ARGUS®

ARGUS ECONOMIC COMMENTARY

November 6, 2023

Stubborn Inflation, Sturdy Consumers: Our Monthly Survey of the Economy, Interest Rates, and Stocks

Stocks continue to slouch toward year-end, shedding a percentage point here and a percentage point there from their early-year gains. The drivers of this shambling performance are hard to discern, as so many factors seem to be at cross-purposes. Inflation is stubborn, and chipping off the last few percentage points to get to the Fed's 2% inflation target is proving more challenging than anticipated. Another Fed rate hike may be in the offing, even though investors had largely ruled that out just a few months ago.

That's partly because the U.S. economy is doing so much better than anticipated at the start of the year. On our "Three E's" theme, the economy just delivered 4.9% GDP growth for the third quarter. Employment is rocking, with 336,000 new nonfarm payroll jobs created in September. And S&P 500 earnings for 3Q23 are now expected to increase in low to mid-single-digit range, representing the first positive EPS growth since 3Q22.

The Economy, Interest Rates, and Earnings

The advance (first) report on 3Q23 real GDP indicated very strong growth of 4.9%, up from 2.1% in the second quarter. In the first nine months of the year, the economy has expanded at a slightly below-trend pace, reflective of stable production and slow population growth.

For 3Q23, the increase in real GDP reflected growth in consumer spending, exports, private inventory investment, and state and local government spending. These gains were offset by a decline in nonresidential fixed investment and an increase in imports, which subtracts from GDP.

Year-to-date, the locus of GDP growth has shifted between consumers and businesses. First-quarter GDP growth featured a very strong consumer and slightly positive business spending. The second quarter featured a more cautious consumer, partly offset by strong trends in corporate investment. In the third quarter, the consumer roared back, while business spending turned slightly negative. This tag-team approach has led to 2%-3% GDP growth year-to-date. Private inventory investment grew in 3Q23, contributing about 1.3% of the overall 4.9% gain, after being neutral in 2Q23 and declining sharply in 1Q23. The GDP data suggests that the broad drawdown in distributor and OEM inventories related to supply-chain overhangs should wind down by year-end.

Personal consumption expenditures (PCE) jumped 4.0% in 3Q23 following a 0.8% gain in 2Q23. Consumer spending on goods increased 4.8% in 3Q23, led by pharmaceuticals and food. Durable goods spending has varied widely in 2023, rising 7.6% in 3Q and 14.0% in 1Q but falling in 2Q23. Nondurable goods spending grew 3.3% in 3Q. Services spending rose 3.6%, led by housing, utilities, healthcare, and financial services.

We believe that a key contributor to consumer spending has been the deceleration in housing activity, which is providing funds for everything else. Sales of vehicles, which have been strong, are now also being impacted by high interest rates and high prices. In addition, the now-ending UAW strike has impacted vehicle availability. We expect consumer spending to remain positive as consumers prioritize services and less expensive goods in a high interest rate environment.

Nonresidential fixed investment, a proxy for corporate capital spending, slipped 0.1% in 3Q after increasing 7.4% in 2Q23; first-quarter business spending was also strong at 5.7%. Corporate capital spending rose in every quarter of 2022.

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Within nonresidential fixed investment, corporate spending on structures grew 1.6% in 3Q after strong double-digit growth in the first half. Spending on equipment fell in 3Q, while spending on intellectual property grew 2.6%. Argus expects business spending to recover in 4Q23, but more slowly than overall GDP.

Residential fixed investment finally posted a positive number in 3Q23 (up 3.9%) after declining in every quarter since 1Q21. This housing-driven category fell 9.0% in 2022. Residential fixed investment could remain positive in 4Q23 and into 2024, but is likely to face pressure from high home prices and mortgage rates.

In 3Q23, exports rose 6.2% after falling 9.3% in 2Q23. Imports rose 5.7%, also rebounding from a down 2Q. Given higher imports compared with exports, net exports were very slightly negative in 3Q23 GDP.

Total government spending rose a higher-than-normal 4.6%. Federal spending rose 6.2%, led by 8% growth in defense spending amid conflicts in Europe and the Middle East. State & local government spending was also strong at 3.7% after rising just 0.2% in 2022.

Outside the GDP report, the jobs economy soared in September, confounding the Fed's efforts to rein in inflation. Nonfarm payrolls grew by 336,000, while July and August were revised higher by 119,000. The three-month average gain rose from a tame 150,000 to a robust 266,000. We continue to expect nonfarm payrolls growth to fall below 200,000 and stay there, but we have been saying that for over a year.

The unemployment rate held steady at 3.8% in September, while annual wage growth edged down to 4.2% from 4.3% in August. Annual wage growth is slightly ahead of PCE core inflation, which rose at a 3.7% pace in September. Although the September payrolls number put a possible December rate hike back on the table, we believe that the Fed will refrain from further hikes through the remainder of the year.

Industrial indicators suggest that most parts of the economy are growing at a subdued rate. Durable goods orders rose 4.7% in September, rebounding from a summer decline that reflected the timing of Boeing aircraft orders. ISM's manufacturing PMI improved to 49.0 in August. While posting its eleventh straight reading in contraction territory (below 50), the purchasing managers' index extended its recovery from July and June. The services PMI continued to signal expansion, rising to 53.6 in September (though down from 54.7 in July).

Signals from the consumer economy remain mixed. Retail sales rose 0.7% month-over-month in September, compared to growth of 0.8% in August and 0.5% in July.

The University of Michigan Consumer Sentiment index fell to 63.8 in October 2023 from 67.9 in September on inflation "weariness." The index of expectations fell more sharply than the current conditions index, meaning that consumers are not expecting price relief anytime soon. The Conference Board's consumer confidence index also fell to 103.0 in September from 108.7 in August. Both series have come down from their 2023 peaks in May and June but remain above fall 2022 levels.

The housing economy remains moribund, with would-be sellers unwilling to give up a low-rate mortgage for a high-rate mortgage. Two-thirds of existing mortgages have rates below 4%, while current 30-year fixed mortgage rates are above 8%. Every housing market indicator, including new and existing home sales, new starts and permits, and the inventory of existing homes, is down in the double digits this year. The upside of the dead-in-the-water housing economy is that consumers are spending on everything else.

In 2022, real GDP increased 1.9%, compared to an increase of 5.8% in 2021 (both reflect the NEA revisions from September 2023). Reflecting the 3Q GDP surge, our GDP growth forecast for 2023 is 2.3%. The Atlanta Fed's initial GDPNow forecast calls for 2.3% growth in 4Q23, moderating from 3Q. Argus expects 1.1% growth in 4Q23.

Our GDP growth forecast for 2024 remains 2.2%; we expect this forecast to remain volatile. We also believe that the U.S. economy can avoid recession in 2023 and 2024.

The Fed has left the door open to at least one more hike in this cycle, possibly in December 2023. Despite strong employment data, healthy consumer spending, and a reasonably solid industrial economy, Argus continues to believe the Fed's 2022-2023 rate hike campaign is over. The decline in inflation has slowed, partly due to energy prices, but inflation continues to come down.

The FOMC did not meet in October after holding rates steady at its September meeting. Fed Chair Jerome Powell has sustained a hawkish tone given the stickiness of certain components in the PCE price index (the Fed's preferred inflation-tracking tool).

The annual change in the core PCE price index fell to 3.7% in September from 3.8% in August and 4.3% in July. And the all-items PCE was up 3.4% annually despite the surge in energy prices since midyear. But while goods prices are up just 0.9% over the past year, services prices are up more than 4%. Housing inflation (shelter), which represents about one-third of total inflation, has been particularly sticky

Stubborn and even resurgent inflation contributed to the rising rate environment in September and October. Rates at the short end of the curve began to stabilize in July and were little changed in late October as investors anticipated the end of the Fed's rate hike cycle. But rates at the long end continue to move higher.

The two-year Treasury yield was 4.99% at the end of October, compared to 5.02% at the end of September. The five-year yield moved to 4.76% from 4.60% at the end of

September. And the 10-year Treasury yield ended October at 4.84% after ending September at 4.60%. The 30-year Treasury bond ended October at 5.03% after ending September at 4.73%.

The twos-10s spread was 15 basis points as of the end of October, its lowest level of inversion since July 2022. Economists are divided as to whether yield-curve inversion accurately predicts recession. Ironically, recession forecasts have had a recurrence of late even as inversion has reached its lowest level in over a year.

The bond market fulfilled our expectations that the entire yield curve would move higher in 2022, carrying well into 2023. With inflation showing signs of slowing and the Fed's hiking cycle potentially finished, we expect to see a slower rise in interest rates going forward. At some point, interest rates may finally begin to decline – but that now seems more likely to occur later in 2024 than early next year.

The 3Q23 earnings season is well underway, with nearly half of S&P 500 component companies having reported results. Earnings are up in the low single digits — a few percentage points higher than the prereporting consensus. The earnings "beat" is a standard-issue part of any reporting period, but we would argue that it is more important than normal this time.

In a reversal of recent past trends, Financial Services stocks are so far helping earnings, while Technology stocks are hurting. The best-performing sectors to date include Energy and Financial Services, along with Consumer Discretionary, Consumer Staples, and Healthcare. Technology is lagging, and a handful of smaller sectors are also negative.

Our data sources include entities such as FactSet and Refinitiv, which provide a "blended" EPS growth estimate that combines data from companies that have reported with estimates from companies that have yet to report. Bloomberg provides cumulative data based on companies that have reported to date, as well as its own blended estimate.

As of 10/30/23, with 49% of companies having reported, FactSet's blended 3Q growth estimate rose to 2.7% from -0.4% a week earlier; that earlier blended estimate was based on a more limited data set, with just 16% of companies having reported at the time. As of 10/30/23, Refinitiv had a blended earnings growth estimate of 4.3%, up from 1.2% a week earlier (which also reflected a much smaller sample size). Bloomberg's actual 3Q23 earnings tracker shows EPS growth of 6.6%, up from 4.4% a week earlier.

In any reporting quarter, 70%-80% of companies will exceed consensus expectations; and the magnitude of that "beat" will average 5%-8%. All three of the reporting entities show 74%-78% of companies beating expectations, and doing so by 6%-7% against consensus. Reversing the trend from the past year, revenue growth is currently running at a slower rate than EPS growth. Bloomberg reports 3Q23 revenue growth of 2.5% to date, weighed down by the Energy and Basic Materials sectors.

Our final 2022 estimate of S&P 500 earnings from continuing operations was $222. Following low single-digit EPS declines in 1Q23 and 2Q23, we look for mid-single-digit EPS growth in 3Q23. We also expect 4Q23 EPS from continuing operations to grow about 11% against a weak year-earlier comparison. For now, we are maintaining our 2023 earnings estimate of $226, implying low single-digit growth from 2022.

For 2024, our forecast for S&P 500 earnings from continuing operations is $245. That estimate implies normal high single-digit EPS growth in a market in which inflation is no longer the chief topic and interest rates are stable or possibly declining.

After a recovery through the first seven months of 2023, the S&P 500 crashed more than 9% in August through October. At present, the two-year forward P/E on our 2023 and 2024 non-GAAP EPS forecasts is 17.5; that is about 11% below the prior five-year (2018-2022) average of 19.6. Reflecting inflation and interest rates that are currently higher than they have been over the past five years, as well as other inputs, our adjusted earnings-yield model continues to signal overvaluation in stocks.

Domestic and Global Markets

Nearly every major U.S. index and sector and most major global markets extended September weakness into October, after declining more modestly in August. September's blowout nonfarm payrolls report raised the odds of more Fed rate hikes. Fears that the Israeli-Hamas war would widen into a regional conflict also weighed on the market. In all, our composite of six domestic equity indices and one bond index ended October up 5.7% year-to-date, down from 10.2% in September and 13.0% in August.

The selling has chipped away at growth index leadership while sending several indices into negative territory. Major index performance in 2023 remains divided 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 October, the Nasdaq led with a 22% gain. The S&P 500 was up 9%. The DJIA slipped to a fractional year-to-date decline, deeply lagging the leaders.

Although the broad market (the S&P 500) remains positive year to date, its performance from August through October has demonstrated that those gains are far from guaranteed given high interest rates and still high inflation. The highly contentious presidential election campaign season is now underway, tearing at the fragile fabric of

consumer confidence. We have been saying that bearish investors will need to capitulate at some point; but right now, the trend favors bears sitting tight and waiting for the market to come to them. And while bullish investors are anticipating lower rates in 2024, the may be waiting longer than previously anticipated for a Fed pivot.

Growth sectors soared on spiking AI interest in the May through July period before stumbling in August through October. But no sector has been spared in the recent selling. And because many sectors did not have the performance "cushion" that growth sectors carried into the correction phase, all but three sectors were down year-to-date as of the end of October.

Concentration in perceived AI winners drove gains in growth sectors – Communications Services, Technology, and Consumer Discretionary – in the first seven months of 2023. Although these sectors have corrected, they continue to lead for the year with gains of 35%, 33%, and 19%, respectively.

Every sector lost ground in October relative to the end of September. Three sectors that were positive at the nine-month mark – Energy, Industrials, and Materials – slipped into negative territory as of the end of October. They join the five other sectors (Utilities, Real Estate, Healthcare, Financial Services, and Staples) that were down a month earlier. Breadth deterioration is notable from the end of August, when only three sectors were negative year-to-date.

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. Argus had expected to see a more broad-based advance from a sector perspective in 2023. With just two months left in the year, any full-year gains now appear likely to be concentrated in growth sectors — and only because these sectors had a running six-month start.

Like the U.S. market, global stocks are doing better in 2023 than they did in 2022. But they have also been subject to profit-taking in the August-October period. Unlike in September, when a few markets in our survey gained month-over-month, every market lost ground in October.

On average, our composite of global bourses (which no longer includes Russia) is up 4% year-to-date, down from an 8% gain at the end of September and a nearly 15% gain at midyear. Global theme leadership has also undergone significant change over the last year.

In terms of our themes, mature economies lead with a 9% year-to-date gain; developed world central banks show signs of ending their rate hike cycles. Asia is up 5%, reflecting year-long strength in Japan. Markets in the Americas (including the U.S., Brazil, Mexico, and Canada) are up 4% in 2023, as the U.S. and Mexico continue to surrender early-year gains. Resources economies are up 2%. BRICs-minus-Russia are down less than 1% in 2023, lagging the average due to a double-digit decline in China.

Conclusion

The stock market is on pace for three straight down months in August through October, and concerns that the Fed will again hike rates have been a key driver. Investors have pushed out expectations for the first Fed rate cuts to the second half of 2024, and that too is weighing on stocks.

Not everything is doom and gloom. If expectations are met, the S&P 500 in October and November 2023 will record its first positive earnings season since 3Q22. The government has once again dodged a shutdown, at least through mid-November. And the fourth quarter is statistically the best quarter for stocks in any year.

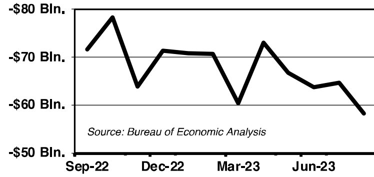
Inflation is stubborn, given ongoing wage growth, high shelter and energy costs, and other factors. The Fed has pledged to be "resolute" until inflation is back to its 2% target range.

The consumer economy appears sturdy, at least partly because consumers are not spending on housing and thus have the ability to spend on everything else. Stubborn inflation and sturdy consumers seem to be at a standoff. Assuming neither side falters, the outlook is for muddling-through into year-end.

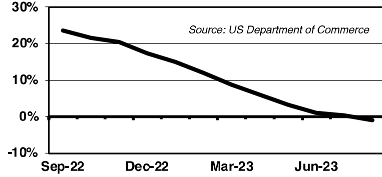
Jim Kelleher, CFA,
Director of Research

ECONOMIC TRADING CALENDAR

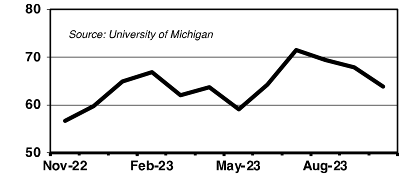
Release: **Trade Balance**
Date: 11/7/2023
Month: September
Previous Report: -$58.3 Bln.
Argus Estimate: -$60.0 Bln.
Street Estimate:



Release: **Wholesale Inventories**
Date: 11/8/2023
Month: September
Previous Report: -1.0%
Argus Estimate: -1.3%
Street Estimate: NA



Release: **U. of Michigan Sentiment**
Date: 11/10/2023
Month: November
Previous Report: 63.8
Argus Estimate: 62.5
Street Estimate: 65.0



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
31-Oct	Consumer Confidence	October	103.0	99.0	100.0	NA
1-Nov	ISM Manufacturing	October	49.0	49.4	49.0	NA
	ISM New Orders	October	49.2	50.0	NA	NA
	Construction Spending	September	7.4%	7.0%	NA	NA
2-Nov	Nonfarm Productivity	3Q	3.5%	4.0%	4.0%	NA
	Unit Labor Costs	3Q	2.2%	1.0%	1.0%	NA
	Factory Orders	September	0.5%	1.3%	NA	NA
3-Nov	Nonfarm Payrolls	October	336 K	160 K	164 K	NA
	Unemployment Rate	October	3.8%	3.8%	3.8%	NA
	Average Weekly Hours	October	34.4	34.3	NA	NA
	Average Hourly Earnings	October	4.2%	4.1%	NA	NA
	ISM Services Index	October	53.6	53.0	53.0	NA
	Total Vehicle Sales	October	15.67 Mil.	15.40 Mil.	NA	NA

Next Week's Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
14-Nov	Consumer Price Index	October	3.7%	NA	NA	NA
	CPI ex-Food & Energy	October	4.1%	NA	NA	NA
15-Nov	PPI Final Demand	October	2.2%	NA	NA	NA
	PPI ex-Food & Energy	October	2.7%	NA	NA	NA
	Retail Sales	October	3.8%	NA	NA	NA
	Retail Sales ex-autos	October	3.2%	NA	NA	NA
	Business Inventories	September	1.0%	NA	NA	NA
16-Nov	Industrial Production	October	0.1%	NA	NA	NA
	Capacity Utilization	October	79.7%	NA	NA	NA
	Import Price Index	October	-1.7%	NA	NA	NA
17-Nov	Housing Starts	October	1,358 K	NA	NA	NA

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