MORNING BRIEFING
May 9, 2023

Jobs Driving The Economy

Check out the accompanying chart collection.

Executive Summary: It's tough to believe that a recession is imminent with the Coincident Economic Indicators index as strong as ever. The CEI's payroll employment component hit a record high in April, suggesting that the other three (yet-to-be-reported) components did too. Admittedly, the Leading Economic Indicators hasn't been strong; its weakness purportedly indicates a coming downturn in the CEI and real GDP. But look at its ten components: Services are noticeably absent. So the LEI is not as trusty a recession bellwether as the CEI, in our view. … Also: Joe Feshbach's insights on the stock market from a trader's perspective.

US Economy: The Key Coincident Indicator. The US labor market continues to provide stronger-than-expected gains in payroll employment, which rose by 253,000 during April to a new record high of 155.7 million. Payroll employment is one of the four components of the Index of Coincident Economic Indicators (CEI). The others are real personal income less transfer payments, real manufacturing and trade sales, and industrial production (*Fig. 1*). Debbie and I consider payroll employment to be the most important of the four. That's because it is the first reported one and provides lots of clues about the other three. Consider the following:

(1) *Payroll employment.* Like the other three CEI components, payroll employment tends to peak when the business cycle peaks. But it shows no signs of doing so, as we discussed in yesterday's *Morning Briefing*.

It's hard for us to work up much concern about an impending recession while payroll employment is rising to new record highs. That's because April's record-high payroll employment strongly suggests that the other CEI components rose to record highs in April too, and the overall CEI is the best monthly coincident economic indicator of the business cycle there is. Its peaks and troughs occur at the same time as the peaks and troughs in the business cycle (*Fig. 2*). So an imminent recession is hardly a worry when the CEI is rising to new record highs!

(2) *Real personal income less transfer payments.* When the employment report is released, usually on the first Friday of each month, we multiply it by the average workweek to get total hours worked in billions; then we multiply the product of those two variables by average

hourly earnings. The result is our Earned Income Proxy (EIP) for private wages and salaries in personal income, which is highly correlated with—and accounts for 78% of—private wages and salaries (*Fig. 3*). The difference between the two is attributable to salaries.

Actual private wages and salaries accounts for 54% of personal income less transfer payments (*Fig. 4*). In other words, our EIP provides a useful advance reading on personal income less transfer payments. The former rose to a record high in April, suggesting that the latter did the same.

Personal income is reported near the end of each month, about a week after the Conference Board releases its report on the CEI and the Index of Leading Economic Indicators (LEI). So the Conference Board uses an estimate of personal income, which undoubtedly is based on its calculation of the EIP and the other components of personal income less transfer payments, as well as on the PCED price measure used to deflate this CEI component.

(3) *Real manufacturing and trade sales.* The retail sales report is released a couple of days before the Conference Board calculates the CEI for the previous month. Released at the same time as retail sales is manufacturing and trade sales but with a lag of one month (*Fig. 5* and *Fig. 6*). So this component of the CEI is also estimated by the Conference Board. Again, payroll employment and our EIP provide some insight into retail sales since wages and salaries is the main driver of personal income and consumers' purchasing power (*Fig. 7*).

(4) *Industrial production.* Industrial production is usually released the same day as retail sales. Once again, we can get an advance estimate from the employment report's aggregate weekly hours index for manufacturing (*Fig. 8*). The manufacturing hours index peaked during September and October 2022 and has been flat since then through April, when it edged up 0.1%.

(5) *Bottom line.* So far, there isn't even a hint of a recession in the CEI. During March, it was up 1.8% y/y (*Fig. 9*). It tracks the comparable growth rate of real GDP, which was 1.6% during Q1-2023.

Yes, but what about the LEI? It peaked at a record high during December 2021, falling 8.0% through March (*Fig. 10*). On a y/y basis, it was down 7.8% through March (*Fig. 11*). Doesn't that indicate that a sharp downturn in the CEI and real GDP is imminent?

The LEI includes 10 economic indicators. The three financial components are the leading credit index, the S&P 500, and the interest spread between the 10-year Treasury bond yield and the federal funds rate.

The seven nonfinancial components are initial unemployment claims, consumer expectations, house building permits, the ISM index of new manufacturing orders, average weekly hours in manufacturing, manufacturers' nondefense capital goods orders (estimated), and manufacturers' new orders for consumer goods & materials (estimated). The Conference Board also adds a "trend adjustment factor."

Notice that four of the nonfinancial indicators are related to manufacturing. In the past, manufacturing was among the most cyclical economic sectors. The consumer is represented by three of the nonfinancial indicators. Like manufacturing, housing is also a very cyclical sector of the economy. Notably absent are any variables for services.

This explains why the LEI on a y/y basis is better correlated with the y/y growth rate in real GDP for goods rather than real GDP for goods and services (*Fig. 12*).

Strategy: Trader's Corner. Here is Joe Feshbach's latest thoughts on the market from a trading perspective:

"The market is still sending a bunch of mixed signals, which argues in favor of the continuation of the large trading range but with some unfinished business on the upside for the short term. As I mentioned last week, as I sit here staring at the Nasdaq Composite chart, it's really hard to see how this index does not take out its prior intraday high of 12269.55. Typically there's some follow-through in the ballpark of around 2%.

"While the Put/Call Ratio most definitely improved on last week's early setback and supports new current rally highs, there are too many warning signs for me to get too excited. Important rallies typically prefer broad participation, and this rally has been accompanied by way too much narrow breadth. Amazingly, the cumulative Advance/Decline Line for Nasdaq was just making new lows this past week. And by the way, AAPL and MSFT now account for 14% of the S&P 500 weighting.

"Furthermore, most of the known large-cap tech stocks have already rallied significantly and are now witnessing very good earnings news. As I mentioned last week, this is more of an 8th inning development rather than a 3rd inning occurrence. Therefore, as this current phase of the rally finishes off, I still expect the market to fall back into its larger trading range."

Calendars

US: **Tues:** NFIB Small Business Optimism Index; API Crude Oil Inventories; EIA Short-Term Energy Outlook; Williams; Jefferson. **Wed:** Headline & Core CPI 0.4%m/m/5.0%y/y & 0.4%m/m/5.5%y/y; Federal Budget Balance -$302b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: **Tues:** France Trade Balance –€9.4b; UK Halifax House Price Index; Lane. **Wed:** Germany CPI 0.4%m/m/7.2%y/y; Italy Industrial Production 0.3%; UK RICS House Price Balance -40%; Japan Leading & Coincident Indicators; China CPI 1.0%y/y; China PPI -2.5%y/y; BOJ Summary of Opinions; Wuermeling. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week simultaneously for all three of these indexes for the first time in six weeks and only the third time since they peaked at record highs last June. All three are slowly rising now from their lows during February and March. Through the week ending May 5, LargeCap's forward earnings rose 0.5% w/w for its seventh gain in the last nine weeks and is now 1.7% above its 54-week low during the week of February 10. MidCap's increased 0.7% w/w to 1.1% above its 55-week low during the week of March 10. SmallCap's gained 0.3% w/w to 1.8% above its 72-week low during the March 17 week. For a 45th 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 4.3% 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 12.0% 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 14th straight week, but improved w/w to -2.4% y/y from a 27-month low of -3.1% 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 -4.9% y/y is at a 30-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 -9.7% y/y is at a 30-month low during the April 28 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 and 2024 had been heading steadily lower since last June, but 2023's estimates are ticking higher now as analysts add Q1's strong earnings beats into their forecasts . Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.3% and 11.6%), MidCap (-10.3, 13.3), and SmallCap (-8.2,14.9).

S&P 500/400/600 Valuation (*link*): Valuations ticked lower w/w through the May 5 week for these three indexes. LargeCap's forward P/E dropped 0.2pt w/w to 18.0 from its nine-month high of 18.2 a week earlier. 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 fell 0.2pt to 13.3, which is 1.4pts below its recent 10-month high of 14.7 in early February. It's now 2.2pts 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 to 12.6 and remains 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 is at a 26% discount relative to LargeCap's, not much improved from a 23-year-low 28% discount last July. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 30% discount to LargeCap's P/E last week is also not much improved from a 21-year low of 32% in April 2022. That compares to 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 99th straight week; the current 5% discount has weakened from 1% during the March 31 week. That 1% discount 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 decelerate q/q for a seventh straight quarter in Q1-2023 to -3.2% y/y from -1.6% in Q4-2022 on a frozen actual basis. On a pro forma basis, they expect the y/y earnings decline to lessen in Q1-2023, to -0.7% from -3.2% in

Q4-2022. 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 (55.0% in Q1-2023 versus -15.6% in Q4-2022), Industrials (25.5, 41.4), Energy (19.6, 59.1), Financials (7.3, -8.9), Consumer Staples (-0.3, -2.5), S&P 500 (-0.7, -3.2), Real Estate (-7.8, -3.2), Communication Services (-9.4, -28.2), Information Technology (-9.9, -10.0), Health Care (-14.8, -2.7), Utilities (-22.2, -4.6), and Materials (-22.6, -20.4).

S&P 500 Q1 Earnings Season Monitor (*link*): With the Q1-2023 earnings season nearly 85% complete, this season is turning out to be 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 424 of the S&P 500 companies finished reporting for Q1-2023, revenues are ahead of the consensus forecast by 2.5%, and earnings have exceeded estimates by 7.3%. At the same point during the Q4 season, revenues were 1.7% above forecast and earnings had beaten estimates by 1.6%. Just 75% of the 342 Q1 reporters that have reported so far through Friday's close has reported a positive revenues surprise, while 77% has reported an earnings beat. Those are big improvements from their Q4-2022 readings, when they probably bottomed 68% for both revenues and earnings. 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 424 reporters so far has dropped to 3.8% from 5.8% at the same point in Q4-2022, and earnings are down 2.8% y/y from a 0.5% 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 (61%) than positive y/y revenue growth (73%). These figures are not expected to change much 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.

Global Economic Indicators

Germany Industrial Production (*link*): More bad news has come out of Germany following last week's report of a plunge in factory orders in March. Germany's *headline production, which includes construction*, tumbled 3.4% in March, more than double the expected decline and the steepest in a year. It had rebounded 5.9% the first two months of the year from December's 2.4% drop. Meanwhile, *production excluding construction* (which the overall Eurozone uses) contracted 3.1% in March from a 4.5% rebound the prior two months. Construction output sank 4.6% in March after rebounding 13.6% the first two month of this year from the 8.9% drop the final two months of 2022. Manufacturing output plunged 3.2% in March, wiping away a good portion of the 4.5% surge the first two months of the year, with production of motor vehicles tumbling 5.4%, following February's 6.5% surge. Looking at the main industrial groupings, *output of capital goods* sank 4.4% in March after a seven-month surge of 9.7%, while *output of intermediate goods* contracted 3.5% in March after rebounding 8.7% the first two months of this year from a 5.9% drop during the final months of 2022. Meanwhile, *consumer durable goods production* rebounded 8.0% during the two months through March, nearly reversing the 8.9% drop the prior five months, while *consumer nondurable goods production* fell 1.1% in March, following a 1.8% gain and a 1.0% loss the prior two months. On a *year-over-year* basis, only capital goods (15.7% y/y) and consumer durable goods (2.2) production were in the plus column, while the remaining industrial groupings were in the red: energy (-10.2), intermediate goods (-4.5), and consumer nondurable goods (-4.2). March's disappointing industrial production report follows last week's factory orders report, which showed a 10.7% drop in March billings, with foreign orders from both outside (-14.8%) and inside (-10.8) the Eurozone posting double-digit declines and domestic orders falling two of the first three months of the year by 7.7%.

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