MORNING BRIEFING
November 8, 2023

Captain America

Check out the accompanying chart collection.

Executive Summary: The US economy has remained remarkably strong in the face of the Fed's attempts to tame inflation at the economy's expense. So far, so good: Inflation has been moderating nicely but not bringing the economy down with it. Today, we review the major reasons for the US economy's resilience. … In contrast, the global economy is weak as evidenced by the plunge in oil prices. Record US oil production has helped to lower oil prices from their September peak. ... And: Joe looks at analysts' estimate revisions activity in the wake of a strong Q3. Despite that strength, Q4 estimates are dropping at rates faster than usual.

US Economy: Superhero. Like Captain America, the American economy seems to have an indestructible shield. The Fed has raised the federal funds rate aggressively by 525bps since March 2022 with the aim of tightening financial conditions to slow the economy and to raise the unemployment rate with the ultimate aim of bringing down price and wage inflation (*Fig. 1*).

Yet real GDP jumped 4.9% (saar) and rose 2.9% y/y during Q3 (*Fig. 2* and *Fig. 3*). Real nonfarm business output, which is used to calculate productivity, soared 5.9% (saar) during Q3 and rose 3.1% y/y! The unemployment rate has remained below 4.0% since February 2022. Yet both consumer price and wage inflation rates have dropped from their 2022 peaks of 9.1% and 5.9% to 3.7% in September and 4.4% in October (*Fig. 4* and *Fig. 5*).

Debbie and I have been discussing the main reasons for the economy's resilience and disinflationary tendencies since early last year. Here is a brief review and update:

(1) *Resilient consumers.* Consumer spending has continued to grow despite the tightening of credit conditions (*Fig. 6*). As a result, employment has continued to grow, boosting the purchasing power of consumers. Payroll employment rose to a record high of 156.9 million during October, up 1.9% y/y (*Fig. 7*). Many of the industries with the largest payrolls are continuing to expand their employment rolls into record-high territory, including construction (8.0 million), educational services (4.0 million), financial activities (9.2 million), health care & social assistance (21.7 million), leisure & hospitality (17.0 million), and professional & business services (23.0 million).

Some of the industries that are expanding their payrolls are doing so because of strong demand for their services by Baby Boomers, most of whom now are seniors. These include financial activities, health care & social services, and leisure & hospitality. Retired Boomers have over $75 trillion in net worth and will be spending much of it as they grow older. Many of their adult children likely anticipate inheriting some of their parents' net worth, prompting them to save less and spend more of their incomes.

Also keep in mind that unearned personal income (from interest, dividends, rent, and proprietors' income) rose to an all-time record high of $6.5 trillion (saar) during September (*Fig. 8*).

(2) *Onshoring & technology-led capital spending.* Onshoring is boosting capital spending, as evidenced by the 14.1% y/y jump in real capital spending on new manufacturing structures during Q3 (*Fig. 9*). Companies are allocating more of their capital spending budgets to technology hardware and software to boost their productivity in response to chronic labor shortages. As a result, production of high-tech equipment and spending on software are at all-time highs (*Fig. 10*). Also booming is industrial production of defense, which is likely to continue rising to new record highs given the geopolitical turmoil around the world. (*Fig. 11*).

(3) *Fiscal stimulus.* Federal government spending is growing rapidly, led by outlays on net interest paid. They totaled a record $659.2 billion over the past 12 months through September. That's an unsettling development, for sure. However, keep in mind that high interest rates represent a big windfall for households that receive interest income, which has increased significantly. Meanwhile, the spending bills passed by Congress last year will continue to boost construction spending on public infrastructure, which is at a record high (*Fig. 12*).

(4) *Refinanced balance sheets.* In his November 1 *press conference*, Fed Chair Jerome Powell acknowledged that the Fed "may have underestimated the balance sheet strength of households and small businesses." That's partly because many of them refinanced their debts at record-low interest rates over the past few years. So the rise in interest rates since early last year hasn't boosted their interest payments on their debts enough to weigh on their overall spending.

(5) *Domestic migration.* Since the pandemic, there has been significant migration from northern states to southern ones that have warmer weather, lower taxes, and more job openings. That's created a big demand for housing, especially rental apartments. It's also meant that the states with increasing populations must spend more on infrastructure to

accommodate their new residents and workers.

Global Economy: Unheroic. The NYMEX price of a barrel of crude oil peaked this year at $93.68 on September 27. Notwithstanding the war that started between Israel and Hamas on October 7, the price is down $16.27 from that peak to $77.42. That's even though Saudi Arabia and Russia reduced their exports during the summer and maintained their cuts through year-end.

One reason for this development is that US crude oil field production is back at record highs (*Fig. 13*).

Another reason is that the global economy remains weak. For example, China's October merchandise trade data showed that while imports rose 5.8% y/y, exports fell 4.5% over the same period. In fact, both have been relatively flat since early 2022 (*Fig. 14*). Japan's industrial production fell in September (-3.7% y/y) and also has been flat since early 2022 (*Fig. 15*).

Strategy: Analysts Trimming Estimates Despite Strong Q3. As of mid-day Tuesday, the S&P 500's Q3-2023 reporting season is more than 85% complete. Like all earnings seasons, there has been good news and bad news. While the just-reported Q3's results have been mostly good—with strong earnings and revenues surprise data indicating a lot of better-than-expected results—analysts and investors are always looking ahead at the forecasts for the future.

Managements have been tempering their future expectations for their companies, so analysts have been following suit, trimming their estimates for future periods at faster-than-typical rates. But we're not alarmed. The rate of decline suggests a soft landing for the economy, as we've been expecting. A few sectors continue to do very well, most are holding up just fine, and only a few are experiencing challenges, as Joe shows below (note that the data below represent the collective results of just those 85% of S&P 500 companies that have reported Q3 earnings so far, as of mid-day Tuesday):

(1) *Q3 revenue and earnings surprise and growth.* Comparing Q3's aggregate revenue and earnings surprises to Q2's at the same point in the reporting season shows fewer companies exceeding analysts' estimates but greater y/y growth rates. Specifically, the revenue beat has weakened to 0.7% from Q2's 1.9%, and the earnings surprise has eased to 7.0% from Q2's 7.9%. However, the y/y growth rates of both revenues and earnings have improved. Revenues are up 1.4% y/y compared to 0.9% at the same point in the Q2

season, and earnings are up 2.4% y/y compared to a 7.7% decline in Q2.

(2) *Q4 forecasts are being trimmed at a faster rate.* The S&P 500's consensus Q4 EPS estimate has fallen 3.6% in the five weeks since the start of Q4-2023. That's more than the declines during the first three quarters of 2023 over the analogous five-week timeframe (-0.5% in Q3, -0.7% in Q2, and -3.5% in Q1).

However, the decline in the Q4-2023 estimate is still less than the 4.1% and 4.4% declines that occurred in Q3-2022 and Q4-2022, when the MegaCap-8 stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) contributed heavily to the results. Looking back at the 55 quarters since Q1-2010, Q4-2023's estimate decline of 3.6% to date has been eclipsed during just eight of the 55 quarters (Q4-2011, Q3-2012, Q1-2015, Q1-2016, Q1-2019, Q2-2020, Q3-2022, and Q4-2022).

(3) *Single-digit y/y earnings growth now expected in Q4-2023.* According to I/B/E/S data from the London Stock Exchange Group, the S&P 500's proforma y/y earnings growth forecast for Q4-2023 has dropped to 7.0% as of November 3 from a projected 11.0% on October 1. Among the S&P 500's 11 sectors, only Communication Services and Tech improved since the start of the quarter, while Health Care has posted the biggest drop.

Here's how the S&P 500 sectors' Q4-2023 growth rates have fared: Communication Services (50.0% as of November 3, 49.5% as of October 1), Consumer Discretionary (21.5, 28.5), Consumer Staples (1.8, 5.2), Energy (-20.0, -20.6), Financials (11.3, 11.7), Health Care (-14.9, 2.4), Industrials (0.3, 6.3), Information Technology (15.6, 14.7), Materials (-16.5, -7.6), Real Estate (11.7, 14.3), and Utilities (54.5, 55.4).

(4) *Waiting for Q4 before adjusting 2024's expectations.* Looking ahead to 2024, analysts have taken only a light pencil to their forecasts so far. They'll press down harder during the Q4-2023 reporting season, when the managements of the companies they follow provide more detail about their expectations for 2024.

For now, the consensus S&P 500 earnings-per-share forecast of $245.75 for 2024 is down 0.7% over the past five weeks. The quarterly forecasts have changed as follows: Q1 down 1.3%, Q2 down 1.0%, Q3 up 0.8%, and Q4 down 0.9% (*Fig. 16*). Analysts still expect solid earnings growth of 11.5% in 2024, with their quarterly projections at 7.1% y/y (Q1), 11.0% y/y (Q2), 9.9% y/y (Q3), and 16.0% y/y (Q4) (*Fig. 17*).

Calendars

US: Wed: MBA Mortgage Applications; Wholesale Inventories 0.0%; Crude Oil Inventories & Gasoline Production; Powell; Barr; Williams; Jefferson; Cook. **Thurs:** Initial & Continuous Jobless Claims 215,000/1.815m; Natural Gas Storage; Powell. (FXStreet estimates)

Global: 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. **Thurs:** ECB Economic Bulletin; Lagarde; Nagel; Balz; Lane. (FXStreet estimates)

Strategy Indicators

S&P 500 Q3 Earnings Season Monitor (*link*): With the Q3-2023 earnings season over 85% complete, the indications from the companies that have reported so far suggest a weaker revenue and earnings surprise compared to Q2-2023. During Q4-2022, the earnings surprise was the lowest since Q4-2008, and the revenue surprise the smallest since Q1-2020. Furthermore, the earnings surprise failed to outpace the revenue surprise in Q4-2022 for the first time since we began tracking that data in Q1-2009. With 423 of the S&P 500 companies finished reporting for Q3-2023, revenues are ahead of the consensus forecast by 0.7% and earnings have exceeded estimates by 7.0%. At the same point during the Q2 season, revenues were 1.9% above forecast and earnings had beaten estimates by 7.9%. Just 59% of the 423 Q3 reporters through mid-day Tuesday has reported a positive revenues surprise, while 80% has reported an earnings beat. That's on pace for the weakest revenues surprise reading since Q3-2019; but the percentage with positive earnings surprises would be near the highest since Q3-2021 if it holds to the end of the season. The early reporters' aggregate y/y growth rates have ticked up for revenues from their Q2-2023 readings and improved for earnings: to 1.4% from 0.9% for revenues growth and to 2.4% from -7.7% for earnings growth. Over the past 58 quarters through Q2-2023, y/y earnings growth has trailed y/y revenues growth in only 16 quarters and for six straight quarters, but earnings growth is ultimately likely to outpace revenue growth in Q3-2023 as the Energy sector becomes less of a drag on overall results. Slightly fewer companies have been reporting positive y/y earnings growth in Q3 (61%) than positive y/y revenues growth (63%). With seven of the MegaCap-8's results complete, they have been a net positive contributor to the S&P 500's revenue and earnings surprise and the y/y growth rates. While the surprise metrics remain positive without the MegaCap-8 reporters, the y/y growth rates are flat or negative without them. Looking at the S&P 500 excluding the MegaCap-8 reporters to date, the revenue surprise remains steady at 0.7%, the earnings surprise falls to 5.6% from 7.0%, revenue growth drops to 0.3% from 1.4%, and earnings growth falls to -4.5% from 2.4%. These figures are no expected to change much as the remaining Q3-2023 results are reported in the coming weeks. While we expect y/y revenues growth rates to remain positive yet again in Q3, earnings growth will be positive on a y/y basis for the first time in four quarters.

US Economic Indicators

Merchandise Trade (*link*): The *real merchandise trade deficit* in September widened to $86.5 billion after narrowing from $88.3 billion in July to $83.8 billion in August. The Q3 average deficit was $86.2 billion per month, narrowing from Q2's $90.3 billion. *Real exports* rose for the fifth straight month in September by 2.0% m/m and 5.9% over the period. Meanwhile, *real imports* rose 2.5% in September, after falling three of the prior four months by 3.2%. Looking at *real exports versus a year ago*, they're down 0.9%—as the decline in exports of industrial supplies & materials (-9.6% y/y) offset gains in exports of other goods (22.5), automotive vehicles, parts & engines (14.4), foods, feeds & beverages (6.0), and nonfood consumer goods ex autos (3.4), with exports of capital goods ex autos (0.1) flat with a year ago. Turning to *real imports versus a year ago*, they're down 0.8%, as imports of other goods (20.3% y/y) and automotive vehicles, parts, and engines (15.2) both rose at a double-digit pace, though imports of foods, feeds & beverages (-7.4), nonfood consumer goods ex autos (-5.4), capital goods ex autos (-4.7), and industrial supplies & materials (-1.7) were below year-ago levels.

Global Economic Indicators

Germany Industrial Production (***link***): German industrial production declined for the fourth successive month, with September's data a surprise on the downside, as motor vehicle production contracted 5.0% during the month. Germany's *headline production*, which includes construction, declined for the fourth successive month, by 1.4% (vs -0.4% expected) in September and 3.5% over the period; it's down 1.1% ytd. Meanwhile, *production excluding construction* (which the overall Eurozone uses) fell four of the past five months, by 1.6% m/m and 3.7% over the time span. It's down 2.6% ytd. Looking at the main industrial groupings, *capital goods* production fell three of the past four months, declining

0.2% m/m and 4.3% over the period, though remains at a relatively high level. *Consumer durable goods* production is down sharply since March, sinking 5.0% in September and 13.2% over the period, while *consumer nondurable goods* production has dropped 6.6% since June. Meanwhile, *intermediate goods* output remains on a steep downtrend, falling 10.6% from its recent peak in March 2021. On a *y/y basis*, headline production dropped 3.7% including construction and 4.4% excluding construction. Looking at the *main industrial groupings*, only capital (1.3% y/y) goods production is in the plus column, with consumer durable goods (-11.7) and energy (-10.6) output posting double-digit declines and consumer nondurable (-9.0) and intermediate (-6.2) goods production in the single digits.

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