MORNING BRIEFING
March 28, 2023

'Yes, There Will Be Growth in the Spring!'

Check out the accompanying chart collection.

Executive Summary: Stock market bears have long expected a recession, but now the prospective credit crunch that could cause one seems more plausible after the SVB crisis. … We expect that the Fed and FDIC will contain the crisis. But we do see regional banks paying higher deposit rates now to prevent disintermediation. That's likely to hurt their profitability and prompt more cost-saving M&A activity among them. … Also: The latest batch of economic indicators supports a soft-landing scenario.

Banking I: Disintermediation 2.0? The bear case last year was that the Fed would have to tighten monetary policy aggressively because the Fed was behind the inflation curve and had to scramble to catch up. That would cause a recession, which is the only way to bring inflation down, according to the narrative. As a result, valuation multiples would tumble, and so would earnings.

That scenario played out well for the bears as the S&P 500 dropped 25.4% from January 3 through October 12 of last year. However, the bear market was mostly attributable to a 29.8% plunge in the S&P 500's forward P/E (*Fig. 1*). Forward earnings actually rose 6.2% during the bear market because the recession didn't happen as expected by the bears (*Fig. 2*).

Nevertheless, they are still growling. A recession is still coming, and it will depress both the valuation multiple and earnings, they claim. The forward P/E is up from 15.1 on October 12, 2022 to 17.5 last Friday, but it is likely to fall down to single digits in the bears' scenario. They're saying S&P 500 earnings could fall 15% to $185 per share this year, down from $218 last year.

The banking crisis that started when the FDIC seized Silicon Valley Bank (SVB) on March 10 will cause the credit crunch that causes a recession this year, the bears contend, and sooner rather than later. Money will pour out of bank deposits into safer Treasury securities that are yielding more than deposits. Banks will be forced to sell their underwater bonds. They'll be forced to stop lending, resulting in a credit crunch. Credit crunches attributable to disintermediation have always caused recessions.

Banking II: Let's Make a Deal. That's all a very plausible litany of what has gone wrong and could continue to go wrong. What could go right is that the banking crisis is contained by the actions taken so far by the Fed and the FDIC. They undoubtedly will respond with more contagion-containing measures if necessary.

On Sunday, March 12, the Fed provided a new emergency liquidity facility for the banks. According to the Fed's *press release*: The Bank Term Funding Program (BTFP) offers loans of up to one year in length to depository institutions pledging US Treasuries, agency debt and mortgage-backed securities, and other qualifying assets as collateral. These assets will be valued at par. "The BTFP will be an additional source of liquidity against high-quality securities, eliminating an institution's need to quickly sell those securities in times of stress."

In effect, the Fed guaranteed 100% of deposits for 100% of depositors by providing the BTFP as a backstop to stop bank runs. So far, so good.

The FDIC started to do its job immediately after it seized SVB. The regulator transferred all SVB deposits and assets into a new "bridge bank" to protect depositors of the failed lender. On Monday morning, March 27, the FDIC announced that First Citizens BancShares will buy SVB's deposits and loans, just over two weeks after the biggest US banking collapse since the global financial crisis. The FDIC estimated that SVB's failure will cost its Deposit Insurance Fund (DIF) around $20 billion, with the exact amount to be determined once the receivership is terminated.

There could be more mergers and acquisitions among the regional banks. To avert disintermediation, they will have to raise their deposit rates, which will squeeze their profitability. That could force many of them to consolidate to lower their costs.

In any event, industry analysts who cover the S&P 500 Regional Banks industry responded quickly to the banking crisis. During the March 16 week, they cut their 2023 and 2024 revenues-per-share estimates by 7.0% and 7.6% (*Fig. 3*). They reduced their estimates for earnings per share those years by 6.3% and 7.0% (*Fig. 4*).

Investors slashed the S&P 500 Regional Banks stock price index by 25.8% from March 9 through March 24 (*Fig. 5*). That caused the forward P/E to plunge from just above 10.0 during February to a record low of 6.3 on March 15 (*Fig. 6*).

By the way, the FDIC's Deposit Insurance Fund had a balance of $128.2 billion at the end of last year (*Fig. 7*).

US Economy: Not Landing. Meanwhile, the US economy is continuing to grow at a solid "no-landing" pace. The Atlanta Fed's *GDPNow* tracking model shows real GDP increasing 3.2% (saar) during Q1-2023 as of March 24. Most impressive is that real personal consumption expenditures is tracking at a 5.0% annual rate! It was last revised higher on March 15 after the release of retail sales, which dipped 0.4% during February, though January's gain was revised up from 3.0% to 3.2%, the biggest monthly gain since March 2021.

Let's review the latest batch of economic indicators that on balance supports the soft-landing scenario:

(1) *Surprise index.* The Citigroup economic surprise index (CESI) rose from a recent low of -24.7 on January 18 to 61.2 on Friday, the highest reading since April 27, 2022 (*Fig. 8*).

(2) *Flash PMIs.* The S&P Global flash estimate for the M-PMI in the US rose from a recent low of 46.2 during December to 49.3 in March (*Fig. 9*). The flash estimate for the NM-PMI rose from 44.7 to 53.8 over the same period (*Fig. 10*).

(3) *Housing.* New home sales rose in February, climbing for the third month in a row as mortgage rates eased off their highs of the past year and buyers looked to new construction amid historically low inventory of existing homes for sale. Sales of new single-family houses were 640,000 (saar), up from a revised 633,000 in January (*Fig. 11*).

Existing home sales jumped 14.5% m/m during February to 4.58 million units (saar) (*Fig. 12*). It was the first monthly gain in 13 months and the largest increase since July 2020, just after the start of the Covid-19 pandemic. Sales might have been even higher were it not for what are still very low inventories of existing homes.

The monthly sum of single-family existing and new home sales closely tracks the four-week average of mortgage applications for purchasing homes, which is sensitive to mortgage rates (*Fig. 13*). Mortgage rates probably peaked along with the 10-year Treasury bond yield at the end of October (*Fig. 14*). If so, then housing activity may be starting to bottom.

(4) *Durable goods orders.* Nondefense durable goods orders excluding aircraft has been essentially flat for the past six months through February (*Fig. 15*). That's the bad news. The good news is that it has stalled in record-high territory. Data available through January show that new orders for industrial machinery has also stalled at a record high in recent months, while new orders for construction machinery remain on an uptrend that started after the

pandemic lockdowns (*Fig. 16*).

(5) *Regional business surveys.* Four of the five regional bank surveys conducted by the Federal Reserve's district banks are available through March (*Fig. 17*). Unlike the S&P Global flash estimate, the average of their composite business indicators remained weak in March, which suggests that the national M-PMI might have fallen further below 50.0 in March.

(6) *Bottom line.* In the 1979 film "Being There," Peter Sellers plays Chauncey Gardner, who is a middle-aged, simple-minded man named "Chance." He lives in the townhouse of a wealthy old man in Washington, D.C. Chance has spent his entire life tending the garden and has never left the property. Other than gardening, his knowledge is based solely on what he sees on television. He is forced to wander outside the property when his benefactor passes away. Through various twists of fate, Chance the gardener becomes "Chauncey Gardiner" and is embraced by the upper echelons of society, business, and government. When asked by the president of the United States about the economic outlook, he says, "Yes, there will be growth in the spring!" That's our forecast too.

Calendars

US: Tues: Consumer Confidence 101.0; Richmond Fed Manufacturing Index -8; S&P/CS HPI Composite Index 20 City -0.5%m/m/2.5%y/y; Wholesale Inventories 0.2%; API Weekly Crude Oil Inventories; Barr. **Wed:** MBA Mortgage Applications; Pending Home Sales -3.0%; Crude Oil Inventories & Gasoline Production; Barr. (Bloomberg estimates)

Global: Tues: France Business Survey 102.5; Italy Consumer & Business Confidence 104.0/102.5; BOE Quarterly Bulletin; Lagarde; Enria; Balz; Mauderer; Woods; Bailey; Ramsden; Wuermeling; Nagel; Kuroda. **Wed:** Germany Gfk Consumer Climate Index -29.0; France Consumer Confidence 81.0; Italy Unemployment Rate 7.8%; BOE FPC Meeting Minutes; European Central Bank Non-Monetary Policy Meeting; Mauderer; Mann; Schnabel; Balz; Gravelle. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for all three indexes in what were their first simultaneous gains in 11 weeks and only the second in the past nine months. However, the gains were primarily due to the many constituent changes that took place during the week, rather than improving earnings. Through the week ending March 23, LargeCap's forward earnings rose 0.1% w/w to an eight-week high and 0.7% above its 54-week low during the week of February 10. MidCap's rose 0.5% w/w to 0.6% above its 55-week low during the week of March 10. SmallCap's soared 2.4% w/w from a 72-week low and is down in 21 of the past 24 weeks. For a 39th 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 5.2% below its record high at the end of June; MidCap's is 7.6% below its record high in early June; and SmallCap's is 11.5% 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 fifth straight week, edging down to a 26-month low of -2.1% 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 -1.6% y/y is up slightly from a 27-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 -5.5% y/y is up from a 29-month low of -7.4% y/y, but 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 (4.8%, 1.5%, and 12.0%), MidCap (17.3, -9.3, 13.3), and SmallCap (9.0, -5.4, 15.0).

S&P 500/400/600 Valuation (*link*): Valuations ticked higher w/w through the March 23 week for LargeCap and MidCap, but SmallCap's fell for a third week. LargeCap's forward P/E of 17.5 was up 0.3pt w/w, but is down from a nine-month high of 18.2 in early February. It's up 2.4pts 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 13.0 from a 13-week low and is 1.7pts below its recent 10-month high of 14.7 in early February. It's now 1.9pts above its 30-month low of 11.1 at the end of September, which 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 dropped 0.2pt w/w to a 12-week low of 12.6 and is now 1.7pts below its recent 12-month high of 14.3 in early February. It's 2.0pts 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 25% discount. It had been at a 21% discount a week earlier, which was near its best reading since November 2021. SmallCap's discount has improved from a 21-year low of 32% last April to 28% last week; but that's down from a 22% discount several weeks earlier which was near its lowest 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 93rd straight week; the current 3% discount is down from 1% in the prior week. That had been its lowest since July 2021 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 -7.4% y/y from -1.7% in Q4-2022 on a frozen actual basis and to -4.6% from -3.2% on a pro forma basis. 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 (36.2% in Q1-2023 versus -15.6% in Q4-2022), Industrials (17.4, 41.4), Energy (15.5, 59.1), Financials (5.4, -8.9), S&P 500 (-4.6, -3.2), Consumer Staples (-5.0, -2.5), Real Estate (-7.8, -3.2), Utilities (-9.6, -4.6), Communication Services (-12.5, -28.2), Information Technology (-13.0, -10.0), Health Care (-18.8, -2.7), and Materials (-33.7, -20.4).

US Economic Indicators

Regional M-PMIs (*link*): Four Fed districts (New York, Philadelphia, Kansas City, and Dallas) have reported on *manufacturing activity* for March; they show growth declined for the 10th successive month—and at a faster rate than in February—deteriorating to -15.9 from -10.9, the weakest since May 2020. Activity in the New York (to –24.6 from -5.8) region contracted at quadruple January's pace, while declines in the Philadelphia (-23.2 from -24.3) and Dallas (-15.7 from -13.5) regions were a close match to their February declines. Meanwhile, Kansas City's was at zero for the second successive month. *New orders* (-19.3 from -10.2) fell for the 10th month, dropping at virtually double February's pace, with billings in the New York (-21.7 from -7.8), Philadelphia (-28.2 from -13.6), and Kansas City (-13.0 from -6.0) regions all contracting at a faster pace, while Dallas' (-14.2 from -13.2) virtually matched its February pace. *Employment* (2.0 from 2.1) showed little change in March, as hirings in the Philadelphia (-10.3 from 5.1) region swung from positive to negative and Dallas' (10.4 from -1.0) from negative to positive. Meanwhile, New York (-10.1 from -6.6) factories cut jobs at a faster rate, while Kansas City's (18.0 from 11.0) hired at a faster pace. Looking at *prices-paid* indexes, both the New York (41.9 from 45.0) and Dallas (20.3 from 25.1) regions saw price pressures ease a bit in March after tightening slightly in February, while Philadelphia's (23.5 from 26.5) slowed to a 31-month low this month. New York's gauge was at a record high of 86.4 during April 2022, while Dallas (84.1) and Philadelphia (83.6) both posted record highs in November 2021. Meanwhile, Kansas City's (30.0 from 26.0) measure accelerated this month, though remained considerably below its record high of 84.0 recorded during May and October of 2021. *Prices-received* indexes were mixed: New York's prices-received measure eased to 22.9 in March after climbing from a two-year low of 18.8 in January to 28.4 in February; it was at a record high of 56.1 in March 2022. The Philadelphia measure moved down for the second month to 7.9 in March from 14.9 and 29.9 during February and January, respectively; it was at a record high of 65.8 in November 2021. Kansas City's eased to 13.0—the lowest since the end of 2020—it was at a record-high 60.0 in August 2021. Prices received in the Dallas (7.0 from 15.8) region rose at roughly half the pace of last month; it was at a record-high 51.3 during October 2021.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "Despite turbulence at some international banks, the German economy is stabilizing," noted Clemens Fuest, Ifo's president. German business *confidence* extended its winning streak to five weeks in March, climbing to its highest level since February 2022, up 8.6 points over the period, from 84.7 to 93.3. The *expectations* component accounts for the upswing, rising by a total of 15.2 points over the five-month period to a 13-month high of 91.2. It had plunged 22.0 points—from 98.4 last February to 76.4—by September, which was the lowest since April 2020. Meanwhile, *current conditions* has remained around recent lows, though did rise 1.5 points this month to 95.4, averaging 94.2 the past six months. There were signs of hope, with all four sectors moving higher again this month: The *manufacturing* sector saw its business climate index continue to improve, moving further into positive territory. It's jumped 21.9 points the past five months, from a 28-month low of -15.3 last October to +6.6 this month, as companies were less pessimistic about the future (to -5.1 from -40.0 in October) over the period; the current assessment component was up from November's recent low of 10.3 to 19.0 this month. The *service sector* saw its business climate index improve for the fifth month, from -8.5 last October to +8.9 this month, as its expectations (to -3.9 from -35.2 in September) measure moved to within striking distance of positive territory, while businesses were somewhat more satisfied with their current conditions, advancing for the second month from 16.8 at the start of this year to 22.6 this month. Sentiment in the *trade sector* (-10.0 from -32.1 in September) improved for the sixth month, posting its highest reading since February 2022, as expectations (-26.6 from -57.2) continued its rebound from historical lows and current conditions (to 8.1 from -2.5) posted its fourth successive reading above zero. Both wholesalers and retailers are getting over last year's collapse in sentiment, though retail trade confidence was little changed this month. The *construction sector* remained entrenched in negative territory, though improved for the third successive month, to -17.9. Its expectations component improved for the fifth month in a row, to -38.4 from -46.8 last October, though remained extremely pessimistic, while its current conditions measure continued to bounce around recent lows, slipping from 7.4 to 5.3 this month—averaging 5.0 the past six months; it had peaked at 33.4 last February.

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