MORNING BRIEFING
September 27, 2023

Consumers, Earnings & MegaCap-8

Check out the accompanying chart collection.

Executive Summary: The US economy has been doing well thanks to consumers, defying the gravitational pull of aggressive Fed tightening. Driving the consumers' record-high real spending is rising real disposable income. Rising real incomes are a function of strong employment. … Supporting the hot labor market are robust construction activity, consumer spending trends, and Baby Boomers' lifestyles in retirement. … Also: Joe examines the rates of Q3 earnings and revenues growth that analysts expect for the S&P 500 with and without two sets of stocks that sway results significantly: the MegaCap-8 and the S&P 500 Energy sector.

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

US Consumers I: What's Been Driving Them? The main reason that the US economy has dodged a recession so far is that payroll employment remains strong. It's hard to have a recession when employment is rising to record highs month after month (*Fig. 1*). Employment gains have bolstered consumer spending. So too has inflation-adjusted average hourly earnings, which has been rising since the start of the year (*Fig. 2*).

As a result, consumers' real disposable personal income has been on an upward trend since the start of the year (*Fig. 3*). During July, it was up 3.8% y/y and 3.5% above its January 2020 reading, just before the pandemic. However, it is still below its pre-pandemic trendline.

So with consumers' real disposable income growing at a slower pace than it was before the pandemic, how is it that real personal consumption expenditures was at a record high in July? In fact, it hit a then-record high in early 2021 and has resumed its pre-pandemic upward trend since then.

The answer, of course, is that consumers' high rates of saving during the pandemic supported their record-high spending pace afterwards. Inflation-adjusted personal saving soared along with real disposable income during the pandemic as Americans saved more of their earnings and much of the three rounds of pandemic relief checks (*Fig. 4*). That allowed them to save less and spend more as the pandemic abated, even as inflation eroded their disposable income from mid-2021 through mid-2022.

Since then, the pace of consumers' real saving has stopped falling but remains low compared to their pre-pandemic real saving. But their rising real disposable income has provided consumers with the purchasing power to drive real consumer spending to record highs along the same upward trend as before the pandemic.

US Consumers II: Why Is Employment So Strong? The resilience of the labor market has been one of the main reasons why the widely expected recession has been a no-show since early last year. It was widely expected that the Fed's aggressive tightening of monetary policy would reduce consumer demand and depress employment, which would further weigh on consumer spending. In his *press conference* last Wednesday, Powell frequently stated that the labor market is coming into balance, but he still described it as "very hot." Why hasn't it cooled off, and will it do so? Consider the following:

(1) *Many industries at record highs.* Payroll employment was at a record high in August because many of its components were at or near record highs in August, including the following: construction, heavy & civil engineering construction, transportation & warehousing, wholesale trade, food services & drinking places, professional & business services, financial activities, educational services, hospitals, ambulatory health care services, and social assistance.

(2) *No recession in construction industry.* Record highs in construction employment don't happen during recessions (*Fig. 5*). Single-family housing starts have been in a recession since early last year (*Fig. 6*). However, multi-family starts remained strong until they plunged in August. The result has been that construction employment in the residential building sector rose to a record high in August (*Fig. 7*).

Construction employment in the nonresidential building industry also rose to a record high in August, boosted by more spending by manufacturers on onshoring and by the government on infrastructure (*Fig. 8*).

(3) *Online shopping is booming.* Retail sales, excluding food services and online retail sales, has been relatively flat since May 2022 (*Fig. 9*). On the other hand, online shopping, which soared to record highs during the pandemic, has continued to do so (*Fig. 10*). Such sales on a per-household basis and at an annual rate have doubled from about $5,000 just before the pandemic to almost $10,000 currently (*Fig. 11*).

Over this same period, employment in warehousing and storage (i.e., mostly fulfillment centers for online retailers) has increased by more than 500,000, while employment in retail trade has been flat (*Fig. 12*).

(4) *Baby Boomers dining out and visiting healthcare providers.* Americans are going to restaurants in record numbers since the end of the pandemic. That's resulted in a big increase in employment in food services & drinking places (*Fig. 13*).

Many of the Baby Boomers no longer have their children at home, and more of them are retiring with ample nest eggs. That explains the strength in restaurant sales and employment. The aging of the Baby Boomers also explains why employment in healthcare is booming, as older people tend to visit healthcare providers more often than younger ones (*Fig. 14*).

(5) *The bottom line.* Some of the post-pandemic strength in payroll employment is attributable to the abatement of the pandemic itself. Some is also related to more structural developments, including onshoring of manufacturing and the aging of the Baby Boomers. The labor market is showing some signs of cooling, but it is likely to remain a source of jobs and economic strength. In our opinion, that doesn't mean that the Fed must continue to raise interest rates to subdue inflation. They are high and restrictive enough to do the job. Besides, the inflation shocks attributable to the pandemic are also abating.

Earnings I: With & Without MegaCap-8. During 2022, the collective revenues and earnings growth rates of the MegaCap-8 stocks (i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) sagged considerably after surging for pandemic-related reasons during 2021. Quarterly revenues growth last year 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. However, Q2 was a notable turning point for the MegaCap-8's earnings and revenues growth. And both are expected to improve further in Q3, as Joe shows below:

(1) *Q2 revenue and earnings results*. During Q2-2023, the MegaCap-8's collective y/y revenues growth reaccelerated to double-digit percentages, and its earnings growth turned positive for the first time in five quarters. The MegaCap-8's revenues rose 10.2% y/y in Q2-2023 following a 4.6% rise in Q1-2023, and the group's earnings jumped 29.7% y/y after declining 3.1% in Q1. In stark contrast, the S&P 500's revenues growth slowed to 1.2% y/y during Q2-2023 from 4.6% in Q1, while its y/y earnings decline slowed to -0.4% on a proforma basis from -4.9% in Q1.

When we exclude the MegaCap-8 from the S&P 500, Q2-2023's y/y growth metrics were substantially weaker for revenues and earnings. S&P 500 revenues growth without the MegaCap-8 fell to an anemic 0.2% y/y in Q2-2023 from 1.2%, and the y/y earnings decline worsened to -5.1% from -0.4%.

(2) *Q3's outlook for revenue and earnings growth*. Looking ahead to Q3-2023, analysts collectively expect the S&P 500 companies' aggregate y/y revenues growth rate to slow to a 0.8% crawl from 1.2% in Q2, and for earnings to drop 1.6% y/y following a 0.4% decrease in Q2. But they hold shining expectations for the MegaCap-8's Q3 revenues growth, which they see accelerating to 11.1% y/y from 10.2% in Q2, and for the group's earnings growth, projecting a jump to 39.1% from 29.7%. The former would be the strongest revenues growth the MegaCap-8 has experienced since Q1-2022, and the latter would be its best earnings growth since Q3-2021!

Looking at the Q3 revenues and earnings growth predicted for the S&P 500 minus the boosts provided by the MegaCap-8 is a sorry sight. Without these eight stocks, revenues would be expected to *decline* 0.4% y/y in Q3, compared to a 0.2% gain in Q2, and the earnings decline projected in Q3 would deepen from Q2's decline, to -7.6% from -1.6%. If those forecasts come to pass, it would be the first revenue decline for the S&P 500 ex-MegaCap-8 since Q4-2020 and the third straight quarterly decline in earnings.

Earnings II: With & Without Energy. During 2023, the S&P 500 Energy sector's revenues and earnings growth has tumbled deep into negative territory following the cyclically high double- and triple-digit percentage increases of 2022. Energy's revenues growth turned negative in Q1-2023 and worsened in Q2, while the sector's earnings growth turned negative on a y/y basis in Q2. However, analysts expect Q3 to be less bad for the Energy sector, and the S&P 500's ex-Energy earnings results are expected to improve considerably, as Joe shows below:

(1) *Q2 revenue and earnings results*. During Q2-2023, Energy's percentage y/y revenue decline worsened to -28.9% from 5.2% in Q1, and the sector's earnings tumbled 47.7% y/y after rising 21.0% in Q1. This dragged down the S&P 500's revenues growth to 1.2% y/y during Q2-2023 from 4.6% in Q1, while its y/y earnings decline slowed to -0.4% on a proforma basis from -4.9% in Q1.

When we exclude the Energy sector from the S&P 500, Q2-2023's y/y growth metrics for revenues become substantially stronger and earnings growth actually turns positive. S&P 500 revenues growth without Energy jumps to 4.4% y/y in Q2-2023 from 1.2% with Energy, and the y/y earnings decline of 0.4% turns into a gain of 3.6%.

(2) *Q3's outlook for revenue and earnings growth without Energy*. As mentioned above, the S&P 500's y/y revenues growth rate is expected to slow to 0.8% in Q3 from 1.2% in Q2, and its earnings aren't expected to grow at all y/y but to decline 1.6% versus a 0.4% decline in Q2. Analysts think that the worst is past for the Energy sector and that Q2 marked the worst of the y/y comparisons. They still expect revenues and earnings to fall on a y/y basis in Q3, but less so, as oil prices are recovering now, and consensus forecast declines have given way to upward revisions in recent weeks.

Analysts are calling for Energy's revenues decline to lessen to 22.5% y/y in Q3 from -28.9% in Q2, and for the sector's earnings growth to jump to 39.1% from 29.7%. The S&P 500's revenue and earnings growth predictions are markedly better without the Energy sector: Revenues are expected to *rise* 3.4% y/y in Q3 compared to a 4.4% gain in Q2, and the earnings increase picks up to 6.7% without Energy from 3.6% in Q2. If those forecasts come to pass, the S&P 500 ex-Energy's revenues growth rate will be positive yet again, and earnings growth would be positive for a second straight quarter after being negative for four quarters through Q1-2023.

On a brighter note, earnings seasons typically deliver an upside surprise for revenues and earnings. Just how much of a surprise, and whether the S&P 500's earnings growth will be positive on a y/y basis instead of falling, the coming weeks will tell. This year's quarters so far have pleasantly surprised, and we think Q3 will too.

Calendars

US: Wed: Durable Goods Orders -04%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Real GDP & GDP Price Index 2.2%/2.0%; Headline & Core PCED 2.5%/3.7%; Corporate Profits 1.6%; Kansas City Manufacturing Index; Initial & Continuous Jobless Claims 217k/1.675m; Pending Home Sales; Natural Gas Storage; Powell; Cook; Goolsbee. (FXStreet estimates)

Global: Wed: Eurozone Private Sector Loans 1.2%; Germany Gfk Consumer Climate -25.5; France Consumer Confidence 84; European Central Bank Non-Monetary Policy Meeting; Japan Leading & Coincident Indicators -1.2%/-1.1%. **Thurs:** Eurozone Business & Consumer Confidence 92.5; Eurozone PPI; Germany CPI 0.4%m/m/4.6%y/y; Italy Business Confidence 98; Italy Business Confidence 106.0; Spain Retail Sales 3.4%y/y; Spain CPI

3.5%y/y; Japan Unemployment Rate 2.6%; Japan Industrial Production -0.8%; Japan Retail Sales 6.6%y/y; ECB Economic Bulletin; Enria; McCaul. (FXStreet estimates)

US Economic Indicators

Consumer Confidence (*link*): Consumer confidence fell in September for the second successive month, with expectations exceptionally weak. “Write-in responses showed that consumers continued to be preoccupied with rising prices in general, and for groceries and gasoline in particular. Consumers also expressed concerns about the political situation and higher interest rates. The decline in consumer confidence was evident across all age groups, and notably among consumers with household incomes of $50,000 or more,” observed Dana Peterson, chief economist at The Conference Board. *Headline* consumer confidence slumped 11.0 points during the two months through September to 103.0. Through the first nine month of this year, it has decreased six times and increased three times for a ytd loss of 6.0 points. *Expectations* plunged 14.3 points over the past two months to 73.7 after jumping 16.5 points over the two months through July to an 18-month high of 88.0. The report notes that the expectations component fell back below 80.0—the level that historically signals a recession within the next year. The *present situation* remains in a volatile flat trend, ticking up 0.4 point to 147.1 in September, after declining 8.6 points during the two month through August; it is basically flat ytd, down 0.3 point. *Current business conditions* were slightly less pessimistic in September, with the percentage of consumers saying business conditions were good at 20.9%, down from 21.5% in August, and those saying conditions were bad falling to 16.4% from 17.3% in August. Meanwhile, consumers’ assessment of the current labor market was slightly more positive this month, with 40.9% of consumers saying jobs are plentiful, up from 39.9% in August, and 13.6% saying jobs are hard to get, little changed from 13.2% last month. *Short-term business conditions* (six-month outlook) deteriorated again in September: The percentage expecting conditions to worsen climbed to 18.4% from 17.3% in August, while those expecting business conditions to improve fell to 14.1% from 17.5% in August. Consumers’ assessment of the *short-term labor market* was also less favorable, with the percentage of consumers expecting more jobs to be available six months from now falling to 15.5% from 17.5% last month and the percentage anticipating fewer jobs rising to 18.9% from 18.0%. Consumers’ *short-term financial prospects* deteriorated in September, with 16.3% expecting their incomes to improve, down from 18.7% in August; it’s steadily been declining since May’s 18.9%. Meanwhile, 14.4% expect their incomes will decrease, up from 11.9% last month

New Home Sales (*link*): New home sales (counted at the signing of a contract) dropped sharply in August as mortgage rates continue to rise. Sales sank 8.7% in August to 675,000 units (saar), following an 8.0% gain and a 3.7% loss the prior two months. Sales the first eight months of this year have increased five months and decreased three months for a ytd gain of 6.1% and a y/y gain of 5.8%. Regionally, sales in the Northeast rose 6.7% during August, while they fell in the South (-7.5), West (-9.4), and Midwest (-17.2). Of the 675,000 homes sold in August, 264,000 had been completed, 298,000 were under construction, and 113,000 hadn't been started. Of the 436,000 homes for sale during August, 76,000 had been completed, 254,000 were under construction, and 106,000 hadn't yet broken ground. The median sales price for a new home fell 1.4% in August to $430,300, down from its record high of $496,800 last October. The supply of homes for sales rose 11.4% during the two months through August, equating to a 7.8-months' supply.

Regional M-PMIs (*link*): Four Fed districts have reported on manufacturing activity for September—New York, Philadelphia, Dallas, and Richmond—and the results were a mixed bag. *Manufacturing* activity (to -6.2 from -7.8) contracted at a slightly slower rate this month, though was consistent with readings since June. The New York (to 1.9 from -19.0) and Richmond (5.0 from -7.0) regions swung from contraction to expansion, while Philadelphia's (-13.5 from 12.0) swung from expansion to contraction. Meanwhile, the Dallas (-18.1 from -17.2) region contracted at a steady pace. The *new orders* (-1.8 from –7.7) gauge is moving closer to the breakeven point of zero, up from its recent low of -19.8 in March. The Philadelphia (-10.2 from 16.0) area experienced a wide 26.2-point swing back into contractionary territory. Meanwhile, New York's (5.1 from -19.9) measure recorded a positive 25.0-point swing back into expansionary territory, while Richmond's (3.0 from -11.0) recorded a positive 14.0-point swing. Meanwhile, the Dallas (-5.2 from -15.8) measure is moving nearer to expansionary territory. *Employment* (3.1 from -1.5) has been bouncing around the breakeven point of zero for several months, with September readings showing slight contractions in the rate of manufacturers' hiring in both the New York (-2.7 from -1.4) and Philadelphia (-5.7 from -6.0) regions and faster hiring in Dallas (13.6 from 4.3) and Richmond (7.0 from -3.0); Richmond's pace rebounded from an August decline. Looking at the prices-paid indexes, the Philadelphia (25.7 from 20.8) measure showed an acceleration from April's 8.2 reading—which was its lowest since mid-2020—while the Dallas (25.0 from 17.4) gauge also continued to accelerate from its 38-month low of 1.4 in June, and Richmond's (40.6 from 31.7) from August's 32-month low. New York's (25.8 from 25.2) measure held steady. *Prices-received* indexes were mixed: New York's (19.6 from 12.8) measure picked up a bit from July's three-year low, while Philadelphia's (14.8 from 14.1) barely budged in September though did ease from May's 23.0, while Richmond's (30.6 from 31.3) also changed little. The Dallas measure was unchanged at 1.8. (Note: The New York, Philadelphia, and Dallas measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.)

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