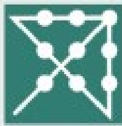
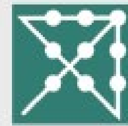
 Yardeni Research 

MORNING BRIEFING
May 31, 2023

Another Hated Bull Market

Check out the accompanying chart collection.

Executive Summary: The S&P 500 has been in a bull market since October. So how come there are so many bears refusing to believe that? Today, we recount the reasons that they write off the stock market's legitimately broad-based advance since fall as just a rally within a bear market. We also correct a few of their misperceptions and outline the bulls' stronger case. … And for a trader's perspective on this divisive market, a few words from Joe Feshbach.

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

Strategy I: The Bears' Litany. The latest bull market started on October 12 when the previous bear market ended (*Fig. 1*). It may be on course to be among the most hated bull markets in history. Here's why:

(1) *Valuation stretched.* The naysayers hate that the bull market started with historically high P/Es (*Fig. 2*). In the past, valuations usually offered much more compelling opportunities at the end of bear markets. Not so this time. The S&P 500 forward P/E bottomed at 15.1 on October 12. On Friday, May 26 it was back up to 18.3. The historical average P/E is 15.0. So the P/E didn't fall below this "fair value" during the bear market and now is well above it again.

(2) *Recession coming.* Most despicable is that the bull has the audacity to charge ahead when almost everyone agrees that a recession is coming any day now. The bull is a contrarian, bucking the consensus. The consensus crowd hates that and continues to claim that the rally since October 12 isn't the start of a new bull market at all but just a rally in a bear market.

The S&P 500 is one of the 10 components of the Index of Leading Economic Indicators (LEI). The LEI peaked during December 2021 and is now down to the lowest reading since September 2020 (*Fig. 3*). It has peaked before each of the previous eight recessions, by an average of 12 months prior to the peak in the business cycle that marked the start of the recession.

The S&P 500 peaked during January 2022. The naysayers correctly observe that it has never bottomed before a recession has even started (*Fig. 4*). The bull market in stocks begs to differ with the hard-landers. So do we.

(3) *Banking in crisis.* Bears were taking a victory lap when the banking crisis started in mid-March. So far, it hasn't morphed into an economy-wide credit crunch; but it soon will, they claim, triggering their long-awaited recession. They correctly observe that the Fed's Senior Loan Officer Opinion Survey showed that credit lending standards started to tighten significantly during Q4-2022 and continued to do so during Q1-2023, especially for commercial real estate loans (*Fig. 5* and *Fig. 6*).

The stock market generally doesn't perform well when the S&P 500 Financials sector is weak. While the S&P 500 is up 17.6% since October 12, the S&P 500 Financials sector has underperformed with a gain of 5.9% (*Table 1*). Since March 8, the S&P 500 is up 5.3%, while the Financials sector is down 8.1% (*Table 2*).

By the way, the LEI includes a Leading Credit Index (*Fig. 7*). During economic expansions, it tends to be under zero, fluctuating around -1.0. It has been ranging between 0.0 and 1.0 since early 2022. It is highly correlated with the yield spread between the high-yield corporate bond index and the 10-year Treasury yield, which has remained surprisingly narrow (*Fig. 8*).

(4) *Fed not done.* Now that the banking crisis seems to have stabilized, the bears are saying that the Fed isn't done raising interest rates because inflation isn't coming down fast enough. The markets have been discounting another prospective 25bps rate hike at the June or July meeting of the FOMC to a range of 5.25%-5.50%. The 2-year Treasury note yield bottomed at 3.81% on May 4. It was back up to 4.46% yesterday. Here are federal funds rate futures yields as of Friday: nearby (5.16%), 3-month (5.25%), 6-month (5.28%), and 12-month 4.67%) (*Fig. 9*).

(5) *Bad breadth.* Especially disconcerting to the haters is that the S&P 500 has continued to rally since March 8, when the banking crisis started. They observe that the ratio of the equal-weighted to market-cap-weighted S&P 500 has plunged since then (*Fig. 10*). Such bad breadth, they point out, is not the hallmark of young bull markets. That's true. However, we see no reason why breadth might not improve over the rest of the year, led by a rebound in Financials if the banking crisis continues to abate, as we expect.

(6) *MegaCap-8 again.* The breadth problem is attributable to the remarkable

outperformance in recent months of the MegaCap-8 stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla). The banking crisis caused investors to favor them again since they have very strong balance sheets, generate lots of cash flow, and they don't have to borrow money from the banks or in the capital markets. They've also been buoyed (inflated) by all the excitement about artificial intelligence (AI), since they are the most obvious ways to play this new investment theme.

The collective market capitalization of the MegaCap-8 stocks bottomed this year at $6.8 trillion and rose 54.3% to $10.5 trillion by Friday, only 15.0% below their 2021 record high of $12.3 trillion (*Fig. 11*). A.k.a. the "Magnificent-8," these stocks now account for 26.4% of the S&P 500's market cap, matching the previous record high during 2021 (*Fig. 12*). They now account for 47.5% of the market cap of the S&P 500 Growth index.

The bears say that the MegaCap-8 stocks are in an AI bubble that will burst. The collective forward P/E of these stocks has soared from a low of 21.1 at the start of this year to 29.4 on Friday (*Fig. 13*). Without them, the forward P/E of the S&P 500 is 16.0.

The bears often have observed that without the MegaCap-8, the S&P 500 would be down. Here are the percent changes in the S&P 500 with and without the MegaCap-8 since October 12 (17.6%, 11.4%), ytd (9.5%, -1.4%), and since March 8 (5.3%, -1.6%) (*Fig. 14*).

The implication often seems to be that only the MegaCap-8 stocks are up since the start of the bull market. We ran a performance derby on the S&P 500 and its 11 sectors and 100+ industries since October 12 (*Table 1* again). There are plenty of industries with double-digit gains that don't include any of the MegaCap-8, for example: Homebuilding (47.7%), Casinos & Gaming (42.6), Health Care Supplies (39.6), Construction & Engineering (37.7), Industrial Conglomerates (29.0), and Industrial Gases (27.9).

Strategy II: The Bulls' List. All of the bears' points recounted above are legitimate concerns. But in the stock market, there are always two sides to every story. We've already countered some of the bearish narratives above with our own bullish spin. Let's consider a few more debating points from the bulls' perspective:

(1) *Rolling recession & disinflation.* In yesterday's *Morning Briefing*, Debbie and I discussed the economy's various shock absorbers that have absorbed the shock and after-shocks of the pandemic. We observed that there is lots of "helicopter money" left over from the pandemic relief checks sent to consumers and businesses during the pandemic. In addition, the government is spending lots of money on incentivizing onshoring, especially building

semiconductor plants, as well on infrastructure.

Many of the most cyclical and interest-rate sensitive industries are still expanding their payrolls, some to new record highs. Many of these industries are benefitting from the resilience of consumer spending, which is partly attributable to retiring Baby Boomers, who have plenty of wealth and retirement income to spend on travel, eating out, and healthcare.

(2) *The Fed is (almost) done.* Fed officials, including Fed Chair Jerome Powell, have said that their goal is to raise the federal funds rate up to a “restrictive” level and to keep it there until inflation falls closer to their 2.0% target. In both their December and March Summary of Economic Projections (SEP), they projected that a 5.1% federal funds rate would be the terminal rate.

They could change their minds. The latest batch of economic and inflation indicators was stronger and hotter than widely expected. Nevertheless, the banking crisis and tightening lending standards certainly confirm that the federal funds rate is restrictive enough. Furthermore, we expect that May’s employment and CPI reports (before the next FOMC meeting) will show slower economic growth and cooling inflation.

(3) *Good breadth.* Finally, have a look at the breadth of earnings forecasts. The percent of S&P 500 companies with positive three-month percent changes in forward earnings rose to 73.9% during the May 26 week (*Fig. 15*).

(4) *AI bubble.* Related to the bear’s MegaCap-8 spin is that those eight stocks have been inflated by hype about AI. We don’t agree. Their initial ascent from their collective bottom on January 5 (based on their aggregate market cap) was attributable to their success in rapidly cutting their bloated costs during H2-2022.

Leading the way in cost-cutting was Meta with 11,000 jobs cut in fall 2022. In March 2023, the company unveiled plans to lay off another 10,000 workers in a further bid to cut costs. Meta’s stock price bottomed on November 3. Microsoft, Amazon, and Google also pared their payrolls. AI is just icing on the cake, in our opinion.

Strategy III: Trader’s Corner. Last, but not least: On Monday, we asked Joe Feshbach for an update of his call on the market from a trader’s perspective: “The debt ceiling has finally been raised, and AI stocks are taking over the world (maybe literally). The good news is all out. The put/call ratio has been low for five out of the past six days, and breadth continues to be narrow. The market should be close to a sharp setback to the middle of its wide

trading range."

Calendars

US: **Wed:** Job Openings 9.775m; MBA Mortgage Applications; Chicago PMI 47.0; API Weekly Crude Oil Inventories; Beige Book; Bowman; Harker; Jefferson. **Thurs:** ADP Employment 170k; Nonfarm Productivity & Unit Labor Costs -2.7%/6.3%; Initial & Continuous Jobless Claims 235k/1.80m; ISM M-PMI & Price Index 47.0/52.0; Construction Spending 0.1%; Fed's Balance Sheet; Crude Oil Inventories & Gasoline Production; Natural Gas Storage; Harker. (Bloomberg estimates)

Global: **Wed:** Germany CPI 0.8%m/m/7.8%y/y; Germany Import Prices -0.9%m/m/-5.9%y/y; Germany Unemployment Change & Unemployment Rate 14k/5.6%; France CPI 0.3%m/m/6.4%y/y; France GDP 0.1%q/q/0.8%y/y; France Consumer Spending 0.3%; Italy GDP 0.5%q/q/1.8%y/y; Italy CPI -0.1%m/m/7.8%y/y; Canada CPI 0.4%q/q/2.8%y/y; Japan Household Confidence 36.1; Japan Housing Starts -4.3%; Japan M-PMI 50.8; China Caixin M-PMI 50.3; Australia M-PMI 48.0; Australia Retail Sales 0.0%; ECB Financial Stability Report; Lagarde Mann. **Thurs:** Headline & Core CPI 0.6%m/m/7.0%y/y & 0.8%m/m/5.5%y/y; Eurozone Unemployment Rate 6.5%; Eurozone, Germany, Franc, Italy, and Spain M-PMI 44.6/42.9/46.1/45.8/47.8; Germany Retail Sales 1.0%m/m/-5.0%y/y; UK M-PMI 46.9; UK Nationwide HPI -0.5%; ECB Publishes Accounts of Monetary Policy Meeting; Lagarde; Enria. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for two of these three indexes, but none were at a record high—which was the case for a 48th straight week. During the May 4 week, all three had risen simultaneously for the first time in six weeks and only the third time since they peaked at record highs last June. However, all three are up from their lows during February and March. Through the week ending May 26, LargeCap's forward earnings dropped 0.1% w/w to 1.7% above its 54-week low during the week of February 10. MidCap's rose 0.2% w/w to 2.3% above its 55-week low during the week of March 10, and SmallCap's gained 0.2% w/w to 0.9% above its 72-week low during the March 17 week. The forward earnings downtrend since mid-2022 for these three indexes has been relatively modest this time around compared to their deep declines during

the Great Virus Crisis and the Great Financial Crisis. LargeCap's is 4.2% below its record high at the end of June; MidCap's is 6.0% below its record high in early June; and SmallCap's is 12.8% below its mid-June record. Forward earnings momentum remains near its two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a 17th straight week, but improved to -2.9% y/y from a 28-month low of -3.2% 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 -5.9% y/y is at a 31-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 -11.7% y/y is also at a 31-month low, 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 briefly ticked higher during the Q1 reporting season as analysts added the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (0.6% and 11.7%), MidCap (-9.6, 12.5), and SmallCap (-9.7,14.9).

S&P 500/400/600 Valuation (*link*): Valuations were mixed for these three indexes through the May 26 week. LargeCap's forward P/E rose 0.1pt w/w to a 13-month high of 18.3. It's up 3.2pts 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 0.1pt to 13.0, and is 1.7pts below its recent 10-month high of 14.7 in early February. It's now 1.9pts 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 rose 0.1pt to 12.9, which compares to a 19-week low of 12.5 during the May 12 week and is now 1.4pts below its recent 12-month high of 14.3 in early February. It's 2.3pts 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 down to a 24-year-low 29% discount relative to LargeCap's. 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 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 discount 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 102nd straight week; the current 1% discount is 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. With 97% of the Q1 earnings season complete, the S&P 500's earnings growth rate decelerated q/q for a seventh straight quarter in Q1-2023 to -2.9% y/y from -1.6% in Q4-2022 on a frozen actual basis. On a pro forma basis, the y/y earnings decline lessened in Q1-2023, to -0.1% from -3.2% in Q4-2022. Five sectors recorded 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 nearly-final earnings growth rates for Q1-2023 versus their final Q4-2022 growth rates: Consumer Discretionary (55.6% in Q1-2023 versus -15.6% in Q4-2022), Industrials (27.0, 41.4), Energy (20.9, 59.1), Financials (7.8, -8.9), Consumer Staples (0.2, -2.5), S&P 500 (-0.1, -3.2), Real Estate (-7.7, -3.2), Information Technology (-8.8, -10.0), Communication Services (-9.0, -28.2), Health Care (-14.8, -2.7), Utilities (-21.8, -4.6), and Materials (-22.2, -20.4).

S&P 500 Q1 Earnings Season Monitor (*link*): With the Q1-2023 earnings season now 97% complete, this season turned 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 485 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 1.1% above forecast and earnings had beaten estimates by 1.1%. Just 74% of the 485 Q1 reporters that have reported so far through mid-day Tuesday has reported a positive revenues surprise, while 77% 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 485 reporters so far has dropped to 4.0% from 5.7% at the same point in Q4-2022, and earnings are down 3.0% 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 (55%) than positive y/y revenue growth (69%). As the last 15 companies in the S&P 500 report results over the next few weeks, we don't expect any material changes to the index's aggregate results. The y/y revenue growth rate will remain positive in Q1, but y/y

earnings growth will be negative for a second straight quarter.

US Economic Indicators

Consumer Confidence (*link*): Confidence fell for the fourth time this year, dropping to a six-month low, as consumers became more pessimistic about the labor market and continued to worry about inflation. “While consumer confidence has fallen across all age and income categories over the past three months, May’s decline reflects a particularly notable worsening in the outlook among consumers over 55 years of age,” noted Ataman Ozyildirim, senior director of economics at The Conference Board. *Headline* consumer confidence fell by 1.4 points in May and 6.7 ytd to 102.3, with expectations down 11.9 points ytd and the *present situation* component up 1.2 points over the period, to 71.5 and 148.6, respectively—though the present situation component dropped 3.2 points in May. *Current business conditions* improved in May, with the percentage of consumers saying business conditions were good climbing to 19.6% from 19.0% in April and those saying conditions were bad falling from 18.1% in April to 17.0% in May—the lowest percentage since March 2020. Meanwhile, the *current labor market* deteriorated, with 43.5% of consumers saying jobs are plentiful (the least since April 2021), down from 47.5% in April, and 12.5% saying jobs are hard to get, up from 10.6% last month. *Short-term business conditions* (six-month outlook) this month was slightly more pessimistic than April: 12.9% expected business conditions to improve this month, down from 14.1% in April, while the percentage expecting conditions to worsen dipped to 20.6% from 21.4% in April. Consumers’ assessment of the *short-term labor market* was slightly more favorable, with the percentage of consumers expecting more jobs to be available six months from now ticking down to 13.6% from 14.3% last month; however, 20.2% anticipated fewer jobs, down from 21.3% last month. Their *short-term financial prospects* was, on balance, slightly more favorable, with 17.8% of consumers expecting their incomes to increase, up slightly from 17.3% last month, and 11.5% expecting incomes to decrease, unchanged from April.

Regional M-PMIs (*link*): Five Fed districts now have reported on manufacturing activity for May—New York, Philadelphia, Kansas City, Richmond, and Dallas—and show *manufacturing activity* (to -17.5 from -12.8) contracted at its fastest pace since May 2020. New York’s (to -31.8 from 10.8) activity showed a big swing from expansion to contraction, while activity in the Dallas (-29.1 from -23.4) and Richmond (-15.0 from -10.0) regions fell at a faster pace than in April and Philadelphia’s (-10.4 from -31.3) fell at a third of April’s rate. Meanwhile, Kansas City’s (-1.0 from -10.0) was at a virtual standstill. *New orders* (-19.2 from -9.6) fell deeper into contractionary territory, posting its weakest reading since May

2020—and the 12th consecutive reading in negative territory. Billings in the New York (-28.0 from 25.1) region showed a deep contraction in May after a big expansion in April, while Richmond's (-29.0 from -20.0) contracted at its fastest pace since the height of the pandemic, and Dallas' (-16.1 from -9.6) also deteriorated. Meanwhile, orders in the Philadelphia (-8.9 from -22.7) and Kansas City (-14.0 from -21.0) regions continued to contract, though at a slower pace. The *employment* (1.9 from -0.2) measure ticked back above zero in May after dipping below in April for the first time since mid-2020. Hirings in the Kansas City (7.0 from -1.0) region swung from contraction to expansion, while Richmond's (5.0 from 0.0) showed the first expansion in employment this year, and hirings in the Dallas (9.6 from 8.0) region held steady. Meanwhile, Philadelphia (-8.6 from -0.2) hirings contracted at a faster pace, while New York's (-3.3 from -8.0) declined at a slower pace.

Regional Prices Paid & Received Measures (*link*): We now have May's prices-paid and -received data for the five Fed regions—New York, Philadelphia, Richmond, Dallas, and Kansas City. (Note: The New York, Philadelphia, Dallas, and Kansas City measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.) The *prices-paid* measure in May eased for the third month after a brief blip up in February (to 40.3), falling to 25.0 this month, the lowest since September 2020; it peaked at a record high of 90.2 during September 2021. The Philadelphia (10.9 from 8.2) measure picked up marginally this month after slowing dramatically in April to its lowest percentage since mid-2020, while New York's (34.9 from 33.0) was little changed near two-year lows. Meanwhile, the Kansas City (16.0 from 32.0) prices-paid measure posted its slowest pace since July 2020, while Richmond's (49.5 from 75.7) was the slowest since February 2021, and Dallas' (13.8 from 19.5) since July 2020. Turning to the *prices-received* measure, it eased for the sixth month, from 39.0 in November to a 29-month low of 17.4 in May; it was at a record high of 59.0 last March. Prices-received indexes were mixed: Kansas City's (16.0 to 21.0) eased a bit in May, while New York's (23.6 from 23.7) held steady not far from January's two-year low of 18.8. Meanwhile, Philadelphia's moved down for the fourth month to -7.0—the weakest since April 2020—while the Dallas (0.4) and Richmond (53.9) measures were the weakest since July 2020 and June 2021, respectively.

Global Economic Indicators

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Indexes (ESI) for both the EU and Eurozone remain in volatile flat trends around recent lows. The *EU's*

measure fell 1.9 points in May to 95.2, while the Eurozone's gauge fell 2.5 points to 96.5—down from their January readings of 97.7 and 99.6, respectively; they were at record highs of 117.8 and 118.7 during October 2021. ESIs among *the six largest EU economies* were mostly lower in May, with Spain (-3.0 to 100.5) posting the biggest loss, followed by Germany (-2.9 to 95.5), Italy (-2.3 to 102.5), and the Netherlands (-1.5 to 95.0); sentiment in Poland (+1.9 to 93.3) and France (+1.5 to 94.9) moved higher. They were at 101.7, 97.8, 102.6, 94.4, 90.2, and 98.4, respectively, at the start of the year. *By sector*, consumer confidence in the overall EU hasn't posted a decline since sinking to a record low of -29.8 last September, rebounding 11.5 points during the eight months through May to -18.3. Retail trade confidence sank 3.4 points in May to -4.8 after climbing six of the previous seven month by 5.5 points—from a recent low of -6.9 last September to -1.4 this April. Industrial confidence remains in a freefall since reaching a record high of 12.9 in December 2021, dropping to -5.8 this May, while construction confidence deteriorated to -2.3 in May from a record high of 8.4 at the end of 2021. Meanwhile, service confidence dipped 1.8 points this month to 5.8, down from a recent high of 19.5 in October 2021.

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