experiencing a soft landing, a.k.a. a "growth recession."

The rolling recession is rolling through the single-family housing industry. It is rolling through the retailing industry that is scrambling to discount merchandise to clear unintended bloated inventories. It is rolling through the auto industry, which finally seems to have the parts needed to boost production; but the jump in interest rates is depressing the demand for auto loans and autos.

Dimon undoubtedly can see the weakness in both mortgage demand and auto loans. An index of mortgage applications for new purchases is down 37% y/y through the September 30 week to the lowest since October 2015 (*Fig. 1*). Single-family housing starts are down 23% since February through August (*Fig. 2*). September's auto sales were relatively weak at 13.7 million units (saar), down 10% from January's 15.2 million units, even though the auto industry's supply-chain problems are abating by most accounts (*Fig. 3*). The weakness in auto sales is occurring for domestic autos and light trucks as well as imports (*Fig. 4*).

Dimon undoubtedly also sees that demand for commercial and industrial (C&I) loans is booming. Indeed, total C&I loans rose 14.6% y/y through the September 28 week (*Fig. 5*). The sum of C&I loans and nonfinancial commercial paper is up $290 billion ytd through the end of September (*Fig. 6*). This series is highly correlated (not surprisingly) with the value of business inventories, which rose to a record high partly as a result of unintended accumulation and rapidly rising prices.

(2) *Our new growth recession forecast.* There was no growth in real GDP during the first half of this year, confirming the notion of a growth recession. Growth was actually down slightly during Q1 and Q2. So far, Q3's growth isn't following anyone's recessionary script.

The Atlanta Fed's *GDPNow* tracking model's latest estimate is that real GDP was up 2.9% (saar) during the quarter. We are raising our Q3 forecast for real GDP from 1.5% to 2.5% and lowering our Q4 one from 1.5% to 1.0%. We are lowering our 2023 GDP growth rate projection from 2.5% to 1.5% (*Fig. 7*). So we think that the growth recession could linger well into 2023.

(3) *Consumers are still consuming.* So far, consumers haven't read the recession memo. They are spending freely, according to MasterCard SpendingPulse, which found that retail sales grew by double digits, both online and offline, in September 2022. Excluding autos, off-line retail sales increased 11% y/y, and e-commerce sales rose 10.7% y/y. (The data are based on in-store and online retail sales across all forms of payment and are not adjusted for inflation.)

Not surprisingly, MasterCard's data show relative weakness in housing-related retail sales. Furniture & furnishings and hardware retailers had small gains of 1.4% and 1.7%, respectively.

On the other hand, "experiential" spending is strong. In September, spending at restaurants rose 10.9% y/y, and spending on airlines and lodging also experienced double-digit y/y growth of 56.4% and 38.1%. (See the October 7 CSA *article* titled "Mastercard: September U.S. retail sales sizzle.")

US Economy II: Small Business Owners Remain Depressed. Yesterday, the National Federation of Independent Business (NFIB) released its September survey of small business owners. They are about as depressed as they have ever been. That's not because their sales are terrible. Rather, they can't find enough workers to expand their businesses. So they've had to raise both the wages they pay and the prices they charge. However, September's survey suggested that inflationary pressures are moderating. Consider the following:

(1) *Depressed outlook.* The NFIB index of the outlook for general business fell to a record low of -61 during June (*Fig. 8*). It was back up to -44 during September, which was still well below the previous troughs in this series that started in 1974. Inflation is the number one problem faced by 30% of small business owners, according to the latest survey (*Fig. 9*). It peaked at 37% during July, but these readings are in line with similar ones during the Great Inflation of the 1970s.

(2) *Raising prices.* Small business owners are contributing to the inflationary pressures. The percentage of them raising prices in September was 51%, down from a recent peak of 66% (*Fig. 10*). Somewhat more encouraging is that the percentage planning to raise their prices fell from a recent peak of 54% during November to 31% in September.

(3) *Tight labor market.* In recent months, nearly 50% of small business owners said that they have job openings, holding near last September's and this May's record high of 51.0% going back to the start of the series in 1974. This series is highly inversely correlated with the unemployment rate (*Fig. 11*). On a three-month-average basis, 23% of them plan to raise worker compensation, down from a record high of 32% the last three months of 2021 (*Fig. 12*). That suggests that the y/y increases in both the Employment Cost Index and average hourly earnings may be peaking (*Fig. 13*).

Strategy: The Latest Earnings Season. We are still forecasting S&P 500 operating earnings per share of $215 this year and $235 next year. Given our new prolonged growth recession forecast, we most likely will lower those numbers by $5-$10 each. But first, we will wait to see how the current earnings reporting season, for Q3, unfolds. We aren't the only ones cutting earnings estimates. Consider the following:

(1) *Quarterly earnings.* Industry analysts collectively have continued to lower their earnings

estimates for the S&P 500 too. During the October 6 week, they shaved their earnings estimates for Q3 and Q4 this year and for every quarter of next year (*Fig. 14* and *Fig. 15*). Nevertheless, they are currently projecting that Q3 earnings will be up 2.9% y/y (*Fig. 16*). But that's down from their projected growth rate of 7.0% at the beginning of this year. They are currently estimating that Q4 earnings will be up 6.7% y/y, but that's down from 14.2% at the start of this year.

Here are the analysts' current consensus estimates for the quarterly y/y growth rates in 2023: Q1 (4.1%), Q2 (2.2), Q3 (9.2), and Q4 (9.2) (*Fig. 17*).

(2) *Annual earnings.* During the October 6 week, analysts were estimating the following annual earnings and growth rates: 2022 ($223.34, 7.1%), 2023 ($240.97, 7.9%), and 2024 ($260.52, 8.1%) (*Fig. 18*).

(3) *Forward revenues, earnings, and profit margin.* During the September 29 week, S&P 500 forward earnings rose to yet another record high (*Fig. 19*). However, forward earnings peaked at a record $239.93 during the June 23 week. It has been drifting lower, reaching $236.90 during the October 6 week, the lowest reading since August 11.

The forward profit margin peaked at a record 13.4% during the June 9 week. It was down to 13.0% during the September 29 week.

(4) *NERI.* The net earnings revision index of the S&P 500 was -9.7% during September, down from -9.0% in August and the worst reading since July 2020 (*Fig. 20*).

(5) *Q3 earnings season by sectors.* Here are the currently projected Q3 y/y earnings growth rates for the S&P 500 and its 11 sectors: Energy (121.0%), Industrials (26.3), Consumer Discretionary (13.5), Real Estate (11.0), S&P 500 (2.9), Materials (-2.1), Consumer Staples (-2.4), Information Technology (-3.5), Health Care (-4.2), Utilities (-7.4), Financials (-10.5), and Communication Services (-16.1).

Calendars

US: Wed: Headline & Core PPI 0.2%m/m/8.4%y/y/0.3%m/m/7.3%y/y; MBA Mortgage Applications; API Weekly Crude Oil Stock; FOMC Meeting Minutes; OPEC Monthly Report; EIA Short-Term Energy Outlook; WASDE Report; IMF Meetings; Barr; Bowman. **Thurs:**

Headline & Core CPI 0.2%m/m/8.1%y/y; 0.5%m/m/6.5%y/y; Initial & Continuous Claims 225k/1.365m; Federal Budget Balance; Natural Gas Storage; Crude Oil Inventories; IEA Monthly Report; IMF Meetings. (Bloomberg estimates)

Global: **Wed:** Eurozone Industrial Production 0.6%m/m/1.2%y/y; UK GDP 0.0%m/m/; UK Headline & Manufacturing Industrial Production -0.2%m/m/0.6%y/y & 0.2%m/m/0.8%y/y; UK Trade Balance – 20.4b; NIESR Monthly GDP Tracker; Japan PPI 0.2%m/m/8.8%y/y; BOE FPC Meeting Minutes; Lagarde; Mann; Pill; Haskel. **Thurs:** Germany CPI 1.9%m/m/10.0%y/y; China CPI 0.4%m/m/2.8%y/y; China Trade Balance ¥81.0 billion; China Exports & Imports 4.1%/1.0% y/y; BOE Credit Conditions Survey; Mann; Nagel. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q3 Earnings Season Monitor (*link*): The Q3-2022 earnings season is off to the poorest start of a quarterly reporting season since Q1-2020. With 4% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues have missed the consensus forecast by 0.2%, and earnings have fallen short by 3.4%. At the same point during the Q2 season, revenues were 1.4% above forecast and earnings had beaten estimates by 3.9%. For the 20 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 20 reporters so far collectively has a y/y revenue gain of 12.6%, but an earnings gain of only 5.8%. Just 50% 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 Q3 (65%) than positive y/y revenue growth (95%). 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

NFIB Small Business Optimism Index (*link*): “Inflation and worker shortages continue to be the hardest challenges facing small business owners,” said Bill Dunkelberg, NFIB chief economist. "Even with these challenges, owners are still seeking opportunities to grow their business in the current period." September's Small Business Optimism Index (SBOI) rose for the third successive month, climbing 0.3 points last month and 2.6 points over the period to 92.1—the ninth consecutive month below the 48-year average of 98. The SBOI didn't post an increase during the first six months of this year, sinking 9.4 points over the period to 89.5 in June—which was the lowest reading since January 2013. In September, five of the 10 components of the SBOI improved, while five deteriorated. The biggest positive contributor was sales expectations (+9 ppts to -10%), while the remaining four posted minor contributions: hirings (+2 to 23), earnings trends (+2 to -31%), expected credit conditions (+2 to -6), and now is a good time to expand (+1 to 6). Partially offsetting these gains were plans to increase inventories (-4 to 0), current job openings (-3 to 46), current inventory (-2 to 1), expect economy to improve (-2 to -44), and capital outlay plans (-1 to 24). Inflation continued to be small business owners' single biggest problem in September, ticking up from 29% to 30%, though the percentage is down 7ppts from July's peak of 37%. While inflation measures remained high, the percentage of owners raising selling prices eased to a net 51% last month, down from a near record high of 66% in March, while the percentage of owners planning to increase selling prices fell from a near record high of 52% in March to a 20-month low of 31% by September. Quality of labor remained business owners' second biggest problem, though it eased from a net 26% in August to 22% in September; it was at a record high of 29% last November.

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