MORNING BRIEFING
October 19, 2022

On Mid-Terms, Earnings & Commodities

Check out the accompanying chart collection.

Executive Summary: Octobers tend to turn out decent returns during mid-term election years. Twelve bear markets have met their demise during October, often setting the stage for Santa Claus rallies. … Q3 earnings season has stumbled out of the gate, but stocks have rallied anyway. We look at which sectors and industries benefited the most and where estimate-cutting industry analysts are cutting the most. … Also: Melissa discusses how recent news from China and Europe has been affecting commodities prices.

Strategy I: 'Bear Market Killer.' In a recent TD Ameritrade *interview*, Paul Schatz, the Chief Investment Officer of Heritage Capital, observed, "October is known as the 'bear killer', especially in 1974, 1990, 1998, and 2002. Mid-term [election] years usually see major bottoms in the fourth quarter. … Stocks will bottom and interest rates will peak long before the Federal Reserve finishes hiking."

A September 23 *post* on TheStreet reported, "According to the Stock Trader's Almanac … September is the worst month for stocks. … Since 1950, October has been the 7th worst month for returns. However, returns are substantially better than usual in mid-term election years, with the S&P 500 and NASDAQ returning 2.7% and 3.1% on average. Between 1999 and 2003, Octobers were big winners during the Internet bust when high-valuation stocks were similarly entrenched in a vicious bear market. The Stock Trader's Almanac writes that October 'turned the tide in 12 post-WWII bear markets: 1946, 1957, 1960, 1962, 1966, 1974, 1987, 1990, 1998, 2001, 2002, and 2011.'

"October also ends the Almanac's 'worst six months of the year,' setting the stage for historically stronger returns. According to the Almanac, November is NASDAQ's best month of the year during mid-term election years, returning 3.5% since 1971. Furthermore, the six months from November through April have generated an average return of 7.5% on the Dow Jones Industrial Average, versus a 0.8% average gain from May through October. Since many bear markets have coincidentally ended in October, it's called a 'bear killer.'"

Now consider our numbers:

(1) Joe observes that since 1928, the S&P 500 fell 1.1% on average during September, by

far the worst performance of any month. October, November, and December were up 0.5%, 0.6%, and 1.4% on average (*Fig. 1*). Yes, Virginia, there really is a Santa Claus rally. Apparently, it tends to be even more likely during mid-term election years.

(2) Joe observes that since 1942, during each of the 3-month, 6-month, and 12-month periods following each of the 20 mid-term elections the S&P 500 was up on average by 7.6%, 14.1%, and 14.9% (*Fig. 2* and *Fig. 3*). I asked him to double-check his numbers, and they checked out!

Strategy II: Earnings Season Has Started. Wouldn't you know it? Stock prices have rallied the past four days through Tuesday even though the Q3 earnings reporting season has started out poorly. Consider the following:

(1) Below, Joe reports that the Q3 earnings reporting season is off to the weakest start since Q1-2020. For the 45 companies that have reported Q3 earnings through mid-day Tuesday, the aggregate earnings growth rate dropped to -1.7% y/y.

Of course, this figure will change significantly as more Q3 results are reported in the coming weeks, particularly from nonfinancial firms with greater exposure to the strong dollar. 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.

(2) Nevertheless, investors mostly liked what they heard on the big banks' earnings calls, which have been leading the market higher since Thursday through Tuesday. The banks' net interest income levels have been boosted by jumps in their net interest margin and record loans on their balance sheets (*Fig. 4*, *Fig. 5*, and *Fig. 6*). Furthermore, they've been reporting that the economy in general and the consumer in particular both are in good shape. The big banks just started to increase their allowances for loan losses in early October (i.e., the start of Q4) but not by much (*Fig. 7*).

(3) Here's the performance derby of the S&P 500 and its 11 sectors over the past three trading days—i.e., Thursday's big reversal day move to the upside, Friday's downside move, and Monday's upside movie: Financials (4.9%), Communication Services (3.6), Information Technology (3.3), Health Care (3.2), Utilities (3.2), Real Estate (3.1), S&P 500 (2.8), Industrials (2.2), Materials (1.9), Energy (1.4), Consumer Discretionary (1.2), and Consumer Staples (0.9) (*Table 1*).

Of the top 10 S&P 500 industry performers, seven are in the S&P 500 Financials sector: Diversified Banks (10.7%), Asset Management & Custody Banks (5.8), Life & Health Insurance (5.0), Multi-Sector Holdings (4.9), Reinsurance (4.9), Regional Banks (4.8), and Multi-line Insurance (4.8).

Strategy III: Looking Forward. It's too early in the earnings season to see how Q3 results will impact industry analysts' expectations for the final quarter of this year and all four quarters of next year. Nevertheless, we know that analysts collectively continued to lower their expectations for Q3 and Q4 of this year and all four quarters of next year during the October 13 week (*Fig. 8* and *Fig. 9*).

Here are the analysts' consensus 2022, 2023, and 2024 earnings-per-share estimates for the S&P 500 companies collectively as of the October 13 week: $222, $239, and $259 (*Fig. 10*). The forward earnings we derive by time-weighting their consensus estimates for the current year and next one is down to $236 from a record high of $239.93 during the June 23 week. The comparable y/y growth rates are 9.0%, 7.0%, and 9.0% (*Fig. 11*).

By the way, for most of the S&P 500's sectors—all but Energy, Real Estate, and Utilities—industry analysts have been lowering their 2022 and 2023 earnings estimates (*Fig. 12*). Both years' revenues expectations have been cut recently for the Consumer Discretionary, Industrials, Information Technology, and Real Estate sectors (*Fig. 13*). The analysts' profit margin expectations (which we calculate from their revenue and earnings estimates) also have been cut for both years, especially for Communication Services, Consumer Discretionary, Consumer Staples, Health Care, Industrials, Information Technology, and even Utilities (*Fig. 14*).

Commodities I: Summits & the Pits. At his coronation this week as China's president-for-life, Xi Jinping declared that economic growth is no longer the number-one priority of the Chinese Communist Party. European Union (EU) leaders are holding a summit on Tuesday, as we write this, to discuss proposals for solving their energy crisis. Both events could have significant recessionary impacts on the global economy, especially commodity markets, if China and the EU fail to overcome the challenges their economies face. Consider the following:

(1) *China.* On Sunday, China's Communist Party Congress opened with a speech by President Xi on his vision for his country's economy, *covered* by CNN. Xi's continued dedication to the authoritarian zero-Covid movement, the country's attempts to deleverage itself with tight business regulations, and comments about the nation's future geopolitical

aims regarding Taiwan and the possibility of invasion all affect commodities markets.

Xi's commitments to authority, self-reliance, and security come at the expense of restoring China's flailing economy, where growth has stalled and the housing market is a mess. The International Monetary Fund has downgraded China's GDP growth outlook largely owing to the drag exerted by China's zero-Covid policy. China's economic slowdown is likely to further put the brakes on its raw materials boom.

The country has delayed the release of its Q3 GDP data, originally scheduled for Wednesday, until after the summit. Data on steel and energy output, property investment, and retail sales also were expected along with the release. No news is probably bad news, because usually good news isn't hidden.

(2) *Europe.* EU leaders are currently considering draft proposals for dealing with their energy crisis. The package of proposals *seen by* Reuters states that as a "last resort," the EU could set a temporary maximum price on a European gas trading benchmark. Most EU countries are looking for a gas price cap but disagree on how to implement one. Germany and the Netherlands say that a cap could leave struggling EU countries to obtain supply from global markets as a replacement for Russian fuel. In other words, a cap does not look likely for now.

Other measures in the EU's package are aimed at mitigating the impact of high prices on consumers and businesses. By January 31, "trading venues must impose upper and lower price limits each day that front-month energy derivatives must trade within, as a way of limiting large price swings. EU energy regulators would also be charged with developing a new liquefied natural gas price benchmark by the end of March, and Brussels will launch a 'tool' for EU countries to start jointly buying gas, according to the draft," Reuters wrote.

It seems that EU leaders aren't doing much to actually solve their energy crisis by producing more of it in their neighborhoods.

Commodities II: Jitters in the Pits. The global economic slowdown, led by China and Europe, is pushing the CRB Raw Industrials Spot Price Index lower. Its latest reading was 561.21 as of Monday, which was 18.5% below its record high on April 4 (*Fig. 15*).

If China's leaders somehow miraculously turn out a believable positive economic growth story, it's possible that commodities prices would react favorably. But we expect them mostly to remain in the pits. That is, except for gas prices that have been energized by the crisis in Europe. Here are some related recent developments:

(1) *Natural gas.* Russian President Vladimir Putin recently *warned* of a “terror” risk to global energy infrastructure in a thinly veiled direct threat to global energy markets. Russian supplies to Europe have been severely strained by suspiciously damaged energy pipeline infrastructure. Benchmark natural gas prices have slumped from a peak but remain elevated (*Fig. 16*).

(2) *Metals.* The London Metal Exchange recently *floated* with clients the prospect of banning deliveries of Russian metal. The Biden administration also is *considering* a possible prohibition on Russian aluminum imports. That could be a positive for US metals producers but could also strain global supplies, elevating prices.

But softening global demand due to the weakening global economy is pressuring metals prices downward. The metals component of the CRB Raw Industrials Spot Price Index dropped 34.0% from its recent record on April 4 (*Fig. 17*).

Steel and copper prices, known to be heavily under the influence of China demand, both recently have fallen (*Fig. 18*).

(3) *Soybeans.* Poor weather impacting yields and lessening demand from China could continue to pressure the market for soybeans (*Fig. 19*). China remains the largest purchaser of US soybeans despite import tariffs on American goods. But China forecasts that soybean imports will decline as it weans itself from dependence on other countries for this and other commodities.

“The China Soybean Industry Association (CSIA) predicted that soybean imports in October may fall to a two-year low of about 5 million tons as the nation aims to reduce reliance on imports to stabilize supplies and prices amid falling US soybean exports,” *according* to Nasdaq.

Calendars

US: Wed: Housing Starts & Building Permits 1.475mu/1.530mu; MBA Mortgage Applications; Cushing Crude Oil Inventories; Gasoline Production Beige Book; Bullard. **Thurs:** Leading Indicators -0.3%; Initial & Continuous Jobless Claims 230k/1.375m; Philadelphia Fed Manufacturing Index -5.0; Existing Home Sales 4.70mu; Natural Gas

Storage; Federal Budget Balance -$173.5b; Bowman; Cook; Jefferson. (Bloomberg estimates)

Global: Wed: Eurozone Headline & Core CPI 1.2%m/m/10.0%y/y & 1.0%m/m/4.8%y/y; UK Headline & Core CPI 0.4%m/m/10.0%y/y & 0.5%m/m/6.4%y/y; UK PPI Input & Output -0.4%m/m/18.8%y/y & 0.3%m/m/15.7%y/y; Canada CPI -0.1%mm/6.8%y/y; Japan Merchandise Trade – ¥2,167b; Australia Employment Change 25k; Australia Unemployment & Participation Rates 3.5%/66.6%; China PBoC Loan Prime Rate; Mann. **Thurs:** Germany PPI 1.3%m/m/44.7%y/y; France Business Survey 101; EU Leaders Summit; UK Gfk Consumer Confidence -52; Japan Core CPI 3.0%y/y. (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, assessed by the four surprise metrics we measure for both earnings and revenues. With 9% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 1.0%, and earnings have exceeded estimates by 4.7%. At the same point during the Q2 season, revenues were 1.2% above forecast and earnings had beaten estimates by 4.1%. Excluding Financials, Q3's revenue surprise falls sharply to 0.5% from 1.0%, and the earnings surprise tumbles to just 0.7% from 4.7%. For the 45 companies that have reported Q3 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed from their readings from Q2-2021 to Q2-2022. The small sample of 45 reporters so far collectively has a y/y revenue gain of 7.9%, but an earnings decline of 1.7%. Just 58% of the Q3 reporters so far has reported a positive revenue surprise, and 69% has beaten earnings forecasts. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q3 (56%) than positive y/y revenue growth (84%). These figures will change markedly as more Q3-2022 results are reported in the coming weeks, particularly from non-Financial firms with greater exposure to the strong dollar. 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

Industrial Production (*link*): Industrial output was a surprise on the upside, climbing to a new record high in September, while August's decline was slightly less negative. *Headline production* advanced during two of the last three months, up 0.4% m/m and 1.1% over the period, with August's shortfall revised to -0.1% (from -0.2%). Manufacturing output rose every month of Q3, climbing 0.4% in September and 1.5% over the period to its highest reading since summer 2008, after slumping 1.1% during the two months through June. *By market group:* Business equipment production rebounded 2.9% during the three months through September, more than recovering from its brief setback in May and July; in September, it rose 5.9% ytd and 8.2% y/y to its highest level since December 2018. Industrial equipment output slipped 0.3% last month, but that was after increasing eight of the prior 10 months, by 8.9%, to its highest level since the end of 2014. Production of information & processing related equipment jumped 3.1% during the two months through September a new record high. Transit equipment output headed higher after fluctuating in a volatile flat trend, jumping 5.2% during the three months through September to its highest level since December 2019. *Consumer durable goods* production headed back toward April's record high, rebounding 2.4% during the three months through September after falling 4.1% during the two months through June, as home electronics production hit yet another new record high and auto-related output remained near its record high. Production of appliances & furniture rebounded 7.2% during the two months through September, but that followed a three-month dive of 17.5%. *Consumer nondurable goods* production rose for the second time in three months in September, boosting it to within 0.2% of its recent high during April, which was the highest since fall 2011.

Capacity Utilization (*link*): The headline capacity utilization rate continues to hover in a flat trend around recent highs, ticking up to 80.3% last month from 80.1% in August, after climbing from 79.8% in June to 80.3% in July—averaging 79.9% ytd. September's rate was 0.7ppt above its long-run (1972-2021) average. The *manufacturing utilization rate* climbed for the third month, from 79.1% in June to 80.0% in September, back up at April's rate, which was the highest percentage since summer 2000. September's rate was 1.8ppts above its long-run average. Meanwhile, the *capacity utilization rate for mining* climbed from 88.4% in August to 88.8% in September—the highest since April 2019—putting it 2.5ppts above its long-run average. The *utilities rate* dropped for the second month, from 75.9% in July to a nine-month low of 72.8% in September, with the rate substantially below its long-run average.

NAHB Housing Market Index (*link*): "High mortgage rates approaching 7% have significantly weakened demand, particularly for first-time and first-generation prospective buyers," noted Jerry Konter, NAHB's chairman, adding "This situation is unhealthy and unsustainable. Policymakers must address this worsening housing affordability crisis." *Homebuilder's confidence* dropped for the 10th time this year, by 8 points in October and 46 points ytd, to 38—half the level of just six month ago and the lowest 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 October, with future sales (-11 points) posting the biggest decline this month, followed by current sales (-9) and traffic of prospective buyers (-6). *This year to date*, future sales (-50 points to 35) also posted the largest decline, followed by traffic of prospective buyers (-46 points to 25) and current sales (-45 to 45), with current sales and traffic of prospective buyers the lowest since May 2020 and future sales the lowest since mid-2012. They were at record highs of 89, 77, and 96, respectively, during November 2020.

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