MORNING BRIEFING
March 7, 2023

Selected Sectors Short Studies

Check out the accompanying chart collection.

Executive Summary: Our base-case economic outlook is upbeat. Stock investors likewise seem optimistic about the economy given which S&P 500 sectors have led the index's advance since October. We recommend overweighting five S&P 500 sectors this year: Energy, Financials, Industrials, Information Technology, and Materials. … Also: We zero in on the themes and data supporting two of these recommendations, Information Technology, which stands to benefit from companies spending on productivity-enhancing technologies in this tight labor market, and Industrials, which should benefit from strong spending on infrastructure construction, manufacturing capacity, and industrial machinery in a growing economy.

S&P 500 Sectors I: Leaders & Laggards. Joe and I believe that the latest bear market in stocks ended on October 12, 2022. We don't expect the bear to make a comeback this year. We will be wrong about that if the economic releases in coming months support either the inflationary no-landing scenario or the hard-landing one, both of which are bearish. We will be right if the data support the soft-landing scenario or disinflationary no-landing scenario, both bullish. We are still assigning a 40% subjective probability to a soft landing and 20% each to the three alternatives.

The S&P 500 is up 13.1% since October 12, 2022 through Friday's close, when it bounced off its 200-day moving average (dma) and closed above its 50-dma (*Fig. 1*). On Monday, it edged up 0.1%. Could this be the third major bear-market rally rather than the start of a new bull market? Could it be just another unsustainable short-covering rally? It could be. However, in our opinion, the S&P 500 sectors leading the latest advance are signaling that investors may be correctly turning more optimistic about the fundamental outlook for the US and global economies.

Here is the performance derby of the S&P 500 and its 11 sectors since October 12, 2022 through Friday's close: Materials (23.3%), Industrials (21.9), Information Technology (19.6), Financials (18.7), Real Estate (14.1), S&P 500 (13.1), Communication Services (10.6), Energy (7.8), Consumer Staples (7.2), Utilities (7.2), Health Care (5.8), and Consumer Discretionary (3.6) (*Table 1*).

Our overweight recommendations for 2023 are Energy, Financials, Industrials, Information

Technology, and Materials. They are consistent with our opinion that the US and global economies should continue to grow this year. Here is a scattershot of themes behind our picks:

Capital spending in the US will get a boost from onshoring and government spending on infrastructure and semiconductor plants. The S&P 500 Information Technology sector will also benefit from spending by many companies on productivity-enhancing technologies to solve their labor shortage problem. The proliferation of electric vehicles will increase the sales and earnings of companies in the Energy and Materials sectors. Artificial Intelligence, robotics, and automation will require many more data centers that also happen to require lots of electricity, supplied by both fossil and renewable sources of energy. The demand for cloud computing and data storage is likely to continue to grow rapidly. Spending on defense will also remain strong. The same can be said about spending on commercial aircraft. Financial intermediaries are well capitalized and have been increasing their reserves for loan losses in case of a recession. If it doesn't happen, they will be able to reduce their reserves, thus boosting their earnings.

Let's turn from this scattershot of themes to a closer look at two of our recommended sectors in the following sections.

S&P Sectors II: Not Your Father's Tech Wreck. The S&P 500 Information Technology sector's price index is up 19.6% since last year's bear-market low. Leading the way have been the Semiconductors (47.0%), Semiconductor Equipment (40.4), and Application Software (20.8) industries (*Table 1*).

During the bear market, this sector's price index fell 34.3%. It is currently still 21.4% below its record high on December 27, 2021 (*Fig. 2*). Its forward P/E fell from 28.7 on September 2, 2020 to 18.1 on October 12, 2022 (*Fig. 3*). The sector's forward earnings peaked at a record high during the week of June 2 last year and fell 9.3% since then through the February 23 week. The sector's forward revenues is down 3.4% over this same period, while its forward profit margin is down from a record high of 25.4% to 23.9% (*Fig. 4*).

Here is more on the sector:

(1) *Revenues & earnings growth.* Currently, industry analysts project that the sector's revenues will be flat this year and grow 8.4% next year (*Fig. 5*). Earnings are expected to be down 3.1% this year and up 15.7% next year (*Fig. 6*).

(2) *Tech Wrecks, now & then.* Last year's rout in technology stocks led a few bearish strategists to predict that it could turn out to be as awful as the Tech Wreck of the early 2000s. We didn't agree. The forward P/E of the S&P 500 was 23.5 during February, down from December 2021's peak of 28.1 (*Fig. 7*). Just prior to the Tech Wreck, the sector's forward P/E exceeded 45.0. It eventually bottomed at 10.4 during November 2008. This time is also different because the current spread (5.9ppts) between the sector's share of the S&P 500's market capitalization (27.6%) and earnings share (21.7%) is well below the spread between the two at the height of the 1990s tech bubble in March 2000 (*Fig. 8*). Back then, the capitalization share peaked at 33.7%, while the earnings share was at 18.2%.

Back during the Tech Wreck, analysts' consensus expectations for the sector's long-term earnings growth rate (LTEG, over the next five years) peaked at a record 28.7%, boosting the LTEG of the S&P 500 to a record 18.7% (*Fig. 9*). That was unrealistic, to say the least. The S&P 500 can't sustainably grow faster than nominal GDP (the source of revenues).

This time, LTEG peaked at the end of 2021 at 22.5% and 18.8% for the S&P 500 and its Tech sector. Both fell to about 11.0% at the end of last year, which still seems high but at least is more in line with expectations during market troughs, when analysts tend to be less exuberant.

(3) *Mini Y2K.* There is one similarity between the early 2000s Tech Wreck and the sector's recent woes. The Tech Wreck was at least partly caused by the Y2K issue, which caused many companies to ramp up their spending on technology to fix their systems' inability to handle the millennium date change before the new millennium began. So at the start of the 2000s, technology capital spending fell off a cliff.

This time, spending also dropped, but it was spending on technology by consumers that fell, after they purchased all the equipment and software they needed for their home offices during the pandemic.

(4) *Forward earnings, now & then*. We can see these developments in the forward earnings of the S&P 500 Information Technology sector and its major industries (*Fig. 10* and *Fig. 11*). During the Tech Wreck, the sector's forward earnings fell 61.4% from peak to trough, led by an over 100% fall in the Communications Equipment industry's forward earnings to a loss.

This time, the sector's forward earnings is down 9.3% so far from its record high during the June 2, 2022 week, led by declines of 32.1% and 17.5% in Semiconductors' and Semiconductor Equipment's forward earnings. This time, Communications Services'

forward earnings is still rising to new highs. The same can be said about Data Processing & Outsourced Services' forward earnings.

(5) *Semiconductor cycle.* The worldwide sales of semiconductors tends to be very cyclical (*Fig. 12*). The figure falls sharply when the US economy is in a recession. It's down sharply now by 20% from its record high of $620 billion (saar) during May 2022 to $496 billion at the start of this year. Industrial production of semiconductors is one of the areas hit by the economy's rolling recession; the economy has yet to experience a widespread recession (*Fig. 13*).

The worst is likely over for the industry and for the stock price indexes of the S&P 500 Semiconductors and Semiconductor Equipment industries unless the US does fall into an official recession, which we don't expect to happen (*Fig. 14* and *Fig. 15*). Rolling recessions tend to be followed by recoveries rather than outright recessions, as we discussed in yesterday's *Morning Briefing*.

(6) *Relative performance.* The S&P 500 Information Technology price index outperformed the broad S&P 500 index during the previous bull market (*Fig. 16*). The sector has been a market performer since the end of the pandemic lockdown. We expect it to outperform again as companies spend more on productivity-enhancing technologies.

S&P Sectors III: Industrials Outperforming. The 21.9% increase in the S&P 500 Industrials sector's price index since October 12, 2020, has been led by Construction Machinery & Heavy Trucks (34.2%), Construction & Engineering (29.1), Airlines (27.6), Industrial Machinery (27.2), Industrial Conglomerates (25.6), Electrical Components & Equipment (22.2), Aerospace & Defense (20.7), and Air Freight & Logistics (20.5). These all will benefit from more capital and infrastructure spending, onshoring, better global economic growth, and more international travel.

Here is more on the sector:

(1) *Relative performance.* The S&P 500 Industrials price index was mostly a market performer in the recent years prior to the pandemic (*Fig. 17*). Its outperformance is a new development since the end of the previous bear market as investors are worrying less about an imminent recession and focusing more on long-term opportunities.

(2) *Fundamentals.* While US construction spending is likely to remain weak in the residential sector, the outlook for the nonresidential and public sectors is quite bright. Construction

spending on commercial and manufacturing projects has been especially strong over the past 12 months through January, up 22.1% and 53.6%, respectively (*Fig. 18*). Orders for industrial machinery have been especially strong, more than doubling the past two years through January, while orders for construction equipment are up 25.9% y/y (*Fig. 19*).

(3) *Forward metrics.* The forward revenues of the S&P 500 Industrials sector has stalled at a record high over the past year but managed to edge up to a new record high during the February 23 week (*Fig. 20*). The sector's forward earnings has also been stalled at a record high since mid-2022 (*Fig. 21*). The forward profit margin has edged down in recent weeks to 10.0%, which is still a relatively high reading for the sector (*Fig. 22*). There's no recession going on in this highly cyclical sector.

Calendars

US: Tues: Consumer Credit $22.8b; Wholesale Inventories -0.4%; EIA Short-Term Energy Outlook; Powell Testifies. **Wed:** ADP Employment 200k; Job Openings 10.5m; Trace Balance -$68.9b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; WASDE Reptor; Powell. (Bloomberg estimates)

Global: Tues: Germany Factory Orders -1.0%; Spain Industrial Production -0.6%; UK Halifax House Price Index; Japan Current Balance; Lowe; Woods. **Wed:** Eurozone GDP 0.1%q/q/1.9%y/y; Eurozone Employment Change 0.1%q/q/1.5%y/y; Germany Industrial Production 1.5%m/m/-1.8%y/y; Italy Retail Sales 2.0%; UK RICS House Price Balance -49%; Canada Trade Balance 0$0.06b; BOC Rate Statement 4.50%; Japan GDP 0.2%q/q/0.8%y/y; China CPI 0.7%m/m/2.2%y/y; China PPI -0.5% y/y; Japan Leading & Coincident Indicators; Lagarde; Panetta; Dhingra. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for all three of these indexes last week. Through the week ending March 2, LargeCap's forward earnings is 0.2% above its 54-week low during the week of February 10, but is down in 16 of the past 22 weeks. MidCap's dropped 0.1% w/w to a 54-week low and has fallen in 21 of the past 24 weeks. SmallCap's tumbled 1.7% w/w to a 70-week low and is down in 19 of the past 22 weeks. For a 36th 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 5.7% below its record high at the end of June; MidCap's is 8.0% below its record high in early June; and SmallCap's is 12.5% 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 -1.5% 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 -0.8% y/y is at a 26-month low, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's rate of -5.6% y/y is at a 28-month low, down from a record high of 124.2% in June 2021; it compares to 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 (5.5%, 1.3%, and 12.0%), MidCap (16.6, -8.5, 12.7), and SmallCap (5.8, -3.1, 16.7).

S&P 500/400/600 Valuation (*link*): Valuations rose w/w for these three indexes through the March 2 week and remain near their multi-month highs at the beginning of February. LargeCap's forward P/E gained 0.4pt w/w to 17.9 from a five-week low of 17.5 and is down from a nine-month high of 18.2 in early February. It's up 2.8pts 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 0.3pt to 14.4 from a four-week low of 14.1 and is 0.3pt below its recent 10-month high of 14.7. It's now up 3.3pts 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 jumped 0.5pt w/w to 14.2, and is just 0.1pt below its recent 12-month high of 14.3. It's 3.6pts 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 19% discount, which is its best reading since November 2021. SmallCap's discount has improved from a 21-year low of 32% last April to 21% last week; that's its lowest discount since August 2021. 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 a 90th straight week; the current 2% discount is its lowest since July 2022 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 Q1-2023 to -7.1% y/y from -1.4% in Q4-2022 on a frozen actual basis and to -4.5% from -3.2% on a pro forma basis. Just four sectors are expected to record positive y/y percentage earnings growth in Q1-2023, up from only two 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 (28.9% in Q1-2023 versus -15.9% in Q4-2022), Energy (17.2, 59.2), Industrials (18.4, 42.3), Financials (5.5, -11.7), Consumer Staples (-3.8, -0.6), Real Estate (-6.5, -1.9), Utilities (-9.1, -4.6), Information Technology (-11.2, -8.0), Communication Services (-13.5, -28.1), Health Care (-18.4, -2.7), and Materials (-34.0, -20.4).

US Economic Indicators

Manufacturing Orders & Shipments (*link*): Factory orders contracted 1.6% at the start of the year, as transportation orders plunged 13.3%, dragged down by a 54.5% plunge in nondefense aircraft & parts. *Excluding transportation*, orders were up 1.2% following a 2.4% drop the prior two months of last year. February's ISM manufacturing survey, reported last week, showed the new orders (to 47.0 from 42.5) measure remained in contractionary territory, though showed billings fell at a slower pace than during January. Turning to core capital goods orders and shipments, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) has been moving sideways since reaching a record high last August, though climbed 0.8% in January to within 0.1% of last August's record high. *Nondefense capital goods shipments excluding aircraft* (used in calculating GDP) jumped 1.1% at the start of this year, after contracting 0.7% the last two months of 2022, climbing to a new record high. On a year-over-year basis, core capital goods orders and shipments are up 4.3% and 6.6%, respectively, slowing from their peak rates of 22.3% and 17.7% during April 2021.

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales fell short of expectations, rising 0.3% in January—less than one-third the expected 1.0% gain—after contracting two of the prior

three months by a total of 2.4%. A 1.5% drop in sales of *automotive fuels* accounted for the decline in January sales—after increasing 1.2% the last two months of 2022. Spending on *food, drinks & tobacco* rebounded 1.8% in January after slumping four of the prior five months by 4.0%, rising only three months during all of last year, while sales of *non-food products excluding fuel* advanced 0.8% after dropping two of the prior three months by 2.9%. Over the 12 months through January, only automotive fuels (5.4% y/y) was in the plus column—foods drinks & tobacco (-5.0) and *non-food products ex fuel* (-1.0) were in the red. January data are available for two of the four of the *Eurozone's largest economies*, and show sales in Germany contracted for the third time in four months, down 0.3% m/m and 3.8% over the period, while France ticked up 0.1% after a three-month slide of 3.3% during the final months of 2022. Compared to a year ago, sales in Germany contracted 6.8%, while sales in France fell 2.9%.

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