MORNING BRIEFING
October 18, 2023

Rolling Recovery

Check out the accompanying chart collection.

Executive Summary: The rolling recession that struck goods producers and distributors in early 2021 has ended, and the goods sector is now enjoying a rolling recovery, as stronger-than-expected retail sales and industrial production data attest. Consumers are shopping with gusto and increasingly on stuff; they're not about to retrench as some hard-landers expect. … Likewise emerging from a recession are S&P 500 companies' earnings, which may have hit a record high in Q3 along with their revenues. … And: Joe compares how various style indexes have performed since the S&P 500's July 31 bottom as well as reviews the aggregate S&P 500 earnings data from early reporters and checks in on the MegaCap-8.

Revenues I: Rolling Recovery for Goods Providers. September's retail sales and industrial production were up by 0.7% m/m and 0.3% m/m. Those were stronger-than-expected increases. Debbie and I weren't surprised because we've been seeing signs recently that the rolling recession for goods producers and distributors, which started in early 2021, is turning into a rolling recovery.

Consumers went on a goods buying binge following the pandemic lockdowns (*Fig. 1*). They pivoted to binging on services around March 2021. That's when social distancing restrictions increasingly were lifted in the services sector. When this happened, consumers decided that they had purchased enough "stuff" and it was time to pay for more "stimulus," i.e., the experiences associated with services. Inflation-adjusted consumer spending on goods has been flat y/y, albeit at a record high, since March 2021 through August 2023. The latest retail sales report suggests that spending on goods may be starting to recover from its growth recession.

This development is the latest setback for the hard-landers. There may be fewer of them, but the diehards are convinced that consumers soon will run out of the excess saving they accumulated during the pandemic, forcing them to retrench. We've been countering that it's more likely consumers have been holding onto quite a bit of those excess saving for precautionary purposes. That explains why the saving rate subsequently fell; they felt they had saved enough for a rainy day. That allowed them to spend more of their disposable income, which has been rising since the start of this year, on goods and services (*Fig. 2* and *Fig. 3*).

Let's review the latest relevant data:

(1) *M-PMI and manufacturing output bottoming.* The M-PMI rose to 49.0 in September from a recent low of 46.0 during June (*Fig. 4*). It's still below 50.0. However, the sub-indexes for production (52.5) and employment (51.2) rose above 50.0 in September.

US industrial production rose 0.3% m/m in September (*Fig. 5*). The gain was above expectations of a 0.1% gain, according to a *WSJ* survey. Manufacturing rose 0.4% in September, with motor vehicle production up 0.3% despite the ongoing strike against three automakers (*Fig. 6*). Among the strongest gainers were computer & peripheral equipment (1.3%) and communications equipment (1.1%) (*Fig. 7*). Housing-related production was surprisingly strong, with solid gains in appliances, furniture, and carpeting (4.9%) and construction supplies (1.0%).

(2) *September rebound for retailers.* Retail & food services sales rose 0.7% m/m during September (*Fig. 8*). It also rose 0.7% excluding food services. During the month, the CPI for goods rose 0.1%. So real retail sales (excluding food services) rose 0.6% (*Fig. 9*). The gains were relatively widespread.

Revenues II: Manufacturing & Trade Activity Heading Higher. The Census Department releases data on manufacturing and trade sales (M&TS of goods) at the same time as it releases retail sales but for a month earlier. In other words, retail sales for September came out along with M&TS for August. Nevertheless, we follow the monthly M&TS series because it closely tracks S&P 500 aggregate revenues, even though the latter includes revenues from the sales of both goods and services (*Fig. 10* and *Fig. 11*).

M&TS rose 1.3% m/m and 0.2% y/y during August. S&P 500 aggregate revenues rose 6.1% y/y through Q2. Here are some more insights from the latest M&TS data:

(1) *Growth recession.* Both nominal and real M&TS have been flat for the past year (*Fig. 12*). The weakness has been widespread among manufacturing shipments, wholesale sales, and retail sales (*Fig. 13* and *Fig. 14*).

In current dollars, M&TS inventories has been flat at a record high since mid-2022 through August, consistent with the rolling recession in goods (*Fig. 15*). In real terms, these inventories flattened out around this February's record high through July.

(2) *Deflating prices.* The price deflator for M&TS peaked at a record high during June 2022

(*Fig. 16*). It is down 4.9% since then through July 2023. On a y/y basis, deflation in the goods sector is widespread: M&TS (-3.4%), manufacturing (-4.1), wholesale (-5.6), and retail (-0.3).

Revenues III: Looking Forward. The latest earnings recession has been relatively short and shallow (*Fig. 17*). Earnings fell 7.9% from a record peak during Q2-2022 through the recent trough during Q1-2023. S&P 500 operating earnings per share edged up during Q2 and might have risen to a new record high during Q3! S&P 500 revenues per share probably did the same.

Confirming our predictions are S&P 500 forward revenues and forward earnings, which rose to new record highs during the week of October 5 and October 12, respectively. (FYI: Forward revenues and earnings are the time-weighted average of analysts' consensus projections for the current year and following one. The forward profit margin is calculated from forward revenues and earnings.)

The latest earnings recession was mostly attributable to a drop in the S&P 500's profit margin from Q2-2021's peak of 13.4% to 11.5% during Q4-2022. It rose to 11.8% during Q2. The weekly forward profits series that Joe and I track suggests that the quarterly profit margin continued to rise during Q3.

Strategy I: Market's Recent Swoon Creates Haves and Have-Nots. The rapid rise in bond yields during August and September caught investors off-guard, and their anxiety led to losses in the stock and bond markets. Since then, investors and corporations have re-assessed their "higher for longer" interest-rate expectations and have begun grudgingly to accept the return to more normal levels of interest rates after more than a decade of extraordinarily low ones.

Let's review how much the various investment-style indexes have dropped from the S&P 500's high for the year so far, on July 31, and how much they've risen from their recent bottoms:

(1) *LargeCaps favored over SMidCaps during pullback and recovery.* The S&P 500 fell 7.8% from 4588.96 on July 31 to a four-month low of 4229.45 on October 3 (*Fig. 18*). It narrowly avoided a correction within its rally from its 25.4% bear market low of 3577.03 on October 12, 2022. The S&P MidCap 400 and S&P SmallCap 600 performed worse than their LargeCap counterpart. MidCap's 11.0% decline through October 3 put that index back into a correction, while SmallCap's 13.2% drop through its October 13 low caused it to fall

back into a bear market.

LargeCap has risen 3.4% from its October low through Monday's close, better than the respective 2.2% and 1.8% gains for MidCap and SmallCap.

(2) *Growth mostly beats Value down and up.* The S&P 500's decline since July 31 was led by a 9.4% drop in the S&P 500 Value index, while S&P 500 Growth fell just 6.5%. The declines from the MidCap and SmallCap indexes' July 31 peak to their October troughs likewise were less for Growth than Value: MidCap Growth (-9.5%), MidCap Value (-12.7), SmallCap Growth (-11.4), and SmallCap Value (-15.1).

Growth mostly has led Value across these indexes since their troughs, which seems counter-intuitive when interest rates are rising. Here's how they've performed since their October lows: LargeCap Growth & Value (3.8% vs. 2.9%), MidCap Growth & Value (2.5, 1.9), and SmallCap Growth & Value (1.6, 2.0).

(3) *Recent gains spreading?* While the S&P 500 fell below its 50-day moving average (dma) during its pullback, it has remained above its 200-dma, and the recent buying is spreading. The index rose for a second straight week during the October 13 week after falling in seven of the prior nine weeks. While the index gained just 0.4% for the week, eight of its 11 sectors rose and five outperformed the composite index.

That compares to just three S&P 500 sectors rising during the October 6 week: Communication Services, Consumer Discretionary, and Tech. Those were also the only three sectors to beat the S&P 500 that week. The fact that each houses at least two MegaCap-8 companies certainly helped. (FYI: The MegaCap-8 stocks are: Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla.)

Whether or not last week's gain represents a broadening of the recovery or simply portfolio re-positioning ahead of the Q3 earnings season remains to be seen.

Strategy II: Positive Signs from Early Reporting Financials. The Q3-2023 earnings season is beginning to ramp up with releases from some of the major companies in the S&P 500 Financials sector. In particular, members of the Asset Managers and Banks industry are off to a great start. Among the reporters so far are Bank of New York Mellon, recent S&P 500 index addition BlackRock, Bank of America, Citigroup, JPMorgan Chase, PNC Financial, and Wells Fargo.

They've all reported consensus earnings beats across the board, with Financials' aggregate earnings-per-share beat and y/y earnings growth coming in at 13.3% and 12.6%, respectively. There were mostly positive surprises and positive y/y growth on the top lines as well. Only BlackRock and PNC missed their consensus revenues forecast, albeit slightly, and only PNC's revenues were down from a year earlier. Overall, the Q3 results are impressive considering the industry's challenges this year, including interest-rate angst, regional bank failures, and reduced share buyback activity.

With these and other early reporters' Q3 results tallied, the S&P 500 earnings season is now nearly 8% complete. Actual earnings for the S&P 500 companies that have reported Q3 so far are ahead of consensus forecasts by 9.9%, but their revenues have exceeded expectations by only 0.9%. That compares to 9.7% and 1.3% at the same point during the Q2-2023 earnings season.

In aggregate, earnings for Q3's early reporters are up 8.3% y/y, and their revenues have risen 6.5%. During Q2, the comparable figures were 13.4% for y/y earnings growth and 7.7% for revenue growth.

The Q3 data so far suggest a repeat of Q2's earnings performance—i.e., neither too hot nor too cold—which should help support the nascent recovery in stock prices.

Strategy III: MegaCap-8's Forward Profit Margin at Notable Highs Now. The MegaCap-8 had a relatively forgettable year during 2022 as its revenues and earnings took a steep dive along with its profit margin. Now the group has come full circle and is giving a much-needed boost to the S&P 500's profitability, as Joe shows below.

The S&P 500's latest forward profit margin reading (during the October 6 week) was at a 10-month high of 12.7%. It's up 0.4pt from a two-year low of 12.3% during the March 31 week (*Fig. 19*). That margin performance owes much to the contribution of the MegaCap-8.

When we exclude the MegaCap-8, the latest reading for the S&P 500's forward profit margin drops 1.0pt to 11.7% from 12.7%. That's the MegaCap-8's biggest contribution ever (since December 2012) to the broad index's profit margin. Without the MegaCap-8, the S&P 500's forward profit margin would be up just 0.1ppt from its two-year low of 11.6% during the June 30 week.

The MegaCap-8's forward profit margin was back up to 20.8% last week (ended October 13) from a post-pandemic low of 18.1% during the March 31 week. That 20.8% reading is the highest in two years and only 0.1pt below the group's post-pandemic high of 20.9% two years ago (during the September 10, 2021 week).

The MegaCap-8 is clearly in a rolling profits recovery.

Calendars

US: Wed: Housing Starts & Building Permits 1.380mu/1.455m; /MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; Williams; Waller; Bowman; Harker; Cook. **Thurs:** Leading Indicators -0.4%; Philadelphia Fed Manufacturing Index -6.4; Existing Home Sales 3.89mu; Initial Jobless Claims 213k; Natural Gas Storage; Powell; Barr; Harker; Logan; Goolsbee; Jefferson; Bostic. (FXStreet estimates)

Global: Wed: Eurozone Headline & Core CPI 0.3%/m/4.3%y/y & 0.2%m/m/4.5%y/y; UK 0.4%m/m/6.5%y/y; UK PPI Input & Output 0.6%/0.3&; UK RPI 0.6%m/m/8.9%y/y; UK House Price Index 0.3%; Australia Employment Change 18k; Australia Unemployment & Participation Rates 3.7%/67.0%; Lagarde; Wuermeling; Elderson. **Thurs:** France Business Survey 99; UK Gfk Consumer Confidence -20; China PBoC Loan Prime Rate 3.45%. (FXStreet estimates)

US Economic Indicators

Retail Sales (*link*): Retail sales once again was a surprise on the upside in September, and August sales were revised higher, as consumers continued their spending spree. *Total retail sales* jumped 0.7% (more than double the 0.3% expected) in September, following an upwardly revised 0.8% (from 0.6%) gain in August. Sales in September were up for the sixth straight month, climbing 3.4% over the period, after contracting 1.6% during the two months through March, for a ytd gain of 4.6% to a new record high. Meanwhile, sales in the *control group*—which excludes autos, gasoline, building materials, and food services—has recorded only one decline this year, climbing 0.6% in August and 4.1% ytd to a new record high. This measure correlates closely with the consumer spending component in GDP. Of the *13 nominal retail sales categories*, eight rose in September while three fell, and two were flat: Here's a snapshot of the 13 categories' *September sales performance versus that of a year ago*: miscellaneous store retailers (3.0% m/m & -0.2% y/y), nonstore retailers (1.1 & 8.4), motor vehicles & parts (1.0 & 6.2), gasoline stations (0.9 & -3.5), food services &

drinking places (0.9 & 9.2), health & personal care stores (0.8 & 8.3), general merchandise stores (0.4 & 2.0), food & beverage stores (0.4 & 1.6), sporting goods & hobby stores (0.0 & -2.1), furniture & home furnishings (0.0 & -5.9), building materials & garden equipment (-0.2 & -4.0), clothing & accessories stores (-0.8 & 0.1), and electronics & appliance stores (-0.8 & -2.2).

Business Sales & Inventories (*link*): Both nominal and real business sales remain in record-high territory, though are down from their recent record highs. *Nominal business sales* expanded for the second month, by 1.3% in August and 2.2% over the period. Since reaching a record high last June, sales have declined seven months, increased six months, and were unchanged one month—falling 1.1% from its record high. Meanwhile, *real business sales* increased 0.8% in July, after no change in June. These sales reached a record high in December 2021 and currently are only 0.3% below that record level. In the meantime, the real inventories-to-sales ratio slipped to 1.55 in July, down from 1.57 in March and April—which was the highest since mid-2020, though up from a recent low of 1.43 in fall 2021. Meanwhile, the nominal ratio moved down for the second month to 1.37 in August from 1.40 in the months from March through June—which was the highest since the mid-2020s.

Industrial Production (*link*): Last month's industrial production was a surprise on the upside, with the auto strike having little impact. *Headline production* rose 0.3% in September, triple the expected 0.1% gain, though August's increase was revised down from 0.4% to flat; that followed a 1.0% rebound in July. Output is up 2.1% ytd to a new cyclical high—and within 0.5% of its record high recorded in August 2018. *Manufacturing* production expanded for the second time in three months, by 0.4% in September and 0.7% over the period; it's up 1.9% ytd. *Excluding motor vehicles & parts*, both total production and manufacturing production rose 0.3% in September and are up 1.9% and 1.4%, respectively, ytd. Meanwhile, mining output remains on a steep upward trend, climbing 35.3% from its recent bottom in May 2020, and is only 1.5% below its record high. Utilities output remains in a volatile flat trend, near the top of its range, though did dip slightly in September. By *market group*, *consumer goods* production rose for the second time in three months, by 1.4%, after a two-month decline of 2.2%; it's up 0.4% ytd. Durable consumer goods production is up 2.7% ytd, while nondurable consumer goods production is down 0.4%. *Business equipment* production remains in a volatile flat trend, falling 0.7% in September following a two-month gain of 1.0% and a two-month decline of 0.4%, with output up 0.6% ytd. Production of transit (4.1%) and information processing (2.2) are up ytd, while industrial & other equipment (-1.1) output is in the red.

Capacity Utilization (*link*): The *headline* capacity utilization rate moved up for the second time in three months, from 78.9% in June to 79.7% in September; it peaked recently at 80.8% last September. September's rate is in line with its long-run (1972-2022) average. The *manufacturing* utilization rate also rose for the second time in two months, from 77.6% in June to 77.8% last month, up from its recent low of 77.1% in December, putting it 0.4ppt below its long-run average. Meanwhile, the *mining* utilization rate remains on a steep uptrend, climbing to a new record high of 95.1%—8.7ppts above its long-run average. Meanwhile, the *utilities* rate remains on a volatile downtrend, edging down to 72.7% in September, not far from February's record low of 69.6%. The utilities rate is substantially below its long-run average.

NAHB Housing Market Index (*link*): "Builders have reported lower levels of buyer traffic, as some buyers, particularly young ones, are priced out of the market because of higher interest rates. Higher rates are also increasing the cost and availability of builder development and construction loans, which harms supply and contributes to lower housing affordability," noted NAHB Chairman Alicia Huey. Homebuilders' confidence fell in October for the third month, sinking 16 points over the three-month period to 40. That puts it further below the key break-even measure of 50, with the recent weakness coinciding with the jump in mortgage rates above 7%. Confidence had jumped 25 points the first seven months of this year to 56. Confidence fell all 12 months of 2022, by 53 points, to 31—which was the lowest since the height of the pandemic. All three components of homebuilders' confidence have moved lower in recent months: Current sales (-16 points to 46) and traffic (-14 to 26) have declined for the past three months, while future sales (-18 to 44) has extended its string of declines to four months. On the supply side, builders continue to struggle with shortages of construction workers, buildable lots, and distribution transformers, adding to housing affordability concerns. According to the report, 32% of builders reported cutting home prices in October, unchanged from September but still the highest rate since December's 35%. The average price discount has held steady at 6%.

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