MORNING BRIEFING
June 7, 2023

View From The Pits

Check out the accompanying chart collection.

Executive Summary: Commodities markets have been on a wild ride in recent years, buffeted by pandemic impacts specific to each. The present time finds oil prices weakened by a global supply/demand imbalance, raw industrials prices depressed by China's weak recovery and US recession fears, lumber prices down owing to soft single-family home construction, and both natural gas and most agricultural prices far from their peaks. … The ripple effects of this commodities scenario include downward inflation pressure and upward dollar pressure. … Also: Joe shares his takeaways from S&P 500 Q1 earnings now that most companies have reported and most analysts have tweaked their forecasts.

Commodities I: Oil Market Is Fluid. Over the past weekend, at the OPEC+ meeting in Vienna, Saudi Energy Minister Prince Abdulaziz bin Salman announced a surprising one-month reduction in Saudi crude oil output of 1.0 million barrels per day (mbd) during July. That comes after several OPEC+ producers announced a combined 1.66 mbd of production declines until the end of this year. At the latest Vienna meeting, the oil cartel's members agreed to extend their cuts through the end of 2024. As we noted yesterday, both the April cuts and the latest Saudi cut aren't boosting prices. Instead, they may be slowing the descent of oil prices (*Fig. 1*).

Yesterday, Bloomberg *reported*: "Some Asian refiners are considering buying more crude from Russia and Africa after Saudi Arabia surprised the market by raising prices for its oil following an unexpected pledge to reduce output. At least three Asian refiners are considering asking for less contracted crude from Saudi Arabia in July, and may tap the spot market for cheaper cargoes, according to people familiar with the companies' trading strategies."

The fundamental supply-side problem in the oil market is that the Russians need to sell oil to raise revenues no matter the price, to fund their war with Ukraine. The Saudis need a higher price to boost their revenues to fund their ambitious projects at home. On the demand side, China's latest moves to boost its economy didn't do much to lift oil prices yesterday when Chinese authorities asked the nation's biggest banks to lower their deposit rates for at least the second time in less than a year. The oil market yawned.

Commodities II: Raw Industrials Prices Flagging. The CRB raw industrials spot price index, which does not include petroleum or wood products, peaked at a record high on April 4, 2022 (*Fig. 2*). The index is down 20% since then through June 5.

The metals component of the index peaked at a record high also on April 4, 2022 (*Fig. 3*). It plunged 36% through October 31 and jumped 26% through January 26 on expectations that China's economy would rebound strongly once the country's Covid lockdown was lifted in early December. But since then, the index is down 13% through June 5 on disappointment over China's weak recovery. Also weighing on commodity prices has been concern that the US banking crisis that began in March might cause a recession.

Commodities III: Knock on Wood. The pandemic was a shock, and it has been followed by aftershocks. It certainly had a wild impact on the nearby futures price of lumber (*Fig. 4*). It soared following the end of the US lockdowns through the first half of 2021. The pandemic boosted the demand for single-family homes away from urban centers, with backyards and space for home offices and remote learning.

By mid-2021, lumber prices tumbled only to soar again in early 2022. Since then, prices have tumbled again, down to pre-pandemic levels, as soaring mortgage rates depressed single-family housing starts.

Commodities IV: Out of Gas. Another similar wild rollercoaster ride since the pandemic started was in the natural gas market. In the US, its price increased almost five-fold from mid-2020 through the end of 2022 (*Fig. 5*). Since then, it has plunged back down to its pre-pandemic readings.

Since 1977, the US has switched from being a net importer of natural gas to a significant net exporter of gas (*Fig. 6*). US exports were boosted by demand from Europe last summer when Europeans had to scramble to replace Russian oil sources.

Commodities V: Where's the Beef? Agricultural prices also mostly peaked late last year and have continued to moderate so far this year, though grain prices remain elevated at levels coinciding with the start of Russia's invasion of Ukraine (*Fig. 7*).

On the other hand, live cattle futures have been soaring since mid-2020 (*Fig. 8*). The May 28 *WSJ* *explained*: "Rising costs for feed and other expenses are leading ranchers to sell their calves into feedlots at a faster pace, according to federal data, leaving fewer cattle available for slaughter later this year and in 2023. Persistent drought conditions in the

Western U.S. have parched grazing pastures, requiring cattlemen to spend more on supplemental feed, ranchers and beef industry officials said."

Commodities VI: Inflation & The Dollar. The brief review of commodity prices above supports our view that inflationary pressures are moderating in the commodity pits (except for live cattle).

There tends to be an inverse correlation between the trade-weighted dollar and the S&P GSCI commodity price index (*Fig. 9*). The dollar tends to do well when weak global economic activity is weighing on commodity prices. That seems to describe the current situation and explains why the dollar has firmed up in recent weeks.

Strategy: Q1 Earnings Results. With just a handful of companies left to report Q1 results, Joe reports that S&P and I/B/E/S have compiled their near-final data for S&P 500 companies' Q1 earnings per share. We're still awaiting S&P's final figures for revenues and the profit margins, which we'll analyze after they're released in the next few days.

While we track both S&P's and I/B/E/S' quarterly operating earnings numbers, we generally focus on the I/B/E/S data, especially because we use their data services' measure of forward earnings. In our opinion, the stock market discounts the consensus, or "majority-rule," operating earnings over the coming 12 months rather than S&P's own definition of operating earnings.

For now, let's focus on the bottom-line numbers for Q1:

(1) *S&P 500 Q1 earnings.* S&P 500 operating earnings per share was $53.26 during Q1 according to I/B/E/S, down 3.0% y/y and 8.1% below its record EPS from Q2-2022. The y/y earnings growth rate slowed for a seventh straight quarter and was negative for a second straight quarter, after having edged down 1.7% y/y during Q4-2022 (*Fig. 10*). According to S&P, operating earnings per share was $52.80 during Q1, up 7.0% y/y and positive for the first time in four quarters. However, S&P's EPS remains 6.9% below its record high of $56.73 during Q4-2021. The peak-to-trough declines in operating EPS thus far have been modest relative to those of past downturns.

(2) *Earnings according to S&P and I/B/E/S.* By the way, S&P and I/B/E/S each has their own polling services and derives their estimates and actuals on a different basis. S&P adheres to a stricter in-house definition of operating earnings, while I/B/E/S follows a consensus "majority rule" for presenting companies' earnings forecasts. The industry

analysts polled by I/B/E/S typically follow companies on an adjusted earnings basis (i.e., EBBS, or "earnings excluding bad stuff," a.k.a. write-offs), which makes for a higher earnings series than S&P's. Since Q1-1993, the two series have diverged an average of 5.1%.

During Q1, I/B/E/S' operating EPS actual figure of $53.26 was just 0.9% higher than S&P's $52.80. That was the smallest divergence between the two actuals since Q3-2010. It has declined each quarter since Q2-2022, when it peaked at a nine-quarter high of 23.6%, owing mainly to their treatment of the mark-to-market accounting for Berkshire Hathaway's actual then.

(3) *S&P 500 sectors' Q1 growth.* Four of the 11 S&P 500 sectors recorded positive y/y earnings growth in Q1, unchanged from Q4-2022's count. Among the gainers, Consumer Staples rose y/y for an 11th straight quarter, and Industrials was up for an eighth quarter. Energy rose y/y for a ninth quarter in a row but posted its slowest growth since Q4-2020. Information Technology was down for an unusually lengthy fourth straight quarter as the sector's fortunes continued to wind down from the Covid-19 spending boom (*Fig. 11*).

Here's how the sectors' y/y earnings growth rates stacked up in Q1-2023: Consumer Discretionary (41.1%), Industrials (29.1), Energy (17.6), Consumer Staples (1.3), S&P 500 (-3.0), Financials (-5.0), Information Technology (-9.3), Real Estate (-13.8), Communication Services (-15.1), Health Care (-15.1), Materials (-19.0), and Utilities (-21.1).

(4) *Q2-2023 estimate revisions.* With a month to go before companies close their books on Q2, the recent estimate revisions trend has been encouraging. Analysts' collective Q2 earnings forecast for the S&P 500 companies is down just 1.8% since the beginning of the quarter, markedly less than the 6.2% decline seen in the Q1-2023 estimate over a similar time period. That's also well above the average 4.0% decline seen in all the quarters since 1994.

Among the 11 S&P 500 sectors, five have fared much better than the historical average: Two—Communication Services and Information Technology—have seen their Q2 EPS estimates actually rise since the start of the quarter. And three—Consumer Discretionary, Financials, and Industrials—have had estimate cuts of less than 1%. Such light-handed estimate changing during the quarter sets the table for another strong earnings surprise in Q2.

(5) *Q2 growth forecasts.* Analysts currently expect six of the 11 S&P 500 sectors to record

positive y/y growth in Q2-2023, but S&P 500 earnings are expected to fall 8.1% on a frozen-actual basis in what is likely to be the worst of the y/y comparisons for this cycle.

Here are the analysts' latest proforma y/y Q2-2023 earnings growth rate estimates for the 11 sectors of the S&P 500 versus their final growth rates for Q1-2023 as of the week of June 2: 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).

Calendars

US: Wed: Trade Balance -$63.3b; Consumer Credit $16.5b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. Weekly Crude Oil Inventories; EIA Short-Term Energy Outlook. **Thurs:** Initial & Continuous Claims 238k/1.80m; Fed's Balance Sheet; Wholesale Inventories -0.2%; Natural Gas Storage. (Bloomberg estimates)

Global: 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. **Thurs:** Eurozone GDP 0.0%q/q/1.2%y/y; Eurozone Employment Change 0.6%m/m/1.7%y/y; China CPI -0.1%m/m/0.4%y/y; China PPI -3.2%y/y; Bloomberg estimates)

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales in April was unchanged after falling three of the prior four months by 1.3%, and is down 4.2% since reaching a record high in June 2021. Spending on food, drinks & tobacco fell in April for the sixth time in seven months, sliding 0.5% m/m and 3.4% over the period; it increased only two months during all of 2022. Sales of non-food products excluding fuel rose for the third time in four months, by 0.5% m/m but only 0.7% over the period, remaining on a volatile downtrend—down 3.8% from its mid-2021 record high. Meanwhile, consumption of automotive fuels fell for the third

time in four months, down 2.3% in April and 4.1% over the period. April data are available for three of the four Eurozone's largest economies, with Spain climbing eight of the past nine months, by 1.4% m/m and 7.6% over the period, to its highest level since December 2010. France remains around record highs, falling 0.5% ytd, though is within 3.3% of its record high last September. Germany increased 0.8% in April, following a 1.3% contraction in March, after climbing 0.6% the prior two months; it remains on a downtrend, down 10.2% from its record high in June 2021.

Germany Factory Orders (*link*): German factory orders unexpectedly fell in April, due to a decline in large-scale orders—they were up 1.4% excluding these orders. Manufacturing orders dropped 0.4% (vs a 2.8% expected gain) and follows a 10.9% plunge in March orders. Foreign orders contracted for the second month, by 1.8% in April, after tumbling 13.3% in March; they had increased 9.5% the first two months of the year. Foreign orders from outside the Eurozone plunged 15.7% over the two month period, while foreign orders from within the Eurozone sank 12.9% to their lowest levels since June 2020 and July 2020, respectively. Domestic orders rose 1.6% after a 7.7% loss and a 4.7% gain the prior two months. Versus a year ago, total orders are down 9.9%, with domestic and foreign orders falling 8.7% and 10.7%, respectively. Within foreign orders, billings were down 11.4% y/y within the Eurozone and 10.3% outside the Eurozone. Here's a look at the movements in domestic orders, along with the breakdown from both inside and outside the Eurozone, for the main industry groupings versus a year ago: capital goods (-9.2%, -8.1%, -7.7%), intermediate goods (-4.5, -13.6, -16.8), consumer durable goods (-20.6, -24.7, -21.2), and consumer nondurable goods (-29.7, -13.7, 2.9).

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