MORNING BRIEFING
December 14, 2022

Disinflation?

Check out the accompanying chart collection.

Executive Summary: Inflation peaked in June and continued to moderate in November. The Santa Claus rally should continue unless the Fed's Grinches get in the way. …. Small business owners still facing labor shortages and raising wages and prices. …. S&P 500 forward revenues, earnings, and margins losing their mojo. And: What if home prices don't fall much?

Inflation: Peaked & Moderating. What a bummer! We obviously aren't referring to yesterday's better-than-expected November CPI report. Rather, our data vendor experienced a hack attack, so we couldn't sit back and enjoy flipping through our CPI chart books. We were hoping that Santa would deliver a happy holiday surprise, and he didn't let us down. So the Santa Claus rally is likely to continue through yearend. That's if Fed Chair Jerome Powell concedes that progress is being made on the inflation front at his press conference today. He needs to lighten up on his grinchiness.

The CPI rose 7.1% y/y in November, a slowdown from 7.7% the month before. Overall inflation has been decelerating on a y/y basis since hitting a peak around 9% in June. After stripping out food and fuel prices, which are volatile, the index climbed by 6%. The slowdown in inflation was driven by food, energy and used vehicles. Food price inflation slowed, but grocery bills remain historically high. Rents continued to rise rapidly in November.

The easing of inflation pressures boosted the purchasing power of workers' pay. Real average hourly earnings rose 0.5% for the month, though they were still down 1.9% from a year ago.

US Economy: Small Business Survey Still Troubling. The Fed can take some comfort from yesterday's CPI report. The same cannot be said for yesterday's November's National Federation of Independent Business (NFIB) survey of small business owners. They are reporting that their businesses are challenging and that they still face labor shortages, forcing them to raise their wages and prices. Consider the following:

(1) *Business*. There has been a modest rebound in the outlook for general business conditions reported by their "percent better minus worse over the next six months" rebounded from a record low of -61 during June of this year to -43 in November (*Fig. 1*). That's still below all of the troughs in this series since the start of the data in 1974!

(2) *Labor*. The percent of small business owners with job openings fell to 44% during November (*Fig. 2*). That's down from a record high of 51% during May of this year and September of last year. But it is still very high. This series closely tracks the job openings

series included in the JOLTS report. Fed officials have indicated that they would like to see fewer job openings to take the pressure off wages. Both series are heading in the right direction, but not fast enough. Indeed, a near record 28% of small business owners are planning to raise worker compensation (*Fig. 3*).

(3) *Prices*. There has been some declines this year in the percent of small business owners raising their average selling prices and the percent planning to raise average selling prices. However, both remain elevated with the former at 51% and the latter at 34% (*Fig. 4*).

Strategy: Steady Earnings, For Now. During the Q3 earnings season, industry analysts scrambled to lower their S&P 500 operating earnings per share estimates for Q4 and all four quarters of 2023 (*Fig. 5* and *Fig. 6*). They've stopped doing so over the past five weeks through the December 8 week as all five quarterly estimates have stabilized.

The same can be said for S&P 500 annual and forward earnings. For the past five weeks, the 2023 and 2024 estimates have been around $231 and $254, while the forward earnings has held steady around $230 (*Fig. 7*).

The dip in forward earnings is consistent with our soft-landing economic outlook (*Fig. 8*). That's assuming it remains a dip rather than the start of a recession-induced drop. That's our assumption, of course.

S&P 500 forward revenues peaked during the October 13 week (*Fig. 9*). The 2.1% dip in forward earnings since then through the December 1 week was almost all attributable to a drop in the forward profit margin from 12.9% to 12.7%.

Now let's drill down to the 11 sectors of the S&P 500:

(1) *Forward revenues*. Standing out are the S&P 500 forward revenues of the S&P 500 Consumer Staples, Financials, Health Care, and Utilities sectors (*Fig. 10*). All four rose to record highs during the December 1 week. It's hard to imagine a bad recession ahead when Financials are doing so well! The forward earnings of the other sectors have been mostly moving sideways at record highs in recent weeks including Communication Services, Consumer Discretionary, Energy, Industrials, Information Technology (a wee bit toppy), Materials, and Real Estate.

(2) *Forward earnings*. Among the S&P 500 sectors, the forward earnings of the following have been moving sideways at record highs since the summer: Consumer Staples, Energy, and Industrials (*Fig. 11*). Drifting lower since their summer record highs are the following: Communication Services, Consumer Discretionary, Health Care, Information Technology, Materials, and Real Estate. Financials and Utilities are the only sectors with forward earnings at a record high currently.

(3) *Forward profit margin*. Here are the 2020 lows in the forward profit margins of the sectors and their latest values as of the December 1 week (*Fig 12*): S&P 500 (10.3%, 12.7%), Communication Services (13.2, 14.2), Consumer Discretionary (4.7, 7.4), Consumer Staples (7.2, 7.1), Energy (0.2, 12.7), Financials (13.0, 18.1), Health Care (10.0, 10.1), Industrials (7.3, 10.1), Information Technology (21.6, 24.2), Materials (8.8, 11.5), Real Estate (12.4, 17.4), and Utilities (13.2, 13.7).

US Housing: Waiting for Affordability to Rebound. Lots of would-be-buyers have been priced out of the housing market. Buyers likely are walking away from the home buying process at least over the holidays and until they can get better fixed mortgage rates, or even lower prices. Home prices are falling but have remained elevated while mortgage interest rates have skyrocketed. Existing home sales and the Pending Home Sales Index both fell during October nearly to pandemic time lows (*Fig. 13*). These series dropped for the ninth consecutive month for the former and the 11th time in 12 months for the latter.

Affordability is a major challenge; the media has highlighted in recent weeks. For example, two recent articles in the *WSJ* were titled: "How Did the Housing Market Get So Unaffordable for So Many?" (see *link* dated December 12) and "Homelessness Worsens in Older Populations as Housing Costs Take Toll" (see *link* dated December 11). A recent CNBC *video* dated December 12 was titled: "Housing market 'extremely unaffordable' right now despite rates falling." Because what goes up must inevitably come down, does that mean that we are in for a housing bubble burst?

Melissa and I don't think so. Housing supply dynamics are supporting prices. Freddie Mac *estimated* that the US had a housing supply deficit of 3.8 million units, as of Q4-2020. And that gap preceded the pandemic, which only worsened it. Inventory is expected to remain tight because many homeowners are unwilling to trade up or trade down after locking in historically low mortgage rates in recent years. Because of low supply, housing prices are still expected to be up 9.6% for 2022 despite lower sales, followed by 0% in 2023 and 5.0% in 2024 (when sales are expected to pick up again), according to the National Association of Realtors' (NAR) latest *forecast* released yesterday afternoon.

It's notable, however, that these predictions may hold mostly for existing home prices, which compose the majority of the housing market. The supply of new homes is not as strained as for existing homes, but the lack of affordable inventory for new homes is a challenge for builders. They've been offering incentives like mortgage rate buy downs to sustain sales, but soon, they may be forced to lower prices. On the Toll Brothers December 9 earnings call, the CEO *said*: "We recognize that if market conditions do not improve, we will need to be more aggressive with price reductions to rebuild our backlog and turn our inventory."

Melissa and I also agree with many housing market analysts that this time is not like 2007. Last time, mortgage rates were on the way down when home prices dropped. The 2007-09 housing crisis instead was driven by poor lending standards, which led to lots of foreclosures. Now lending standards are much higher, and homeowners have a healthy amount of equity in their homes. Mortgage debt is lower now than it was then relative to home values and as a ratio of disposable personal income (*Fig. 14*)

The next big housing tipping point will come when the Baby Boomers finally downsize into more manageable spaces, or assisted living facilities. For now, the Boomers largely are aging in place. Whenever they do start to move in a big way, demand still will be supported by the next generations of homeowners, Millennials and Gen Zers, but likely, affordable housing will be most in demand.

Consider the following:

(1) *Single-family home prices fall, but don't drop*. Median existing single-family home price inflation had reached new heights at a rate near 20.0% during August 2021 on the basis of the yearly percent change in 12-month moving average. In October, the series fell to 12.5% (*Fig. 15*). But that's still near the previous peak during 2006 before home prices took a dive. For new homes, the equivalent series fell to 16.1% during October also having recently peaked near 20.0% during April of this year. But it too, remained high relative to prior peaks.

(2) *Mortgage rates take a breather, possibly from a peak*. Meanwhile, the 30-year fixed mortgage rate rose from 2.87% to 5.50% from last August through this August. The rate was above 7.0% this October, the highest in 20 years. It appears like the rate may have peaked, having moved down to 6.81% as of the latest data on December 9. Nevertheless, homebuyers and investors are waiting to see if the drop in mortgage rates persists as this sort of breather had happened recently over the summer.

(3) *Affordability is squeezing buyers, especially for new homes*. Despite home price trends moving downward, the NAR's housing affordability index sunk below the 100 mark during October (*Fig. 16*). New home prices have risen into new territory, almost touching $450,000 during October. Existing home prices too are in the upper $300,000s, flirting with $400,000. For a 30-year fixed mortgage, the monthly payment on a $400,000 home at a 6.0% interest rate would be around $2,300 not including taxes and interest. At a 3.0% rate, the payment obviously would be much more affordable for most Americans at $1,700.

(4) *Traffic & pending home sales plummet to recent lows*. Because of the affordability problem, traffic of prospective homebuyers sank nearly to 2020 lows during November, according to the National Association of Homebuilders (NAHB) Housing Market Index (*Fig. 17*). Pending home sales also dramatically fell in October, the latest month with available data, according to the National Association of Realtors (NAR) (*Fig. 18*).

(5) *Home supply slipping further & builders pulling back*. Supporting prices, however, the months' supply of existing homes on the market remained puny at 3.3 months during October 2022 (*Fig. 19*). Back in 2010, the supply was over 10 months.

Compared to existing homes, there is a notable divergence in the supply of new homes, which are up to around nine months from a pandemic low near three months (*Fig. 20*). However, the supply of new single-family homes could be poised to drop as builders pull back. Single-family housing starts and permits both dropped through October (*Fig. 21*). Even so, the market is much more heavily weighted toward existing homes, with 1.08 million single-family existing homes currently available for sale versus 470,000 new homes.

Calendars

US: Wed: Import & Export Prices -0.5%/-0.4%; Consumer Inflation Expectations; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Interest Rate Decision 4.50%; FOMC Economic Projections; IEA Monthly Report. **Thurs:** Retail Sales Total & Control Group -0.1%/0.2%; Headline & Manufacturing Industrial Production 0.1%/-0.1%; Capacity Utilization 79.8%; Business Inventories 0.4%; NY Empire State Manufacturing Index -1.00; Philadelphia Fed Manufacturing Index -10.0; Initial & Continuous Jobless Claims 230k/1.671m; TIC Net Long-Term Transactions; Natural Gas Storage.

(Bloomberg estimates)

Global: **Wed:** Eurozone Industrial Production -1.5%m/m/3.4%y/y; Spain CPI -0.1%m/m/6.8%y/y; UK Headline & Core CPI 0.6% m/m/10.9%y/y & 0.5%m/m/6.5%y/y; UK Input & Output CPI 0.2%m/m/18.0%y/y & 0.3%m/m/14.6%y/y; Australia Employment Change 19k; Australia Unemployment & Participation Rates 3.4%/66.6%; China Retail Sales -3.6% y//y; China Industrial Production 3.6% y/y; China Fixed Asset Investment 5.6% y/y; Japan Trade Balance; NBS Press Conference. **Thurs:** France CPI 0.4%m/m/6.2%y/y; France Business Survey 100; UK Gfk Consumer Confidence -43; ECB Interest Rate Decision & Deposit Facility Rate 2.50%/2.00%; BOE Rate Decision 3.50%; EU Leaders Summit. Lagarde; (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): As of Monday's close, the S&P 500 Value index was out of a correction at 6.4% below its record high while the S&P 500 Growth price index was still in a deep 27.3% bear market. Growth's underperformance relative to Value began on November 30, 2021 when its price index peaked at a record high. Since then, Value's price index has risen 1.4%, while Growth's is down 24.5%. Growth made a new low for the year on October 12, while Value remained above its September 30 bottom. At that October 12 low, Growth was down 20.1% from its recent high on August 15 to 32.8% below its December 27, 2021 record high. Value was down a lesser 14.6% on September 30 from its August 16 high to 19.2% below its January 12 record high. Looking at their ytd performance through Monday's close, Growth has tumbled 26.3% ytd, well behind the 5.1% decline for the S&P 500 Value index. Looking at the fundamentals, Growth is expected to deliver stronger revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Growth has 5.0% forecasted for STRG and 5.4% for STEG, while Value has forecasted STRG and STEG of 2.0% and 4.0%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and tumbled 40% to a 27-month low of 18.4 on June 16. After rebounding to 23.3 in mid-August, it tested the June with its 18.5 reading on October 12. It was back up to 21.0 on Monday. Value's forward P/E fell 24% from 17.6 in January 2021 to 13.4 on June 16. It made a new 30-month low of 13.0 on September 30, and has since risen to 15.2 as of Monday's close. Regarding NERI, Growth's and Value's were negative for a fifth straight month in November following 26 positive monthly readings. Growth's dropped to a 29-month low of -16.7% in November from -13.4% in October, and Value's was down to a 29-month low of -14.7% from -12.2%. Growth's forward profit margin of 17.6% is down 1.5ppts from its record high of 19.1% in mid-February and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 0.6ppt to 10.8% from its record high of 11.4% in December 2021.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Going into the holiday season, small business owners are seeing a slight ease in inflation pressures, but prices remain high," said NFIB Chief Economist Bill Dunkelberg. "The small business economy is recovering as owners manage an ongoing labor shortage, supply chain disruptions, and historic inflation." November's *Small Business Optimism Index (SBOI)* advanced 0.6 points to 91.9, after slipping from 92.1 to 91.3 in October, coming in below its 49-year average of 98.0 for the

11th consecutive month. The last time the index was at or above the average was last December (98.9). In November, six of the 10 components of the SBOI improved while four decline. *Positive contributions* were led by earnings trends (+8ppts to -22%) and sales expectations (+5 to -8), followed by expect economy to improve (+3 to -43), expected credit conditions (+2 to -6), capital outlay plans (+1 to 6), and now a good time to expand (+1 to 6). The biggest *negative contribution* was attributed to plans to increase inventories (-6 to -4), with the remaining three all posting 2ppt- declines: plans to increase employment (to 18%), current job openings (44), and current inventory (-2).). *Inflation* continued to be small business owners' single biggest problem in November, ticking down to 32%, after a rising from 29% in August to 33% by October; it's 5ppts below July's peak of 37% (which was the highest since Q4-1979). While inflation measures remained high, the percentage of owners raising selling prices increased a percentage point to 51% last month, a high reading though down from the near record high 66% in March. The percentage of owners planning to increase selling prices was at 34% for the second month, after easing from a near record high of 52% in March to a 20-month low of 31% in September. *Quality of labor* remained business owners' second biggest problem, at 21%, down from last November's record high of 29%. A net 40% of owners reported raising compensation last month, down from its 50% record high at the start of the year, while 28% plan to increase compensation in the next three months, down from October's 32%—which was a high for this year.

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