MORNING BRIEFING
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Earnings Bottoming?

Check out the accompanying chart collection.

Executive Summary: Might the worst be over for corporate earnings? The earnings recession in some industries likely continued during Q4, with economically sensitive ones the worst hit. But Q4 may mark the bottom for earnings growth, as we don't see a broad-based recession this year. … In yesterday's *Morning Briefing*, we likened Fed Chair Powell's bond-market conundrum to his predecessor Greenspan's. But does Powell have a lever to hike bond yields that Greenspan didn't? Perhaps, but pulling it is no option. … Consumers aren't tapped out yet: Their revolving debt as a percent of income is only around pre-pandemic levels. … And: The labor market remains unbalanced.

Earnings: Searching for a Bottom. Is the worst ahead for S&P 500 earnings during 2023? Or are we about to see the worst during the Q4-2022 earnings season that starts this week? Joe and I think that earnings will be up this year compared to last year because we are in the soft-landing camp. Lots of other strategists expect that earnings will be down this year mostly because they are expecting a recession in 2023. For many companies and industries, 2022 looked like a recession. So perhaps they've seen the worst of their downturns? Consider the following:

(1) *Revenues.* There certainly was no recession in the revenues per share of the S&P 500 companies last year. Revenues growth exceeded 10% y/y during the first three quarters of 2022 (*Fig. 1*). It was up 13.0% during Q3-2022. Inflation clearly boosted revenues growth. However, even on an inflation-adjusted basis, revenues rose 5.5% y/y during that quarter (*Fig. 2*, *Fig. 3*, and *Fig. 4*).

In current dollars, revenues per share rose to record or near-record highs for 10 of the S&P 500's 11 sectors—all but Communication Services (*Fig. 5*). Here are their y/y growth rates through Q3 and analysts' current consensus expectations for Q4:

S&P 500 (13.0%, 4.1%), Communication Services (4.0, 0.3), Consumer Discretionary (12.4, 8.0), Consumer Staples (8.5, 4.6), Energy (49.5, 12.9), Financials (12.0, 6.4), Health Care (7.9, 2.5), Industrials (17.8, 9.2), Information Technology (6.2, -0.8), Materials (9.0, -3.5), Real Estate (8.3, 6.9), and Utilities (22.0, -18.7).

(2) *Earnings.* S&P 500 operating earnings per share also got a boost from inflation last year, but it was held down by eroding profit margins. The index's y/y earnings growth rate peaked at 88.6% during Q2-2021 and fell to just 4.0% during Q3-2022 (*Fig. 6*).

The Energy sector more than offset the drop in S&P 500 earnings excluding this sector (*Fig. 7*). On a y/y basis through Q3-2022, here are the aggregate earnings growth rates of Energy (134.6%), S&P 500 (3.0%), and S&P 500 excluding Energy (-4.4%). Without Energy, the rest of the S&P 500 fell into an earnings recession during Q2 last year.

The earnings recession continued during Q4-2022, analysts' projections suggest, measured both with and without Energy. Here is what industry analysts are projecting for the y/y change in Q4-2022 earnings (on a per-share basis): Energy (64.7%), S&P 500 (-2.2%), and S&P 500 excluding Energy (-6.7%).

Here are the analysts' latest proforma y/y earnings growth rate estimates for the 11 sectors of the S&P 500 during the week of January 5 for Q4-2022 along with the actuals during the prior quarter: S&P 500 (-2.2%, 4.0%), Communication Services (-21.4, -24.4), Consumer Discretionary (-15.1, 5.5), Consumer Staples (-2.7, -0.2), Energy (64.7, 140.2), Financials (-8.7, -17.1), Health Care (-6.4, 0.4), Industrials (42.7, 18.8), Information Technology (-8.7, -2.1), Materials (-22.4, -10.1), Real Estate (6.9, 11.1), and Utilities (3.4, -5.4) (*Fig. 8*).

Notice that significant declines are expected for most of the economically sensitive sectors. The one surprising exception is Industrials because of the continued rebound in the Aerospace & Defense, Airlines, and Agricultural & Farm Machinery industries. Not surprising is the big increase estimated for Energy.

(3) *Economic correlations.* S&P 500 earnings growth is highly correlated with the national M-PMI (*Fig. 9*). The former peaked at the same time as the latter back in 2021. The M-PMI dropped from a high of 63.7 during March 2021 to 48.4 in December 2022, which is consistent with the small drop in earnings growth estimated by industry analysts.

The M-PMI is also highly correlated with our Net Earnings Revisions Index (NERI) (*Fig. 10*). NERI has been moving deeper into negative territory for the past six months through December. That's consistent with our view that the economy has been in a rolling recession since early last year in response to the tightening of monetary policy by the Fed.

There might be more minor downside in the M-PMI ahead, but we are expecting it to move back above 50.0 as the current year progresses.

The Fed: Tale of Two Conundrums. In yesterday's *Morning Briefing*, we wrote about the similarities between former Fed Chair Alan Greenspan's conundrum from 2004-07 and current Fed Chair Jerome Powell's conundrum in late 2022. Both were surprised that bond yields weren't rising along with the federal funds rate during those periods. They were frustrated that the bond market was easing financial conditions while they were trying to tighten them.

A couple of our accounts observed that there is at least one huge difference between those two conundrums. The Fed's holdings of securities were miniscule when Greenspan was in charge (*Fig. 11*). Under Powell, the Fed's portfolio of Treasuries and mortgage-backed securities ballooned to a record high of $8.5 trillion during the week of May 18, 2022. Implemented last summer, the Fed's QT2 program is on course to reduce that total by $2.8 trillion to $5.7 trillion by the end of 2024 (*Fig. 12*).

Our observant readers suggested an obvious solution to Powell's conundrum. If he prefers to see the 10-year Treasury yield at 4.50% rather than at 3.50%, all he must do is announce that the pace of QT2 will be increased. The Fed is currently sitting on $5.5 trillion of Treasuries and $2.6 trillion of mortgage-backed securities (*Fig. 13*). Almost all of the latter matures in over 10 years, while $1.5 trillion of the Treasuries are over 10 years (*Fig. 14*).

Dumping more of those long-term securities would solve Powell's conundrum immediately. In our opinion, it is very unlikely that the Fed will do that for fear of totally destabilizing financial markets—causing bond yields to soar, stock prices to crash, and the dollar to rebound.

US Consumer: Borrowing More. Are consumers almost tapped out of purchasing power? If so, then a consumer-led recession is likely sooner rather than later. That's not our forecast, but it is a widespread concern. Consider the following:

(1) *Excess saving.* During 2020 and 2021, consumers accumulated $2.5 trillion in excess saving. Before the pandemic, their personal saving totaled about $1.0 trillion on a 12-month moving-sum basis (*Fig. 15*). It jumped to $3.5 trillion over the 12 months through March 2021. It plunged to $0.7 trillion through November.

(2) *Credit cards.* Consumers probably have enough excess saving to boost their purchasing power through year-end. But lots of them are also charging more on their credit cards. Consumer credit rose by a record $350 billion over the 12 months through November, little changed from October's record $353 billion, with revolving credit up by a record $154.0

billion and nonrevolving credit (mostly student and auto loans) up by a near-record $195.5 billion (*Fig. 16*).

(3) *Relative to DPI.* Revolving credit outstanding totaled a record $1.2 trillion during November 2022 (*Fig. 17*). That was equivalent to 6.3% of disposable personal income, which was still below the pre-pandemic level of 6.5% (*Fig. 18*).

US Labor Market: JOLTS Still Out of Balance. According to the latest Job Openings & Labor Turnover Survey (JOLTS) *report*, the quits rate (i.e., the number of quits during the entire month as a percent of total employment) edged up again in November to 2.7% after trending down during the final two months of 2021 from a record high of 3.0% (*Fig. 19*). Quitters quitting at such rates shows not only widespread ability to get higher wages elsewhere but also widespread confidence about job market prospects.

Let's look at more insights gleaned from the November JOLTS report:

(1) *Hires trending down.* The hire rate (i.e., the number of hires during the entire month as a percent of total employment) fell in November to 3.9%, not posting a gain since its recent high of 4.5% during February. Likely that's not because of a lack of job openings but because of the continued labor shortage.

(2) *Plenty of jobs.* The job openings rate (i.e., the number of job openings on the last business day of the month as a percent of total employment plus job openings) continued to trend downward through November to 6.4% after hitting a record of 7.3% during March.

(3) *Layoffs very low.* Very few people are being laid off lately with employers in need of retaining what employees they do have, as the layoff rate during November was at a near-record low of just 0.9%.

(4) *Across all industries.* Here's a list of the job openings rate by industry during November: Leisure & Hospitality (8.7%), Professional & Business Services (8.3), Education & Health Services (7.8), Manufacturing (5.7), Transportation & Utilities (5.4), and Construction (4.8) (*Fig. 20*). None of the industry job openings rates have returned to pre-pandemic levels yet.

(5) *Leisure & Hospitality quitters.* Prior to the pandemic, at the start of 2020, the job openings rate for Leisure & Hospitality was just 5.3%; it then lurched to a record high of 11.7% during December 2021. It has come down some but remains well elevated relative to pre-pandemic times.

Leisure & Hospitality workers are the biggest quitters of all. That's the case both historically and recently, with a quits rate of 5.4% in November (*Fig. 21*). That's perhaps not surprising given that they deal with the public daily. But the gap between this industry's quit rate and the quit rate of all other industries has increased since the pandemic. Likely that reflects the added difficulties of serving the public while short-staffed.

By the way, the overall hires rate has been dragged down from pre-pandemic levels by two industries in particular: Leisure & Hospitality and Construction (*Fig. 22*). The job market story is different for these industries, however. In Leisure & Hospitality, the low hires rate reflects an imbalance of supply and demand for labor—i.e., employers would like to hire more than they can. Construction has both the lowest job openings rate (4.8%) and the lowest quits rate (1.8%) of all industries. Employers aren't hiring, and workers aren't leaving. That situation reflects the weak housing market.

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Headline & Core CPI 0.1%m/m/6.5%y/y & 0.3%m/m/5.7%y/y; Initial & Continuous Jobless Claims 215k/1.705m; Federal Budget Balance -$70.0b; Natural Gas Storage; WASDE Report; Harker. (Bloomberg estimates)

Global: Wed: Spain Industrial Production; Italy Retail Sales; Japan Leading & Coincident Indicators; China CPI -0.1%m/m/1.8%y/y; China PPI -0.1%; Australia Trade Balance $10.8b. **Thurs:** Germany Current Account Balance; China Trade Balance ¥76.2b; ECB Economic Bulletin; Mann (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): As of Monday's close, the S&P 500 Value index has soared 16.2% from its September 30 low and is out of a correction at 6.1% below its January 12, 2022 record high. The S&P 500 Growth price index is up just 2.6% from its October 12 low and remains in a deep bear market, down 31.0% from its December 27, 2021 record high. Growth's underperformance relative to Value began on November 30, 2021 when their relative price index peaked at a record high. Since then, Value's price index has risen 1.8%, while Growth's is down 28.4%. Looking at their ytd performance through Monday's close, Growth is unchanged and behind the 2.6% gain for the S&P 500 Value index. Looking at the fundamentals, Growth is expected to deliver slower revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Growth has 2.0% forecasted for STRG and 1.1% for STEG, while Value has forecasted STRG and STEG of 3.1% and 7.0%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021 before tumbling 42% to a 33-month low of 17.6 last Thursday. It was back up to 18.0 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 since has risen to 16.3 as of Monday's close. Regarding NERI, Growth's and Value's were negative for a sixth straight month in December following 26 positive monthly readings. Growth's improved m/m for the first time in nine months to -16.5% from a 29-month low of -16.7% in November. Value's NERI edged down to a 30-month low of -14.8% from -14.7%. Growth's forward profit margin of 16.1% is down 3.0ppts 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 1.0ppt to 10.4% from its record high of 11.4% in December 2021.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Overall, small business owners are not optimistic about 2023 as sales and business conditions are expected to deteriorate," said NFIB Chief Economist Bill Dunkelberg. "Owners are managing several economic uncertainties and persistent inflation and they continue to make business and operational changes to compensate." December's S*mall Business Optimism Index* (SBOI) fell 2.1 points last month to a six-month low of 89.8, after ticking up from 91.3 to 91.9 in November—coming in below its 49-year average of 98.0 for the 12th consecutive month. The last time the index was at or above the average was December 2021 (98.9). In December, of the 10 components of the SBOI, only current inventory (+3 ppts to a net 1%) was in the plus column, while plans to increase inventories was unchanged at a net -4%, with the remaining components all in the red. Expect the economy to improve (-8ppts to -51%) and earnings trends (-8 to -30) were the biggest drags on the index, followed by current job openings (-3 to 41), expected credit conditions (-3 to -9), and sales expectations (-2 to -10). The remaining three components all were down a net 1%: plans to increase employment (to 17), capital outlay plans (23), and now is a good time to expand (5). *Inflation* continued to be small business owners' single biggest problem in December, holding at 32%, after 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 sank from 51% to a 19-month low of a net 43% last month, down from the near-record-high 66% in March. The percentage of owners planning to increase selling prices dropped 10ppts to a net 24%—its lowest since percentage since December 2020; it was at a near record high of 52% in March. *Quality of labor* remained business owners' second biggest problem, at 23%, up from November's 21% but down from November 2021's record high of 29%. A net 44% of owners reported raising compensation last month, up from 40% in November but below its 50% record high at the start of 2022, while a net 27% plans to increase compensation in the next three months, down from October's 32%—which was a high for 2022.

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