MORNING BRIEFING
April 4, 2023

Crosscurrents

Check out the accompanying chart collection.

Executive Summary: All 11 sectors of the S&P 500 are up since October 12, which we believe was the bear market's bottom and the start of a new bull market in stocks. Leading the charge has been the MegaCap-8 stocks, which collectively now make up nearly a quarter of the S&P 500's capitalization and nearly half of the S&P 500 Growth index's. … With all the focus on a prospective credit crunch, gone relatively unnoticed are two market-buoying positives: Corporate cash flow hit a record high at year-end 2022, and the global economy has been proving rather resilient.

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

Strategy I: Bear Market Rally? We Don't Think So. We still think that October 12, 2022 marked the bottom in—and end of—the latest bear market (*Fig. 1*). The S&P 500 is up 14.9% since then through Friday's close (*Table 1*). All 11 sectors of the S&P 500 are up since then as well. We've been recommending overweighting the Energy (up 3.0%), Financials (6.4%), Industrials (19.4), Information Technology (29.2%), and Materials (17.8%) sectors. Three of them have outperformed the S&P 500, while two of them have lagged (*Fig. 2*).

We don't think this strength has been just a rally in a bear market. The Nasdaq is arguably in a bull market, since it is up 19.7% from last year's low on December 27 through Friday's close (*Fig. 3*). In fact, on a logarithmic scale, the Nasdaq remains on the uptrend line that started from the bottom of the bear market at the start of 2009! It is up 863% since then even though it's 24.1% below its record high on November 18, 2021. Over this same period, the Nasdaq 100 is up 1,163% (*Fig. 4*). It is up 23.4% since late last year's low.

They're back: Leading the way higher has been the MegaCap-8 group of stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla):

(1) *Market capitalization.* The market cap of the MegaCap-8 bottomed early this year, on January 5, at $6.8 trillion (*Fig 5*). It rebounded 35% since then to $9.2 trillion. Since October 12 of last year, the S&P 500's market cap is up 14.0% with and 11.6% without the MegaCap-8.

(2) *Market-cap share.* The MegaCap-8 currently accounts for about 24% of the S&P 500's market cap and about 45% of the S&P 500 Growth index (*Fig. 6*).

(3) *Valuation.* On Friday, the forward P/E of the MegaCap-8 was 28.0, up from this year's low of 21.1 on January 6 (*Fig. 7*). The forward P/Es of the S&P 500 with and without the Mega-Cap-8 were 17.3 and 15.4.

(4) *Investment styles.* The outperformance of the MegaCap-8 since October 12 explains the outperformance of S&P 500 LargeCaps (14.9%) relative to the S&P 400 MidCaps (11.5%) and the S&P 600 SmallCaps (8.5%).

Interestingly, S&P 500 Growth, which underperformed S&P 500 Value during last year's bear market and through the end of 2022, has outperformed Value since the banking crisis started in early March (*Fig. 8*). The same can be said about the equal-weighted S&P 500 relative to the market-cap-weighted index (*Fig. 9*).

Strategy II: Record Corporate Cash Flow. While the banking crisis has caused much ink to be spilled in speculation about a possible credit crunch, not much has been written about the fact that corporate cash flow rose to a record high of $3.2 trillion (saar) at the end of last year (*Fig. 10*).

After-tax corporate profits rose to a record high of $2.5 trillion, while dividends totaled $1.7 trillion, leaving $821 billion in undistributed profits (*Fig. 11*). Undistributed profits plus record economic depreciation of $2.4 trillion equaled Q4's corporate cash flow.

That's all based on data in the National Income & Product Accounts (NIPA) compiled by the Bureau of Labor Statistics (BLS). The Fed's *Financial Accounts of the United States* shows similar data for nonfinancial corporate cash flow, which rose at the end of last year to a record high of $3.0 trillion, well exceeding the record $2.5 trillion in capital spending on a current-dollar basis (*Fig. 12*).

Global Economy: No Boom, No Bust. Yesterday, Bloomberg reported that OPEC+, including Russia, pledged to reduce its production by more than 1 million barrels a day starting next month and lasting through the end of the year. The reduction surprised the energy markets, which had expected the cartel to hold output steady. Adding to the shock, the decision came outside of the group's scheduled timetable for reviewing the market's demand and member's supplies.

Debbie and I view the cartel's decision as a defensive move to avert a further slide in the price of oil rather than to push it back up aggressively. The nearby price of a barrel of Brent crude oil jumped over $110 per barrel early last year when Russia invaded Ukraine (*Fig. 13*). It was back down to $79 at the end of last week when futures prices were in backwardation, i.e., the futures prices followed a downward-sloping curve that put them below spot prices (*Fig. 14*).

The global economy was expected to get a big boost after China abandoned its zero-Covid policy at the beginning of December last year. Apparently, that rebound in China's economy has been muted, as evidenced by falling oil prices. The price of copper, which is a very sensitive indicator of economic activity, did rally during January on expectations of a stronger rebound in China's manufacturing sector than subsequently occurred (*Fig. 15*).

Let's review a few of the latest data points for the global economy:

(1) *Global M-PMI.* Debbie observes that the JP Morgan Global M-PMI is hovering around the breakeven point of 50.0, ticking down to 49.6 in March after edging up from 48.7 in December (the lowest since mid-2020) to 50.0 this February (*Fig. 16*). She adds that March data are available for 31 nations, with 13 signaling expansions in output, 17 signaling contractions, and one—China—at the 50.0 breakeven point.

(2) *US M-PMI.* We aren't surprised by the weakness in the US M-PMI reported yesterday for March. The five regional business surveys we track suggested that was likely to happen. The overall index fell further below 50.0 to 46.3, and its three major components did the same: new orders (44.3), production (47.8), and employment (46.9).

Yes, we know that gives the hard-landers something to gloat about. However, we see the weakness in goods production and distribution as a rolling recession that has been offset by consumers pivoting from buying goods to purchasing services. That's been the trend since mid-2021 (*Fig. 17*).

(3) *Eurozone sentiment.* The Eurozone's economic sentiment indicator fell below 100 during July 2022 on fears of energy shortages during the winter, which did not happen (*Fig. 18*). It bottomed at 93.8 during October and rebounded back to 99.3 during March. That reading is consistent with no growth in the region's real GDP on a y/y basis.

Calendars

US: Tues: Job Openings 10.4m; Factory Orders -0.5%; API Weekly Crude Oil Inventories Cook. **Wed:** ADP Nonfarm Employment 205k; ISM NM-PMI 54.5; S&P Global C-MPI & NM-PMI 53.3/53.8; Trade Balance -$69.0b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: Tues: Germany Trade Balance €17.0b; Canada Building Permits 1.55; Australia NM-PMI 48.2; Japan NM-PMI 54.2; RBA Interest Rate Decision; Tenreyro; Pill; Lowe. **Wed:** Eurozone, Germany, and France C-PMIs 54.1/52.6/54.0; Eurozone, Germany, and France NM-PMIs 55.6/53.9/55.5; Germany Factory Orders 0.4%; France Industrial Production 0.6%; UK C-PMI & NM-PMI 52.2/52.8; Australia Trade Balance $11.1b; China Caixin M-PMI 51.7; Tenreyro. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings were mixed last week for these three indexes. Through the week ending March 30, LargeCap's forward earnings fell 0.1% w/w from an eight-week high to 0.6% above its 54-week low during the week of February 10. MidCap's rose 0.5% w/w to 1.2% above its 55-week low during the week of March 10. SmallCap's was steady at 2.4% above its 72-week low during the March 17 week. For a 40th 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 5.3% below its record high at the end of June; MidCap's is 7.1% 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 -2.5% 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 -1.6% y/y is up slightly from a 27-month low several weeks earlier, 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 -6.1% y/y is up from a 29-month low of -7.4% y/y during the March 17 week 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 2023 and 2024: LargeCap (1.1% and 12.3%), MidCap (-9.2, 13.7), and SmallCap (-6.4, 14.9).

S&P 500/400/600 Valuation (*link*): Valuations jumped higher w/w through the March 30 week for all three of these indexes. LargeCap's forward P/E of 18.0 was up 0.5pt w/w to a seven-week high, but is down from a nine-month high of 18.2 in early February. 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 0.5pt to a four-week high of 13.5 and is 1.2pts below its recent 10-month high of 14.7 in early February. It's now 2.4pts 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 of 13.0 was up 0.4pt w/w to a four-week high from a 12-week low and is now 1.3pts below its recent 12-month high of 14.3 in early February. It's 2.4pts 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 25% discount. It had been at a 21% discount during the March 17 week, 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 during the March 10 week, 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 94th straight week; the current 4% 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 -7.5% y/y from -1.6% in Q4-2022 on a frozen actual basis and to -5.0% 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 final Q4-2022 growth rates: Consumer Discretionary (36.4% in Q1-2023 versus -15.6% in Q4-2022), Industrials (17.9, 41.4), Energy (13.7, 59.1), Financials (5.2, -8.9), Consumer Staples (-4.8, -2.5), S&P 500 (-5.0, -3.2), Real Estate (-8.0, -3.2), Utilities (-9.9, -4.6), Communication Services (-12.6, -28.2), Information Technology (-14.4, -10.0), Health Care (-18.8, -2.7), and Materials (-33.5, -20.4).

US Economic Indicators

Construction Spending (*link*): Construction spending remains stalled at record highs, dipping 0.1% in February after climbing 0.4% in January to a new record high and ticking down 0.1% in December. *Private construction* investment was flat in February, following a 0.2% gain and a 0.3% loss the prior two months, just a tick below last July's record high. *Public construction* spending was little changed in February, slipping 0.2%, after an eight-month surge of 12.8% to a new record high. Within private construction spending, residential investment contracted for the ninth successive month since reaching a record high last May, slumping 9.9% over the period after not posting a decline since May 2020. The weakness in *residential* investment was driven by *single-family* construction spending, which hasn't recorded a gain since last April, plunging 23.4% during the nine months through February. Meanwhile, *multi-family* construction has soared 21.6% over the seven months through February to a new record high. *Home improvement* spending was flat in February, following a 4.2% rebound during the three months through January. Private *nonresidential* spending has advanced in nine of the past 10 months, by 20.3%, reaching a new record high in February.

US Manufacturing PMI (*link*): ISM's March M-PMI sank to its lowest level in nearly three years and was below the break-even point of 50.0 for the fifth successive month. Since peaking at 63.8 in March 2021, the M-PMI dropped to a 34-month low of 46.3 this March. Excluding the pandemic, March's reading is the lowest since mid-2009. Both the *new orders* (to 44.3 from 47.0) and *production* (47.8 from 47.3) measures remained in contractionary territory, with the former back near January's 42.5—which was the weakest since May 2020. In the meantime, the *employment* (46.9 from 49.1) gauge dropped further below 50.0 to its weakest showing since July 2020. The *supplier deliveries* (44.8 from 45.2) measure for March fell to its lowest level since March 2009's 43.2—down sharply from May 2021's peak of 78.8. (A reading below 50.0 indicates faster deliveries to factories.). Meanwhile, inventories (47.5 from 50.1) contracted at the fastest pace in nearly two years, after stabilizing in recent months. ISM's *prices-paid* measure retreated to 49.2 in March after rising from a 32-month low of 39.4 at the end of last year to 51.3 this February; it peaked at 92.1 in mid-2021—which was the fastest since the summer of 1979.

Global Economic Indicators

Global Manufacturing PMIs (*link*): “Global manufacturing output rises as new order intakes show signs of stabilizing and supply chain pressures ease” was the headline of the March release. The JP Morgan Global M-PMI is hovering around the breakeven point of 50.0, ticking down to 49.6 in March after edging up from 48.7 in December (the lowest since mid-2020) to 50.0 this February. March data are available for 31 nations, with 13 signaling expansions in output, 17 signaling contractions, and one—China—at the 50.0 breakeven point. Here’s how March *M-PMIs ranked by country/region* from highest to lowest: India (56.4), Myanmar (55.5), Russia (53.2), Thailand (53.1), Greece (52.8), Philippines (52.5), Indonesia (51.9), Kazakhstan (51.6), Colombia (51.5), Spain (51.3), Italy (51.1), Mexico (51.0), Turkey (50.9), China (50.0), Ireland (49.7), WORLD (49.6), US (49.2), Japan (49.2), Australia (49.1), Malaysia (48.8), Canada (48.6), Taiwan (48.6), Poland (48.3), UK (47.9), Vietnam (47.7), South Korea (47.6), EUROZONE (47.3), France (47.3), Brazil (47.0), Netherlands (46.4), Germany (44.7), Austria (44.7), and Czech Republic (44.3).

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