Yardeni Research

MORNING BRIEFING
July 19, 2023

(Hot) Global Soft Landing

Check out the accompanying chart collection.

Executive Summary: Globally, economic growth has been on a downtrend since mid-2022 according to our Global Growth Barometer. Recent drags include the hot summer, Americans' weaker demand for imports as they spend more on travel and other services, and headwinds in Europe and China unique to them. … Since we don't expect the US to enter a recession anytime soon, we expect the bull market in stocks to continue. Our new S&P 500 targets for year-end 2024 and 2025 suggest the bull market has legs. … And: Joe explains the importance of the MegaCap-8's expected earnings turnaround. With these eight stocks representing 27% of the S&P 500's market cap, their outperformance could power the entire market higher.

Global Economy: Hot Summer Weighing on Growth. It has been a very hot summer around the world, and summer isn't over yet. Record-high temperatures in many places around the world are likely to weigh on global economic growth during July and maybe August too. Global economic growth was lackluster going into the hot summer. Consider the following:

(1) *Eurozone.* The Eurozone is in a mild recession, with real GDP falling during the past two quarters. Economic output in the 20 nations that use the euro currency declined 0.4% (saar) during Q1-2023, after a Q4-2022 contraction of the same magnitude. Consumer spending in the Eurozone fell 1.2% (saar) in the first three months of this year after falling 4.0% in the previous quarter. Imports were also down sharply as demand for goods and services shrank.

The volume of retail sales excluding automobiles and motorcycles in the Eurozone has been falling since early 2022 (*Fig. 1*). It is down 2.9% y/y. The region's Economic Sentiment Indicator has fallen below 100 since mid-2022 (*Fig. 2*). That suggests that real GDP, which was up just 1.0% y/y, could turn negative soon.

(2) *China.* China's real GDP rose 6.3% y/y during Q2 but fell 1.8% q/q (saar) (*Fig. 3*). Inflation-adjusted retail sales rose 3.1% y/y through June (*Fig. 4*). That was relatively weak considering that many areas of China were depressed by government-mandated pandemic lockdowns last year. Indeed, a year ago during June 2022, real retail sales was basically flat y/y.

The Chinese government has been trying to stimulate domestic consumption without much success. The 24-month annualized growth rate of real retail sales has been in the low single digits since early 2020. Of course, some of that weakness was related to pandemic restrictions. But the growth rate in this series has plunged from the high teens during 2010 and 2011, which we attribute mostly to China's rapidly aging demographic profile. China has turned into the world's largest nursing home over the past few years. That's the legacy of the government's horrible One-Child Policy from 1979 to 2015.

(3) *United States.* The US economy is performing better than the other major developed economies. However, American consumers have been pivoting toward spending less on goods and more on services. As a result, inflation-adjusted merchandise imports peaked at a record high during March 2022 and fell 8.3% through May of this year (*Fig. 5*).That's after these imports jumped 45.2% from their post-lockdowns low during May 2020 through last year's peak.

All those imports caused a major backup at the West Coast ports as measured by the 12-month sum of container traffic at those ports during 2021 and 2022 (*Fig. 6*). But that series was back down to its 2020 low during June of this year.

June's US retail sales report, released yesterday by the Census Bureau, showed that retail sales rose just 0.2% m/m during June, following May's 0.5% increase, which was revised up from 0.3%. Excluding gasoline station sales, retail sales rose 0.3% last month. Excluding building materials and food services, it was up 0.4% (*Fig. 7*).

On an inflation-adjusted basis, retail sales has remained relatively flat since mid-2021 (*Fig. 8*).

More Americans than ever are traveling and spending more abroad during their vacations (*Fig. 9*). However, the weakness in their demand for imported merchandise is probably on balance still a drag on the global economy.

(4) *Global Growth Barometer.* Our Global Growth Barometer (GGB) rose slightly last week, but it remains on a downward trend since mid-2022 (*Fig. 10*). Our GGB is simply the average of the Brent crude oil nearby futures price and the CRB raw industrials spot price index (multiplied by 2 and divided by 100).

Strategy I: Raising Our S&P 500 Targets. In case you missed it, Joe and I raised our forward P/E and price targets for the S&P 500 in our Sunday, July 16 *QuickTakes*. (FYI:

The “forward” P/E is the multiple based on forward earnings, which is the time-weighted average of analysts’ consensus operating earnings-per-share estimates for the current year and following one.)

In our November 3, 2020 *Morning Briefing*, we wrote that “we think the S&P 500 bottomed on October 12 and see a few potentially uplifting developments to come.” On January 9, 2023, we predicted: “The S&P 500 will move higher during the first half of the year, rising to 4500 and then stall there until a year-end rally drives it up to a new record high of 4800 in anticipation of higher earnings in 2024.”

Along the way, we trimmed our year-end target to a more reasonable 4600. On June 5, we wrote: “Is all the AI euphoria leading the stock market into another ‘MAMU’—'Mother of All Meltups’? If so, our 4600 target for the S&P 500 by year-end might prove conservative, not controversial.”

The S&P 500 is now almost at 4600. It closed at 4556.27 on Tuesday. Rather than raise our year-end target, we are raising our expectations for what the bull market could deliver through the end of 2024 and beyond. We think that 5400 is achievable by the end of next year. If that happens, then 5800 would be our target for the end of 2025. In other words, we think that the bull market has staying power.

That’s because we give only 25% odds to a recession scenario over the next two and a half years. So we estimate that S&P 500 earnings per share should be $225 this year, $250 next year, and $270 in 2025 (*Fig. 11*). If forward earnings rises to $270 at the end of next year and $290 at the end of 2025, as we expect, then the S&P 500 would be 5400 at the end of 2024 and 5800 at the end of 2025 assuming a forward P/E of 20.0 for both forecasts (*Fig. 12*).

That might seem like an awfully high valuation multiple. However, the S&P 500’s forward P/E has rebounded from 15.0 to 19.6 since October 12 thanks to the rebound in the MegaCap-8. These stocks now account for a record-high 27.3% of the market capitalization of the S&P 500, and they are likely to remain the market’s leaders for the foreseeable future.

Strategy II: MegaCap-8 Leading the Way. The MegaCap-8 group of stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) has been leading the S&P 500 higher in a big way so far in 2023. While they’re not as cheap as they were at the start of this year, when they were very cheap, they are still less expensive than they were during

2020-21, when their forward P/E flirted with 35 (*Fig. 13*). Their improved performance this year in part reflects much improved revenues and earnings growth prospects for most of the eight companies.

The MegaCap-8 still accounts for a large part of the S&P 500's market capitalization, and their soon-to-be-released results for Q2—which come on the heels of aggressive cost-cutting—could continue to set the tone for the S&P 500's performance. I asked Joe for an update on the MegaCap-8. Here it is:

(1) *Market capitalization.* The combined market cap for the MegaCap-8 tumbled 41.5% in 2022 but has since rebounded 63.6% ytd to an 18-month high of $11.5 trillion through Friday's close (*Fig. 14*). Through Friday's close, the S&P 500's market cap is up 17.1% ytd with the MegaCap-8 stocks included but up only 5.5% without them. The MegaCap-8's market-capitalization share of the S&P 500 has recovered too, soaring from 19.4% at the start of the year to a record-high 27.3% during the July 14 week (*Fig. 15*).

(2) *Valuation.* The MegaCap-8's forward P/E rose above 30.0 in mid-June for the first time in 15 months. Since the January 6 week, the forward P/E has soared 46% to 31.2 as of the July 14 week from 21.1. However, it remains below the record-high of 38.5 during the August 28, 2020 week. Since their January 6 bottom, forward P/Es have risen for all of MegaCap-8 stocks, as Joe shows below.

Here's how much valuation has changed for each of the MegaCap-8 stocks since the S&P 500's January 6 bottom: Alphabet (up 28% to 21.3 from 16.6), Amazon (27% to 62.2 from 48.8), Apple (up 45% to 29.4 from 20.3), Meta (up 43% to 22.9 from 16.0), Microsoft (up 45% to 31.1 from 21.4), Netflix (up 14.2% to 33.6 from 29.4), Nvidia (up 40% to 48.4 from 34.5), and Tesla (up 201% to 66.2 from 22.0). Tesla's eye-popping valuation gain has come at the expense of declining forward earnings, as the company has cut vehicle prices sharply to maintain sales growth.

(3) *Forward revenues and earnings.* Seven of the MegaCap-8 companies have enjoyed both rising forward revenues and rising forward earnings so far in 2023. The only laggards are Apple's forward revenues and Tesla's forward earnings. As a group, the MegaCap-8's forward revenues has risen 4.4% ytd, and its forward earnings has soared 12.3%—trouncing the S&P 500's forward revenues rise of 3.1% ytd and forward earnings gain of only 1.9% ytd.

Here's how each of the MegaCap-8 companies' forward revenues and earnings forecasts have performed ytd: Alphabet (forward revenues up 3.2%, forward earnings up 11.9%), Amazon (5.3, 22.8), Apple (-1.4, 1.6), Meta (9.9, 66.2), Microsoft (4.0, 5.7), Netflix (6.8, 22.6), Nvidia (70.5, 118.2), and Tesla (2.2, -17.2). Nvidia's surge in such a short period on expectations for AI chip sales is stunning, and must rank near the all-time top (i.e., since consensus forecasts were first calculated over 40 years ago).

(4) *Forward profit margin.* Through the July 6 week, the S&P 500's forward profit margin has dropped to 12.4% from 12.6% at the start of the year (*Fig. 16*). The MegaCap-8's collective margin has surged from 18.0% to 19.5%. Among the MegaCap-8's, all but Tesla have seen their forward profit margin rise ytd: Alphabet (up from 23.0% to 24.2%), Amazon (3.0 to 3.7), Apple (25.2 to 26.0), Meta (21.1 to 27.0), Microsoft (34.6 to 35.2), Netflix (14.1 to 16.2), Nvidia (36.7 to 47.1), and Tesla (15.9 to 12.7) (*Fig. 17*).

(5) *Q2 revenue and earnings outlook*. During 2022, the MegaCap-8's revenues and earnings growth sagged. Quarterly revenues growth remained positive on a y/y basis but dropped to single-digit percentage rates. Earnings fared much worse, falling y/y for four straight quarters through Q1-2023.

But both are expected to turn positive again in Q2-2023. The MegaCap-8's revenues are forecasted to rise 7.8% y/y in Q2-2023 following a 4.6% rise in Q1-2023, and earnings are expected to gain 16.2% y/y after the prior quarter's 3.5% decline. In stark comparison, the S&P 500's revenues are forecasted to decline 0.9% y/y during Q2-2023, while its earnings drop 8.1% y/y.

Calendars

US: Wed: Housing Starts & Building Permits 1.450mu/1.495mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Leading Indicators -0.6%; Initial & Continuing Jobless Claims 242k/ 1.73m; Philadelphia Fed Manufacturing Index & Price-Paid Index -10.4 & 10.7; Existing Home Sales 4.21mu; Fed's Balance Sheet. (Bloomberg estimates)

Global: Wed: Eurozone Headline & Core CPI 0.3%m/m/5.5%y/y & 0.3%m/m/5.4%y/y; UK Headline & Core CPI 0.4%m/m/8.2%y/y & 0.4%m/m/6.8%y/y; UK PPI Input & Output Prices -3.3%y/y & 1.6%y/y; Japan Balance –¥46.7b; Australia Employment Change 17.0k; Australia Unemployment & Participation Rates 3.6% & 66.9%; Mauderer; Ramsden. **Thurs:** Eurozone Consumer Confidence -16.0; Eurozone Current Account; Germany PPI -

0.4%m/m/0.0%y/y; France Business Survey 100; UK Gfk Consumer Confidence -26; Japan CPI. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2-2023 earnings season just over 7% complete, the early indications from the reporting companies so far are a stronger earnings surprise than during Q1-2023, but the revenue surprise is weaker. During Q4-2022, 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 37 of the S&P 500 companies finished reporting for Q2-2023, revenues are ahead of the consensus forecast by 1.3%, and earnings have exceeded estimates by 9.7%. At the same point during the Q1 season, revenues were 2.0% above forecast and earnings had beaten estimates by 7.8%. Just 62% of the 37 Q2 reporters that have reported so far through mid-day Tuesday has reported a positive revenues surprise, while 84% has reported an earnings beat. That's on pace for the weakest reading for revenues since the Great Virus Crisis, but the percentage with positive earnings surprises would be a record high if it holds to the end of the season. Their aggregate y/y revenue and earnings growth rates have ticked up from their Q1-2023 readings. The collective y/y revenue gain for the 37 reporters so far has edged up to 7.7% from 7.1%, and earnings are up 13.4% y/y from a 1.3% gain. During the past 57 quarterly reporting seasons over the last 14 years through Q1, y/y earnings growth has trailed revenue growth in only 15 of the quarters and for five straight quarters, and it's likely to do so again in Q2-2023 when Energy sector results are reported. Significantly fewer companies are reporting positive y/y earnings growth in Q1 (65%) than positive y/y revenue growth (84%). These figures will continue to change as more Q2-2023 results are reported in the coming weeks. While we expect y/y revenue growth rates to remain positive in Q1, earnings are sure to decline for a third straight quarter.

US Economic Indicators

Retail Sales (*link*): Retail sales fell short of expectations in June, though there was an upward revision to May sales. *Total retail sales* increased 0.2% (vs 0.5% expected) in June, following a revised 0.5% (from 0.3%) gain in May and a 0.4% increase in April. Sales had declined 1.6% during the two months ending March after a 2.8% jump in January. Through the first half of 2023, sales are up 2.4%, climbing to within 0.4% of January's record high. Meanwhile, sales in the *control group*—which excludes autos, gasoline, building materials, and food services—has recorded only one decline during the first half of this year, climbing 0.6% in June and 2.4% ytd to a new record high. This measure correlates closely with the consumer spending component in GDP. Overall retail sales are heavily goods-related, with food services & drinking places the only services category. Of the *13 nominal retail sales categories*, seven rose in June while six fell. Here's a snapshot of the 13 categories' *June sales performance versus that of a year ago*: miscellaneous store retailers (2.0% m/m & 1.5% y/y), nonstore retailers (1.9 & 9.4), furniture & home furnishings (1.4 & -4.6), electronics & appliance stores (1.1 & 0.9), clothing & accessories stores (0.6 & 0.7), motor vehicles & parts (0.3 & 5.3), food services & drinking places (0.1 & 8.4), health & personal care stores (-0.1 & 6.3), general merchandise stores (-0.1 & 0.5), food & beverage stores (-0.7 & 1.3), sporting goods & hobby stores (-1.0 & -1.3), building materials & garden equipment (-1.2 & -3.2), and gasoline stations (-1.4 & -22.7).

Business Sales & Inventories (*link*): Both nominal and real business sales remain in record territory, though are down from their recent record highs. *Nominal business sales* increased for the first time in four months in July, ticking up 0.2%. Since reaching a record highs last June, sales have decreased six months, increased four months, and were unchanged one month—falling 2.6% over the 11-month period through May. Meanwhile, *real business sales* reached a new record high in January 2022, and were down only 1.8% during the 15 months through April. In the meantime, the real inventories-to-sales ratio in April held at 1.49—which was the highest since mid-2020, up from a recent low of 1.37 in fall 2021. Meanwhile, the nominal ratio in May was unchanged again at March's 1.40—which was the highest since mid-2020.

Industrial Production (*link*): Industrial production unexpectedly fell in June, once again led by a sharp drop in utilities output, with manufacturing also contributing to the decline. *Headline production* sank 0.5% last month, weaker than the consensus forecast of no change, while May's decline of 0.5% (vs -0.2%) was more than double the preliminary estimate. Production had increased 1.8% the first four months of the year. *Utilities* output declined for the fifth time in six months, sinking 2.6% in June and 8.3% ytd. *Manufacturing* production contracted for the second month in June, by a total of 0.5%, after a 1.0% gain in April and a 0.8% loss in May. Meanwhile, *mining* production remains on a steep uptrend, up 3.2% ytd and 31.6% from its May 2020 bottom. By *market group, consumer goods* production fell 1.3% in June, following a 0.5% drop in May, reversing the gain reported the first four months of the year. *Durable consumer goods* production in June sank 2.7% after a two-month climb of 4.8%; it's up 1.7% ytd, getting a boost in April from an 8.6% surge in production of auto products. Durable goods output is within 3.4% of January 2021's record high. *Nondurable consumer goods* production slumped 1.6% during the two months through June, following a 1.3% gain during the three months through April. *Business equipment* production showed no change in June, after dropping three of the prior four months by 1.2%, though was flat ytd. Transit equipment output slumped 1.1% in June after a 5.1% jump during the two months ending May. It had dropped the first three months of the year, by 2.9%, but still registered a ytd gain of 1.0%. Production of industrial & other equipment fell during four of the past five months, sinking 2.3%—more than offsetting the 2.0% jump at the start of the year. Meanwhile, production of information processing equipment is down 2.5% from its recent peak last October.

Capacity Utilization (*link*): The *headline* capacity utilization rate moved down for the second month to 78.9% in June from April's to 79.9%; it peaked recently at 80.8% last September. June's rate is 0.8ppt below its long-run (1972-2022) average. The *manufacturing* utilization rate fell during three of the past four months, from 78.5% in February to 78.0% in June, putting it 0.2ppt below its long-run average. Meanwhile, the *mining* utilization rate remains in a volatile flat trend around recent highs, at 91.6% in June, not far from its all-time record high of 94.0% in 1980, while the *utilities* rate remained on a steep downtrend, dropping to a new record low of 68.5% in June. June's rate for mining is 5.2ppts above its long-run average, while the utilities rate is substantially below its long-run average.

NAHB Housing Market Index (*link*): "The lack or resale inventory means prospective home buyers who have not been priced out of the market continue to seek out new construction in greater numbers," noted NAHB Chairman Alicia Huey. "At the same time, builders are troubled over rising mortgage rates approaching 7% and continue to grapple with supply-side challenges, including ongoing scarcity of electrical transformer equipment and growing concerns above low lot availability," she cautioned. *Homebuilders' confidence* has climbed all seven months of this year, by 25pts ytd to a 13-month high of 56, after sliding all 12 months of 2022, by 53 points, to 31—which was the lowest since mid-2021 (excluding a drop to 30 at the height of the pandemic). This July's reading was the first reading above the midpoint of 50 since last July, this June's being the first. Of the *three components of homebuilders' confidence*, two have climbed steadily over the first seven months of this year, current sales (+26 to 62) and traffic (+20 to 40), while future sales ticked down two points in July to 60.0—though is up 25 points ytd. According to July's report, the decline in the future sales expectation reading "is a reminder that housing affordability continues to be challenged by elevated interest rates." In July, only 22% of homebuilders lowered home prices to bolster sales, compared with 25% and 27% in June and May, respectively, and

14ppts below November’s peak of 36%.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102