Yardeni Research

MORNING BRIEFING
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Earnings & The Economy

Check out the accompanying [chart collection].

Executive Summary: While the stock market's technical measures of breadth have been disappointing, two fundamental measures have been staging impressive V-shaped rebounds typical of early bull markets: the breadth of analysts' consensus expectations for S&P 500 companies' revenues and operating earnings. … Their message is confirmed by recent strength in S&P 500 forward revenues, earnings, and profit margins. … Joe provides a deeper look into what forward profit margins have been doing in recent weeks on S&P 500 sector and industry levels. … All these developments jibe with our soft-landing economic forecast. … So do the latest economic indicator releases.

Strategy I: Bad & Good Breadth. Joe and I have recently observed that the S&P 500 has a breadth problem. This is a widely recognized problem by most technicians who track the stock market. The good news is that a more fundamental measure of earnings breadth is performing well. Consider the following:

(1) If we are in a bull market that started on October 12, 2022 as we still believe, our thesis isn't getting much support from the ratio of the equal-weighted to the market-cap-weighted S&P 500 indexes (*Fig. 1*). This measure of breadth was rebounding nicely since the October 12 low, but it then dropped sharply after Silicon Valley Bank hit the fan in early March.

During the start of bull markets, this ratio tends to rise, indicating that more and more stocks are participating in the bull run. The same breadth issue can be seen in the New York Stock Exchange advance/decline line (*Fig. 2*).

(2) Joe and I also monitor the percent of S&P 500 companies trading above their 200-day moving averages (*Fig. 3*). It did rebound from 15.6% on October 14 to a recent high of 72.7% on February 3. But it's been hovering around 50.0% in recent days. We would have liked to see a more V-shaped rebound in this breadth measure.

Also disappointing is the percent of S&P 500 companies with positive y/y price changes (*Fig. 4*). It has remained below 50.0% since the start of the bull market and was 45.2% on May 12.

(3) The good news is that the breadth of analysts' consensus expectations for the S&P 500's revenues and for its operating earnings continue to rebound in V-shaped formations (*Fig. 5* and *Fig. 6*). The percent of S&P 500 companies with positive three-month percent changes in forward revenues rebounded from a recent low of 50.6% during the week of December 30, 2022 to an 11-month high of 75.1% during the May 12 week. The same pattern can be seen in the comparable measure for forward earnings; it rebounded from 44.4% during the December 30, 2022 week to 69.9% during the May 12 week, also an 11-month high. (FYI: "Forward" revenues and earnings are the time-weighted averages of analysts' consensus estimates for the current and next years.)

The solid rebounds in these breadth measures of revenues and earnings are typical of the early stage of bull markets.

(4) The obvious explanation for the divergence of the technical and fundamental measures of breadth since the banking crisis started in early March is that the MegaCap-8 stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) were boosted by the crisis, while the S&P 500 Financials got whacked by it. However, industry analysts didn't see the banking crisis as reason enough to lower their earnings estimates for the Financials sector's companies, as the crisis seems to have been contained so far. Once investors conclude that the crisis is over, the technical measures of breadth should recover.

The market capitalization of the MegaCap-8 has increased 36.4% ytd (*Fig. 7*). The S&P 500 Financials sector is down 6.3% ytd through Friday's close (*Fig. 8*).

Strategy II: Bottoming Earnings. Confirming the improving outlook for earnings are S&P 500 forward revenues and earnings (*Fig. 9*). The former rose to a new record high during the May 4 week, while the latter seems to have been bottoming in recent weeks, implying that the forward profit margin is doing the same. All of these developments are consistent with our soft-landing scenario for the economy.

Here are some more details on earnings:

(1) *Annual.* S&P 500 forward earnings most recently bottomed during the February 9 week (*Fig. 10*). It rose 1.6% through the May 11 week, when industry analysts' consensus earnings estimates for 2023 and 2024 were $220.09 and $245.83. Forward earnings is converging toward the 2024 estimate. (We will update our estimates once the Q1 earnings reporting season is completed within the next few days.)

(2) *Quarterly.* S&P 500 earnings for Q1 are turning out to be better than expected, showing the typical "earnings hook" in the data series as actual results are reported. Five weeks ago, the blended estimate combining estimated and reported results showed a 7.9% y/y decline (*Fig. 11*). During the May 11 week, it was pared to -3.3%.

Here are the y/y growth estimates for the remaining quarters of this year: Q2 (-8.2%), Q3 (0.0%), and Q4 (8.7%). In other words, y/y earnings comparisons should bottom during the current quarter (i.e., Q2). In any event, the stock market increasingly gives more weight to next year's expected results as the current year goes on.

(3) *Sectors.* The bottoming of forward earnings is clearly visible in 10 of the 11 sectors of the S&P 500 (*Fig. 12*). The one exception is S&P 500 Energy, where forward earnings has been falling since last summer. This bottoming breadth among sectors is consistent with the earnings breadth measure that we discussed above.

Strategy III: Forward Profit Margin Rising Following Q1 Results. As of mid-day Tuesday, the S&P 500 companies' Q1 earnings season is nearly 92% complete. Those with quarters ending in April are just starting to release results. This year's Q1 reporting season is notable for its unexpectedly large upside earnings surprise. As a result of the earnings strength, most of the S&P 500's 11 sectors have seen their collective forward profit margin rise. (FYI: We calculate forward profit margins from the forward earnings and forward revenues data derived from analysts' consensus estimates.)

While we await S&P's release of its preliminary revenues and earnings for Q1, let's take a look at our S&P 500 *Sectors & Industries Forward Profit Margins* report to see how the analysts polled by Refinitiv have reacted so far to the results; we highlight the notable changes below:

(1) *S&P 500 margin forecast finding a bottom?* The S&P 500's forward profit margin rose 0.1ppt w/w during the May 4 week to 12.4% from a 24-month low of 12.3% during the April 27 week (*Fig. 13*). That was the first uptick in the forward profit margin since it peaked 10 months ago at a record high of 13.4% during the June 9, 2022 week.

The improvement in the forward profit margin is a welcome sign after nearly a year of steady declines. However, we don't expect a rapid V-shaped margin expansion like the one following the recovery from the Great Virus Crisis' lockdowns. Back then, all 11 S&P 500 sectors' forward margins rebounded sharply. Instead, we envision a rolling margin recovery like the one following the Great Financial Crisis, with the overall S&P 500 forward margin bouncing along until earnings growth returns.

The forward profit margin tends to move slowly. While some sectors' forward margins are benefitting from accelerated cost cutting, their further margin expansion will require stronger revenue growth as well. Other sectors' and industries' margins will continue to languish near their lows or fall further as they continue to lose pricing power amid flattish or falling revenues.

(2) *Majority of sectors improving.* Many of the 11 S&P 500 sectors delivered noticeable earnings beats during Q1, and most saw their forward profit margin tick higher. But only one sector had a big forward margin bounce: Communication Services. From the start of the earnings reporting season during the April 6 week through the May 4 week, its forward profit margin jumped to 15.3% from 14.5%.

Six others saw more modest advances in forward profit margin over those weeks: Consumer Discretionary (up to 7.5% from 7.3%), Industrials (10.5, 10.3), Materials (11.2, 11.0), Information Technology (23.6, 23.3), Real Estate (16.8, 16.6), Consumer Staples (6.8, 6.7). The remaining four sectors' margins either fell or held steady: Energy (11.4, 11.7), Financials (18.2, 18.4), Utilities (13.0, 13.2), and Health Care (9.6, 9.6).

(3) *Best & worst industries.* Over the last four weeks through the May 4 week, more than half of the 100-plus S&P 500 industries have seen their forward profit margin rise (*Table 1*). There isn't any clear secular trend among the industry winners and losers of this margin derby. That fact highlights that picking the right industry with improving secular trends tends to trump getting the overall economic outlook correct.

These are the industries with the biggest forward profit margin gains from the April 6 week to the May 4 week: Casinos & Gaming (down to 5.4% from 4.1%), Interactive Media & Services (21.6, 20.1), Construction Machinery & Heavy Transportation Equipment (12.3, 11.4), Homebuilding (11.5, 10.4), and Gold (15.7, 14.7). Here are the industries with the biggest margin declines: Personal Care Products (7.4, 8.6), Regional Banks (24.1, 26.4), Oil & Gas Refining & Marketing (5.2, 5.5), Consumer Finance (14.5, 15.4), and Paper & Plastic Packaging Products & Materials (6.2, 6.5).

US Economy: No Hard Feelings. All of the above earnings developments are consistent with our soft-landing scenario, as were Tuesday's economic releases for April's retail sales and industrial production. There's no hard landing indicated in these indicators:

(1) *Retail sales.* As we noted following the release of April's employment report, our Earned Income Proxy for private-sector wages and salaries in personal income rose 0.7% m/m during the month (*Fig. 14*). That augured well for April's retail sales, which, however, rose less than expected by 0.4% m/m. But retail sales excluding motor vehicles & parts, service station sales, and building materials & garden equipment showed an increase of 0.7% m/m. A better measure of auto sales is provided by Autodata, which showed a 7.7% m/m increase (*Fig. 15*). The weakness in service station retail sales (down 0.8%) reflected lower gasoline prices. Building materials sales are included in residential investment in real GDP rather than in consumer spending.

(2) *Industrial production.* April's 0.5% increase in industrial production was led by a 13.7% jump in motor vehicle assemblies (*Fig. 16*). Output of high-tech equipment rose 1.5% m/m, led by a 1.5% jump in computer & peripheral equipment to a new record high (*Fig. 17*).

(3) *GDPNow.* There's no hard landing evident in these latest economic releases. Indeed, the Atlanta Fed's *GDPNow* tracking model showed a 2.6% increase in real GDP during Q2, a downtick from 2.7% following the latest economic stats. The estimate for real consumer spending was lowered from 1.8% to 1.6%, while spending on capital equipment was raised from 1.1% to 1.5%.

(4) *Coincident indicators.* On Thursday, the Conference Board will release April's indexes of Coincident Economic Indicators (CEI) and Leading Economic Indicators (LEI). The LEI has been anticipating a recession since early last year. The latest economic indicators, however, suggest that the CEI rose to yet another record high during April.

Calendars

US: Wed: Housing Starts & Building Permits 1.40mu/1.43mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Leading Indicators -0.6%; Philadelphia Fed Manufacturing Index & Prices Paid Index -19.8/8.10; Existing Home Sales 4.30m; Initial & Continuous Jobless Claims 254,000/1.818m; Fed's Balance Sheet; Natural Gas Storage; Barr; Jefferson; Logan. (Bloomberg estimates)

Global: Wed: Eurozone & Core CPI 0.7%m/m/7.0%y/y & 1.0%m/m/5.6%y/y; France Unemployment Rate 7.1%; Spain Consumer Confidence 78.9; Japan Industrial Production 0.8%; Japan Capacity Utilization 1.5%; Japan Trade Balance; Australia Employment Change & Unemployment Rate 25k/3.5%; De Guindos; Panetta; Mauderer; Bailey;

Elderson. **Thurs:** UK Gfk Consumer Confidence -27; BoE Quarterly Bulletin; BoE MPC Treasury Committee Hearings; BoC Financial System Review; Lagarde; De Guindos; Pill; Macklem. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q1 Earnings Season Monitor (*link*): With the Q1-2023 earnings season nearly 92% 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 458 of the S&P 500 companies finished reporting for Q1-2023, revenues are ahead of the consensus forecast by 2.3%, and earnings have exceeded estimates by 7.1%. At the same point during the Q4 season, revenues were 1.8% above forecast and earnings had beaten estimates by 1.0%. Just 74% of the 449 Q1 reporters that have reported so far through Tuesday's close has reported a positive revenues surprise, while 76% has reported an earnings beat. Those are big improvements from their Q4-2022 readings, when they were 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 458 reporters so far has dropped to 4.0% from 5.9% at the same point in Q4-2022, and earnings are down 3.5% y/y from a 1.9% y/y decline in Q4-2022. During the 57 quarterly reporting seasons over the last 14 years through Q1-2023, y/y earnings growth has trailed revenue growth in only 15 of the quarters, and it did so again in Q1 for a fifth straight quarter. Significantly fewer companies are reporting positive y/y earnings growth in Q1 (60%) than positive y/y revenue growth (72%). These figures could edge down as more Q1-2023 results are reported from retailers in the coming weeks. We expect the y/y revenue growth rate to remain positive in Q1, but y/y earnings growth is likely to be negative for a second straight quarter.

US Economic Indicators

Retail Sales (*link*): Retail sales increased in April for the first time in three months, helped by strong jobs growth and an easing of inflation. Sales climbed 0.4% (vs 0.8% expected) last month, following declines of 0.7% in each of the prior two months, though is up 1.9% ytd—boosted by a 2.8% jump in sales at the start of the year. Meanwhile, sales in the *control group*—which excludes autos, gasoline, building materials, and food services—rebounded 0.7% in April (vs consensus estimate of 0.4%) following March's 0.4% shortfall. This measure correlates closely with the consumer spending component in GDP; it's up 2.0% ytd. Of the *13 nominal retail sales categories*, seven rose in April and six fell. Here's a snapshot of the 13 categories' *April sales performance versus that of a year ago*: miscellaneous store retailers (2.4% m/m & 2.6% y/y), nonstore retailers (1.2 & 8.0), health & personal care stores (0.9 & 7.9), general merchandise stores (0.9 & 4.3), food services & drinking places (0.6 & 9.4), building materials & garden equipment (0.5 & -3.7), motor vehicles & parts (0.4 & -0.5), food & beverage stores (-0.2 & 3.7), clothing & accessories stores (-0.3 & -2.3), electronics & appliance stores (-0.5 & -7.3), furniture & home furnishings (-0.7 & -6.4), gasoline stations (-0.8 & -14.6), and sporting goods & hobby stores (-3.3 & -5.4).

Business Sales & Inventories (*link*): Both nominal and real business sales remain in record territory, though are down from their recent record highs. Since reaching a record high last June, *nominal business sales* has decreased five months, increased three months, and was unchanged one month, falling 2.4% over the nine-month period through March. Meanwhile, *real business sales* reached a new record high in January 2022, and was down only 0.7% during the 13 months through February. In the meantime, the real inventories-to-sales ratio in February edged up to 1.48, moving back toward November's recent high of 1.49—which was the highest since mid-2020. Meanwhile, the nominal ratio in March was back up at December's 30-month high of 1.39.

Industrial Production (*link*): Output in April beat consensus estimates, climbing for the first time in two months, led by a solid gain in manufacturing output. The *headline* rate rebounded 0.5%, after showing no growth the prior two months, building on its 1.0% rebound at the start of this year, for a ytd gain of 1.5%. Last year ended with a three-month slump of 1.9% in output. April production was only 0.5% below last September's recent high and within 1.1% of August/September 2018's record high. By industry group, *mining* production remains on an upward trend, rising 0.6% in April after a two-month decline of 1.9%—though still up 2.6% ytd; it's 31.0% above its recent May 2020 bottom. Meanwhile, *utilities* output decreased for the third time in four months, falling 3.3% ytd. Manufacturing production increased for the third time in four months, climbing 1.0% in March and 1.9% over the period; it had dropped 2.9% the final two months of last year. By *market group*, consumer goods production climbed for the third successive month in April, by a total of 1.5%, after a three-month slump of 1.1%. *Durable consumer goods* production in April rebounded 4.5% from March's 1.1% decline, as production of auto products soared 8.3% to within a percentage point of its July 2020 record high, while *nondurable consumer goods* production contracted three of the past five months, showing no growth over the period. *Business equipment* production rebounded 1.2% in April after sliding four of the prior five months by 4.0%. Transit equipment output jumped 3.6% in April after a five-month slide of 6.1%, while production of industrial & other equipment was flat in April after contracting four of the prior five months by a total of 3.2%. Meanwhile, production of information processing equipment rebounded 2.3% last month from the 1.9% drop during the two months through March.

Capacity Utilization (*link*): The *headline* capacity utilization rate moved up to 79.7% in April after falling from a recent peak of 80.8% last September to 79.4% this March. April's rate is equal to its long-run (1972-2022) average. The *manufacturing* utilization rate climbed to 78.3% in April after falling from 78.4% to 77.6% in March, with last month's rate 0.1ppt above its long-term average. Meanwhile, the *utilities* rate in April slumped to 72.7% after shooting up to 75.3% in March after a weather-related plunge from 76.1% in December to a record low of 69.7% by February. April's rate remained substantially below its long-run average. The capacity utilization rate for *mining* climbed to 91.8% in April—5.4ppt above its long-run average—after slipping from 93.0% in January to 91.2% in March.

NAHB Housing Market Index (*link*): "Limited existing inventory, which has put a renewed emphasis on new construction, resulted in a solid gain for builder confidence in May even as the industry continues to face several challenges, including building material supply chains disruption and tightening credit conditions for construction loans," according to the May survey. Homebuilders' *confidence* has climbed all five months of this year, by 19pts ytd to a 10-month high of 50, after sliding all 12 months of last year, by 53 points, to 31—which was the lowest since mid-2021 (excluding a drop to 30 at the height of the pandemic). All *three components* of homebuilders' confidence have climbed steadily the first five months of this year, with future sales (+22pts to 57) showing the biggest gain, followed by current sales (+20 to 56) and traffic (+13 to 33). They were at record highs of 89, 96, and 77, respectively, during November 2020. Incentives have played a key role in attracting buyers, though the latest survey shows that the use of these inducements is gradually slowing: The share of builders lowering home prices dropped to 27% in May, from 30% in April, 31% in February and March, and 36% last November. Meanwhile, 54% of builders offered some type of incentive to bolster sales in May, down from 59% in April and 62% last December, while the average price reduction remains at 6%, unchanged the past four months.

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