



ARGUS ECONOMIC COMMENTARY

June 12, 2023

Coming up Roses (Maybe): Our Monthly Survey of the Economy, Interest Rates, and Stocks

The stock market finished May 2023 with its most positive trading week since March. On the final trading day, investors celebrated the debt-ceiling bill making it through the Senate and heading for a weekend signing by the president. Nonfarm payrolls were good for the economy (339,000 jobs added) but contained data point on unemployment (rising to 3.7%) and wage growth (slowing to 4.3%) to keep the Fed on the sidelines at the June FOMC meeting.

The S&P 500 is now just a few points from meeting the technical definition of a bull market, meaning a 20% rise off the closing lows from October 2022. But is the market really coming up roses? The Fed is expected to stand pat in June, but given recently strong data, investors are increasingly anticipating a rate hike at the July meeting.

Passage of the debt-ceiling bill removes worry of a catastrophic downgrade in U.S. credit ratings. But it also entails a flood of new Treasury issuance. And with it comes resumption of student-loan payments, which may put a crimp on millennial and Gen Z spending.

The market advance has been worrisomely narrow, with investors clustered into a handful of perceive AI beneficiaries — at a time when immediate monetization prospects for AI are murky at best.

In short, there are plenty of things to ponder and worry about. The bull has shown a propensity to climb a wall of worry in the past, but he is not reliably sure-footed.

The Economy, Interest Rates, and Earnings

The second revision to U.S. GDP growth provides a mixed message. The consumer is surprisingly strong so far, while business spending has become more cautious. Similar to the first half of 2022, an outlier data point — private inventories — had an outsized influence on the final number in 1Q23.

The need to rebuild inventories could partly offset spending weakness later in the year.

The preliminary or second report on 1Q23 real GDP shows growth of 1.3%, up from an advance reading of 1.1% growth; however, that initial reading missed the 2% consensus forecast. The consensus estimate had bobbed up and down before the late April release, as different forces tugged GDP in various directions.

For 1Q23, the increase in real GDP reflected growth in consumer spending, exports, broad-based government spending, and non-residential fixed investment. These gains were offset by decreases in private inventory investment and weakness in residential fixed investment (housing). Imports, which subtract from GDP, grew in the quarter.

Personal consumption expenditures (PCE) grew 3.8% in 1Q23, the highest quarterly growth rate since the second quarter of 2021. Consumer spending on goods increased 6.3% in 1Q23, after declining 0.1% in 4Q22. Durable goods spending rose 16.4%, the highest since 1Q21. Non-durable goods spending rose just under 1%. Services spending rose a healthy 2.5%, up from 1.6% in 4Q22 though down from 2Q22 and 3Q22 levels.

Consumer spending on goods declined in every quarter of 2022. Following strength in goods spending in 1Q23, we could see this category moderate in a high-interest rate environment and as inflation drags through a second year.

Capital spending was more moderate in 1Q23. Non-residential fixed investment, a proxy for corporate capital spending, increased 1.4%. That is double the 0.7% gain reported in the advance report, though down from 4.0% growth in 4Q22. In contrast to consumer spending, corporate capital spending rose in every quarter of 2022; the outlook for further business spending in 2023 is uncertain.

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ECONOMIC & MARKET COMMENTARY (CONT.)

Within this category, corporate spending on structures remained strong with a second consecutive quarter of double-digit growth, after declining in every quarter since 1Q21. Spending on equipment fell in single-digit percentages for a second straight quarter. Spending on intellectual property products grew by 5.2% in 1Q23.

Residential fixed investment declined at an annualized 5.2% rate in 1Q23, marking an improvement after three straight double-digit declines. This housing-driven category declined at an average 20%-plus rate from 2Q22 through 4Q22.

Another aspect of the business economy, and one that can act as a swing factor in the broad economy, is the change in private inventories. Beginning late in 2022, inflation caused consumers to reprioritize spending toward necessities. The supply-chain crisis flipped overnight to a supply glut, leaving companies and distributors with too much inventory.

As a result, businesses in 1Q23 reduced the value of goods shipped into private inventories by about \$130 billion compared with 4Q22 – in a period in which the net quarter-over-quarter change in GDP was \$64 billion. Looked at it another way, in a quarter in which GDP increased by 130 basis points, change in private inventories subtracted 210 bps from that growth; and it was the second-largest swing factor, behind the 252 bps contribution to growth from PCE.

Based on positive GDP growth in 1Q23, demand out of distributor and OEM inventories was much stronger in the quarter than sales into distributor and OEM inventories. The need to replenish inventories could be a positive offset to any weakening in overall spending later in the year.

Exports rose 5.2% in 1Q23, 40 basis points (bps) better than in the advance report, while imports were up 4.0%, also stronger than originally estimated. Net exports-imports were moderately positive for GDP growth. Total government spending rose a very brisk 5.2% in 1Q23, led by 10%-plus federal non-defense spending growth. That is not a sustainable number, and one reason our GDP forecast turns more conservative in the 2H23.

Outside the GDP report, the jobs economy remains solid with yet another surprise gain in May. Despite predictions that the jobs economy would downshift in 2023, nonfarm payrolls grew by 339,000 in May, nearly doubling the consensus call. March and April were revised upward by 93,000. Amid headline layoffs at large tech firms, payrolls growth accelerated from March to May.

Unemployment jumped to 3.7% in May from 3.4% in April. Annual wage growth slowed to a 4.3% pace as of May 2023, from 5%-plus growth prevailing in 2022. Higher unemployment and slowing wage growth may be enough to keep the Fed on the sidelines, as many investors expect the central bank to end or pause its rate cycle in June.

Argus looks for more normal nonfarm payrolls growth in the sub-200K range in the second half of the year.

Indicators from the industrial economy suggest some slowing in activity, but nothing like a collapse. Durable goods orders remained strong in April, rising 1.1% after a 3.3% gain in March; core capital goods orders were up 1.4%. Factory orders for April rose 0.4%, compared with 0.6% growth in March.

ISM's manufacturing PMI posted its sixth straight reading in contraction territory (under 50) in April, but the manufacturing PMI did rise to 46.9% month-over-month from 46.3% in March. ISM's services PMI has remained in expansion territory, as consumers continue to dine out and take trips. Small business optimism is sinking under the weight of inflation, however, falling to 89.0 for May.

Signals from the consumer economy are also mixed. Retail sales remain soft, rising just 0.4% for April. According to the BEA, personal incomes were up 0.4% in April, while personal outlays were up 0.8%.

The housing economy remains a drag on consumer confidence, as would be sellers are in "mortgage handcuffs" (unwilling to give up a low-rate mortgage for a high-rate mortgage), while would-be buyers fret high prices and high rates. Consistent with the conflicting factors and reports across the broad economy, consumer sentiment is unsettled. Consumer sentiment for May remained below the 60 level, up slightly from the April level.

For all of 2022, real GDP increased 2.1%, compared with an increase of 5.9% in 2021. Our GDP growth forecast for 2023 is 1.4%. We look for 2Q23 to be the peak GDP quarter for the year, followed by sub-par readings in 3Q23 and 4Q23.

We have, however, raised our preliminary GDP growth forecast for 2024 to 2.1%, from an earlier 1.7%; we expect this forecast number to remain volatile. For now, we continue to believe the U.S. economy can (barely) avoid a recession in 2023.

On May 3, the FOMC raised the fed funds rate by a quarter-point, bringing the tendency to 5.0%-5.25%. This followed a similar quarter point hike in March 2023. Many investors believe the Fed's rate hiking cycle of 2022-23 is now over, or will at least be on pause in June. Recent data may keep pressure on the Fed to act again, however.

In the 14 months between March 2022 and May 2023, the U.S. central bank hiked rates 10 times and raised rates a cumulative 500 bps. We count six prior meaningful rate-hiking periods since 1980, with 2022-23 being the seventh. Compared with recent rate-hiking periods, which lasted on average more than a year and a half, the 2022-23 cycle was shorter than average. The 2022-23 cycle also packed in a larger cumulative rate hike than the average 320 bps increase of those earlier hiking cycles.

ECONOMIC & MARKET COMMENTARY (CONT.)

During those six prior rate cycles from 1980 through 2020, the economy mainly required modest tweaks by the Fed; and the stock market absorbed and adjusted to a higher-rate environment without too much turmoil. The stock market struggled during the 2022-23 rate cycle mainly because the Fed's actions were so intense and concentrated, in response to inflation that took over the economy like a wild fire.

We documented that employment and the economy are not only sidestepping recession, but showing signs of reacceleration. That, along with past Fed hikes, has contributed to a rising-rate environment over the past month. The two-year Treasury yield, which shed over 100 bps in the immediate aftermath of SVB, was 4.50% at the end of May, after ending April at 4.04%. The five-year yield moved to 3.84% at the end of May from 3.60% at the end of April. The 10-year Treasury yield ended May at 3.69% after ending April at 3.44%.

The twos-10s spread, which peaked at 107 bps early in March 2023 and fell to 40 bps in the immediate SVB aftermath, but is now back up to 80 bps. The twos-10s spread is still warning of recession, but has been now for over one year.

Following the May FOMC meeting, the Fed is expected to pause and assess how rate hikes to date are impacting the economy and inflation. As part of its decision-making process, the central bank will likely consider the impact of other factors, such as potentially tighter credit conditions related to bank failures, in setting its agenda going forward.

The bond market fulfilled our expectations that the entire yield curve would move higher across the 2022 year. With recession risks rising and parts of the economy showing signs of slowing, we expect to see less acceleration in rates going forward.

Consumer prices are moderating, but not fast enough; the April CPI rose 0.4% on a monthly basis and 4.9% year-over-year. Producer prices are better behaved, rising just 0.2% month-over-month and 2.3% year-over-year. The PCE price index, the Fed's preferred inflation gauge, was up 4.4% year-over-year in April, rising from 4.2% in March.

Even after the SVB failure, the Fed remains committed to keeping rates elevated until inflation is back in the target range. That has dashed any hopes for more accommodative Fed monetary policy in the back half of 2023. However, our six-month forecast reflects investor expectations that rates will begin to move lower in 2024 as the Fed shifts to accommodative monetary policy.

The first-quarter earnings season exceeded very low expectations while not quite crossing over into positive territory. Calendar 1Q23 earnings are by several metrics better than 4Q22 results, when EPS fell 3%, companies beating expectations were fewer, and the average earnings beat was only 1%.

Heading into 1Q23 EPS season, consensus expectations were for a decline of 6%-7%. With all but a handful of S&P component companies having reported, the forecast decline is 2%, according to FactSet, and less than 1%, according to Refinitiv.

For 1Q23, nearly four-fifths of companies exceeded consensus expectations. Also for 1Q23, the average beat against expectations was around 6.5%. Over the preceding decade, S&P 500 companies on average topped consensus quarterly EPS estimates by about 6%.

As 4Q22 earnings season wound down, we reduced our final 2022 estimate of S&P 500 earnings from continuing operations to \$222, from a prior \$224. We also lowered our 2023 earnings estimate to \$226, from a prior estimate of \$230. And we reduced our 2024 forecast to \$245, from \$250.

The past three times we adjusted our 2022-24 EPS forecasts, we reduced our estimates. Given the much better trend to date in 1Q23 earnings, along with generally benign guidance for 2Q23, the bias in any near-term adjustment to 2023 and 2024 earnings is likely upward.

Domestic and Global Markets

Major index performance in 2023 shows uncommon bifurcation between growth-driven (Nasdaq), the broadest measure of the market (S&P 500), and the bluest of blue chips (the Dow Jones Industrial Average). As of end of May, the Nasdaq was well out in front with a 27% gain. The S&P 500 with dividends was up 12.4%. The DJIA was up just 2.9%; two weeks ago, the Dow was negative for the year.

How common is it for major indices to be so out of step? We looked at performance over the preceding six years, from 2017 to 2022. In that span, returns among the major indexes were more closely bunched in 2021, 2019, 2018, and 2017. Of those four years, index returns were tightly bunched in a down year once, in 2018, and otherwise tightly bunched to the upside. In 2020, the dispersion of index returns was similar to what is happening in 2023, with Nasdaq far out in front, S&P 500 in the middle, and DJIA badly lagging but positive. And, in 2022, we saw a reverse mirror of that performance, with Nasdaq down 33%, the S&P 500 declining 19%, and the Dow off 9%.

Plainly, we would like to see better breadth in the current market. Thinly advancing markets can be topky and prone to falling over on unexpected news. We are already seeing some profit-taking among the market leaders early in June; it would be nice to see that "house money" rotating into this year's underperformers.

After a catch-up April for defensive and cyclical stocks, growth sectors soared on spiking AI interest in May. As of end of May, two sectors -- Technology and Communication Services -- are up more than 35% year-to-date. Consumer Discretionary is up 23%.

ECONOMIC & MARKET COMMENTARY (CONT.)

Even within growth sectors, investment interest is concentrated in relatively few names. The market leaders in 2023 include Nvidia and Meta (both up 100%-plus), Broadcom, Amazon, and Alphabet (all up 45%-plus), and Microsoft (up 40%); all are actively tied to development and monetization of generative AI. This concentration can contribute to fragility of sector gains should investors start taking profits in year-to-date winners.

Currently, five sectors are negative year-to-date: Energy, Utilities, Healthcare, Financial Services, and Consumer Staples. Another sector, Real Estate, is barely up for the year. Intense rotation drained money out of other areas in May and tended to accelerate the bifurcation between have and have-not sectors for 2023 to date. This disparity between in-favor and out-of-favor sectors is a concern for the long-term health of the stock rally.

Now that S&P Global Markets has tweaked several sectors, the broad shape of the market is set for the remainder of 2023. In the biggest shifts, Transactions & Payment Processing Services has moved from Technology to Financial Services; and certain Broadline Retailers have moved from Consumer Discretionary to Consumer Staples.

Within a broadly advancing market in April, defensive sectors played catch-up with growth-focused leaders. But in May, as AI fever seized the market, investors tightened their focus on growth sectors.

As of 5/31/23, Technology had climbed to a 28% weighting within the S&P 500, up from 25.8% at the end of April. Despite being stripped of big payment processors Visa and Mastercard, Technology is actually higher than a year ago, before the payment processors were removed.

Financial Services, which increased to 13.1% weighting as of the end of March, slid to 12.5% as of end of May. Consumer Staples initially increased to a 7.4% with the additions of Target, Dollar General, Dollar Tree, and a few others, but is now back below 7%. Healthcare lost ground in May, down to 13.7% of total S&P sector weight from 14.4% for April.

We have adjusted our recommended sector allocations this month, as we do each quarter at the beginning of March, June, September, and December. The following reflects our guidance for the calendar third quarter of 2023. Although these changes were determined by a quantitative, six-part, "blind" sector model, they align with qualitative and fundamental dynamics in the market outlook.

We raised Consumer Discretionary to Over-Weight from Market-Weight. Employment remains high, and wages are still rising. Consumers are taking over-due vacations, benefiting travel & leisure, hospitality, gaming, and restaurants. Retail inventories are normalizing, and automotive demand is brisk.

We raised Communication Services to Market-Weight from Under-Weight. Social media stocks such as Meta and

Alphabet, which struggled in 2022, are now riding the AI wave. Also in this sector, telecom stocks are likely near the end of mobile device weakness, and improved customer ARPU lies ahead, in our view.

We lowered Industrials to Market-Weight from Over-Weight. Although valuations are attractive, that mainly reflects weak share prices. In a high interest rate environment, enterprise demand for industrial solutions has softened and may take some time to recover.

Finally, we have lowered Energy to Under-Weight from Market-Weight. Petroleum prices have come down from peak due to slow recovery in China from COVID lockdowns and widespread development of renewable resources. Energy earnings are expected to decline sharply in 2023.

Our recommended sector weightings are as follows:

- * Over-Weight: Basic Materials, Consumer Discretionary, Financial Services, Technology

- * Market-Weight: Communication Services, Healthcare, Industrials, Real Estate, Utilities

- * Under-Weight: Consumer Staples, Energy

- * Underweight: Consumer Staples and Energy.

Like the U.S. market, global stocks are doing better in 2023 than they did in 2022. And for just the second time this year, the U.S. benchmark (the S&P 500) is doing better than our global bourse composite. On average, our composite of global bourses (which no longer includes Russia) is up 8.1% year-to-date -- up about 110 bps since the end of April, but now lagging the S&P 500's 12.4% gain.

Global theme leadership has undergone significant change from a year ago. In terms of our themes, mature economies lead with a 14% year-to-date gain. Japan soared in May as the AI craze impacted this nation, which leads in robotic technology. The Eurozone is up in mid-teen percentages, as EU central banks show signs of ending their rate-hiking cycles. Americas markets (including U.S., Brazil, Mexico and Canada) are up 8% in 2023, led by gains in the U.S. and Mexico (up 11%).

Asia is now up 7%, reflecting strength in Japan. Resources economies are up 6%. BRICs-minus-Russia are up less than 1% in 2023, lagging the average due to weakness in China and India.

Conclusion

After recovery in the S&P 500 through the first five months of 2023, the S&P 500 two-year forward P/E on our revised 2023 and 2024 forecasts is 18.2-times; that is about 7% below the prior five-year (2018-22) average of 19.6-times. Reflecting much higher inflation and interest rates at present compared with over the past five years, as well as other inputs, our adjusted earnings-yield model continues to signal overvaluation in stocks.

After a double-digit percentage decline for stocks in 2022, Argus is modeling more-normal returns in 2023,

ECONOMIC & MARKET COMMENTARY (CONT.)

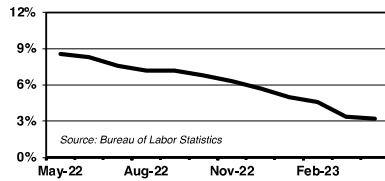
meaning S&P 500 appreciation in high-single-digit to low-double-digit percentages. A normally advancing market usually is led by growth sectors. After 2022, investors have gotten used to buying cyclical, defensive, interest-rate-sensitive, and inflation-beneficiary stocks.

Right now, many of last-year's winners are being left behind; but we are not even at the half-year mark yet. If the market does move higher in 2023, the advance from a sector perspective could be broad-based.

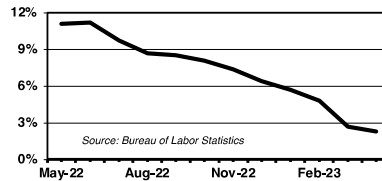
Jim Kelleher, CFA,
Director of Research

ECONOMIC TRADING CALENDAR

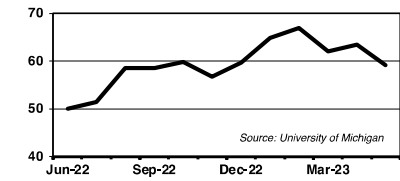
Release: **PPI ex-Food & Energy**
 Date: 6/14/2023
 Month: May
 Previous Report: 3.2%
 Argus Estimate: 2.5%
 Street Estimate: NA



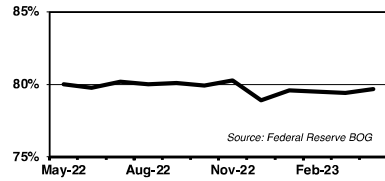
Release: **PPI Final Demand**
 Date: 6/14/2023
 Month: May
 Previous Report: 2.3%
 Argus Estimate: 1.5%
 Street Estimate: 1.5%



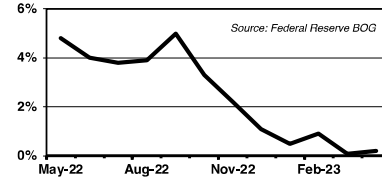
Release: **U. of Michigan Sentiment**
 Date: 6/16/2023
 Month: June
 Previous Report: 59.2
 Argus Estimate: 60.0
 Street Estimate: 60.1



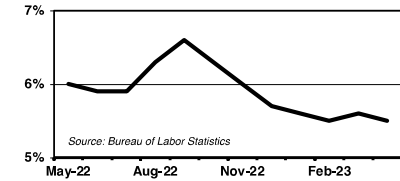
Release: **Capacity Utilization**
 Date: 6/15/2023
 Month: May
 Previous Report: 79.7%
 Argus Estimate: 79.5%
 Street Estimate: 79.7%



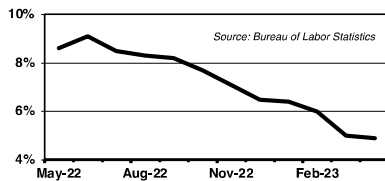
Release: **Industrial Production**
 Date: 6/15/2023
 Month: May
 Previous Report: 0.2%
 Argus Estimate: 0.0%
 Street Estimate: NA



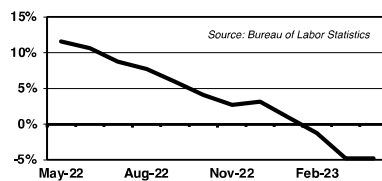
Release: **CPI ex-Food & Energy**
 Date: 6/13/2023
 Month: May
 Previous Report: 5.5%
 Argus Estimate: 5.2%
 Street Estimate: 5.2%



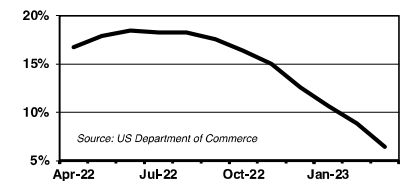
Release: **Consumer Price Index**
 Date: 6/13/2023
 Month: May
 Previous Report: 4.9%
 Argus Estimate: 4.5%
 Street Estimate: 4.1%



Release: **Import Price Index**
 Date: 6/15/2023
 Month: May
 Previous Report: -4.8%
 Argus Estimate: -4.0%
 Street Estimate: NA

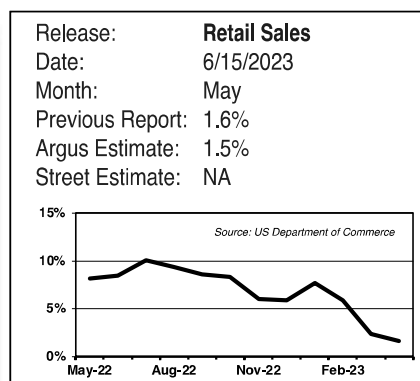
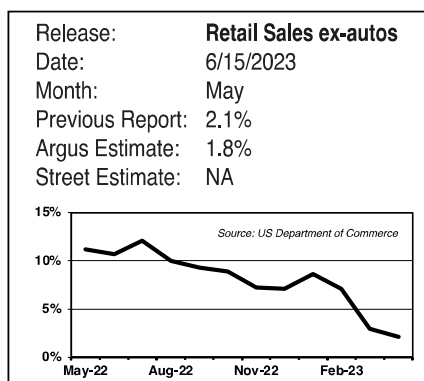


Release: **Business Inventories**
 Date: 6/15/2023
 Month: April
 Previous Report: 6.5%
 Argus Estimate: 5.5%
 Street Estimate: NA



Previous Week's Releases and Next Week's Releases on next page.

ECONOMIC TRADING CALENDAR (CONT.)



Previous Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
5-Jun	ISM Services Index	May	51.9	52.0	52.5	50.3%
	Factory Orders	April	0.5%	0.0%	NA	0.2%
7-Jun	Trade Balance	April	-\$64.2 Bil.	-\$63.0 Bil.	-\$75.0 Bil.	NA
8-Jun	Wholesale Inventories	April	6.2%	4.5%	NA	NA

Next Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
20-Jun	Housing Starts	May	1401 K	NA	NA	NA
22-Jun	Leading Index	May	-0.6%	NA	NA	NA
	Existing Home Sales	May	4.28 Mil.	NA	NA	NA

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