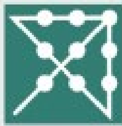
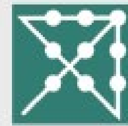
 Yardeni Research 

MORNING BRIEFING
August 9, 2023

Mostly About Consumers

Check out the accompanying chart collection.

Executive Summary: Moody's downgrade of several banks' credit ratings has some investment implications: It's bearish for Financials stocks, but only over the short term, as it will hasten M&A activity. It will facilitate the US Treasury's ability to fund the budget deficit without increasing Treasury bond auction interest rates, supporting our belief that last year's peak in the 10-year Treasury yield won't be breached this year. And it drives home the point that credit conditions are tight enough, which should help deter the Fed from further tightening. … Also: A look at consumers' credit-card usage, rent inflation, and the spending habits of an important demographic—never married singles.

Strategy: Moody's Darkens the Mood for Financials. Joe and I have been predicting that the second half of this year will be more challenging than the first half. The S&P 500 rose 19.5% from the end of last year through the bull market's high of 4588.96 on July 31. So our year-end S&P 500 target of 4600 occurred five months ahead of schedule. We've left it at 4600, figuring that the market might move sideways or sell off through September before commencing a year-end rally back to 4600.

Now we have a good reason for why the second scenario (down, then up) might happen. On Monday, after the markets' close, Moody's cut the credit ratings of several small to mid-sized US banks and said that it may downgrade some of the nation's biggest lenders, warning that the sector's credit strength likely will be tested by funding risks and weaker profitability.

That supports our cautious market call, but it pulls the rug out from under our recommendation to overweight the S&P 1500 Financials, for now. However, we're still expecting lots of M&A activity in the sector to provide a boost to the bank stocks. The downgrade should hasten that scenario. But for now, the downgrade is what it is, i.e., bearish for the Financials over the short term.

The downgrade activated the risk-off trade benefitting the US Treasury bond market, which was downgraded on August 1 by Fitch Ratings 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 quantitative tightening program will continue to reduce the Fed's holdings of Treasuries by about $60 billion per month.

So ironically, Moody's downgrade of the banks should make it easier for the US Treasury to fund its deficit with its securities (downgraded by Fitch) without a significant increase in interest rates in the Treasury's auctions for now. This confirms our prediction that the 10-year Treasury yield's peak of 4.25% last year on October 24 should not be breached this year. It certainly came close on Friday, when the yield jumped to 4.20% before falling closer to 4.00% by day-end.

We still believe that October 12 marked the start of a new bull market in stocks, which should take the S&P 500 up to 5400 by the end of 2024.

Note to our friends at the Fed: Congratulations! You've been aiming for over a year to raise the federal funds rate to a sufficiently restrictive level to bring inflation down without causing a recession. Mission accomplished! But please don't jinx it by saying so. You can say that Moody's downgrade of the banks and your recent Senior Loan Officer Opinion Survey (SLOOS) confirm that credit conditions are tightening quickly so there's no reason to risk an overkill by raising the federal funds rate again.

US Consumers I: Odd Drop in Revolving Credit. Just when many pessimistic prognosticators claimed that consumers were on a credit card fueled buying binge, revolving credit fell $604.5 million during June (*Fig. 1*). That was the first decline in more than two years. Over the previous 24 months, the average pace of consumers' credit card borrowing was $11.8 billion per month. June's decline in credit card debt is odd given that nominal personal consumption expenditures rose 0.5% m/m during June and retail sales increased 0.2% during the month.

In other words, it's hard to explain the latest drop. Perhaps it was a one-month aberration. Also funky was that nonrevolving credit, which includes mostly auto and student loans, rose $18.5 billion during June following a weak gain of just $967.4 million during May, which might have been another statistical aberration. Total consumer credit rose $17.8 billion during June, which is more in line with the pace of such borrowing over the past two years or so.

In any event, we often hear concerns that consumers have had to borrow because inflation has boosted the prices of the goods and services that they buy on credit. That makes

sense. The hard-landers assert that consumers are overindebted to such an extent that when their excess savings accumulated during the pandemic runs out—likely before year-end—they'll have to retrench because they will be maxed out on their credit cards.

Of course, this grim outlook assumes that the prospects for personal income and employment also are likely to deteriorate, though that seems to be an assumption rather than a well reasoned analysis. The assertion is that when the unemployment rate is historically low, as it is now, the next big move is always to the upside, especially when the Fed is tightening monetary policy to achieve that very aim, as it is now.

Now consider the following related observations:

(1) Revolving credit rose to a record high of $1.3 trillion during May (*Fig. 2*). It exceeds the pre-pandemic peak of $1.1 trillion during 2020 by $161.7 billion.

(2) Revolving credit currently equals only 6.3% of nominal disposable personal income and 6.9% of total consumer spending excluding autos and owners' equivalent rent (*Fig. 3* and *Fig. 4*).

(3) At the end of Q2 (i.e., during June), student loans totaled a near-record $1.8 trillion and auto loans totaled a record $1.5 trillion (*Fig. 5*).

(4) The Fed also compiles monthly data on consumer-related loans at all commercial banks on a weekly basis. They rose to a record high of $1.89 trillion during the week of June 14 and edged down $7.2 billion through the July 26 week (*Fig. 6*). Credit card loans rose to a record high of $1.0 trillion at the end of July. The banks' auto loans peaked last year and declined modestly to $508 billion during the July 26 week.

(5) The banks certainly have raised the interest rates they charge on consumer loans. On all credit cards, the rate rose from 14.60% in 2021 to 20.68% in May. The rate on 60-month new car loans is up from 4.82% in 2021 to 7.81% in May. These rates are clearly meant to encourage users to pay off their balances every month.

(6) The Fed's Q3 SLOOS showed that the bankers' willingness to make consumer loans dropped sharply during the past five quarters. This series tends to lead the yearly percent change in consumer loans by four quarters (*Fig. 7*).

(7) Our bottom line is that when it comes to the key drivers of consumer spending,

consumer credit matters but not as much as personal income does. Perhaps once Americans return from their summer vacations in Europe, they'll see how much damage they did on their credit cards and retrench. More likely, they will keep shopping as long as their purchasing power increases along with employment and real wages.

US Consumers II: Rent. The rent components of the CPI and PCED account for much of the stickiness in the inflation rates for both. However, as we noted last week, rent inflation for new leases has declined sharply in recent months, and that should increasingly be reflected in the two price measures that measure rent on all outstanding leases.

Just for fun, Debbie and I played with the rent numbers to assess their importance to consumers and to the inflation rate:

(1) We calculated personal consumption expenditures (PCE) on tenant rent divided by the total number of households that rent (*Fig. 8*). It rose to a record annualized $15,032 per renter household during Q2. It is up 8.3% y/y (*Fig. 9*). This series *loosely* tracks the CPI primary rent inflation rate.

(2) We can do a similar analysis for owners' equivalent rent. It rose to a record annualized $24,245 per homeowning household during Q2 (*Fig. 10*). It also *loosely* tracks the CPI owners' equivalent rent, both on a y/y basis (*Fig. 11*).

(3) Tenant rent and owners' equivalent rent currently account for 3.6% and 11.4% of personal consumption expenditures as well as the headline PCED (*Fig. 12*). Tenant and owners' equivalent rent account for 7.6% and 25.5% of the headline CPI.

(4) The good news is that rent inflation, which is a major component of the PCED services inflation rate (22.5% currently), is likely to head lower at a faster pace in coming months. Rent inflation in the PCED, including both rent of primary residence and owners' equivalent rent, edged down to 8.0% in June from a recent high of 8.4% in April (*Fig. 13*). It lags measures of rent on new leases such as the Zillow Index and the ApartmentList Index, which were down to 4.1% in June and -0.7% in July, respectively.

US Consumers III: Lots of Singles & Fewer Renters. While we are on the subject of the American consumer, here are a few interesting demographic updates:

(1) Among the US population 16 years and older, the number of singles rose to a record high of 137.4 million in July (*Fig. 14*). Singles now account for 51.5% of the civilian

noninstitutional working age population, up from 38% in 1977 (*Fig. 15*). Singles who've never married made up a record 33.1% of the US population in July, while those who are divorced, separated, or widowed represented 18.4% (*Fig. 16*).

With a third of the adult population representing never-married singles, our hunch is that this group must be having some important consequences for the US economy. Never-married singles might have a higher propensity to spend and a lower propensity to save. They are likely to dine out and travel more than married couples and families. They certainly are more mobile, for both work and pleasure, since most aren't tied to the schedules of children.

(2) The number of US households rose to a record high of 130.2 million in June, a 27% increase since 2000 (*Fig. 17*). The number of homeowner-occupied households totaled a record 85.3 million during Q2, while the number of renting households was flat at 44.1 million (*Fig. 18*).

Since the pandemic, there has been a relatively strong demand for homeownership, which has kept home prices high despite soaring mortgage rates (*Fig. 19*). The demand for rentals has dwindled so far this year, which must be putting downward pressure on rent inflation.

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; 10-Year Note Auction. **Thurs:** Headline & Core CPI 0.2%m/m/3.3%y/y & 0.2%m/m/4.7%y/y; Initial & Continuous Claims 230k/1.695m; Real Earnings -0.1%; Federal Budget Balance -$92.5b; Natural Gas Storage; Fed's Balance Sheet; Harker; OPEC Monthly Report. (Bloomberg estimates)

Global: 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. **Thurs:** Italy CPI 0.1%m/m/6.0%y/y; ECB Bulletin. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2-2023 earnings season now 89% 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 445 of the S&P 500 companies finished reporting for Q2-2023, revenues are ahead of the consensus forecast by 1.8%, and earnings have exceeded estimates by 7.7%. At the same point during the Q1 season, revenues were 2.5% above forecast, and earnings had beaten estimates by 7.3%. For the 445 companies that have reported Q2 results so far through mid-day Tuesday, only 62% 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 0.6% 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 4.3% from 0.6%. Significantly fewer companies have been reporting positive y/y earnings growth in Q2 (55%) than positive y/y revenues growth (66%). 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.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "With small business owners' views about future sales growth and business conditions dismal, owners want to hire and make money now from solid consumer spending," said NFIB Chief Economist Bill Dunkelberg. "Inflation has eased slightly on Main Street, but difficulty hiring remains a top business concern." July's *Small Business Optimism Index* (SBOI) increased for the third month, by 0.9 points that month and 2.9 points over the period, to an eight-month high of 91.9. That marks the 19th consecutive month that the index was below its 49-year average of 98.0, not having exceeded the average since December 2021. In July, four of the 10 components increased, two decreased, and four were flat—current job openings (42%), now is a good time to

expand (6), current inventory (-4), and expected credit conditions (-8). Expect the economy to improve (+10ppts to -30%) was the main contributor to July's gain—posting its least pessimistic view since August 2021—with the remaining three positive contributors only slightly higher than in June: plans to increase employment (+2 to 17), capital outlay plans (+2 to 27), and sales expectations (+2 to -12). Earnings trends (-6ppts to -30%) and plans to increase inventories (-1 to -2) were the only drags on the SBOI. Quality of labor (23) and inflation (21) remain small business owners' *single biggest business problem*, seesawing between number one and number two for several months, with taxes (16), cost of labor (10), and government requirements (10) rounding out the top five biggest problems. The net percentage of owners raising selling prices continued to ease, sinking to a 29-month low of 25% in July from a near-record-high 66% last March, while the net percentage of owners *planning to increase selling prices* slipped to 27% in July, after climbing the prior two months from a 29-month low of 21% in April to 31% in June. It was at a record high of 54% during November 2021. A net 38% of owners reported *raising compensation* last month, up from June's 25-month low of 36% but below the 46% the first two months of this year; it was at a record-high 50% at the start of 2022. A net 21% of owners *plan to increase compensation* in the next three months, matching April's two-year low. The percentage is 11ppts below October 2022's 32%, which matched the record high posted the final two months of 2021.

Merchandise Trade (*link*): The *real merchandise trade deficit* narrowed for the second month, from $96.3 billion in April to $86.2 billion in June, though was still a slight drag on real GDP growth during Q2, averaging $90.5 billion per month during Q2 vs $85.6 billion during Q1. *Real exports* rose for the second month, by 0.5% in June and 2.1% over the period, following April's 5.5% drop—which was the steepest monthly decline since April 2020. *Real imports* fell 3.1% over the two months through June, after a 2.6% gain in April. Looking at *real exports versus a year ago*, they're up 1.3%—led by exports of other goods (41.1%), automotive vehicles, parts & engines (13.7), and capital goods ex autos (3.5), which were partially offset by declines in exports of foods, feeds & beverages (-16.8), industrial supplies & materials (-1.7), and nonfood consumer goods ex autos (-1.2). Turning to real imports, they're down 4.0% y/y, led by declines in imports of nonfood consumer goods ex autos (-16.0), foods, feeds & beverages (-8.7), capital goods ex autos (-4.1), and industrial supplies & materials (-3.4). In the plus column were automotive vehicle, parts & engines (20.9) and other goods (10.0).

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

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