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Manufacturing & Digital recession = S&P 500 profit recession, but not for jobs

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IN A NUTSHELL

– Manufacturing starts year with further weakness; on demand, not supply strains
– Past profit recessions from weak manufacturing, but now digital is weak too
– Still tracking 4Q22 results: S&P 4Q22 EPS likely $53.50 and $222.50 for 2022
– The fight with inflation isn't over: Taming service inflation is the big challenge
– We now consider the risk of a near-term S&P 500 10%+ correction to be high

Manufacturing starts year with further weakness; on demand, not supply strains

The US manufacturing Institute for Supply Management (ISM) Purchasing Manager Index weakened to 47.4 for January and the forward-looking new orders index deteriorated to 42.5 in January vs. 48.4 in December. This week's Industrial Production report for January was flat overall, but December was revised to a larger decline and capacity utilization slipped to 78.3%. The Empire State and Philly Federal Reserve (Fed) regional manufacturing surveys reported early February indications that were both still in contraction with Philly sharply diving this month after the Empire took a dive last month.

Weakness in goods production appears to be much more about demand than supply, as inventories are rising. While some supply chain challenges remain, overall availability of inputs is good; albeit more costly as January's Producer Price Index (PPI) report shows. Goods demand weakness is centered at consumer durable goods on a combination of lesser affordability from higher prices and financing costs and consumers diverting their spending power to services and higher priced staple items like food. Some industries did show January production improvement, such as auto, electronics, metals and machinery. But such production problem fix bounce backs are into soft end demand suggesting more price pressure risk.

Past profit recessions from weak manufacturing, but now digital is weak too

Gross domestic product (GDP) and jobs recessions are usually accompanied with sharp S&P 500 profit declines and the manufacturing ISM always falls into contraction territory during recessions. But there were several times when S&P 500 earnings declined out of economic recessions, such as 1967, 1985-86, 1998 and 2015-2016. All of these "profit recessions" were accompanied by the manufacturing ISM dipping below 50 for an extended period. The mfg. ISM has now been below 50 since November 2022. Whether the economy slips into recession or not, there are now clear signs of a profit recession in progress led by manufacturing. But in addition to manufacturing and goods demand weakness, there is weakness or at least a pause in growth at the digital economy too. Manufacturing & Digital are two-thirds of S&P 500 earnings per share (EPS). Only Financials and Healthcare are sectors without macro headwinds right now, but even at these sectors we expect very little earnings growth in 2023. Thus, while S&P EPS can still be flat in 2023 with second half (2H) growth, it's likely a very broad-based stall in earnings growth.

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Still tracking 4Q22 results: S&P 4Q22 EPS likely $53.50 and $222.50 for 2022

S&P 4Q22 earnings are near 90% reported, 4Q EPS will likely finish at $53.50 or -3% y/y, which puts 2022 full year S&P EPS at about $222.50. Analyst consensus bottom-up 2023 S&P EPS has been cut significantly from $234 on Nov 1st last year to $224 now, mostly at 1Q and 2Q. Our long standing forecasts are $225 for full 2023 and $53 and $56 for 1Q and 2Q, both down 3-4% on y/y basis. We still expect S&P EPS y/y growth to be positive in the 2H of 2023. But we see downside risks to our forecasts given the weak macro signals at goods and very cautious company commentaries at digital during 4Q earnings season. Our 2H estimates require better industrial activity or a weaker dollar and higher oil prices.

The fight with inflation isn't over: Taming service inflation is the big challenge

We've argued that the fight with inflation isn't over and the most difficult part lies ahead to get it consistently under 4% and back toward 2%. Time is running out for this to be achieved before lasting damage is done to long-term inflation expectations and what the bond market demands as an adequate long-term inflation risk premium. Goods disinflation was the easy part, albeit commodity inflation risk remains. Such as the recent further jump in food prices show. This should subside, yet energy cost risks remain. Nevertheless, the key issue is taming services inflation amidst an extremely tight labor market that isn't happy about pay. Price increases are outpacing wage growth and wage growth is outpacing productivity. This is misery for both workers and employers. This won't be fixed without improved productivity. But better productivity will be difficult to achieve if the Fed doesn't soon stop the economic uncertainty and dysfunction that comes from high and volatile inflation. Upon the January jobs, inflation and retail spend reports, the bond market reversed expectations for rate cuts in late 2023 and drove up the expected terminal Fed Funds rate and Treasury yields across the curve. Rising real yields usually pressure stocks, particularly when PEs are high and EPS isn't depressed from a recent recession. The year-to-date (YTD) rally pushed the median forward PE of S&P 500 stocks to 20.2 vs. 17.8 average of medians since 1995.

We now consider the risk of a near-term S&P 500 10%+ correction to be high

Our next 5%+ S&P 500 price move signal remains Down and we adjust risk of a 10%+ correction from Moderate to High. Our favored S&P sectors remain: Health Care, Communications, Banks. Least favored: Consumer Discretionary, Materials and now Tech.

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Glossary

Capacity utilization refers to the share of an economy's productive capacity that is in use.

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

The core producer price index (PPI) measures the change in the selling price of goods and services sold by producers, excluding food and energy.
describes a slowing of the pace of price inflation.

Disinflation describes a slowing of the pace of price inflation.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Headline inflation is the raw inflation figure based on the consumer price index (CPI) and not adjusted for seasonality or for the often volatile elements of food and energy prices.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The ISM Purchasing Manager Index, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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