MORNING BRIEFING
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Capital Spending, Automation & Earnings

Check out the accompanying chart collection.

Executive Summary: While surveys of business managers' capital spending plans suggest more spending caution, that could partly reflect all the recession talk recently. Actual capital spending shows no sign of recession; it hit a record high last quarter. … Also: Factory managers are flocking to technological solutions to their many challenges, reports Jackie; Rockwell updates the story. … And: Joe reviews what Q1 results reported to date collectively say about how companies fared last quarter and how results jibe with analysts' expectations. Notably, analysts haven't been slashing estimates after hearing managements' conference calls, as they've done in recent quarters.

Industrials I: Capital Spending Surveys Downbeat. Recessions depress capital spending, which worsens the recessions (*Fig. 1*). Capital spending in real GDP rose to a record high of $3.0 trillion (saar) during Q1-2023. So there is no recession evident in capital spending so far. Various surveys of business managers' capital spending plans do show that they're turning more cautious about making large outlays of capital. But that certainly can be explained by all the talk of recession going on these days. If a recession is on the horizon, it will be the most anticipated recession on record!

While it's possible for us to talk ourselves into a recession, Jackie and I don't think a broad-based recession is coming partly because ongoing structural labor shortages and onshoring will force businesses to invest in productivity-enhancing technologies and in supply chains that are more homebased. Let's review the surveys and then the actual data on capital spending:

(1) *CEO survey.* The Business Roundtable *CEO Economic Outlook Index* is based on a survey—conducted quarterly since the Q4-2002—of the organization's members. The CEOs are asked about their plans for hiring and capital spending, as well as their expectations for sales, over the next six months.

The overall Index for Q1-2023 increased slightly by six points from last quarter to 79. The results mark the third consecutive quarter at or below the long-run average of 84 but still above the expansion or contraction threshold of 50. This quarter's survey was conducted from February 8 through March 8, 2023, before the Silicon Valley Bank crisis. A total of 141

CEOs completed the survey.

The overall index tends to be a good leading indicator of the y/y growth rate of both nominal and real capital spending in GDP (*Fig. 2*). During Q1, they were up 9.5% and 2.7% respectively, down from their Q2-2021 peaks of 13.2% and 12.5%. We don't expect to see either one of these series to show negative y/y comparisons over the rest of this year or during 2024.

(2) *Regional business surveys.* The regional business surveys conducted by five of the 12 Federal Reserve district banks include questions about current and future capital spending. The respondents tend to be skewed toward manufacturing companies. Based on the surveys, Debbie and I have constructed an average of the current capital spending indexes for three of them and a similar average future index for all five (*Fig. 3* and *Fig. 4*).

The current regional capital spending index rose to a cyclical high of 25.8% during December 2021 and fell to 5.3% during April. The future index peaked at 33.8% during July 2021 and fell to 6.5% in April. So both have dropped significantly but remain in positive territory.

(3) *Small business survey.* The most depressing capital spending survey-based indexes are the ones compiled monthly by the National Federation of Independent Business of its membership of small business owners. During March, only 2% of them agreed that now is a good time to expand (*Fig. 5*). That's a record low! However, 20% said that they planned to invest in their businesses over the next three to six months. The low in this series was 14% during March 2009.

Industrials II: Actual Capital Spending Upbeat. As noted above, overall capital spending rose to a record high during Q1-2023. However, there were pockets of weakness that were more than offset by areas of strength:

(1) Prior to the mid-1990s, real capital spending on structures exceeded spending on equipment and on intellectual property (*Fig. 6*). From then up until the pandemic, equipment investment exceeded the other two series. Then during the pandemic, equipment and intellectual property tracked closely, rising to new record highs. Spending on structures has been essentially flat since the early 1980s.

By the way, intellectual property includes software, research & development (R&D), and entertainment, literary, and artistic originals.

(2) During Q1, equipment investment edged down from Q3-2022's record high, while spending on structures edged up after mostly falling since the pandemic lockdown, and intellectual property remained at a record high.

(3) Among the strongest categories of capital spending have been information technology equipment, software, and R&D (*Fig. 7*). They all remain on solid uptrends in record-high territory.

(4) Also showing some signs of life are spending on industrial equipment and manufacturing structures (*Fig. 8* and *Fig. 9*). Both are likely to move higher as manufacturing continues to automate to boost productivity and to bring supply chains onshore to reduce geopolitical risk.

Industrials III: The Factory Renaissance. Factory managers are embracing all manner of technology to improve their businesses and profitability. They're using technology to overcome labor shortages, minimize supply-chain risks, monitor product quality, harness data, and beef up cybersecurity. That's what 1,353 global manufacturers told Rockwell Automation in its 8th annual State of Smart Manufacturing *report*. I asked Jackie to look at some of the report's findings as well as Rockwell's fiscal Q2 (ended March 31) earnings, which beat Wall Street analysts' consensus forecast:

(1) *Survey says: Factories going high tech.* Manufacturers are facing a wide array of challenges, and they're hoping to come up with solutions by harnessing technology. Nearly half of the survey respondents, 46%, said they lacked the skilled workforce to outpace the competition over the next 12 months. Many also lack the necessary technology (43%), innovation (39%), speed (38%), ability to use data to make decisions (35%), production capacity or quality (34% and 31%), access to data (30%), and capital (25%). (Respondents picked their top five problems.)

Over the next year, manufacturers plan to invest in the following technologies: cloud technology, applications, and infrastructure (44%), automation (42%), security/cybersecurity management (39%), business and/or manufacturing software (38%), smart/connected tools & equipment (35%), maintenance management (35%), robotic process automation (33%), sales and operations planning (33%), inventory management (32%), and lean manufacturing (30%). (Respondents checked off all areas that applied.)

(2) *Rockwell benefits from trends.* US companies across a host of industries are breaking ground on new factories as they reshore operations or tap into federal dollars and tax

incentives available in many green energy industries. Globally, factories are using technology to solve many of the problems highlighted in the State of Smart Manufacturing report. These positive trends have helped Rockwell's top and bottom lines.

Rockwell's fiscal Q2 revenue jumped 25.8% y/y to $2.3 billion, and its adjusted earnings per share jumped 81.3% y/y to $3.01, well above analysts' consensus $2.58 forecast. Cash flow from operating activities in the quarter doubled y/y to $187 million, and Rockwell increased its guidance for fiscal 2023 (ending September 30).

We're "seeing across all verticals an increased focus on automation, and that's due to large durable trends, things like scarcity of trained workforce and so the need to complement people with the technologies and the software and the services that we provide. So … while we continue to pay close attention to macroeconomic conditions, we think the setup for multiyear growth in automation and information is there," said CEO Blake Moret on the company's April 27 earnings *conference call*.

Within Rockwell's automotive segment, which includes electric vehicles and batteries, sales grew more than 40% y/y, and sales in the semiconductor unit rose by a y/y rate in the mid-teens. The company also saw strong growth in its energy, food and beverage, and its life sciences businesses, but management called out a mid-single-digit y/y sales decline in its e-commerce and warehouse automation divisions.

(3) *Strong, but slower second half?* Rockwell's order backlog started this fiscal year at $5.2 billion and had increased to $5.6 billion by the end of fiscal Q2. The backlog is expected to decline to around $5.0 billion by year-end, which the company attributed to the improvement in semiconductor chip supplies as well as its own additional capacity. The additional product will allow lead times to improve as orders and shipments converge.

Rockwell upped its fiscal 2023 sales growth guidance to 12.5%-16.5% from 10.0%-14.0% previously and its adjusted earnings per share forecast to $11.50-$12.20 from $10.70-$11.50. Assuming analysts' consensus forecasts in the *WSJ* are on the mark, the company's earnings will jump from $7.96 a share in fiscal 2022 to $11.82 this fiscal year and $12.84 in fiscal 2024. They're calling for fiscal Q3 (ending June 30) earnings to grow 18.4%, and fiscal Q4 earnings to jump 9.5%.

Rockwell shares peaked at $350.76 in December 2021, fell to a low of $191.09 in June 2022, and since have rebounded to $282.65 as of Monday's close.

Earnings: Q1 Halfway Review. The Q1 earnings season has now passed the halfway mark. With 57% of the S&P 500 companies having already released their interim financials through midday Tuesday, the results thus far suggest that the worst of the analysts' downward estimate revisions cycle is in the rearview mirror.

Cost-cutting has helped companies to easily beat analysts' forecasts for the Q1 bottom line, but the top-line surprise is not getting better relative to prior quarters, and y/y growth comparisons remain challenged at both lines, top and bottom. The silver lining is that revenues growth isn't so strong as to imply that inflation remains an underlying problem, as that could lead to a higher-than-expected terminal federal funds rate.

Below, Joe summarizes the Q1 results and their impact on analysts' forecasts:

(1) *Companies still beating estimates.* For the 285 companies that have reported thus far, Q1's revenue beat of 2.1% is an improvement from the 11-quarter low of 0.8% at the same point during the Q4 season (*Fig. 10*). More impressive has been the earnings surprise of 7.7% so far, which compares to a 14-year low of 1.2% at the same point during Q4 (*Fig. 11*). The earnings beat is turning up now and on pace to be the strongest since Q3-2021. However, the revenue surprise remains below the average post-economic shutdown rate of 2.9% seen from Q2-2020 to Q4-2022.

For a second straight quarter, it appears that the S&P 500's Energy sector will not meaningfully skew the revenue and earnings beats of the overall S&P 500 composite index. That implies companies will have less pricing power going forward. During the recovery coming out of the pandemic, many companies passed their higher energy and transportation costs on to their customers, which resulted in a boost to their revenue and earnings growth rates.

(2) *Y/Y growth comparisons continue to slow.* Revenues growth is continuing to weaken so far in Q1 compared to the double-digit percentage growth readings of 2021-22. For the 285 companies, it's up just 3.8% y/y, down from 5.2% at the same point during the Q4-2022 season. That's also the slowest growth rate since Q4-2020. On the other hand, the y/y earnings decline remains relatively moderate and has stabilized. Earnings for the 285 reporters is down just 0.6% y/y compared to a 1.9% decline at the same point in Q4. However, the y/y quarterly earnings growth is trailing revenues growth for a fifth straight quarter. For perspective, this previously happened only seven times in the 43 quarters prior to the pandemic.

(3) *Earnings growth still energized, but revenues de-energizing.* Energy is having a mixed effect on overall revenues and earnings growth so far. For the S&P 500 companies that have reported to date, the Q1 revenues growth of 3.8% y/y would be 0.8ppt higher without Energy, or 4.6%. However, Energy continues to push the needle on earnings. Among the reporters so far, S&P 500 earnings is down just 0.6% y/y, but without Energy it would be a much worse 2.8%.

(4) *A sigh of relief.* As companies issue their press releases and 10-Qs, the analysts that follow them look at the financials and consider what management says during the quarterly conference calls. What they're hearing so far suggests that the profits outlook isn't getting better. But it isn't getting worse either.

We had a "whoa" moment when we saw that the S&P 500's bottom-up forecast for 2023 rose during the April 27 week for a second week in a row (*Fig. 12*). That prompted a look behind the curtain at analysts' forecasts for the rest of the year. We found that the gain in the 2023 estimate was attributable only to the amount of the Q1 surprise, not to improving prospects for the remaining three quarters of the year (*Fig. 13*). While those quarterly estimates are down, the decrease has been very minor compared to the cuts that began following the Q2-2022 earnings season (*Fig. 14*).

In short, analysts are not embarking on heavy estimate cutting following earnings reports for the first time in three quarters.

Calendars

US: **Wed:** ADP Employment 143k; ISM NM-PMI 51.8; S&P Global C-PMI & NM-PMI 53.5/53.7; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 5.25%. **Thurs:** Nonfarm Productivity & Unit Labor Costs -1.8%/5.2%; Merchandise Trade Balance -$63.3b; Initial & Continuous Jobless Claims 240k/1.863m; Fed's Balance Sheet; Natural Gas Storage. (Bloomberg estimates)

Global: **Wed:** Eurozone Unemployment Rate 6.6%; Italy Unemployment Rate 8.0%; UK BOE Quarterly Bulletin; Jochnick; McCaul; Wuermeling; Balz; Ellis. **Thurs:** Eurozone PPI -1.6%m/m/6.2%y/y; Eurozone, Germany, and France C-PMIs 54.4/53.9/53.8; Eurozone, Germany, France, Italy, and Spain NM-PMIs 56.6/55.7/56.3/56.7/59.5; ECB Interest Rate Decision & Deposit Facility Rate 3.75%-3.25%; Germany Trade Balance €16.1b; Spain Unemployment Change -23.1k; UK C-PMI & NM-PMI 53.9/54.9; China Caixin NM-PMI 57.3;

RBA Monetary Policy Statement; Lagarde; Macklem. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q1 Earnings Season Monitor (*link*): With the Q1-2023 earnings season now 57% complete, indications are that this season is a big improvement from Q4-2022's relatively weak showing. Then, the earnings surprise was the lowest since Q4-2008, and the revenue surprise the smallest since Q1-2020. Furthermore, the earnings surprise failed to outpace the revenue surprise in Q4-2022 for the first time since we began tracking that data in Q1-2009. With 285 of the S&P 500 companies finished reporting for Q1-2023, revenues are ahead of the consensus forecast by 2.1%, and earnings have exceeded estimates by 7.7%. At the same point during the Q4 season, revenues were 0.8% above forecast and earnings had beaten estimates by 1.2%. Just 73% of the 285 Q1 reporters that have reported so far through mid-day Tuesday has reported a positive revenues surprise, while 78% has reported an earnings beat. Those are big improvements from their Q4-2022 readings, when they probably bottomed. However, their aggregate y/y revenue and earnings growth rates are little changed from their Q4-2022 readings. The collective y/y revenue gain for the 285 reporters so far has dropped to 3.8% from 5.2% at the same point in Q4-2022, and earnings are down 0.6% y/y from a 1.9% y/y decline in Q4-2022. During the past 56 quarterly reporting seasons over the last 14 years, y/y earnings growth has trailed revenue growth in only 14 of the quarters, and it's likely to do so again in Q1-2023. Significantly fewer companies are reporting positive y/y earnings growth in Q1 (57%) than positive y/y revenue growth (70%). These figures will continue to change as more Q1-2023 results are reported in the coming weeks. While we expect y/y revenue growth rates to remain positive in Q1, earnings are likely to decline for a second straight quarter.

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI was negative for a tenth straight month in April, but improved to a nine-month high of -6.7% from -7.3% in March. That's up from a 30-month low of -15.6% in December. It had been negative for 13 straight months through July 2020 due to the pandemic shutdown. The 23-month positive streak that ended in June 2022 had exceeded the prior 18-month positive streak during the cycle that ended October 2018, when NERI reached a tax-cut-induced then-record high of 22.1% in March 2018. April's reading compares to a record-high 23.1% in July 2021 and an 11-year low of -37.4% in May 2020. All 11 sectors had negative NERI again in April, compared to 10 with negative readings in February. Among the 11 sectors, five improved m/m: Consumer Discretionary, Health Care, Industrials, Materials, and Real Estate. Communication Services was negative for an 18th month, and Consumer Discretionary and

Health Care for a 13th month. Here are the April NERIs for the S&P 500 and its sectors compared with their March readings: Industrials (-0.6% in April, up from -3.0% in March), Consumer Staples (-1.6, -0.6), Information Technology (-3.5, -3.3), Health Care (-4.0 [12-month high], -4.2), S&P 500 (-6.7, -7.3), Consumer Discretionary (-4.3 [12-month high], -8.7), Communication Services (-7.8, -7.4), Utilities (-8.5 [33-month low], -8.4), Real Estate (-12.1, -13.2), Financials (-12.8 [34-month low], -11.6), Energy (-19.2 [34-month low], -17.0), and Materials (-19.2, -19.3).

S&P 500 Sectors Net Revenue Revisions (*link*): The S&P 500's NRRI weakened m/m in April for the first time in five months, but was positive for a third month. It dropped to 4% from a nine-month high of 1.8% in March. Before the 24-month positive streak ended in August, it had been negative for 21 straight months. That positive streak exceeded the prior 19-month streak during the cycle that ended in October 2018, when NRRI reached a tax-cut-induced then-record high of 14.7% in March 2018. April's reading compares to a record-high 25.9% in August 2021 and an 11-year low of -35.8% in May 2020. Five of the 11 S&P 500 sectors had positive NRRI in April, down from six a month earlier. Three sectors had NRRI move higher m/m, down from six improving in March and January's 25-month high of nine sectors rising. Financials' NRRI turned negative m/m. Communication Services was negative for an 18th straight month, followed by Tech at 10 months and Materials at nine. Here are the April NRRIs for the S&P 500 and its sectors compared with their March readings: Consumer Staples (17.4% in April, down from 19.5% in March), Utilities (16.1, 11.9), Health Care (8.3, 9.0 [14-month high]), Consumer Discretionary (8.3 [15-month high], 4.8), Industrials (7.5, 8.2 [nine-month high]), S&P 500 (1.4, 1.8 [nine-month high]), Financials (-2.1, 1.5), Real Estate (-2.1 [26-month low], -0.9), Materials (-4.9, -5.3), Information Technology (-5.9, -5.7 [eight-month high]), Communication Services (-14.6, -11.1 [11-month high]), and Energy (-25.9 [34-month low], -25.8).

US Economic Indicators

JOLTS (*link*): *Job openings* have dropped by 1.6 million over the first three months of this year to a 23-month low of 9.6 million during March from 11.2 million at the end of last year. But March's level is still consistent with a tight labor market. The series peaked at a record-high 12.0 million last March. Openings reached 10 million during June 2021 for the first time in the history of the series going back to 2000—remaining above that level through January of this year. There were 5.8 million unemployed in March, so there were 1.64 available jobs for each unemployed person that month, the lowest since October 2021 and down from a record high of 2.01 last March. By industry, the *biggest declines* in job openings over the

past three months occurred in accommodations & food services (-394,000), professional & business services (-370,000), health care & social assistance (-280,000), retail trade (-247,000), construction (-147,000), financial activities (-124,000), and durable goods manufacturing (-105,000). *Hirings* are down 178,000 during the two months through March, to 6.1 million, with virtually all the decline occurring in February; hirings were at 6.6 million a year ago. Meanwhile, the number of *quits* remained at a high level in March at 3.9 million, but that's down from the record-high 4.5 million during November 2021.

Manufacturing Orders & Shipments (*link*): Factory orders rose 0.9% in March, after contracting 3.2% the first two months of this year, boosted by a 78.3% jump in civilian aircraft orders. *Excluding transportation*, orders fell for the fourth time in five months, by 0.7% in March and 3.1% over the period; the March level is 4.1% below last June's record high. Meanwhile, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) fell 1.4% during the two months through March, though is only 1.7% below last August's record high. *Nondefense capital goods shipments excluding aircraft* (used in calculating GDP) fell for the second consecutive month in March, by 0.9%, from January's record high. On a year-over-year basis, core capital goods orders and shipments are up 1.7% and 4.2%, respectively, slowing from their peak rates of 22.3% and 17.7% during April 2021. In March, orders for electrical equipment, appliances & components reached a new record high, while orders for machinery, motor vehicles & parts, and fabricated metals remained in record-high territory.

Global Economic Indicators

Eurozone CPI Flash Estimates (*link*): The CPI rate for April is expected to uptick slightly to 7.0% y/y after slowing steadily from a record-high 10.6% last October to 6.9% this March. Looking at the main components, *energy* is expected to return to positive territory, accelerating 2.5% y/y after falling 0.9% y/y in March, following double-digit yearly gains from April 2021 through February of this year; it peaked at a record high of 44.3% last March. The rate for *food, alcohol & tobacco* is expected to slow to 13.6% y/y after accelerating steadily from June 2021's 0.5% to a record high of 15.5% this March. The rate for *non-energy* industrial goods is predicted to ease for the second month to 6.2% y/y from February's record-high 6.8%. The *services* rate is forecast to accelerate for the third month, to 5.2% y/y in April—which would be the highest since May 1993. Of the *top four Eurozone economies*, rates in both Italy (8.8% y/y) and Germany (7.6) are expected to be above the Eurozone's rate of 7.0% and France's (6.9) rate just a tick below; Spain's (3.8) is predicted to be roughly half the headline rate. Here are the record-high inflation rates and dates they

were achieved for the four countries: Italy (12.6%, October & November 2022), Germany (11.6%, October 2022), France (7.3%, February 2023), and Spain (10.7%, July 2022).

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