Yardeni Research

MORNING BRIEFING
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From Strong To Soft Patch?

Check out the accompanying chart collection.

Executive Summary: Is the surprising Q3 strength in the economy sustainable? Clues in the latest data releases suggest not, and our forecast calls for a renewed soft landing. A stronger-for-longer economy wouldn't jibe with the Fed's higher-for-longer interest-rate stance. ... But the economic outlook hinges much on what consumers do next. We don't see them slamming on the spending brakes, as the hard-landers predict will happen when excess savings are depleted. But they might start tapping on the brakes, especially given the imminent resumption of student loan payments and tightening credit conditions.

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

US Economy I: Another Soft Landing Ahead. Our economic forecast has put us in the soft-landing camp since early last year. That worked out well so far. However, Q3 is turning out to be a very strong patch in the soft-landing scenario. We doubt it is sustainable.

The question is: What comes next? Will the strong patch be followed by a resumption of our rolling recession paradigm, which has been driving our soft-landing scenario? Or will it be followed by the recession that was so widely expected last year and early this year? A recession is still expected by many economic forecasters even now, but not as widely as at the start of this year.

Of course, from a contrarian perspective, the biggest surprise of all would be that the current strong patch is the start of better-than-expected economic growth for the rest of this year and into next year. Debbie and I like to be contrarians when it makes sense. But stronger-for-longer economic growth seems to be at odds with the Fed's current higher-for-longer stance on interest rates. On the other hand, fiscal policy remains very stimulative. Capital spending might strengthen as business managers do what they can to boost productivity to offset the shortage of workers, especially skilled ones.

Then again, the rolling recession is rolling into the commercial real estate sector, hitting office buildings hard and boosting nonperforming loans at the banks. The rolling recovery in housing starts is likely to be aborted by the recent jump in mortgage interest rates. The consumer has been remarkably resilient. However, consumers' excess savings could be depleted by the end of this year. Student loan payments are resuming. Delinquency rates on consumer loans are moving higher. Nevertheless, we don't expect these developments to result in a hard landing.

Let's review the latest data relevant to assessing which way the economy is heading:

(1) *GDP.* The Atlanta Fed's *GDPNow* tracking model shows real GDP rising 5.6% (saar) during Q3 as of September 1. That follows increases of 2.0% and 2.1% during the first two quarters of this year (*Fig. 1*). Leading the way is a 7.2% increase in residential investment following declines of 4.0% and 3.6% during Q1 and Q2. Also strong is personal consumption expenditures with a gain of 4.2% compared to 1.7% during Q2. In capital spending, equipment is up 2.7%, while nonresidential structures is up just 0.2%.

(2) *Coincident indicators.* There may be a bust coming according to the Index of Leading Economic Indicators, which peaked during December 2021. But there is still no hint of a recession in the Index of Coincident Economic Indicators (CEI), which rose 0.4% m/m to yet another record high in July (*Fig. 2*). On the other hand, there's no boom in the CEI, which on a y/y basis tracks real GDP very closely. The former rose 1.7% in July, while the latter rose 2.5% during Q2.

The CEI probably rose again during August. Payroll employment, which is one of the four components of the CEI, rose 0.1% last month to a new record high. Real personal income less government transfer payments, another CEI component, most likely rose too since aggregate hours worked increased 0.4% to a new record high last month (*Fig. 3*). Wages as measured by average hourly earnings rose 0.2% last month, which might have been a downtick on an inflation-adjusted basis.

Another CEI component, real business sales, might have been weighed down by some weakness in August retail sales after July was boosted by Amazon's Prime Day. Auto loans suggest that autos sales may be weakening. Finally, the aggregate number of hours worked in manufacturing rose 0.2% during August, suggesting that manufacturing output remained relatively flat last month (*Fig. 4*).

None of the above confirms the strength in Q3's real GDP or suggests that it is sustainable. Nor do they hint at an impending recession.

(3) *Housing.* Housing starts rebounded during the spring and early summer (*Fig. 5*). Single-

family starts led the way. Meanwhile, multi-family starts remained high, but multi-family building permits have been falling since March, when the banking crisis first hit (*Fig. 6*). In addition to tightening credit conditions, rapidly falling rent inflation may also be weighing on multi-family starts (*Fig. 7*).

Real residential investment could very well increase during Q3, but it's easier to imagine another leg down ahead rather than further gains (*Fig. 8*). Mortgage applications for new home purchases declined during August to the lowest since April 1995 (*Fig. 9*). That does not augur well for new and existing home sales.

(4) *Capital spending.* The Business Roundtable CEO Outlook Index stabilized during the first half of this year around 75.0, down from a record high of 123.5 during Q4-2021 (*Fig. 10*). Not surprisingly, it is highly correlated with the growth rate of capital spending in real GDP on a y/y basis. JP Morgan Chase CEO Jamie Dimon is a member of the Roundtable and might have depressed the other members with his warnings last year of a coming recession.

Real capital spending rose at a solid pace of 4.2% y/y during Q2, but could now start to slow. Nondefense capital goods orders have stalled this year through July at a record high (*Fig. 11*). However, on an inflation-adjusted basis, this series has been falling since early 2022. Industrial production of business equipment has also been relatively weak since the end of last year (*Fig. 12*). The regional business surveys conducted by five of the 12 Federal Reserve district banks have been showing relatively weak capital spending readings in recent months (*Fig. 13*).

(5) *Construction.* One area of strength in capital spending has been nonresidential construction, led by a building boom in factories (*Fig. 14*). Onshoring and federal government incentives have boosted these outlays. In addition, the federal government is spending lots of money on infrastructure, lifting public construction spending to a new high in June (*Fig. 15*).

(6) *Bottom line*. All of the above suggest that Q3's strong patch isn't likely to be sustainable. However, we still need to spend some time with the elephant in the room: The economic outlook will be mostly determined by consumers. Let's turn to a review of what we know about them in the next section.

US Economy II: Born To Shop. Debbie and I have often observed that Americans are born to shop. We've also observed that they spend when they are happy and sometimes spend even more when they are depressed. That’s because shopping releases dopamine in the brain and makes us feel better.

Consumer confidence has been depressed by high inflation over the past couple of years; yet consumers continued to shop, no doubt frustrating the hard-landers with their dire forecasts. Nevertheless, the hard-landers are confident that a consumer-led recession is coming soon once consumers’ excess saving is depleted. Let’s review the outlook for consumers since they are likely to make or break the pessimists’ outlook:

(1) *Excess saving.* It is certainly true that personal saving rose significantly during the pandemic years of 2020 and 2021 (*Fig. 16*). It totaled $5.2 trillion over the course of those two years compared to $2.6 trillion over the prior two years. It was down to $658 billion in 2022 and has remained low so far in 2023.

The resulting drop in the personal saving rate since mid-2021 has meant that consumers spent more of their disposable income on goods and services (*Fig. 17*). If now they were to reverse that behavior abruptly, returning to saving at the pre-pandemic rate, that undoubtedly would cause a consumer-led recession.

However, if they were to increase their rate of saving gradually rather than abruptly or if they were to delay increasing their low saving rate for a while, a recession wouldn’t be a foregone conclusion. Those might be more likely scenarios because consumers shouldn’t be in a rush to replenish their savings, as they didn’t actually deplete their savings to spend more over the past two years. Rather, they accumulated less net worth (by saving less) because they had accumulated so much during the pandemic period!

In short, there’s no compelling reason for consumers to suddenly slam on their spending brakes. That’s especially true if both payroll employment and real wages continue to rise to record highs. In our scenario, real consumer spending should grow along with real disposable income, driven by rising employment and real wages. That’s assuming that consumers aren’t in a rush to save more of their disposable income than they’re now saving.

Collectively, US households’ net worth totaled a near-record $140.6 trillion during Q1, up a whopping $36.4 trillion since Q1-2020, just before the pandemic (*Fig. 18*). Are consumers really under pressure to suddenly save more? We don’t think so.

(2) *Student loan payments.* The Chamber of Commerce updated its fact sheet on *Student*

Loan Debt on July 6. Student loan payments were put on hold during March 2020. They are set to resume on October 1. According to the US Department of Education, 43.6 million Americans have federal student loan debt, amounting to more than $1.64 trillion. The average amount of federal student loan debt is $37,717.

The resumption of student loan payments undoubtedly will weigh on consumer spending. That's one reason why we expect that the recent strong patch in economic growth isn't sustainable. However, we don't expect that the resumption of student loan payments will result in a consumer-led recession.

(3) *Delinquencies.* Tightening credit conditions are starting to stress some low-and middle-income consumers. This year, credit card delinquencies have hit 3.8%, while 3.6% of car loan holders have defaulted on their car loans, according to credit agency Equifax. Both figures are the highest in more than 10 years.

There are 70 million more credit card accounts open now than before the pandemic in 2019, and credit card debt surpassed $1 trillion for the first time ever this year, according to the New York Federal Reserve. Also, retailers—including Macy's, Kohl's, and Nordstrom—have called out rising delinquency rates among their customers with private-label store cards.

(4) *Mortgage payments.* Last but not least: Let's not forget that many of the approximately 50 million households with mortgages have refinanced them at record-low interest rates between 3%-4% in 2020 and 2021. They obviously have more cash to spend than they would have had they not refinanced. On the other hand, they aren't likely to move to another home anytime soon, a situation that should continue to exert drag on housing-related consumer spending.

Calendars

US: Wed: Trade Balance -$68.0b; ISM NM-PMI 52.5; MBA Mortgage Applications; Beige Book; API Weekly Crude Oil Inventories. **Thurs:** Initial & Continuous Jobless Claims 235k/2.715m; Nonfarm Productivity & Unit Labor Costs 3.7%/1.6%; Williams; Bowman; Logan; Harker; Goolsbee. (FXStreet estimates)

Global: Wed: Eurozone Retail Sales -0.2%m/m/-1.2%y/y; Germany Factory Orders -4.0%; Australia GDP 0.3%q/q/1.7%y/y; Canada Labor Productivity -0.1%; Canada Trade Balance -$3.6b; China Exports & Imports -9.8%/-.8%y/y; BoC Interest Rate Decision 5.00%; BoE

MPC Treasury Committee Hearings; Balz; McCaul; Lowe; Wuermeling. **Thurs:** Eurozone GDP 0.3%q/q/0.6%y/y; Eurozone Employment Change 0.2%q/q/1.5%y/y; Germany Industrial Production -0.2%; Italy Retail Sales 0.2%; UK Halifax Price Index -0.1%; Japan GDP 1.5%q/q/6.0%y/y; Japan Coincident & Leading Indicators; Elderson. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for all three indexes simultaneously, making a second straight week that's happened. While it's been 62 weeks since any of these indexes has hit a record high, all three are up from their lows during February and March, and LargeCap's may soon reach a new record. LargeCap's forward earnings is now 0.3% 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 struggling at 12.7% below its mid-June 2022 record. Through the week ending September 1, LargeCap's forward earnings has risen 5.9% from 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 just 1.1% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrend since mid-2022 has been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Forward earnings momentum remains near two-year lows but is no longer worsening. The yearly rate of change in LargeCap's forward earnings has improved to 0.7% y/y from a 29-month low of -3.2% y/y during the June 23 week. Those levels compare to a record-high 42.2% at the end of July 2021 and, on the downside, to -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -4.6% 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 -10.4% 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 June last year, but the 2023 estimate for the S&P 500 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 (1.5% and 12.0%), MidCap (-12.0, 13.6), and SmallCap (-11.7, 12.6).

S&P 500/400/600 Valuation (*link*): Valuations rose for these three indexes during the September 1 week. LargeCap's forward P/E rose 0.4pt w/w to 18.9, but remains below its 18-month high of 19.6 during the July 28 week. It's up 3.8pts from its 30-month low of 15.1

at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.4pt w/w to 14.0 from a nine-week low of 13.6, but remains below its 21-week high of 14.4 during the July 28 week. It's now 0.7pt below its recent 10-month high of 14.7 in early February and up 2.9pts from its 30-month low of 11.1 at the end of September 2022, 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 13.8 from a seven-week low of 13.4, which compares to a 21-week high of 14.1 during the July 28 week and is now 0.5pt below its recent 12-month high of 14.3 in early February. It's up 3.2pts from its 14-year low of 10.6 in September 2022 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 27% discount to LargeCap's P/E last week is not much improved from 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 116th 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 through Q1-2023 before easing for Q2-2023. Looking at Q3-2023, the revisions pendulum has turned positive again, as analysts now have increased their estimates since the beginning of the quarter nine weeks ago. They're now forecasting that the S&P 500's earnings will rise 0.1% y/y in Q3-2023. That's up from a 5.3% decline in Q2-2023, which likely marked the cyclical bottom for earnings growth. On a pro forma basis, they expect a y/y earnings gain of 1.8% in Q3, up from a 2.9% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 7.3% y/y in Q3-2023, an improvement from the 3.5% gain in Q2-2023, 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 Q3-2023, unchanged from Q2-2023's count. However, that's 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 Q3-2023 versus their nearly final earnings growth rates for Q2-2023: Communication Services (34.6% in Q3-2023 versus 16.0% in Q2-2023), Consumer Discretionary (21.9, 55.1), Financials (15.2, 9.9), Industrials (12.9, 15.7), Utilities (12.7, 0.6), S&P 500 ex-Energy (7.3, 3.5), Information Technology (5.5, 5.0), S&P 500 (1.8, -2.9), Consumer Staples (1.6, 8.4), Real Estate (-6.7, -2.2), Health Care (-10.6, -26.7), Materials (-19.7, -26.4), and Energy (-37.9, -47.7).

US Economic Indicators

Manufacturing Orders & Shipments (***link***): Factory orders plunged in July after a string of gains, on a sharp drop in transportation orders, primarily civilian aircraft. *Manufacturing orders* contracted 2.1%, after a four-month gain of 3.7%; it's within 2.3% of last June's record high. *Excluding transportation*, orders climbed 1.1% during the two months through July, after a four-month slump of 2.4%. Meanwhile, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) remains in record territory—within 0.3% of this May's record high. *Nondefense capital goods shipments excluding aircraft* (used in calculating GDP) followed suit, also within 0.3% of this May's record high. In July, shipments of machinery and motor vehicles & parts reached new record highs, while shipments of electrical equipment, appliances & components were just a few ticks below its record high; fabricated metals and primary metals held around record highs.

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