



ARGUS ECONOMIC COMMENTARY

July 31, 2023

Economy and Earnings Send Mixed Signals

The second-quarter earnings season is entering its heavy-volume weeks, which will stretch from late July into mid-August. Earnings to date are performing about as expected, which is to say a bit better than consensus expectations but still negative on a year-over-year basis.

The gloom among economists regarding a potential recession continues to hang in the air. At the same time, actual economic data have been reasonably solid, and not yet indicative of any meaningful downturn. Consumers seem to be feeling better than business owners.

One key concern is that the stock market has been racing ahead. If 2Q earnings miss expectations, and second-half EPS swing negative despite consensus expectations for growth, the market could find itself meaningfully overvalued.

Preliminary Earnings Indicators

Heading into the 2Q23 earnings season, the consensus of analyst estimates signaled a mid- to high single-digit decline in adjusted EPS on a year-over-year basis. As always, a few early reporters have skewed the overall trend; specifically, Merck's one-time charge has lowered the consensus EPS forecast, which now calls for a sharper decline in the high single digits.

As usual, however, most companies are beating their consensus estimates; and most are beating by several percentage points. With less than 20% of S&P 500 constituent companies having reported, the actual annual decline in 2Q23 S&P 500 earnings from continuing operations is in the 2%-4% range. Argus still expects 2Q23 earnings to decline in the low to mid-single-digit range.

The percentage of companies beating EPS expectations is currently running right around 75%, approximately in line with the five- and 10-year averages. This also represents

recovery from the trend in the second half of 2022 and is approximately in line with the "surprise" percentage in 1Q23.

The magnitude of the EPS beat is also better than 2H22 trends and more in line with 1Q23. Companies are averaging a roughly 6% beat against consensus expectations. That is close to the 10-year average of a 6.4% beat against consensus.

Although we are still at an early stage of the earnings season, the sector map is already fairly well established. Five sectors are forecast to post positive year-over-year earnings in 2Q23, while six are expected to be down from the prior year. Notably, only one sector (Consumer Discretionary) is expected to deliver double-digit growth in 2Q23. Much of this gain is due to Amazon, which is likely to swing to EPS growth in 2Q23 after a negative posting in 2Q22. Three sectors (Healthcare, Energy, and Materials) are expected to see double-digit annual earnings declines.

Sectors forecast to generate single-digit earnings growth in 2Q23 include Communication Services, Industrials, Financial Services, and Consumer Staples. Sectors forecast to deliver a single-digit decline include Utilities, Real Estate, and Technology.

When inflation accelerated in mid-2022, companies were forced to raise prices in order to cover skyrocketing costs. This led to outlier revenue growth on a quarterly basis from mid-2021 through late 2022. Given inflation that remains high enough to impact demand, and tough prior-year comparisons, revenue is on track to be flat to slightly lower in 2Q23. We expect revenue growth in sectors such as Financial Services and Communication Services, and look for declines centered in the commodity sectors (Energy and Materials).

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ECONOMIC & MARKET COMMENTARY (CONT.)

Slightly Better Consumer Data

In July, the economic data has been in line with the full-year trend – which is to say, inconclusive. In the first half of the year, industrial and commercial economy data was generally stronger than consumer economy data. Consumers were feeling inflation-battered, and that may have impacted consumer activity. As inflation has slipped to lower (though still too high) levels, consumers appear to be feeling better. Businesses, by contrast, appear to be growing more cautious.

Early in the month, the ISM Manufacturing Purchasing Managers Index (PMI) for June came in at 46.0, weakening from 46.9 in May and badly missing the 47.3 consensus call. Readings below 50 in this diffusion index reflect expectations for contracting manufacturing activity. Factory orders were reported up 0.3%, in line with the prior month though lagging the 0.9% consensus estimate.

Industrial Production for June declined 0.5%, weaker than the consensus call for a flattish reading but in line with the decline in May. Capacity Utilization, which remained above the optimal 80% level in 2022, declined to 89.9% in June from 79.4% in May.

Small businesses have been hurt by higher costs and a “skills mismatch” in the available labor pool. NFIB’s Small Business Optimism Index crept higher in June, however, rising to 91.0 from 89.4 for May. With more potential employees available due to large-company layoffs, wage pressure is abating at smaller companies.

Employment data for June was mixed. ADP Private Payrolls soared by 497,000, up from a gain of 267,000 in May and more than double the consensus call. Nonfarm payrolls growth, however, was more muted at 209,000, below the 213,000 consensus forecast and down from a revised 306,000 in May. Unemployment ticked down to 3.6% from 3.7%, while remaining above the cycle low of 3.4%. The annual change in hourly wage growth accelerated to 4.4% in June from 4.2% in May. The jobs economy, which has outperformed expectations for well over a year, remains sound but is finally showing signs of slowing.

Retail Sales rose by a sluggish 0.2% in June, missing the 0.5% consensus call. Consumer Sentiment, on the other hand, stunned with a July reading of 72.6, according to the University of Michigan Survey Center. That was up from 64.4 in June and was the highest reading in this series since September 2021. According to the survey, consumers appeared to be feeling good about the still solid labor market and signs of moderating inflation.

Inflation reports dominated the middle weeks of July. The June All-Items Consumer Price Index (CPI) was up 0.2% from the prior month and 3.0% from the prior year. Core inflation (less food and fuel) also rose 0.2% from May while rising a sharper 4.8% on an annual basis. Still, that was the first annual core CPI reading below the fed funds rate (5.0%-5.25%) since mid-2021. Further up the pipeline, prices are growing more slowly. The Producer

Price index (PPI) for June showed monthly changes of 0.1% in both all-items and core inflation. The annual change in the all-items PPI was just 0.1%, while core PPI was up 2.4%.

The Fed appears on track to raise rates at its July FOMC meeting. Even if it does, both investors and consumers recognize that most of the Fed’s work is done, and that rates are unlikely to go much higher. That is stimulating activity in the one area of the economy most impacted by interest rates: housing.

Housing starts showed surprising strength in spring 2023 but have since moderated slightly. In June, housing starts ran at a 1.43 million seasonally adjusted annual rate (SAAR), down from 1.56 million in May and slightly below consensus. Permits came in at a 1.44 million SAAR in June, down from 1.50 million in May. The June starts and permits numbers were still meaningfully above those seen in the winter months of 2023.

Houses available for sale are about 14% below prior-year levels, according to the National Association of Realtors (NAR). That is due to mortgage “handcuffs” (low mortgages on owned homes, versus high mortgages for prospective buyers) and years of insufficient new home supply. Existing home sales ran at a 4.16 million SAAR in June, down 3.3% from May but a sharper 18.9% from the prior year.

Builders, after turning deeply pessimistic as inflation raged, are finally feeling better about their prospects and are stepping up new home construction. In May, according to the U.S. Census Bureau, Construction Spending rose 0.9% — better than the 0.5% consensus call and up from 0.4% growth in April.

Conclusion

While business sentiment appears to be sinking, consumer sentiment is bobbing higher. That is a net positive for GDP given that consumer spending accounts for about 70% of gross domestic product. As of the final weeks of June, the Atlanta Fed’s GDPNow tracker was forecasting 2.4% growth in 2Q23 GDP. Argus projects 2.3% growth.

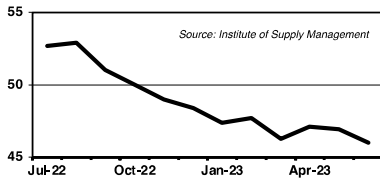
The second half, in our view, will be make-or-break for the U.S. economy. Argus projects 0.6% growth in 3Q23 GDP, followed by better but still subpar 1.1% growth in 4Q. Weak or potentially negative GDP readings in 3Q23 and/or 4Q23, along with disappointing earnings, could put the U.S. economy on the brink of recession.

Argus believes that the U.S. economy can avoid recession in the second half of 2023 and, for that matter, in 2024. Economists have been kicking the recession can down the road since early 2022. By mid-2024, we expect the Fed to have begun its rate-reduction cycle, responding to inflation that is finally back within its comfort zone.

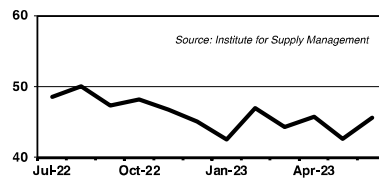
Jim Kelleher, CFA,
Director of Research

ECONOMIC TRADING CALENDAR

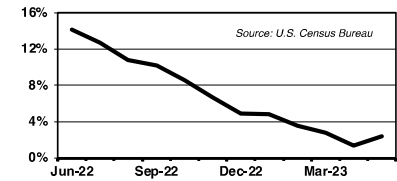
Release: **ISM Manufacturing**
 Date: 8/1/2023
 Month: July
 Previous Report: 46.0
 Argus Estimate: 47.0
 Street Estimate: 46.5



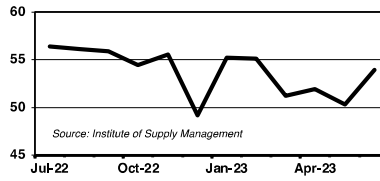
Release: **ISM New Orders**
 Date: 8/1/2023
 Month: July
 Previous Report: 45.6
 Argus Estimate: 46.0
 Street Estimate: NA



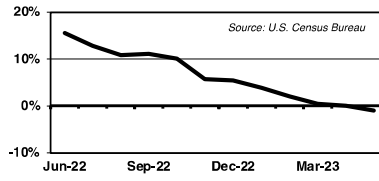
Release: **Construction Spending**
 Date: 8/1/2023
 Month: Jun
 Previous Report: 2.4%
 Argus Estimate: 2.5%
 Street Estimate: NA



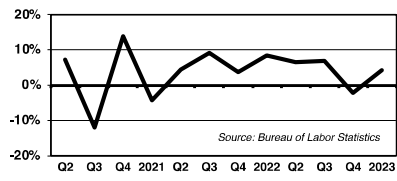
Release: **ISM Services Index**
 Date: 8/3/2023
 Month: July
 Previous Report: 53.9
 Argus Estimate: 54.5
 Street Estimate: 53.0



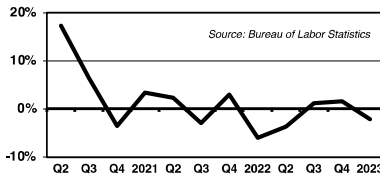
Release: **Factory Orders**
 Date: 8/3/2023
 Month: Jun
 Previous Report: -1.0%
 Argus Estimate: -1.0%
 Street Estimate: NA



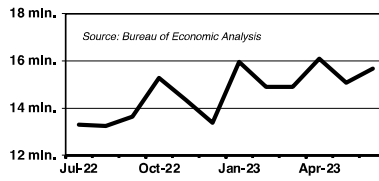
Release: **Unit Labor Costs**
 Date: 8/3/2023
 Month: 2Q
 Previous Report: 4.2%
 Argus Estimate: 3.0%
 Street Estimate: 2.6%



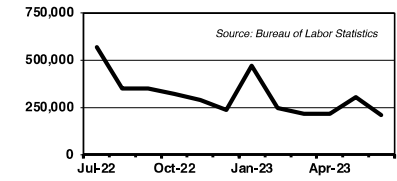
Release: **Nonfarm Productivity**
 Date: 8/3/2023
 Month: 2Q
 Previous Report: -2.1%
 Argus Estimate: 1.5%
 Street Estimate: 1.2%



Release: **Total Vehicle Sales**
 Date: 8/3/2023
 Month: July
 Previous Report: 15.68 mln.
 Argus Estimate: 15.75 mln.
 Street Estimate: NA

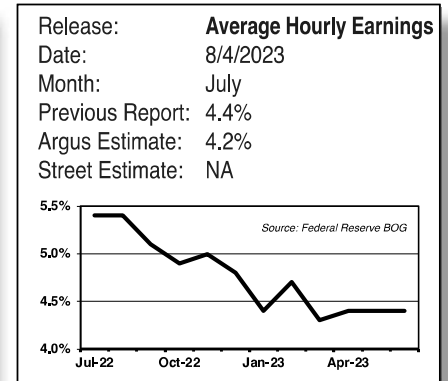
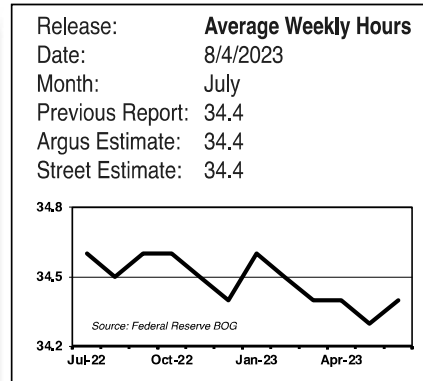
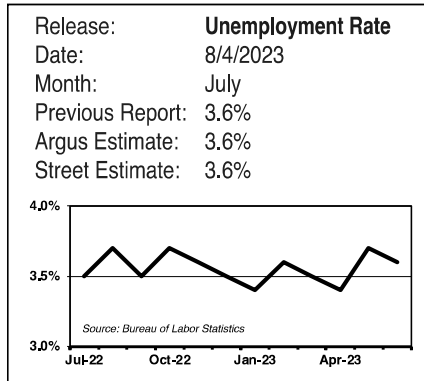


Release: **Nonfarm Payrolls**
 Date: 8/4/2023
 Month: July
 Previous Report: 209000
 Argus Estimate: 180000
 Street Estimate: 182000



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
25-Jul	Consumer Confidence	July	109.7%	112.0%	113.0%	NA
26-Jul	New Home Sales	June	763 K	725 K	721 K	NA
27-Jul	GDP Annualized QoQ	2Q	2.0%	2.3%	1.80%	NA
	GDP Price Index	2Q	4.1%	3.0%	3.00%	NA
	Durable Goods Orders	June	7.4%	5.2%	NA	NA
28-Jul	Personal Income	June	5.5%	5.0%	NA	NA
	Personal Spending	June	6.0%	5.5%	NA	NA
	PCE Deflator	June	3.8%	3.5%	NA	NA
	PCE Core Deflator	June	4.6%	4.2%	4.2%	NA

Next Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
8-Aug	Wholesale Inventories	June	3.7%	NA	NA	NA
	Trade Balance	June	-\$69.0 Bil.	NA	NA	NA
10-Aug	Consumer Price Index	July	3.0%	NA	NA	NA
	CPI ex-Food & Energy	July	4.8%	NA	NA	NA
11-Aug	PPI Final Demand	July	0.1%	NA	NA	NA
	PPI ex-Food & Energy	July	2.4%	NA	NA	NA

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