Yardeni Research

MORNING BRIEFING
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A Remarkably Resilient Economy

Check out the accompanying chart collection.

Executive Summary: Interest rates have been ascending and the tight labor market has been a problem for companies this year and last, but the US economy has been robust regardless. Today, we look at what accounts for its unusual resilience. … Hoisting the economy has been strength in the construction industry, especially multi-family, home improvement, and nonresidential building. … Also contributing to the economy's resilience has been US corporations' awesome cash generating capability. … And good news for next year: Signs are mounting that the rolling recession in the goods producing sector of the economy is bottoming and should give way to a rolling recovery in 2024.

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

US Economy I: Construction Is Booming. The US economy has been remarkably resilient in the face of the Fed's aggressive tightening of monetary policy since early last year. One of the sectors that accounts for that resilience is the construction industry. In the past, rising interest rates always depressed construction, which exacerbated the resulting recessions (*Fig. 1* and *Fig. 2*). This time, the weakness in residential construction has been offset by relatively strong private nonresidential and public construction (*Fig. 3* and *Fig. 4*). Here's more:

(1) *Private residential construction.* While single-family housing construction has been weak, that weakness has partially been offset by record spending on multi-family construction and near-record spending on home improvements, which are almost as large as spending on single-family construction (*Fig. 5* and *Fig. 6*).

(2) *Private nonresidential construction.* Many of the components of nonresidential construction spending are at or near their record highs, including education, highway & street, amusement & recreation, commercial, and office (*Fig. 7* and *Fig. 8*). The strength of the last two categories is surprising. They might weaken with a lag (maybe in 2024) in response to the tightening of credit conditions during 2022 and 2023. But for now, they are a source of economic strength.

Off the charts is construction spending on manufacturing facilities because of the increase in onshoring owing to federal incentives (*Fig. 9*). In current dollars, it is up a whopping 71.6% and 136.8% on one-year and two-year bases.

(3) *Public construction.* Most of the major categories of public construction spending are also at or near their record highs (*Fig. 10*). Here are their y/y growth rates through October: power (55.9%), sewage & waste disposal (27.2), office (18.1), education (16.5), water supply (15.3), highway & street (12.7), and transportation (8.6).

(4) *Construction employment.* Payroll employment in the construction industry occasionally has been a leading economic indicator and often has been a coincident indicator of the business cycle. So it tends to fall during recessions. There's no sign of a recession in construction employment currently. It has been rising to fresh record highs since May 2022 (*Fig. 11*). Employment is strong across all the major building trades, including residential, nonresidential, and heavy & civil engineering (*Fig. 12*).

(5) *Related stock indexes.* Since the October 27 low in the S&P 500, the stock price index of its Real Estate sector has recovered nicely. So have the stock price indexes of the various S&P 500 REITs (*Fig. 13*). Here is their performance derby since then through Friday's close: Office (26.1%), Telecom Tower (25.1), Industrial (21.5), Single-Family Residential (18.2), Self-Storage (17.9), Hotel & Resort (17.7), Real Estate sector (17.3), Retail (16.5), Broadline (15.1), and Data Center (15.1).

US Economy II: Surveys Suggest Goods Recession Is Bottoming. The rolling recession in the goods producing sector of the economy shows signs of bottoming and should transition into a rolling recovery next year. For now, the latest data suggest that the sector may be bottoming:

(1) *M-PMI composite.* November's national composite M-PMI remained below 50.0 for the 13th month in a row (*Fig. 14*). However, it bottomed at 46.0 in June and has remained slightly above that low through November. The regional M-PMI bottomed in May at -16.5 and rose to -4.7 in November.

(2) *M-PMI orders.* A V-shaped recovery is more discernible in the national and regional orders sub-components of the M-PMI surveys (*Fig. 15*). Both bottomed in May. They've recovered since then and should be back in growth territory early next year, in our opinion.

(3) *Supply-chain index.* The rolling recession in the goods producing sector has been the pause that refreshes. It has taken the kinks out of global supply chains. The New York

Fed's Global Supply Chain Pressure Index, which starts with 1998 data, fell from a record high of 4.3 at the end of 2021 to a record low of -1.7 during October (*Fig. 16*). That's helped significantly to lower goods inflation over the period.

US Economy III: Record Corporate Cash Flow. The economy's resilience can also be attributed to the awesome ability of US corporations to generate cash flow. It totaled a record $3.4 trillion (saar) during Q3-2023 (*Fig. 17*). That's despite the pressure on companies' profit margins coming from high labor costs and higher interest rates over the past couple of years. Here are a few related stats:

(1) Corporate cash flow is up 4.1% y/y, with tax-reported depreciation up 6.9% and undistributed profits down 3.3%. The latter has been relatively flat since Q3-2009.

(2) After-tax corporate profits from current production was down 1.7% during Q3, with dividends down 0.9% and undistributed profits down 3.3% (*Fig. 18*).

(3) The dividend payout ratio using after-tax profits from current production was 67.9% during Q3 (*Fig. 19*).

Calendars

US: Tues: JOLTS Job Openings 9.35m; ISM NM-PMI 52.0; S&P C-PMI & NM-PMI 50.7/50.8. **Wed:** ADP Employment Change 128k; Nonfarm Productivity & Unit Labor Costs 4.7%/-0.8%; Trade Balance -$64.1b; MBA Mortgage Applications; Weekly Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Tues: Eurozone PPI 0.2%m/m/-0.4%y/y; Eurozone, Germany, and France C-PMIs 47.1/47.1/44.5; Eurozone, Germany, and France NM-PMIs 48.2/48.7/45.3; France Industrial Production 0.2%; UK C-PMI & NM-PMI 50.1/50.5; Australia GDP 0.3%q/q/1.7%y/y. **Wed:** Eurozone Retail Sales 0.2%m/m/-0.9%y/y; Germany Factory Orders 0.0%; China Trade Balance; Canada Trade Balance $1.5b; BoC Interest Rate Decision 5.00%; BoE Financial Stability Report; BoE FPC Meeting Minutes; Bailey; Mauderer; Nagel. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose simultaneously for all three of these indexes for a second straight 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 rose 0.1% w/w to 5.2% below its record high in early June 2022, and SmallCap's edged up less than 0.1% w/w to 10.9% below its mid-June 2022 record. Through the week ending November 30, LargeCap's forward earnings has risen 7.9% from its 54-week low during the week of February 10; MidCap's is 3.1% above its 55-week low during the week of March 10; and SmallCap's is 3.1% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrends since mid-2022 have 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 a 13-month high of 5.8% 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 1.0% y/y is at a 10-month high and 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 -3.8% y/y rate is also at a 10-month high; it's 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. Following the Q3 season, they've kept LargeCap's 2023 estimate little changed and have trimmed SMidCap's. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.2% and 11.3%), MidCap (-13.1, 11.0), and SmallCap (-8.9, 8.0).

S&P 500/400/600 Valuation (*link*): Valuations rose for these three indexes during the December 1 week. LargeCap's forward P/E was up 0.1pt w/w to a 13-week high of 18.8 and is up from a seven-month low of 17.0 during the October 27 week. That's down from its 18-month high of 19.6 during the July 28 week. It's still up 3.6pts 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 0.4pt w/w to a 13-week high of 13.9 and is up from a 12-month low of 12.1 at the end of October. It's now 0.8pts below its 10-month high of 14.7 in early February and up 2.8pts 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 0.3pt w/w to a 10-week high of 13.2 and is up from a 12-month low of 11.3 at the end of October. It's now 1.1pt below its recent 12-month high of 14.3 in early February. It's up 2.6pts 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 26% discount to LargeCap's P/E is up from 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 30% discount is up from a 23-year-low 34% discount several weeks 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 129th straight week; the current 5% 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. They're forecasting that the S&P 500's earnings will rise 3.7% y/y in Q4-2023. That's a tad below the 3.9% gain in Q3-2023 and up from a 5.8% decline in Q2-2023, which marked the cyclical bottom for earnings growth. On a pro forma basis, they expect a y/y earnings gain of 5.4% in Q4, down from a 7.1% gain in Q3 and up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 8.3% y/y in Q4-2023. That compares to a 12.6% gain in Q3-2023, a 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 Q4-2023, unchanged from Q3-2023's and Q2-2023's counts. 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 Q4-2023 versus their nearly final earnings growth rates for Q3-2023: Communication Services (49.2% in Q4-2023 versus 46.5% in Q3-2023), Utilities (23.3, 10.3), Consumer Discretionary (20.0, 42.3), Information Technology (16.5, 14.9), Real Estate (11.0, -5.4), Financials (10.1, 23.5), S&P 500 ex-Energy (8.3, 12.6), S&P 500 (5.4, 7.1), Consumer Staples (1.5, 6.7), Industrials (-0.3, 12.0), Health Care (-18.2, -17.3), Materials (-20.6, -18.1), and Energy (-20.7, -33.0).

US Economic Indicators

Manufacturing Orders & Shipments (***link***): Factory orders lost momentum in October, posting its biggest monthly decline since April 2020, as a double-digit decline in transportation equipment billings dragged durable goods orders lower, though all remain in at high levels. *Manufacturing orders* plunged 3.6% in October from September's record high. Durable goods orders fell for the third time in four month, by 7.3%, from its June record high as transportation equipment orders tanked 19.9% from its June record high. *Excluding transportation*, orders declined 1.2% after a four-month gain of 3.1% through September. Still, it's within 3.4% of last June's record high. Meanwhile, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) remains in a volatile flat trend in record territory, only 0.5% below August's record high, while *nondefense capital goods shipments excluding aircraft* (used in calculating GDP) was within 0.2% of its record high, also posted in August. In October, shipments of machinery, electrical equipment, appliances & components, and fabricated metals all remained stalled around their record while primary metals recorded a five-month decline of 2.1%.

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