MORNING BRIEFING
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Slippery Slopes

Check out the accompanying chart collection.

Executive Summary: Oil prices are slipping notwithstanding Saudi Arabia's production cuts, which aren't as effective at halting such slides as they used to be. Too much global oil production capacity in the world relative to too little demand is the problem. … If oil prices are on a slippery slope, so is inflation; indeed, the latest inflation indicators suggest it is continuing to moderate. … As for the latest economic indicators, the NM-PMI and LEI are misleading. Their weakness doesn't point to a broad-based recession. The forecast still looks like a rolling recession to us.

Slippery Slope I: Crude Oil. The Saudis are kicking the barrel down the road. Saudi Energy Minister Prince Abdulaziz bin Salman announced an extra 1 million barrel-a-day (mbd) supply cut in July following a tense OPEC+ meeting in Vienna over the weekend. "Others in the group pledged to maintain existing cuts until the end of 2024," Bloomberg *reported*, "though Russia made no commitment to curb output further and the United Arab Emirates secured a higher production quota for next year."

The price of a barrel of West Texas Intermediate (WTI) crude oil tumbled 11% last month as concerns about demand, especially from China, weighed on the market. Bloomberg reported that the Saudi oil minister pledged at the meeting to do "whatever is necessary to bring stability to this market." In the days prior, he had warned bears in the futures markets to "watch out." The markets are likely to call his bluff.

The Saudis' problem isn't bears in the futures market but rather too much world oil production and not enough world oil demand. Reducing their output by 1.0 mbd for one month isn't likely to fix the imbalance. The problem is that the Russians are selling whatever they can at a discount to China and India. The US and Canada are pumping more oil. And global demand for oil has been weak, especially in China.

Consider the following:

(1) *Saudis vs backwardation.* Production cuts began in October, when OPEC+ reduced supply by 2.0 mbd. Then in February, Russia announced that it would reduce production by 0.5 mbd in March; when March arrived, Russia extended the cuts through the end of June.

But the oil market shrugged off both production cuts because economic growth and demand for oil were expected to slow. Central bankers around the world were busy raising interest rates to fight inflation when the US banking crisis arrived in March, sparking fears of a global recession. Despite the oil production cuts, the price of a barrel of Brent crude oil futures fell from a November 4 high of $98.57 to a low of $72.97 on March 17 (*Fig. 1*).

It took a third production cut on Sunday, April 2 to grab investors' attention. Saudi Arabia and other OPEC+ members announced plans to cut production by another 1.2 mbd from May through year-end. Together, the three cuts take roughly 3.7% of the world's oil off the market. And the oil market responded: The price of Brent crude oil futures jumped to $84.94 as of the April 4 close, up $5.17 from before Sunday's cut and up $11.97 from its low on March 17.

But on Friday, June 2, the price of a barrel of Brent was back down to $76.13. The Brent futures market was in backwardation: nearby ($76.13), 6-month ($74.61), 1-year ($72.89), and 2-year ($70.41) (*Fig. 2*).

(2) *Russian roulette.* On May 30, Bloomberg *reported*: "Russian crude oil flows to international markets are edging lower, but still show no substantive sign of the output cuts that the Kremlin insists the country is making. Four-week average seaborne shipments, which smooth out some of the volatility in weekly numbers, fell for the first time in six weeks in the period to May 28, slipping to 3.64 million barrels a day. But crude flows to international markets remain elevated and are still more than 1.4 million barrels a day higher than they were at the end of last year and 270,000 barrels a day up on February, the baseline month for the pledged cut."

(3) *WTI & US oil field production.* The price of a barrel of WTI has been as weak as the Brent price, dropping from a high this year of $ $83.26 on April 12 to $71.74 on Friday (*Fig. 3*). Yet US crude oil field production has increased since early September 2021 from 10.0 mbd to 12.2 mbd at the end of May (*Fig. 4*).

(4) *Total US production, demand, & net exports.* The US is the world's largest producer of petroleum, producing a near-record 20.4 mbd during April. That includes crude oil field production (12.3 mbd), natural gas liquids (5.9 mbd), and biofuels plus processing gains (2.2 mbd) (*Fig. 5*).

April's US production is higher (at 21.9 mbd) if it is imputed as products supplied (20.0 mbd) minus net imports (-1.9 mbd) (*Fig. 6*). In any event, data reported by the US Department of

Energy (DOE) show that the US has been a consistent (though slight) net exporter of petroleum since early 2022.

(5) *Global crude oil production.* The DOE also compiles data on global crude oil production, though the latest available data are only through February. They show a V-shaped post-lockdown recovery from a low of 70.3 mbd during June 2020 to 82.3 mbd during February, back near the pre-pandemic pace of production (*Fig. 7*).

Saudi Arabia and Russia each were producing about 11.0 mbd of crude oil in the months prior to the pandemic (*Fig. 8*). The US and Canada combined produced more than 17.0 mbd prior to the pandemic and are probably producing as much now. Saudi Arabia and Russia are both struggling to achieve their pre-pandemic highs.

(6) *China syndrome.* What does Professor Copper, the base metal with a PhD in economics, have to say about the price of oil? The price of copper and the price of Brent are highly correlated (*Fig. 9*). That's because both reflect the pace of global economic activity, falling (rising) when it is weak (strong).

Both copper and oil prices are especially sensitive to developments in China. They diverged earlier this year when the price of copper rallied on expectations that the end of China's Covid lockdowns would boost China's economic activity significantly. Professor Crude disagreed with Professor Copper's bullishness and seems to have been correct in her assessment, as the price of copper has been falling since January 26 on disappointing economic news from China. China's M-PMI was especially weak during May, when the index and its major components were all below 50.0 (*Fig. 10*).

(7) *Bottom line.* The price of WTI closed at $71.74 on Friday. It jumped to $74.20 on Sunday at 6:10 p.m. It was back down to $71.91 at the end of Monday.

Slippery Slope II: Inflation. If the price of oil is on a slippery slope, then inflation probably also is on a slippery slope. We believe that inflation will continue to moderate. Here are some relevant recent developments:

(1) Yesterday, we were encouraged to see the prices-paid index in the ISM's NM-PMI fell from 59.6 in April to 56.2 in May (*Fig. 11*). That's because it is a great three-month leading indicator of the CPI inflation rate on a y/y basis. It suggests that the latter could fall below 3.0% later this summer!

(2) That's confirmed by the NFIB's small business survey, which found that the percent of small business owners planning to raise their average selling price fell to 21.0% in May, down from a peak of 54.0% during November 2021 (*Fig. 12*). This series tends to be a very good five-month leading indicator of the CPI inflation rate. So it is predicting a sub-3.0% inflation rate this fall.

(3) The prices-paid index of the M-PMI is a good three-month leading indicator of the y/y inflation rate in the CPI goods index (*Fig. 13*). The latter was 2.1% in April. It should be slightly negative later this coming summer.

Slippery Slope III: Recession Forecasts. Yesterday's NM-PMI release was weaker than widely expected. After all, consumers are deemed to have pivoted away from buying goods to purchasing services instead. Yet the overall NM-PMI fell from 51.9 in April to 50.3 in May (*Fig. 14*). It is down from a peak of 67.6 during November 2021.

While this index is often called the "Services PMI," it is actually for the nonmanufacturing sector including construction, which has been a relatively weak industry, especially for single-family homes.

Yes, but how about the M-PMI? It has been below 50.0 since November and edged down from 47.1 in April to 46.9 in May (*Fig. 15*). It is also highly correlated with the Index of Leading Economic Indicators (LEI) on a y/y percentage basis.

That's true, but the weakness in the M-PMI is consistent with our rolling recession forecast, as it is rolling through the goods sector of the economy, while the services sector remains stronger than misleadingly suggested by the latest NM-PMI report. Also misleading is the LEI, which seems to be biased to reflect what is happening in the goods sector much more than the services sector.

Recession forecasters should take note of the misleading signals sent by the NM-PMI and the LEI. The forecast still looks to us like a rolling recession, not a broad-based recession of the economy as a whole.

Calendars

US: Tues: Weekly Crude Oil Inventories; EIA Short-Term Energy Outlook. Wed Trace Balance -$63.3b; Consumer Credit $16.5b; MBA Mortgage Applications; Crude Oil

Inventories & Gasoline Production. (Bloomberg estimates)

Global: **Tues:** Eurozone Retail Sales 0.2%m/m/-3.1%y/y; Germany Factory Orders -2.2%; Spain Industrial Production; Australia GDP 0.8%q/q/2.7%y/y; China Trade Balance ¥71.6b; RBA Interest Rate Decision 3.85%; Lowe; Bullock. **Wed:** Germany Industrial & Manufacturing Production -1.3%/-0.3%; Italy Retail Sales 0.3%m/m/4.3%y/y; UK Halifax House Price Index 0.0%m/n/09,9%y/y; Japan GDP 0.4% q/q/1.6% y/y; Japan Leading & Coincident Indicators; Canada Leading Index; Canada Trace Balance $0.2b; BOC Interest Rate Decision 4.50%; De Guindos; Fernandez-Bollo; Panetta; Wuermeling. (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 for a 49th straight week. During the May 4 week, all three had risen simultaneously for 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 June 2, LargeCap's forward earnings jumped 0.9% w/w to 2.6% above its 54-week low during the week of February 10. MidCap's rose 0.3% w/w to 2.6% above its 55-week low during the week of March 10, and SmallCap's fell 0.2% w/w to 0.8% 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 double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is now 3.4% below its record high at the end of June 2022; MidCap's is 5.8% below its record high in early June 2022; and SmallCap's is 12.9% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for an 18th straight week, but improved to -2.8% y/y from a 28-month low of -3.2% y/y several weeks earlier; 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 -5.7% y/y is up from a 31-month low of -5.9% a week earlier, 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 fell to a 31-month low of -11.9% y/y, 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 (1.3% and

11.7%), MidCap (-9.6, 12.5), and SmallCap (-10.1,14.8).

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 0.2pt w/w to a 15-month high of 18.5. It's up 3.4pts 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 rose 0.3pt to a five-week high of 13.3, and 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 rose 0.4pt to a 12-week high of 13.2, 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 lessened to a 28% discount to LargeCap's from a 24-year low 29% discount a week earlier. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 28% discount to LargeCap's P/E last week has improved from 30% a week earlier and 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 103rd straight week, but barely so; the current discount of less than 1% 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 estimate declines accelerated considerably for the three quarters ending through Q4-2022 before easing for Q1-2023. Looking ahead to Q2-2023, analysts are forecasting that the S&P 500's y/y earnings growth rate will mark its cyclical bottom with an 8.1% decline, down from -2.9% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -5.4% in Q2, down from less than -0.1% in Q1-2023. S&P 500 ex-Energy earnings are forecasted to be flat y/y in Q2-2023, an improvement from the 1.7% decline in Q1-2023 and the 7.4% drop in Q4-2022. Six sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors doing so in Q1-2023 and only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their nearly-final earnings growth rates for Q1-2023: Consumer Discretionary (24.8% in Q2-2023 versus 56.0% in Q1-2023), Financials (10.6, 7.8), Communication Services (9.4, -9.0), Industrials (6.1, 27.0), Consumer Staples (2.2, 0.2), Utilities (0.3, -21.8), S&P 500 ex-Energy (0.0, -1.7), Information Technology (-3.6, -8.5), Real Estate (-4.9, -7.7), S&P 500 (-5.4, -0.01), Health Care (-15.6, -14.8), Materials (-27.2, -22.2), and Energy (-43.4, 20.9).

US Economic Indicators

US Non-Manufacturing PMIs (*link*): The US service sector in May slowed for the third time in four months since swinging from contraction in December (49.2) to expansion in January (55.2). It was the fifth consecutive month of expansion in the service sector, but the slowest in the current sequence. Meanwhile, inflationary pressures are slowing at a fast pace. The report notes, "The majority of respondents indicate that business conditions are currently stable; however, there are concerns relative to the slowing economy." The ISM NM-PMI ticked down to 50.3 in May—the slowest since May 2020—remaining above 49.9, a level ISM says over time indicates growth in the overall economy. Of the four components of the NM-PMI, the forward-looking *new orders* gauge slowed to 52.9 after accelerating from 52.2 in March to 56.1 in April, while *business activity* slowed steadily from 60.4 at the start of the year to 51.5 in May. The *supplier deliveries* component moved down from 48.6 to 47.7—back near March's 45.8—which was the fastest delivery performance since April 2009! The service sector's *employment* (49.2 from 50.8) gauge remains in a volatile flat trend. On the *inflation* front, the price index dropped to 56.2—the lowest since May 2020—down from a record-high 84.5 at the end of 2021. The service sector's report comes on the heels of the ISM's manufacturing report, which showed the M-PMI (46.9) in May was in contractionary territory for the seventh consecutive month, holding near March's 34-month low of 46.3.

Manufacturing Orders & Shipments (*link*): Factory orders rose 0.4% in April, posting only one decline over the past five months—a sharp 1.7% decline in February—though was up 0.5% over the period. April's gain was led by transportation. *Excluding transportation*, orders fell for the fifth time in six months, by 0.2% in April 3.2% over the period; the April level is 4.3% below last June's record high. Meanwhile, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) rebounded 1.3% in April to a new record high, after slumping 0.8% the prior two months. *Nondefense capital goods shipments* excluding aircraft (used in calculating GDP) rose 0.5% after falling the prior two months, and is back at January's record high. In April, orders for electrical equipment, appliances & components, machinery, motor vehicles & parts, and fabricated metals all remain in record territory.

Global Economic Indicators

Global Composite PMIs (*link*): "Growth of global economic activity at 18-month high as service sector upturn remains solid" was the headline of the May survey, with the service sector remaining the prime growth engine. The manufacturing measure remains below the break-even point of 50.0. The growth in services activity accelerated to its best since November 2021, while manufacturing, through subdued in comparison, still improved to an 11-month high. The *C-PMI* advanced to a 18-month high of 54.4 in May after sliding steadily from 53.5 last June to 48.0 by November. The *NM-PMI* shot up from 48.0 during the final two months of 2022 to a 18-month high of 55.5 in May, while the *M-PMI* remained at 49.6 for the second month, its ninth successive reading below 50.0 and down sharply from its peak of 56.0 in May 2021. *Geographically*, the report noted that for the 13 countries for which combined manufacturing and services PMI were available, India and mainland China topped the global rankings. The US, Japan, and China were among the faster growers, while the upturns in the Eurozone and the UK weakened. Meanwhile, increases in both input and output changes continued to ease, reaching a 31-month low for the former and a 27-month low for the latter. Manufacturers saw a decline in both price measures, while service providers saw rates of increase ease.

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