MORNING BRIEFING
April 19, 2023

Construction, MegaCap-8 & Financials

Check out the accompanying chart collection.

Executive Summary: Even as the rolling recession rolls through segments of the real estate market, areas of the construction industry have never been stronger. Residential construction isn't one of them, but nonresidential and public construction each hit new record highs in February. Construction industry employment did the same in March. … Also: If industry analysts' forecasts are on the mark, the eight MegaCap-8 companies that exert outsized influence over the S&P 500's performance can look forward to a rebound of their collective y/y earnings comparisons starting in Q2-2023. … And: The S&P 500 Financials sector's growth prospects improved overnight when the Transaction & Payment Processors industry was added. Joe takes a look.

US Economy: Construction on a Roll. The rolling recession is likely now to be rolling into the commercial real estate sector and possibly into the multi-family housing sector. But it may also be rolling out of the single-family housing sector. Meanwhile, there's plenty of construction of nonresidential structures going on, excluding commercial ones. The outlook for public construction remains bright. Consider the following:

(1) *Commercial.* The banking crisis that started in early March may mean more bad news for the commercial real estate industry (CRE). The pandemic caused lots of workers to work from home. Many of them liked the experience so much that they don't want to go back to the office. Many companies have downsized their offices, leaving enough space that their employees can at least get together for group meetings and interactions on an occasional basis. So lots of office buildings are vacant.

All commercial banks held a record $2.9 trillion in CRE loans as of April 5, up $284.2 billion on a y/y basis (*Fig. 1*). Large and small domestically chartered banks along with foreign-related banks held $0.8 trillion, $1.9 trillion, and $0.1 trillion in such loans. On a y/y basis, they are up $20.6 billion, $252.7 billion, and $11.0 billion (*Fig. 2*).

Senior loan officers surveyed by the Fed every quarter were already tightening lending standards significantly on CRE loans at the end of last year (*Fig. 3*). As a result, the demand for such loans weakened significantly at the end of last year, according to the same survey (*Fig. 4*). That was before the banking crisis, which undoubtedly tightened lending standards for CRE loans further.

(2) *Nonresidential excluding commercial.* Commercial construction put-in-place totaled $123 billion (saar) during February, down slightly from January's record high (*Fig. 5*). It accounted for 20.4% of total nonresidential construction during February. Even if it weakens in coming months, construction of manufacturing structures—which totaled a record $140 billion during February—should continue to move higher thanks to onshoring by many companies and the building of semiconductor plants subsidized by the federal government.

Meanwhile, also at record highs are construction of health care and transportation facilities.

(3) *Public.* Also receiving a big boost from federal spending is infrastructure construction. We can see that in the record (or near-record) highs in construction put-in-place of highways and streets, sewage & waste disposal, water supply, and health care facilities (*Fig. 6*).

Before turning to residential construction, let's compare some of the construction numbers. Total construction put-in-place rose to a record $1.8 trillion (saar) in February (*Fig. 7*). That's despite soaring interest rates and tightening lending standards.

Residential construction fell in February to $852 billion (saar), down 9.8% from its record high during May 2022 (*Fig. 8*). Nonresidential and public construction each rose to their new record highs during February, i.e., $601 billion and $391 billion. So together, they exceeded residential construction.

(4) *Residential.* Residential construction consists of single-family and multi-family units as well as spending on home improvements (*Fig. 9*). Single-family construction is down 23.4% from its record high during April 2022 to $368 billion during February. Multi-family construction rose to a record $123 billion that month.

Still near its record high was home improvements at $361 billion during February. It is now as big as construction spending on single-family homes! It has soared since the pandemic, which caused more people to spend more time at their homes. (Just try finding a construction crew!)

Tighter lending conditions already have depressed single-family housing starts, but they may be bottoming now that mortgage rates have declined from their October 2022 peaks (*Fig. 10*). Multi-family construction may soon be moderated by tighter lending standards and easing rent inflation.

(5) *Construction employment.* The construction market is proving to be more resilient than in the past when credit conditions tightened. That's evident in the construction industry's payroll employment headcount, which rose to a record high during March (*Fig. 11*).

Strategy I: Spring for MegaCap-8 Earnings. In our April 12 *Morning Briefing*, titled "Bulls vs Bears," Joe reviewed the MegaCap-8 group of stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla). He discussed how these companies' cost-cutting has helped to spur nascent recoveries in their collective market capitalization, forward earnings, and forward profit margin this year to date. However, the group was then and still is expected to see Q1-2023 earnings decline markedly.

Below, Joe updates his review, summarizing the group's past quarterly earnings growth performance and expanding on their outlooks for Q1-2023 and the remaining quarters of the year.

(1) *Peak and trough earnings growth rates.* The MegaCap-8 recorded positive quarterly earnings growth during the shutdown of the US economy and benefitted tremendously from its re-opening as businesses and consumers transitioned to a post-Covid19 work/life balance. The group's float-adjusted earnings growth quickly rose from a trough of 3.8% y/y during Q1-2020 to a peak of 107.2% in Q1-2021 and slowed over the next four quarters through Q1-2022. Their y/y earnings growth rate first turned negative during Q2-2022 and probably bottomed at -17.9% during Q4-2022, when Tesla was the only MegaCap-8 component with positive growth.

Analysts' consensus Q1-2023 earnings forecasts for the eight companies suggest a fourth straight quarter of y/y earnings declines for the group collectively, but this time the drop should be a more moderate 11.3%. Microsoft headlines the group in Q1 as the sole y/y gainer, while Tesla's earnings are forecasted to be down for the first time since before the pandemic.

(2) *Return to positive y/y growth comparisons just around the bend.* If the analysts are right, then the worst of the MegaCap-8's y/y earnings growth comparisons already occurred in Q4-2022. They're expecting 9.5% growth in Q2-2023, with all but Meta and Netflix improving y/y. Again assuming that the analysts are right, Q2-2023 would mark the MegaCap-8's first positive contribution to S&P 500 quarterly earnings growth since Q1-2021.

Looking ahead to Q3- and Q4-2023, the MegaCap-8's y/y earnings growth is expected to improve to 18.2% and 28.2%, with all of the companies except Tesla participating in the rebound.

Strategy II: Financials Get Growth Hormone. Athletes use steroids to make them stronger, but that has the impact of making them bulkier and slower. On the other hand, HGH (human growth hormone) fuels growth and maintains tissues and organs through life.

The addition of the Transaction & Payment Processors (TPPS) industry to the Financials sector on March 20 is like a shot in the arm of HGH, improving the sector's long-term growth prospects and profitability. As GICS classifications changes go, it was the biggest one that S&P and MSCI had made since the Telecommunications sector was reconstructed in September 2018.

(1) *A big boost to the sector's market cap.* The addition of TPPS to the Financials sector was stunning, boosting its market capitalization by 26% to $4.3 trillion. At $885 billion on March 20, TPPS' market cap approached the $929 billion market cap of the Diversified Bank industry, the biggest in the Financials sector.

Visa and Mastercard together accounted for 90% of TPPS' market capitalization, a lot higher than the 62% combined market-cap share of Diversified Bank's two weightiest constituents, JPMorgan Chase and Bank of America.

(2) *Resetting Financials' margin and LTEG.* Following the addition of TPPS, Financials' forward profit margin reset 1.0ppt higher to 18.5% from 17.5%. Since then (through the April 6 week), Financials' margin edged down to 18.4%, while TPPS' margin was unchanged at 32.8%.

An even more stunning reset from the TPPS addition was the jump in the Financials sector's expected long-term earnings growth (LTEG)—i.e., five-year forward consensus earnings growth. It improved overnight on March 20 from 6.0% to 8.6%. With an LTEG forecast of 16.1%, TPPS' long-term prospects top those of all other Financials sector's industries.

(3) *Financials' future brighter than before?* Just before the Fed began its current rate-hike cycle in March 2022, Financials' forward profit margin was 18.7%, just 1.1ppts short of its record-high 19.8% hit during August 2021 (*Fig. 12*). One year later, by the March 16 week of this year, the sector's margin had fallen 1.2ppts to 17.5% due to declining earnings from sharply higher interest rates as well as the stock market downturn and the IPO market

collapse in 2022.

However, this period of margin contraction for the sector was relatively mild compared to those during the GFC and GVC (Great Financial Crisis and Great Virus Crisis), when Financials' forward profit margin fell to around 5% and 13%, respectively. We believe the addition of TPPS to the sector should help to stabilize its profit margin until the economy improves and send it to new highs during the next growth cycle.

Strategy III: Trader's Corner. We checked in with Joe Feshbach last weekend to hear his latest thoughts on the stock market. Joe writes: "The S&P 500 is approaching its early February highs. While it may exceed them, I believe the bulk of this rally is behind us now. I suggest building up some defensive reserves for a better opportunity down the road. The sentiment measures just don't support meaningful upside from here. Furthermore, the widely spoken about tech rally looks to me, chartwise, to be about 90% done."

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; Williams. **Thurs:** Leading Index -0.6%; Philadelphia Manufacturing Index -19.2; Exiting Home Sales +5.0% to 4.5mu; Initial & Continuous Jobless Claims 240k/1.82m. (Bloomberg estimates)

Global: Wed: Eurozone Headline & Core CPI 0.9%m/m/6.9%y/y & 1.2%m/m/5.7%y/y; Eurozone Current Account; UK Headline & Core CPI 0.5%m/m/9.8%y/y& 0.6%m/m/6.0%y/y; UK PPI Input & Output 12.0%/8.7% y/y; Japan Industrial Production 4.5%; Japan Trade Balance -¥1.29t; China PBoC Loan Prime Rate; Australia NAB Quarterly Business Confidence; BOE Quarterly Bulletin; Schnabel; Mann; Lane. **Thurs:** Eurozone Trade Balance; Germany ZEW Economic Sentiment 15.1; UK Average Earnings Index Including & Excluding Bonus 5.1%/6.2%; UK Employment Change 3m/3m 52k; UK Unemployment Rate 3.7%; UK Claimant Count Change 10.2k; UK Labor Productivity 0.3%; Canada Headline & Core CPI 4.3%/4.8% y/y; Macklem; Rogers. (Bloomberg estimates)

US Economic Indicators

Housing Starts & Building Permits (*link*): Housing starts and building permits both fell in

March, after bouncing back in February, on sharp declines in volatile multi-family building; single-family data are showing signs of stabilizing. *Housing starts* slipped 0.8% in March after rebounding a revised 7.3% (from 9.8%) in February, which was the first increase in six months. Starts are down 17.2% from a year ago. Single-family starts advanced for the third time in four months, by 2.7% in March and 6.7% over the period to 861,000 units (saar), with February starts stronger than first reported. *Single-family* starts were in a freefall from last March through November, plunging 33.5% over the period. They are 27.7% below a year ago, though the decline has narrowed from November's 33.9% drop. Volatile *multi-family* starts fell 5.9% in March to 559,000 units (saar), after rebounding 27.2% the first two months of this year from December's 23.7% shortfall. They are 6.5% above a year ago, led by a 21.4% increase in two- to four-unit structures, with five or more unit structures 6.1% above a year ago. *Building permits* fell 8.8% in March to 1.413mu (saar) after a two-month increase of 15.9%, though single-family permits advanced for the second month, up 4.1% in March and 13.3% over the two-month period to 818,000 units (saar), after sliding for 11 consecutive months by 40.0% (to 722,000 units from 1.204mu). Multi-family permits fell 22.1% last month to 595,000 units, after gains of 23.8% and 1.8% the previous two months. Homebuilders' confidence for April, reported on Monday, was encouraging. The *three components* of homebuilders' confidence show steady climbs over this year's first four months in both the current sales (to 51 from 36) and future sales (50 from 35) measures, each posting gains of 15 points, while traffic of prospective home buyers (31 from 20) advanced 11 points over the first three months of the year but was unchanged at 31 during April.

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