MORNING BRIEFING
November 7, 2023

What's Next? Pickleball!

Check out the accompanying chart collection.

Executive Summary: Back and forth we expect the bond and stock markets to bounce for the foreseeable future as the bulls and bears in each market alternate control. We see the 10-year Treasury bond yield ending the year at 4.50% and the S&P 500 at 4600. Next year, we expect continued volleying between bulls and bears to keep the bond yield rangebound between 4.00% and 5.00% and the S&P 500 rising to 5400 by year-end. … As for the economy, we think surprisingly strong economic growth is likely next year, led by a productivity boom that continues for the remainder of the decade—our "Roaring 2020s" scenario taking hold at last.

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

Strategy I: What's Next? The answer to this question is: pickleball. The bulls and the bears in the bond market are likely to keep the 10-year Treasury bond yield in play between 4.50% and 5.00% through the end of this year. The bulls and the bears in the stock market are likely to keep the S&P 500 in play between 4117 and 4589 over the rest of the year, i.e., in a range between the October 27 low and the July 31 high. We are expecting the bulls will prevail by the end of this year, with the bond yield at 4.50% and the stock index at 4600. Consider the following:

(1) *Bonds.* A year ago, in early November, we called the top in the 10-year Treasury bond yield at 4.25% on October 24, 2022. That remained the top for about a year, until September 13 of this year when the yield rose once again to 4.25% and kept rising, peaking at 4.98% on October 19 (*Fig. 1*). At the end of last week, it was back down to 4.57%.

Now we reckon that the yield might be rangebound through next year between 4.00% and 5.00%. That would be in line with the yield range that occurred from 2002 through 2007, i.e., the years before the New Abnormal period from the Great Financial Crisis to the Great Virus Crisis, when the Fed repressed interest rates.

Why such a wide projection range? Because we think the forces influencing the bond market will keep the yield fluctuating to-and-fro within that range.

On the one hand, we are reasonably confident that inflation will continue to moderate through next year. Yesterday, we observed that nonfarm unit labor cost (ULC) inflation is a major determinant of the CPI inflation rate. That's especially the case for the CPI excluding food, energy and shelter, which rose 2.0% y/y in September (*Fig. 2*). The ULC inflation rate was down to 1.9% during Q3. Moderating inflation, a bullish force, will tend to pull the yield closer to the lower 4.00% end of our target range.

On the other hand, fiscal policy (like our border with Mexico) is out of control. The federal deficit is at a record high excluding the pandemic period. Federal debt is at a record high. The fastest growing component of federal outlays is interest expense (*Fig. 3*). This bearish factor will tend to push the yield closer to the higher 5.00% end of our target range.

So the tug-of-war between the bond bulls (who are focusing on falling inflation) and the bond bears (who are focusing on the mounting debt) will continue for the foreseeable future, keeping the bond yield in a range of 4.00% to 5.00%, in our opinion.

(2) *Stocks.* At the end of last year, the widespread consensus was that 2023 would start with a mild recession during H1 and a modest recovery in H2. The Street consensus was that H1 would be bearish for stocks and H2 would be bullish for them. We were bullish with our S&P 500 price index forecast of 4600 by the end of 2023 and our S&P 500 earnings-per-share estimate of $225 for the year.

The S&P 500 peaked just shy of 4600 on July 31. We declared victory and concluded that a correction down to the 200-day moving average (dma) of the S&P 500 was likely next, followed by a year-end rally back to 4600. When the index fell below its 200-dma on October 20, our confidence in that forecast got a little wobbly. It's less so now that the index jumped to its 50-dma last week (*Fig. 4*).

Joe and I are sticking with our estimate of $225 for S&P 500 earnings per share for this year (*Fig. 5*). As of the November 1 week, the consensus of industry analysts was $216. We are also still projecting $250 and $270 for 2024 and 2025.

S&P 500 forward earnings per share rose to a record high of $241.85 during the November 2 week (*Fig. 6*). If it hits $250 by the end of this year, our year-end target for the S&P 500 price index of 4600 would imply a forward P/E of 18.4.

If forward earnings reaches $270 by the end of next year, the forward P/E implied by our S&P 500 target of 5400 at year-end 2024 would be 20.0.

US Economy: What's Next? The big surprise in 2024 won't be a recession. That's because if a recession does happen, it won't be a surprise since it has been the most widely anticipated recession in history. The really big surprise would be better-than-expected economic growth that would be led by productivity. In this scenario, the Fed might actually get inflation down to 2.0%, while real economic growth might be 3.0% or more rather than 2.0% or less.

Our earnings forecasts above reflect our confidence in this Roaring 2020s scenario finally coming to life. While Debbie and I have been having some fun with the no-show *Godot* recession, we must admit that the productivity growth boom likewise has been a no-show. But as we observed last week in our November 2 *QuickTakes*, Q3's productivity report suggests that our Godot scenario may be starting to play out. Consider the following:

(1) *Productivity.* Nonfarm business productivity rose 2.2% y/y during Q3 (*Fig. 7*). Productivity growth pops typically occur at the tail end of recessions and early recovery periods. The latest pop is consistent with our view that the economy has been in a recession since early 2022, with the proviso that it has been a rolling recession rather than an economy-wide one.

Why might the latest productivity pop be the start of a productivity growth boom? Companies are facing chronic labor shortages, especially of skilled and qualified workers. So they must do whatever they can to boost the productivity of their workers. The working-age population (16 years or older) rose just 1.1% y/y over the 12 months through October (*Fig. 8*). The labor force is up 1.7% over this same period on the same basis. But it's constrained by the growth rate of the working-age population.

(2) *Real hourly compensation.* The main driver of inflation-adjusted hourly compensation is productivity (*Fig. 9*). Many economists have been alarmed by the widening gap between the two since 1973, with the former increasingly lagging the latter. That's most noticeable when the CPI is used to deflate hourly compensation. But the CPI has an upward bias. The so-called compensation-productivity gap mostly disappears when the nonfarm business price deflator is used instead of the CPI.

The productivity growth boom we expect for the remainder of the decade should boost real compensation growth commensurately.

(3) *Inflation.* As noted above, ULC inflation was down to only 1.9% y/y during Q3 as hourly compensation growth of 4.2% was offset by productivity growth of 2.2% (*Fig. 10*, *Fig. 11*,

and *Fig. 12*).

Calendars

US: Tues: Trade Balance -$60.3b; Consumer Credit $12.0b; API Weekly Crude Oil Stock; Williams; Barr; Logan; Waller. **Wed:** MBA Mortgage Applications; Wholesale Inventories 0.0%; Crude Oil Inventories & Gasoline Production; Powell; Barr; Williams; Jefferson; Cook. (FXStreet estimates)

Global: Tues: Eurozone Industrial Production; Eurozone PPI; Germany Industrial Production 0.0%; Nagel. **Wed:** Eurozone Retail Sales -0.2%m/m/-3.2%y/y; Germany CPI -0.2m/m/3.0%y/y; Japan Leading & Coincident Indicators; China CPI -0.2%y/y; China PPI -2.8%y/y; Eurogroup Meetings; Nagel; Enria. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for two of these three indexes during the November 3 week. LargeCap's forward earnings rose 0.1% w/w to a new record high after first hitting that mark during the September 15 week for the first time in 15 months, dating back to the June 24 week of 2022. MidCap's dropped 0.8% w/w to 4.8% below its record high in early June 2022, and SmallCap's fell 0.7% w/w to 8.3% below its mid-June 2022 record. Through the week ending November 3, LargeCap's forward earnings has risen 7.1% from its 54-week low during the week of February 10; MidCap's is 3.6% above its 55-week low during the week of March 10; and SmallCap's is 6.1% 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 steadily ticking higher now. The yearly rate of change in LargeCap's forward earnings has improved to 4.5% 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 -0.3% 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 -4.6% 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 of 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 (1.1% and 11.5%), MidCap (-12.7, 12.0), and SmallCap (-7.0, 9.8).

S&P 500/400/600 Valuation (*link*): Valuations moved sharply higher for these three indexes during the November 3 week. LargeCap's forward P/E was up 1.0pt w/w to 18.0 from a seven-month low of 17.0. That's down from its 18-month high of 19.6 during the July 28 week. It's still up 2.9pts 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 0.8pt w/w to 12.9 from a 12-month low of 12.1. It's now 1.8pts below its 10-month high of 14.7 in early February and up 1.8pts 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 0.9pt w/w to 12.2 from a 12-month low of 11.3, and is now 2.1pts below its recent 12-month high of 14.3 in early February. It's up 1.6pts 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 28% 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 32% discount is up from a 23-year-low discount of 34% a week earlier, which compares to a 22% discount during the March 10 week; that one 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 125th straight week; the current 6% discount is 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 turned slightly negative w/w in the usual performance right before the start of the earnings season ahead of the typical earnings surprise hook. Analysts are forecasting that the S&P 500's earnings rose 3.4% y/y in Q3-2023. That's up from a 5.8% 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 5.7% in Q3, up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 11.1% y/y in Q3-2023, an improvement from the 3.6% 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 that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected blended earnings growth rates for Q3-2023 versus their final earnings growth rates for Q2-2023: Communication Services (46.3% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (41.2, 57.0), Financials (21.8, 9.3), Information Technology (12.3, 5.0), Industrials (11.2, 15.7), S&P 500 ex-Energy (11.1, 3.6), Utilities (8.4, 0.6), S&P 500 (5.7, -2.8), Consumer Staples (5.3, 8.5), Real Estate (-5.5, -2.1), Health Care (-18.4, -26.7), Materials (-18.9, -26.4), and Energy (-33.9, -47.5).

Global Economic Indicators

Global Composite PMIs (*link*): Global growth stagnated in October, as both the downturn in manufacturing growth and the slowdown in services growth continued. The *C-PMI* posted its fifth successive decline, slowing to 50.0 last month from May's 18-month high of 54.3. The C-PMI was above the 50.0 line dividing expansion from contraction the prior eight months. The *NM-PMI* slowed to a nine-month low of 50.4 after climbing from 48.1 last November to an 18-month high of 55.3 this May, while the *M-PMI* remained below 50.0 for the 14th straight month, edging down from 49.2 in September to 48.8 in October; it's down sharply from its peak of 56.0 during May 2021. Geographically, six of the 15 countries for which October C-PMI data were available recorded expansions, led by India (58.4) and Russia (53.6). Weakness was mainly centered in Europe, with France (44.6), Germany (45.9), Italy (47.0), the UK (48.7), and Ireland (49.7), all seeing contractions and Spain at the breakeven point of 50.0. Meanwhile, mainland China was also at 50.0. *Price pressures* eased in October, with input costs at a three-month low and output charges the weakest since December 2020. The report notes that developed nations (on average) registered steeper rates of inflation for both price measures compared to those indicated for emerging markets.

Germany Factory Orders (*link*): German factory orders surprised on the upside in September, ticking up 0.2% (vs an expected 1.5% decline), as foreign orders climbed. *Factory orders* ticked up 0.2% in September, following a downwardly revised August gain of 1.9% (from 3.9%) and an 11.4% drop in July. Orders increased 14.4% during the three months through June and are basically flat ytd. *Foreign* orders increased 4.2% in September, with orders from both within the Eurozone (6.2) and outside the Eurozone (2.9) climbing. Domestic orders contracted 5.9%. *Versus a year ago*, total orders fell 4.3%, narrowing from -10.1% in July, with the yearly percent change in domestic (-11.0) orders widening from May's -2.1% and the yearly percent change in foreign order (0.3) moving just above zero. Within foreign orders, billings were up 1.5% within the Eurozone and down 0.5% outside the Eurozone. Here's a look at the movements in domestic orders, along with the breakdown from both inside and outside the Eurozone, for the main industry groupings versus a year ago: capital goods (-11.9%, +6.5%, -0.3%), intermediate goods (-8.8, -0.2, -0.6), consumer durable goods (-6.3, -19.4, -8.1), and consumer nondurable goods (-21.0, -16.0, +3.0).

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