MORNING BRIEFING
September 21, 2023

The Fed, The Deficit & Earnings

Check out the accompanying chart collection.

Executive Summary: The Fed once again alerted the financial markets that the federal funds rate will remain restrictively aloft for longer than generally expected. Managing the market's expectations in this way rather than raising rates further might lower the risk of a credit crunch and recession. We agree with the FOMC members who collectively anticipate a soft landing. … Also: Inflation has boosted federal entitlements and interest outlays, ballooning the federal budget deficit to worrisome heights, and soon the Biden administration's spending spree will take it further north. … And: Get ready for a better Q3 earnings season; that's the message from the earnings estimate data that Joe tracks for S&P 500 companies.

The Fed: Holding for Longer. The FOMC's latest *Summary of Economic Projections* (SEP) shows that the median forecast for the federal funds rate (FFR) for 2023 is 5.6%, unchanged from June's SEP. The 2024 forecast was raised to 5.1% from 4.6%. As we expected, the FOMC's message is that the FFR might be lowered next year by 50bps rather than 100bps.

The latest SEP shows headline PCED inflation continuing to moderate from 3.3% this year to 2.5% next year, 2.2% in 2025, and 2.0% in 2026. That's nearly identical to the path projected in June's SEP.

So why did the committee raise the FFR trajectory to holding-for-longer? The economy has been stronger than expected. The committee boosted this year's estimated real GDP growth rate from 1.0% to 2.1% and next year's from 1.1% to 1.5%. As a result, the trajectory of the unemployment rate was lowered to 3.8% this year from 4.1% and to 4.1% next year from 4.5%.

It all adds up to a soft-landing scenario. Skeptics undoubtedly will claim that the Fed is always wrong, so a hard landing is an even more likely outcome. We are siding with the Fed. We think they've done a very good job so far. They've been guiding the markets to expect higher-for-longer interest rates since last year. Now they are guiding markets to expect that the Fed will hold the federal funds rate for longer. That's a better way to keep monetary policy restrictive without raising the federal funds rate further (or much further). This approach reduces the chances of a financial crisis and credit crunch, in our opinion.

Bond and stock prices were hit hard yesterday. We did warn you that September isn't over. Now that the FOMC's blackout period has ended, we can expect more hawkish squawking from Fed officials. The only good news yesterday was that the price of oil also was knocked down.

US Budget Deficit: More To Come. It is widely assumed that the recent widening of the federal deficit is mainly attributable to the spending programs enacted by the Biden administration during 2022. In fact, the recent widening is mainly attributable to inflation, which has boosted federal government outlays on Social Security and net interest. The biggest contributor to the bulging deficit has been a decline in individual income tax revenues during the current fiscal year after they were boosted last year when investors sold lots of their stocks that had capital gains during the 2022 bear market. They paid lots of capital gains taxes.

So outlays will get boosted even more in coming years by all the spending Congress approved last year. To monitor this development, Debbie and I are tracking total outlays excluding spending on the major entitlement programs, defense, and net interest: Here is what the data show so far:

(1) Federal government outlays totaled $6.4 trillion over the past 12 months through August. Also on a 12-month basis, the sum of outlays on Social Security, Medicare, health, income security, defense, and net interest was $5.3 trillion (*Fig. 1* and *Fig. 2*).

The difference between total outlays and the sum of the nondiscretionary spending categories listed above (including defense) is mostly attributable to discretionary spending on goods and services (*Fig. 3*). This series has been too noisy since the pandemic to be useful for our purposes.

(2) On a quarterly basis, we can track federal government spending on goods and service in nominal GDP to assess when Biden's spending spree will hit the economy (*Fig. 4*). This series did rise 6.0% y/y during Q2 with more to come. By the way, federal government outlays on income redistribution account for 74.6% of total federal outlays during Q2 (*Fig. 5*).

Earnings: A Sweeter Outlook for Q3 Earnings Growth. Joe has been tracking the quarterly earnings forecast for S&P 500 companies collectively each week since the series started in Q1-1994. Each reporting season brings a typical playbook: Industry analysts cut their estimates gradually until reality sets in during the final month of the quarter, when some companies warn of weaker results. The combination of falling forecasts for companies that have underperformed earlier expectations, steady forecasts for those holding good news close to their vests, and insufficient estimate increases so close to reporting time to balance out the lowered expectations invariably creates an “earnings hook” pattern in the charted estimate/actual data as reported earnings exceed the latest estimates—i.e., a positive earnings surprise. In other words, the final month of quarters usually sets the stage for better-than-expected earnings reports.

That’s what usually happens, but the upcoming Q3-2023 earnings season has marked a departure in the data trend: Analysts have raised their estimates on a net basis over the course of the quarter so far.

Let’s recap briefly what brought us to this point: The strong earnings recovery following the Great Virus Crisis (GVC) had analysts scrambling to raise their forecasts for six straight quarters from Q2-2020 through Q3-2021, and not even coming close to catching up to the actual earnings results. The S&P 500 recorded unusually high double-digit percentage earnings beats for the first time since the aftermath of the Great Financial Crisis (GFC) during 2009-10.

The tide turned after Q1-2022, and y/y earnings growth has been slightly negative for three straight quarters through Q2-2023. The latest earnings downturn has been largely a mild profits recession, as revenue growth has remained positive throughout. But signs of a turnaround have emerged recently, as analysts’ earnings estimates have increased over the course of the quarter, not decreased as usual, and they now expect a return to positive y/y earnings growth in Q3-2023.

Below, Joe separates the good news in what the data tells us from the bad news:

(1) *Q3 marks departure from quarters of estimate cutting.* After falling slightly during H1-2022, the pace of estimate declines for the S&P 500 throughout the quarter accelerated in Q3-2022, when the estimate dropped 6.6%. Declines remained elevated during Q4-2022 and Q1-2023, abated for Q2-2023, and now have turned into a gain for Q3-2023. Specifically, the Q4-2022 estimate was down 5.9% during the runup to its earnings season, followed by a similar 6.2% in Q1-2023, then just 2.5% in Q2-2023. With two weeks left before the end of Q3-2023, the S&P 500’s Q3 estimate has risen 0.3% so far.

Q3-2023’s estimate gain is the first in seven quarters and the largest since Q3-2021. If the gain holds until the end of September, it would only be the 21st time that has occurred in the 118 quarters dating back to Q2-1994.

(2) *Most S&P 500 sectors have rising Q3 estimates now.* Analysts had been too bullish and overestimated the length of the post-GVC boom in earnings, resulting in very broad quarterly earnings declines at the sector level during their runup to the earnings seasons through Q1-2023. At the peak of optimism in Q2-2021, nine of the 11 sectors had their quarterly estimate rise during the quarter. By Q1-2022, that count was down to five sectors (Energy, Financials, Real Estate, Tech, and Utilities) before dwindling to just one sector during Q3-2022 (Energy), Q4-2022 (Utilities), and Q1-2023 (Utilities). During Q2-2023, the count recovered to four sectors and it has further improved to six sectors as of the September 14 week (*Fig. 6*).

Among the six sectors with gains, Consumer Discretionary's Q3-2023 earnings estimate has risen 5.7% since the end of Q2-2023, ahead of Communication Services (4.7%), Information Technology (4.0), Energy (2.1), Real Estate (1.3), and Financials (1.1). Analysts who read the recession memo earlier this year since have tossed it into the recycle bin, reversing course to play catch-up, especially in the Energy, Financials, and Real Estate sectors.

Among the weakest sectors, here's how much their collective Q3-2023 estimate has changed over the course of the quarter: Materials (-12.0%), Utilities (-4.2), Industrials (-4.1), Consumer Staples (-3.4), and Health Care (-2.1).

(3) *Seven sectors to show y/y growth in Q3-2023.* Seven sectors are expected to record positive y/y percentage earnings growth in Q3-2023, unchanged from Q2-2023's count, but five of the seven are expected to record double-digit percentage gains. That's up from three sectors with double-digit gains in Q2-2023. With 34.5% expected y/y growth for Q3-2023, Communication Services is well ahead of Consumer Discretionary (22.2%), Financials (15.3), Utilities (13.1), Industrials (10.3), Information Technology (5.6), and Consumer Staples (1.4).

Along with the large number of sectors with double-digit positive percentage y/y growth, analysts now expect the S&P 500's earnings growth rate to be positive on a frozen actual basis for the first time in four quarters. They expect 0.1% y/y growth in Q3-2023, up from -5.4% y/y in Q2-2023, -3.1% in Q1-2023, and -1.5% in Q4-2022. On a pro forma basis, they expect earnings to rise 1.9% in Q3-2023. That compares to a 2.9% decline in Q2-2023, a 0.1% gain in Q1-2023, and a 3.2% decline in Q4-2022. When the dust finally clears on the Q3 earnings reports, we think y/y growth will settle around 3.5%.

(4) *Energy remains a drag on overall S&P 500 earnings.* Looking at the data without the Energy sector is telling as well. On an ex-Energy-sector basis, S&P 500 earnings are expected to rise 7.3% in Q3 for its second straight gain and its biggest since Q4-2021. That compares to a 3.6% rise in Q2, a 1.6% decline in Q1-2023, and the 7.4% drop in Q4-2022. The typical earnings surprise hook again in Q3 could easily result in double-digit percentage y/y growth for the S&P 500 ex-Energy on a pro forma basis. Here's the four sectors expected to report a y/y earnings decline in Q3: Energy (-37.0%), Materials (-20.2), Health Care (-9.6), and Real Estate (-6.8).

(5) *Y/Y growth streaks: winners and losers.* In Q3-2023, the S&P 500 is expected to break its three-quarter string of y/y earnings declines on a frozen actual basis. The Industrials sector remains on a strong positive earnings growth path, with Q3-2023 on track for its 10th straight quarter of growth. Consumer Staples and Financials are expected to rise for a third straight quarter, followed by two quarters of growth for Communication Services and Information Technology. Materials is expected to mark its fifth straight y/y decline in quarterly earnings, followed by Health Care at four quarters (*Fig. 7*).

Calendars

US: Thurs: US Leading Indicators -0.5%; Philadelphia Fed Manufacturing Index -1.0; Existing Home Sales 4.10mu; Initial & Continuous Jobless Claims 225k/1.695m; Natural Gas Storage. **Fri:** M-PMI & NM-PMI Flash Estimates 47.9/50.3; Baker-Hughes Rig Count; Cook. (FXStreet estimates)

Global: Thurs: Eurozone Consumer Confidence -16.5; France Business Survey 97; Nagel; UK Gfk Consumer Confidence -27; UK BoE Interest Rate Decision 5.50%; UK BoE Inflation Letter; BoJ Interest Rate Decision -.10%; Lagarde; Schnabel. **Fri:** Eurozone, Germany, and France C-PMIs 46.3/44.8/46.1; Eurozone, Germany, and France M-PMI Flash Estimates 44.0/39.5/46.0; Eurozone, Germany, and France NM-PMI Flash Estimates 47.5/47.1/46.0; UK C-PMI, M-PMI, and NM-PMI Flash Estimates 48.6/43.0/49.0; UK Headline & Core Retail Sales 0.5%m/m/-1.2%y/y & 0.6%m/m/-1.3%y/y; De Guindos. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* was below 3.00 for the seventh successive week this week, edging down to 2.13 in each of the prior two weeks from 2.25 the week before. It had dropped from 2.38 during the August 22 week to 2.07 during August's final week—which was the lowest since the last week in May; it was at 3.07 seven weeks ago. _Bullish_ sentiment slipped to 48.6% this week after climbing the prior two weeks by 7.6ppts (to 50.7% from 43.1%). It was at 57.1% during the August 1 week—which was the most bulls since November 2021, when the reading reached a danger level of 57.2%. Meanwhile, _bearish_ sentiment climbed for the fourth week to a 16-week high of 22.8% this week, after falling four weeks ago from 20.0% to 18.6%—it had fluctuated in a volatile flat trend before the recent move up. The _correction count_ climbed this week to 28.6% after falling the prior three weeks by 10.3ppts (to 26.8% from 37.1%); it was 24.3% seven weeks ago, which was the lowest since the start of the year. Turning to the _AAII Sentiment Survey_ (as of September 14), bullish and bearish sentiment fell this week, with both below average, while neutral sentiment increased, remaining above its historical average. The _percentage expecting stock prices to rise over the next six months_ dropped to 34.4% this week after climbing the prior two weeks by 9.9ppts (to 42.2% from 32.3%)—putting optimism below its historical average of 37.5% for the fourth time in five weeks. The _percentage expecting stocks to fall over the next six months_ fell for the third week by 6.7ppts (to 29.2% from 35.9%). It was below its historical average of 31.0% for the second straight week. The _percentage expecting stock prices will stay essentially unchanged over the next six months_ increased 8.1ppts to 36.4%, the highest since May 18 (37.4%)—above its historical average of 31.5% for the fourth time in five weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (_link_): The S&P 500's forward profit margin was unchanged w/w at a nine-month high of 12.7% during the September 14 week. That's up from a 24-month low of 12.3% during the March 30 week, but is down 0.7pt from its record high of 13.4% achieved intermittently in 2022 from March to June. It's now 2.4pts above its seven-year low of 10.3% during April 2020. Forward revenues edged down less than 0.1% w/w from its record high. Forward earnings was unchanged w/w at its highest level since July 2022, and is less than 0.1% below its record high during the June 16, 2022 week. Both had been steadily making new highs from the beginning of March 2021 to June 2022; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for forward revenues growth was steady at an 11-month high of 4.3% and is now up 2.0pts from its 33-month low of 2.3% during the February 23 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth was unchanged w/w at a 15-month high of 9.8%, and is now 6.3pts above its 31-month low of 3.5% in mid-February. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 2.1% in 2023 (down 0.1pt w/w) and 4.8% in 2024 (unchanged w/w) compared to a revenues gain of 12.3% in 2022. They expect an earnings gain of 1.1% in 2023 (unchanged w/w) and an 11.6% rise in 2024 (unchanged w/w) compared to an earnings gain of 7.1% in 2022. Analysts expect the profit margin to drop 0.1ppt y/y to 12.0% in 2023 (unchanged w/w), compared to 12.1% in 2022, and to rise 0.8ppt y/y to 12.8% in 2024 (unchanged w/w). The S&P 500's weekly reading of its forward P/E was unchanged w/w near a three-month low of 18.8 and is down from a 17-month high of 19.8 during the July 20 week. That's still up from a 30-month low of 15.3 in mid-October. It also compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio was up 0.01pt w/w to 2.38 and compares to a 15-month high of 2.46 during the July 27 week. That's up from a 31-month low of 1.98 in mid-October and compares to a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Looking at the S&P 500 sectors, the September 14 week saw consensus forward revenues rise for three of the 11 sectors and forward earnings rise for three sectors. The forward profit margin moved higher for five sectors. Two sectors have forward revenues at post-pandemic or record highs this week: Health Care and Industrials. Among the remaining nine sectors, only Energy and Financials have forward revenues more than 5.0% below their post-pandemic highs, while Materials is nearly in that doghouse. None of the 11 sectors has forward earnings at a record high this week, but these five were at records a week earlier: Communication Services, Consumer Discretionary, Industrials, Information Technology, and Utilities. Among the remaining six sectors, only Energy and Materials have forward earnings down more than 20.0% from their post-pandemic highs. All but the Industrials sector have seen forward profit margins retreat from their post-pandemic or record highs, but six of the 11 sectors are showing signs of recovering from their lows in early 2023. Industrials' forward profit margin is at a record high again this week, but Health Care is at a record low. Those of Communication Services, Consumer Discretionary, Financials, Real Estate, and Tech remain close to their post-pandemic highs. Energy and Industrials were the only two sectors to have their profit margins improve y/y for full-year 2022, and these six sectors are expected to see them improve y/y in 2023: Communication Services, Consumer Discretionary, Financials, Industrials, Information Technology, and Utilities. Here's how the sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.0%, down from its 25.4% record high in June 2022), Financials (18.2, down from its 19.8 record high in August 2021), Real Estate (17.1, down from its 19.2 record high in 2016), Communication Services (16.4, down from its 17.0 record high in October 2021), Utilities (13.1, down from its 14.8 record high in April 2021), S&P 500 (12.7, down from its record high of 13.4 achieved intermittently in 2022 from March to June), Energy (11.2, down from its 12.8 record high in November), Materials (11.1, down from its 13.6 record high in June 2022), Industrials (10.8, record high this week), Health Care (9.2, record low this week and down from its 11.5 record high in February 2022), Consumer Discretionary (8.1, down from its 8.3 record high in 2018), and Consumer Staples (6.8, down from its 7.7 record high in June 2020).

S&P 500 Sectors & Industries Forward Profit Margin Since March 30 Bottom (*link*): The S&P 500's forward profit margin remained steady w/w at a nine-month high of 12.7% as of the September 14, 2023 week. It's now up 0.4ppt from a two-year low of 12.3% during the March 30 week. Seven of the 11 sectors' margins have improved since then, with the S&P 500's gain paced by four sectors. It's still down 5.8%, or 0.7ppt, from its record-high 13.4% during the June 9, 2022 week, as eight of the 11 sectors' margins are down since then, with the S&P 500's drop paced by three of the 11 sectors. Here's the sector performance since the S&P 500's forward profit margin bottom on March 30: Communication Services (up 13.0% to 16.4%), Consumer Discretionary (up 11.6% to 8.1%), Information Technology (up 7.2% to 25.0%), Industrials (up 5.0% to 10.8%), S&P 500 (up 3.1% to 12.7%), Real Estate (up 2.8% to 17.1%), Consumer Staples (up 1.7% to 6.8%), Materials (up 0.4% to 11.1%), Utilities (down 0.7% to 13.1%), Financials (down 1.2% to 18.2%), Health Care (down 3.7% to 9.2%), and Energy (down 3.7% to 11.2%). These are the best performing industries since the March 30, 2023 bottom: Casinos & Gaming (up 91.6% to 7.4%), Publishing (up 22.4% to 3.0%), Wireless Telecommunication Services (up 19.9% to 13.7%), Homebuilding (up 19.3% to 12.8%), Semiconductors (up 18.0% to 31.0%), Personal Care Products (up 18.0% to 10.0%), Interactive Media & Services (up 16.8% to 23.3%), Hotels, Resorts, & Cruise Lines (up 16.5% to 13.3%), Passenger Airlines (up 16.3% to 6.2%), and Brewers (up 15.0% to 9.1%).

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