MORNING BRIEFING
August 8, 2023

Worry List Update

Check out the accompanying chart collection.

Executive Summary: Most investors and analysts are newly optimistic about the economic outlook and corporate earnings prospects. Like them, we see low (15%) odds of a hard landing anytime soon. That's notwithstanding the yield curve's ongoing recession signal. … But six worries, should they become more worrisome, could change our sanguine stance. We're watching closely for fallout from the US commercial real estate crisis; a reinvigorated wage-price spiral; the off chance that consumers retrench; the soaring federal deficit, which could cause Bond Vigilantes to get more vigilant; and the possibility that Fed Chair Powell might take a page from predecessor Volcker's playbook.

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

Strategy I: Don't Worry, Be Happy. The hard-landing scenario has had a hard landing. Fewer economists are worrying about an imminent recession. Stock investors are also less concerned about a downturn that could send corporate earnings lower. The S&P 500 rose 28.3% from its bear market bottom on October 12, when it closed at 3577.03, to its bull market high on July 31 of 4588.96 (*Fig. 1*).

The rebound in the S&P 500 has been led by its forward P/E, which rose from 15.1 on October 12 last year to 19.6 on July 31 (*Fig. 2*). So it rose 29.8% over this period, while the S&P 500 rose 28.3%, indicating that investors are discounting an improvement in earnings in coming months.

Industry analysts have also turned more optimistic, as evidenced by S&P 500 forward earnings, which recently bottomed during the February 9 week and rose 4.0% through the August 3 week (*Fig. 3*). S&P 500 forward revenues has continued to rise to record highs, while the forward profit margin has stopped falling in recent months. (FYI: Forward earnings and revenues are the time-weighted average of industry analysts' forecasts for the current year and following one, the forward P/E is the multiple based on forward earnings, and the forward profit margin is the margin calculated from forward revenues and earnings.)

Stock market sentiment has turned very bullish since the start of the current bull market. Investor's Intelligence Bull/Bear Ratio was down to 0.57 during the October 11 week (*Fig.*

4). It rose to 3.07 during the August 1 week. The percentage of bulls rose from 25.0% to 57.1% over this period, while the percentage of bears fell from 44.1% to 18.6%.

The 10-year Treasury bond yield peaked last year at 4.25% on October 24, fell to a 2023 low of 3.30% on April 5, and rose back to just a bit over 4.00% last week (*Fig. 5*). The 2-year Treasury bond yield fell to this year's low (so far) of 3.75% on May 4, mostly on fears that the March banking crisis would turn into an economy-wide credit crunch and recession (*Fig. 6*). Since that low, the 2-year yield jumped to 4.78% on Friday.

Of course, the depleted contingent of hard-landers can still take some comfort from the inverted yield curve. The yield spread between the 10-year and 2-year Treasury notes widened to a low of -100bps on June 30 (*Fig. 7*). It narrowed to -67bps on Monday. But it was still significantly negative, supporting the opinion of some prognosticators that a recession is still coming, since inverted yield curves have always predicted recessions. We don't share that view currently.

Strategy II: Worry, But Be Happy Anyway. So now that investors, analysts, and investment strategists are mostly bullish, Debbie, Joe, Melissa, and I are on the alert for what could go wrong. We've been updating our worry list over the past couple of weeks. Here is our latest update:

(1) *Commercial real estate crisis.* According to the latest US *National Office Report* from CommercialEdge, the national vacancy rate for office buildings was 17.1% as of July 2023, up from 15.3% a year ago. This means that out of the total US office stock of 6.8 billion square feet, about 1.2 billion square feet of office space was vacant.

Some owners of vacant office buildings are demolishing them and building structures that should be easier to lease. For example, owners of a two-building campus in Santa Ana, California are taking the unusual step of tearing down their recently renovated property and converting the eight-acre site into a logistics hub.

"Picklemall" may be the solution for some vacant mall space. A pickleball facility has replaced the former At Home store in Tempe, Arizona. It's a 104,000-square-foot business that's now home to more than a dozen pickleball courts.

Nevertheless, many owners of commercial real estate may have no choice but to default on their mortgages, and their bankers will have to sell the properties at distressed prices.

The Fed's Q3 Senior Loan Officer Opinion Survey (SLOOS) found that 67.8% of lenders continued to tighten lending standards for commercial real estate (CRE) loans (*Fig. 8*). The net percentage of lenders reporting stronger demand was -53.3% (*Fig. 9*).

CRE loans at all commercial banks have been flat at a record high just below $3.0 trillion since the March 15 week, the same time as the banking crisis hit (*Fig. 10*).

(2) *Renewed wage-price spiral.* The economic recovery from the Covid-19 pandemic unleashed a wage-price spiral in the labor market. As the economy reopened, workers pushed for higher wages and better benefits, forcing companies to raise their prices. Many workers achieved wage increases by quitting their jobs for better paying ones. They could do so because the demand for labor has exceeded the supply since May 2021 (*Fig. 11*). That's still the case, though wage and price inflation both have moderated.

Meanwhile, unionized workers haven't been doing as well as nonunionized ones. The Employment Cost Index for the former rose 3.6% y/y through Q2 and for the latter 4.5% y/y (*Fig. 12*). As a result, labor unions have grown more assertive. And they've grown more powerful, as they've succeeded in organizing new workers and winning strikes in recent years. The labor unrest is being felt across a wide range of industries, including transportation, healthcare, and retail.

The United Auto Workers union is starting negotiations with the auto industry by demanding a 20% immediate wage increase and an additional 5% during each year of the contract. The autoworkers' wages at the Big Three currently range from roughly $18-$32 an hour, depending on seniority, according to the union. Starting wages are about $10-per-hour lower than what they would be had they kept up with inflation since 2007, the UAW said.

Unionized workers are a relatively small percentage of the labor force. But their contracts can have an influence on wages in the nonunionized sector.

(3) *Consumers retrench*. Of course, it's still possible that when consumers' excess savings run out later this year, they will reduce their spending. A more important determinant of consumer spending is disposable personal income, which depends on aggregate weekly hours worked. Friday's employment report showed that the latter rose just 1.3% y/y during July, the slowest pace since March 2021 (*Fig. 13*). This slowdown is partly offset by the fact that average hourly earnings adjusted for inflation has been rising in recent months.

(4) *Federal deficit spiral.* The US federal deficits and the resulting mounting US debt are

growing as percentages of nominal GDP. On a 12-month-sum basis, the former just jumped from $1.0 trillion last July to $2.3 trillion through this June, as outlays have been soaring while revenues have fallen (*Fig. 14* and *Fig. 15*). The net interest paid by the government has continued to rise rapidly along with interest rates since early last year. This outlay rose to a record $615.8 billion over the 12 months through June (*Fig. 16*). Just before the pandemic, it was $383.7 billion.

On August 1, Fitch Ratings downgraded US government debt from AAA to AA+ for all the reasons that have been concerning the bond market for years. None of this is news. However, the Fitch downgrade reminds us all that fiscal policy continues to get more and more profligate. The US Treasury will be selling lots of notes and bonds during August and over the rest of this year, while the Fed's QT program will continue to reduce the Fed's holdings of Treasuries by about $60 billion per month (*Fig. 17*).

(5) *Bond Vigilantes rampage*. The Bond Vigilantes may be turning more vigilant following the Fitch downgrade. They are happiest when the economy is weak and inflation is subdued. They are not so happy right now.

We are still expecting that the 10-year Treasury yield won't rise above the October 24 high of 4.25%. But it wouldn't take much for that to happen, which would set off lots of alarm bells about the yield potentially rising to 5.00%-5.50%. In that scenario, the valuation multiple of both the S&P 500 and Nasdaq would likely take significant hits.

Over the years, we've frequently been asked why we aren't more concerned about the widening US federal government budget deficit. We've consistently responded that we will be concerned about it when the financial markets are concerned about it.

We believe that supply and demand for bonds isn't usually as important to the determination of the bond yield as are actual and expected inflation and the expectations of how the Fed will respond to them. So given that we expect inflation to continue to moderate, we currently predict that the bond yield won't rise above 4.25%. If we are wrong about that, and the bond market has trouble financing the government's huge deficits at current market interest rates, then the Bond Vigilantes will go wild. If that happens, head for the hills for the rest of the summer and maybe September too.

(6) *Fed goes Volcker.* If inflation doesn't continue to moderate and appears increasingly sticky well above the Fed's 2.0% target, Fed Chair Jerome Powell and his colleagues may conclude that they have no choice but to "Volckerize" interest rates, i.e., raise them until

they vaporize economic growth, as former Fed Chair Paul Volcker did in the late 1970s.

(7) *Bottom line.* The half dozen worries listed above will likely keep us busy over the rest of this year. For now, our economic outlook remains 85% odds of a no-landing or soft-landing scenario and 15% odds of a hard landing; that should remain the case unless one or several of the worries become more worrisome.

We think the S&P 500 should churn below 4600 over the rest of the year, offering opportunities to invest in those companies, industries, and sectors that have been performance laggards over the first half of this year while taking some profits in the leaders—which may face challenges to their lofty valuations from the Bond Vigilantes.

Calendars

US: Tues: NFIB Small Business Optimism; Trade Balance -$65.7b; Wholesale Trade Sales & Inventories 0.3%/-0.3%; EIA Short-Term Energy Outlook. **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; 10-Year Note Auction. (Bloomberg estimates)

Global: Tues: Germany CPI 0.3%m//m/6.2%y/y; France Current Account –¥0.40b; China CPI 0.0%m/m/-0.5%y/y; China PPI -4.0%y/y. **Wed:** UK RICS House Price Balance -50%; Japan PPI 0.2%m/m/3.5%y/y; Japan Machine Tool Orders -21.7%y/y. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for LargeCap and MidCap, and was unchanged for SmallCap. While it's been 58 weeks since any of these indexes has hit a record high, all three are up from their lows during February and March. Through the week ending August 4, LargeCap's forward earnings is 4.0% above its 54-week low during the week of February 10. MidCap's is 3.5% above its 55-week low during the week of March 10, and SmallCap's is 1.5% 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

2.1% below its record high at the end of June 2022; MidCap's is 4.9% below its record high in early June 2022; and SmallCap's is 12.3% 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 a 27th straight week, and up to -0.7% y/y from a 29-month low of -3.2% y/y during the June 23 week; 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 -3.8% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -10.9% y/y rate is up from a 32-month low of -12.9% in mid-June and 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 ticked higher during the Q1 and Q2 reporting seasons as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (0.4% and 12.2%), MidCap (-11.0, 13.3), and SmallCap (-10.7, 12.9).

S&P 500/400/600 Valuation (*link*): Valuations moved lower for these three indexes through the August 4 week. LargeCap's forward P/E fell 0.5pt w/w to 19.1 from an 18-month high of 19.6. It's up 4.0pts 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 dropped 0.3pt to 14.1 from a 21-week high of 14.4, and is just 0.6pt below its recent 10-month high of 14.7 in early February. It's now up 3.0pts from 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 fell 0.1pt to 14.0 from a 21-week high of 14.1, which compares to a 19-week low of 12.5 during the May 12 week and is now just 0.3pt below its recent 12-month high of 14.3 in early February. It's 3.4 pts 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 26% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 26% discount to LargeCap's P/E last week is not much above its 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 112th straight week; the current 1% discount is near 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 -2.8% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -4.2% in Q2, down from a 0.1% gain in Q1-2023. However, S&P 500 ex-Energy earnings are forecasted to be up 2.0% y/y in Q2-2023, an improvement from the 1.6% decline in Q1-2023 and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their final earnings growth rates for Q1-2023: Consumer Discretionary (52.1% in Q2-2023 versus 56.2% in Q1-2023), Communication Services (15.5, -8.9), Industrials (13.9, 27.1), Consumer Staples (7.4, 0.4), Financials (7.3, 7.7), Utilities (3.7, -21.8), S&P 500 ex-Energy (2.0, -1.6), Information Technology (1.9, -8.3), Real Estate (-2.1, -6.2), S&P 500 (-4.2, 0.1), Materials (-26.1, -22.2), Health Care (-26.6, -14.8), and Energy (-47.7, 21.0).

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2-2023 earnings season now over 85% complete, the indications from the companies that have reported so far suggest a slightly stronger earnings surprise than in Q1-2023 but a weaker revenues surprise. 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 426 of the S&P 500 companies finished reporting for Q2-2023, revenues are ahead of the consensus forecast by 1.9%, and earnings have exceeded estimates by 7.9%. At the same point during the Q1 season, revenues were 2.5% above forecast, and earnings had beaten estimates by 7.3%. For the 426 companies that have reported Q2 results so far through mid-day Monday, only 63% has reported a positive revenues surprise; if the companies yet to report don't raise that number, Q2 would have the narrowest revenues beats reading since Q1-2020. But the percentage with positive earnings surprises is well above the pace of the prior six quarters dating back to Q4-2021. The reporting companies' aggregate y/y revenues and earnings growth rates are mixed from their Q1-2023 readings: tumbling to -7.7% from -2.8% for earnings growth and dropping to 0.9% from 3.8% for revenues growth. Over the past 57 quarters through Q1-2023, y/y earnings growth has trailed y/y revenues growth in only 15 quarters including the past five, and it's already doing so again in Q2-2023 as Energy sector results are being reported. Excluding the Energy sector's results from the S&P 500 companies that have already reported underscores Energy companies' outsized drag on the S&P 500's y/y growth rates: earnings growth improves to -1.2% from -7.7%, and revenue growth rises to 4.6% from 0.9%. Significantly fewer companies have been reporting positive y/y earnings growth in Q2 (56%) than positive y/y revenues growth (67%). These figures will change as more Q2-2023 results are reported in the coming weeks, but the overall tune has been set. We expect the overall y/y revenues growth rate to remain positive in Q2, but results from the companies in the Energy and Materials sectors are likely to cause the biggest y/y earnings decline for the S&P 500 since Q2-2020.

Global Economic Indicators

Germany industrial Production (*link*): German industrial production was much weaker than expected in June. Germany's *headline production*, which includes construction, fell 1.5% in June, triple the expected 0.5% decline, while May's 0.3% gain was revised to a 0.1% decline. Declines in construction and motor vehicle output were major drags on production during June, contracting 3.5% and 2.8%, respectively. Headline production fell during three of the past four months, by a total of 3.7%; this weakness followed a strong start to 2023, climbing 4.7% the first two months of the year. Meanwhile, *production excluding construction* (which the overall Eurozone uses) also declined three of the past four months, contracting 1.3% in June and 3.4% over the period. Meanwhile, energy output ticked up 0.6% in June, following a six-month plunge of 14.9% to a record low. Looking at the main industrial groupings, *capital goods* production posted the sole decline in June, sinking 3.9%, though remains around recent highs. *Consumer durable goods* rebounded 2.0%, following a 6.4% drop the prior two months; *consumer nondurable goods* production climbed 3.3% during the three months through June, erasing the 3.3% decline the first three months of the year. Meanwhile, *intermediate goods* output ticked up 0.4% in June after a three-month decline of 3.2%, though was still up 4.0% ytd. On a *y/y basis*, headline production dropped 1.7%, with construction output 2.5% below a year ago. Looking at the *main industrial groupings*, it was a sea of red, with only production of capital goods (4.2% y/y) posting a gain. Energy (-20.2% y/y) output led declines, followed by intermediate (-5.4), consumer durable (-2.3), and consumer nondurable (-0.2) goods production.

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