MORNING BRIEFING
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On US Earnings & India's Economy

Check out the accompanying chart collection.

Executive Summary: This earnings season stands out from most, and not in a good way: Hearing managements discuss their companies' Q4 results on conference calls has sent analysts back to their spreadsheets. Consensus earnings estimates for all four quarters of this year have been falling. … Looking at valuations in the context of falling estimates suggests that the S&P 500 isn't cheap after its runup since October. SMidCaps and overseas stocks are cheaper. ... Also: India aims to usurp China as the go-to nation for outsourcing, hoping to shed its "developing" status and become a global trade leader. But first, it may need to clean up its act.

Weekly Webcast. If you missed yesterday's live webcast, you can view a replay *here*.

Strategy I: Earnings Hooks & Upticks. The Q4 earnings season is almost over now that retailers are reporting their results. Since the first week of January through the February 16 week, the S&P 500's Q4 earnings forecast fell 0.5% from what was expected by industry analysts to what was reported (*Fig. 1*). Often when the economy has been growing in the past, the charted data series showed "earnings hooks," as the actual results turned out to be better than the expected ones. That did not happen during the latest earnings season.

The forward guidance that managements provided to industry analysts during companies' latest earnings reporting conference calls was negative on balance. We can see that from the steady declines in consensus earnings estimates for each of the four quarters of this year that occurred during the latest earnings season (*Fig. 2*). The only sign of life was the small upticks during the latest week for the Q3 and Q4 estimates.

The annual consensus S&P 500 operating earnings-per-share estimates for 2023 and 2024 stopped falling during the February 16 week at $222.85 and $249.42 (*Fig. 3*). Earnings per share was $218.16 in 2022. So the expected 2023 and 2024 growth rates are now 0.3% and 11.8% (*Fig. 4*). These expectations for earnings are consistent with the scenario for the economy that we most expect, involving a soft landing this year and a recovery next year.

Strategy II: Thinking Forward. S&P 500 forward earnings edged up to $226.43 during the February 16 week. This is the time-weighted average of analysts' consensus expectations for 2023 and 2024 earnings. The time weighting is such that the series gradually converges toward the 2024 estimate throughout this year, and by year-end it is identical to the 2024 estimate. The stock market discounts forward earnings, in our opinion. The recent 16.8% rally in the S&P 500 from the October 12 low (3577.03) through the February 2 high (4179.76) seemed to reflect investors' focus leaping over all the concerns about the economy and earnings this year to the bullish expectations for next year. Consider the following:

(1) *Forward fundamentals.* S&P 500 forward revenues remains close to a record high as of the February 16 week (*Fig. 5*). During that same week, forward earnings edged up from the lowest reading since the January 27, 2022 week. It is down 5.7% from its record high during the June 16 week of 2022. As a result, the forward profit margin has dropped from a record high of 13.4% during the June 9 week of 2022 to 12.4% during the February 16 week.

(2) *Forward valuation.* During the rally since October 12, 2022, the S&P 500's forward P/E and forward P/S (price-to-sales) ratios rose. The forward P/E was at 18.5 as of February 17 (*Fig. 6*). Excluding the MegaCap-8 stocks (with a collective forward P/E of 25.8), the forward P/E was 17.0. The forward P/S was up to 2.3 as of February 17 (*Fig. 7*). It was 2.0 excluding the MegaCap-8 (with a forward P/S of 4.6).

At such valuations, stocks aren't cheap unless investors are willing to fully discount analysts' consensus expected 2024 earnings per share of $249. Even so, that would put the S&P 500 forward P/E at 16.8 (based on the recent high of 4179).

Current forward valuation multiples are more attractive for S&P 400 MidCaps (14.4) and S&P 600 SmallCaps (14.0) (*Fig. 8*). S&P 500 Value had been a good value at 13.0 on September 30, 2022. But the index was rebalanced to include some share of the MegaCap-8 at the end of last year and now trades around 16.9 (*Fig. 9*). On a relative valuation basis, the MSCI All Country World (currently at 12.8) looks especially cheap.

India I: Growth Story. India's economy is poised to outpace most other major world economies over the next decade. It's been "remarkably resilient to the deteriorating external environment," according to the World Bank. Indeed, India's investment story is gaining appeal for geopolitical reasons: Many Western companies are starting to regard the friendly democracy as an outsourcing alternative to China. That's a narrative India promotes, as it's positioning itself to become the premier bridge between the East and West. The nation sent so many emissaries to the 2023 World Economic Forum, CNN *reported*, that one investor described the main road leading to Davos as "Little India."

However, India’s growth story is not perfect. The nation continues to face high unemployment and inflation despite its impressive post-pandemic growth recovery. India’s growth story has been described as “K shaped,” with legs going both up and down, because small businesses are struggling while large prosperous companies drive domestic growth. Additionally, income inequality is worsening, and the increasing concentration of wealth and power at the top has fostered cronyism and corruption.

But global investors have been attracted to India’s size, young and growing population, and democratic political system. Last quarter, India’s Sensex index traded at the highest in a decade versus the S&P 500. Indian MSCI equities have soared since hitting a pandemic low during 2020 and are now trading at historically elevated multiples (*Fig. 10*).

Here’s more on economic conditions in India:

(1) *Outperforming output.* “India is expected to be the world’s fastest growing major economy [in 2023],” predicts the World Bank (see *Global Economic Prospects* Table 1.1). India’s real GDP growth is projected at 6.6% next fiscal year (ending March 31, 2024) compared to 0.5% for the US and 4.3% for China—but that’s a slowdown for India from the 6.9% projected this fiscal year and 8.7% last year. For the latest quarter of available data, India’s real GDP grew 6.7% y/y, outpacing the US (1.0%), China (2.9%), and Japan (0.6%) (*Fig. 11*). As a recent government *survey* put it, the Indian economy “has nearly recouped what was lost, renewed what had paused, and re-energized what had slowed during the pandemic and since the conflict in Europe.”

Looking ahead, Bloomberg Economics sees India’s GDP growth peaking at 8.5% in the next decade. At the current trajectory, India could become the world’s third-largest economy (with GDP of $10 trillion) by 2035, up from fifth largest ($3.5 trillion) currently, *according* to the Centre for Economics and Business Research.

(2) *Populating working age.* India’s population growth is *expected* to surpass China’s this year. Currently, over 900 million Indian people are of working age, a cohort that could reach more than 1 billion over the next decade (*Fig. 12*). India’s workforce is known to be entrepreneurial, digitally literate, and English speaking.

Unlike other Indian economic indicators, which are healthy, unemployment is elevated. Nearly 37 million workers looked for work in December, the most since June 2021 at the height of the pandemic, *reported* Reuters. Urban unemployment hit 10.1% in December (*Fig. 13*). That’s up from 6.0%-7.0% before the Covid lockdowns.

Part of the problem is a skills mismatch: Much of India's young workforce is highly educated and looking for white-collar jobs, while the growing manufacturing sector is looking for low-skilled workers. Small businesses, which employ the majority of workers, were battered during the pandemic, as a 2020 *NYT* article discussed.

(3) *Banking on inflation.* Like other central banks around the world, the Reserve Bank of India (RBI) reversed its pandemic-induced ultra-loose monetary policy when Russia's war on Ukraine worsened inflationary pressures. More recently, the bank has indicated that borrowing costs are likely to remain higher for longer.

On February 8, India's central bank raised its policy rate by 25 basis points to 6.50% (*Fig. 14*). It was the sixth and smallest increase since May 2022, when the rate stood at 4.0%, *observed* Barron's. The bank's governor Shaktikanta Das kept the door open for further tightening, saying in a webcast that while consumer inflation declined in November and December 2022, core inflation "remains sticky."

India's consumer inflation rate hit 6.5% during January (*Fig. 15*). A recent government survey said it's projected to reach 6.8% this fiscal year and said that level is neither so high that it would deter consumption nor so low that it would weaken investment, even though it's above the central bank's 2.0%-6.0% target range.

(4) *Optimistic consumers.* Despite current inflationary pressures, consumer optimism over India's economic situation, employment, and income for the next year has improved sharply, the RBI's consumer confidence survey has shown (*Fig. 16*). Future expectations hit a two-year high in January, and the current situation index also increased. Around 83% of survey respondents expects inflation to moderate over the next year, while more than half expects improvement in the general economic situation and employment conditions.

(5) *Battling inequality.* Many consumers are optimistic, but surely not all. "If we do not take care of inequality, we can't get very far with growth," said former RBI governor Duvvuri Subbarao in January, *according* to Bloomberg.

Since 1995, India's wealth gap between the top 1% and bottom 50% has increased about three times more than the equivalent metric for the US. As of fiscal 2022/23, the wealth of India's billionaires accounted for nearly 30% of GDP, *wrote* *Fortune India*. However, while inequality has increased along with India's growth over the past several decades, the poverty level has decreased.

(6) *Capitalizing cronies.* Still, the concentration of wealth has fostered corruption in the nation. The allegations against the powerful and well connected Adani Group *reported* by the *National Review* are a prime example. Whether they're true or not, the story highlights how a businessperson's close relationship with India's Prime Minister could make it easier to cross ethical lines and get away with it.

India II: Modi's Moment. In an August speech, Prime Minister Narendra Modi told his nation to settle for nothing less than to "dominate the world," reported the January 22 Bloomberg article linked above. Once dubbed "Ronald Reagan on a white horse," Modi's goal for India is to achieve developed nation status within the next 25 years. He is planning reforms with an eye toward promoting India's economic growth and geopolitical position.

Modi's united majority party has a better chance of leading India to growth than any prior government over the past three decades—all of which had coalitions of disparate political parties—*according* to *Reform Nation* author Gautam Chikermane. "The conviction of Narendra Modi is fast trickling down to governments and business," he said in the book.

Consider the following:

(1) *Made in India.* Modi's government has *succeeded* at implementing infrastructure projects on scale and at speed. Nearly 20% of the country's budget this year is directed at capital investments, the most in a decade, wrote Bloomberg in the January 22 article linked above.

Modi's "Made in India" campaign aims for manufacturing to contribute 25% of domestic GDP. The ratio rose to 17.4% in 2020 from 15.3% in 2000, according to McKinsey data, reported Bloomberg.

Over the next few years, the government is providing more than $24 billion in incentives in more than a dozen industries to compete with China. Some will support the production of mobile phones, semiconductors, and solar panels. "In the coming decade, manufacturing productivity has the potential to rise by about 7.5 percent per year, contributing to more than one-fifth of the incremental GDP in our estimates," McKinsey wrote in a comprehensive 2020 *report*.

(2) *Seven Indian priorities.* Earlier this month, Finance Minister Nirmala Sitharaman underscored the government's seven highest priorities in fiscal 2023/24: inclusive development, reaching the last mile, infrastructure and investments, unleashing potential,

green growth, youth power, and the financial sector, *according* to *The Financial Express*. The public-sector investments are anticipated to have an output-multiplier effect. New tax regimes proposed should leave more disposable income in the hands of the people.

(3) *Sustainable green sweep.* At the forefront of India's capital investments are green technologies. Pollution is a major problem in India's urban areas, and the government wants to make Indian cities more sustainable.

India has committed to reach net-zero emissions by 2070, with renewables accounting for 50% of the country's energy by 2030, reported CNN in the article linked above. Soon, the government's incentive program will be extended to manufacturers of electrolyzers and other equipment needed to make green hydrogen.

(By the way, the *National Review* article linked above observes that Adani Group energy corporations stand to benefit from Modi's green-energy pledges.)

(4) *Biden Boom coming.* Earlier this month, US Commerce Secretary Gina Raimondo *told* CNBC that the US is looking to collaborate with India on manufacturing jobs to boost competition against China. Raimondo will visit India in March with US CEOs to discuss an alliance on manufacturing semiconductor chips. Biden's August CHIPS and Science Act supplies $52 billion for US companies to invest in chip manufacturing.

The constructive business investment sentiment between the two countries is mutual. Air India recently *signed* a mega-deal to purchase 200 American-made aircraft from Boeing. Upon announcing the deal, Biden affirmed that he was looking forward to deepening US ties with India and with Modi.

(5) *Culture of corruption will no longer do.* In return for inclusion in a 13-country Indo-Pacific framework, the US wants India to promise to abide by certain labor, environmental, anti-corruption, and rule-of-law standards. That's necessary to unlock US business and capital flowing to India. So India will need to break with its past—when nepotism and cronyism at the top of government flourished—and check corruption at the door if it aspires to become a global market leader.

Calendars

US: **Wed:** MBA Mortgage Applications; API Weekly Crude Oil Inventories; FOMC Meeting

Minutes; Williams. **Thurs:** Real GDP & Price Index 2.9%/3.5%; Core PCE Prices 3.9%; Corporate Profits Initial & Continuous Jobless Claims 200k/1.70m; Kansas City Manufacturing Index; Chicago Fed National Activity Index; Natural Gas Storage; Bostic. (Bloomberg estimates)

Global: **Wed:** Eurozone CPI; Germany Ifo Business Climate Index, Current Conditions & Expectations 91.4/95.0/88.3; Germany CPI 1.0%m/m/8.7%y/y; Italy CPI 0.3%m/m/11.6%y/y; ECB Non-Monetary Policy Meeting. **Thurs:** Eurozone Headline & Core CPI -0.2%m/m/8.6%y/y & -0.8%m/m/5.2%y/y; UK Gfk Consumer Confidence -42; Japan National Core CPI 4.2% y/y; Nagel; Buck; Bullock; Mann; Cunliffe. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for the first time in six weeks for LargeCap and MidCap, but SmallCap's fell after rising a week earlier for the first time in five weeks. Through the week ending February 16, LargeCap's forward earnings rose 0.2% w/w from a 54-week low, but is down in 14 of the past 20 weeks. MidCap's rose 0.3% from a 51-week low, but has dropped in 19 of the past 22 weeks. SmallCap's dropped 0.8% w/w to a 67-week low and is down in 17 of the past 20 weeks. For a 34th straight week, none of these three indexes had forward earnings at a record high. However, forward earnings remains on a modest downtrend for these three indexes compared to their deep declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is 5.6% below its record high at the end of June; MidCap's is 7.7% below its record high in early June; and SmallCap's is 10.4% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a second straight week, falling to a 24-month low of -0.8% y/y; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of 0.9% y/y is at a 25-month low, down from a record high of 78.8% in May 2021, and compares to a record low of -32.7% in May 2020. SmallCap's rate of -2.9% y/y is at a 27-month low, down from a record high of 124.2% in June 2021. It had been at a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 have been heading lower since June. Here are the latest consensus earnings growth rates for 2022, 2023, and 2024: LargeCap (4.8%, 2.1%, and 11.9%), MidCap (16.0, -7.1, 11.8), and SmallCap (6.4, -0.5, 15.8).

S&P 500/400/600 Valuation (*link*): Valuations were mixed w/w for these three indexes through the February 17 week, but remain below their multi-month highs from the beginning of February. LargeCap's forward P/E edged down 0.1pt w/w to 18.0 and is down from a nine-month high of 18.2 the week before that. It's up 2.9pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.1pt to 14.4, and is just 0.3pt below its recent 10-month high of 14.7. That's up 2.8pts from a 30-month low of 11.1 at the end of September and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.3pt w/w to 14.0, just below its recent 12-month high of 14.3. That's 3.4pts above its 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's P/E relative to LargeCap's has improved from a 23-year-low 28% discount last July to a 20% discount, which is near its best reading in 15 months. SmallCap's discount has improved from a 21-year low of 32% last April to 22% last week; that's near its lowest discount in 18 months. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for an 88th straight week; the current 3% discount is near its lowest in five months and an improvement from its 20-year low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. Analysts expect the S&P 500's earnings growth rate to weaken q/q in Q4 to -0.9% y/y from 4.0% in Q3 on a frozen actual basis and to -2.8% from 4.4% on a pro forma basis. Just four sectors are expected to record positive y/y percentage earnings growth in Q1-2023, up from three sectors doing so in Q4-2022. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2023 versus their blended Q4-2022 growth rates: Consumer Discretionary (31.8% in Q1-2023 versus -16.9% in Q4-2022), Energy (19.1, 59.3), Industrials (18.3, 42.0), Financials (5.3, -10.3), Consumer Staples (-3.3, -1.9), Real Estate (-6.0, 7.6), Utilities (-8.6, -6.4), Information Technology (-11.5, -8.8), Communication Services (-12.2, -25.6), Health Care (-17.8, -2.5), and Materials (-30.9, -18.8).

S&P 500 Q4 Earnings Season Monitor (*link*): With the Q4-2022 earnings season now over 80% complete, it's now clear that this season is a relatively poor one as assessed by the four surprise metrics we measure for both earnings and revenues. Revenue and earnings surprises are deteriorating q/q due to the slowing economy, higher costs, and currency translation. With 83% of S&P 500 companies finished reporting for Q4, revenues are ahead of the consensus forecast by just 1.7%, and earnings have exceeded estimates by only 1.7%. The surprises are tracking to be the weakest since Q4-2008 for earnings and since Q1-2020 for revenues. At the same point during the Q3 season, revenues were 2.2% above forecast and earnings had beaten estimates by 3.8%. For the 415 companies that have reported Q4 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings of Q2-2021 to Q3-2022. The collective y/y revenue gain for the 415 reporters so far has slowed from double-digit percentage gains in the prior seven quarters to 5.8%, and earnings are down 0.7% y/y as higher costs and increased loan-loss provisions continue to pressure profit margins. Just 68% of the Q4 reporters so far has reported a positive revenue surprise, and a similar 68% has beaten earnings forecasts. Those are the weakest readings since the Great Virus Crisis in H1-2020. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q4 (61%) than positive y/y revenue growth (73%). These figures will change less markedly as more Q4-2022 results are reported in the coming weeks, but signals from the early retail reporters are disappointing too. While we expect y/y revenue growth rates to remain positive in Q4, earnings are expected to decline for the first time since Q2-2020.

Global Economic Indicators

US PMI Flash Estimates (*link*): The US private sector gained momentum in February, according to flash estimates, moving above the breakeven point of 50.0 for the first time since mid-2022, led by a pickup in the service economy. Meanwhile, price measures were a mixed bag. The *C-PMI* increased the first two months of this year, climbing to an eight-month high of 50.2 in February after falling in eight of the prior nine months, from 57.7 last March to 45.0 by December. The *NM-PMI* advanced for the second month, from 44.7 at the end of last year to 50.5 this month, while the *M-PMI* rose from 46.2 to 47.8 over the two-month period, though remained in contractionary territory for the fourth successive month. Turning to *prices*, input price inflation was the second slowest since October 2020 this month as both the manufacturing and service sectors saw an easing, while selling prices accelerated at the fastest pace since last October, with both the manufacturing and service sectors contributing to the pickup.

Eurozone PMI Flash Estimates (*link*): Economic activity in the Eurozone was the strongest in nine months this month, as the service sector expanded at a faster rate, while the manufacturing sector continued to contract—though manufacturing output (to 50.4 from 48.9) returned to growth, posting its best performance in nine months. The Eurozone's *C-*

PMI rose for the fourth month, to 52.3, after falling steadily from 55.8 last April to a 23-month low of 47.3 by October. The *M-PMI* slipped to 48.5 this month after advancing the prior three months, from 46.4 to 48.8, while the *NM-PMI* increased for the third month from 48.5 to an eight-month high of 53.0 over the period. Looking at the two largest Eurozone economies, *Germany's C-PMI* moved into expansionary territory for the first time since mid-2022, climbing for the fourth month from 45.1 in October to 51.1 this month. *Germany's NM-PMI* moved further into expansionary territory, climbing four of the past five months from 45.0 in September to 51.3 this month, while the *M-PMI* fell to 46.5 after increasing from 45.1 in October to 47.3 in January. Meanwhile, *France's C-PMI* advanced to a seven-month high of 51.6 this month, after sliding eight of the previous nine months from 57.6 last April to 49.1 by this January. *France's NM-PMI* moved back above the breakeven point of 50.0, climbing to a five-month high of 52.8 this month, after declining from 58.9 last April to 49.4 this January. Meanwhile, *France's M-PMI* slipped back into contractionary territory, falling 2.5 points to 47.9 this month, after rising the prior three months, from 47.2 in October to 50.5 in January. *Elsewhere across the region*, activity expanded at a nine-month high, rising to 53.9 this month—with both the manufacturing and services sector contributing to the acceleration. Looking at inflation for the entire Eurozone, *input cost inflation* cooled further this month, particularly in the manufacturing sector, while rates of *selling price inflation* remained stubbornly high, especially in the service sector, reflecting higher wage costs, though the overall rate of selling price inflation slowed to a 16-month low.

Japan PMI Flash Estimates (*link*): "Stronger service sector growth contrasts with deeper manufacturing downturn" was the headline of this month's survey. Japan's *C-PMI* remained at 50.7 this month from 49.7 at the end of 2022—with the measure bouncing around the demarcation line between expansion and contraction most of last year. The *NM-PMI* climbed for the fifth time in six months, from 49.5 last August to an eight-month high of 53.6 this month, as service providers posted sharper rises in activity and new business as the latest wave of Covid 19 faded, boosting demand. Meanwhile, February's *M-PMI* remained in a freefall, plummeting from 55.4 at the start of last year to 30-month low of 47.4 this month. *Inflationary pressures* remained stubbornly high this month, with input prices accelerating at the fastest pace since last October, while output prices rose at a sharper pace than in January. The survey notes that companies hope to see a meaningful slowing in price pressures in coming months.

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