Sunpointe
Investments

Economic Review

October 2023

Labor market bucks the trend again in September - is inflation starting to creep higher?

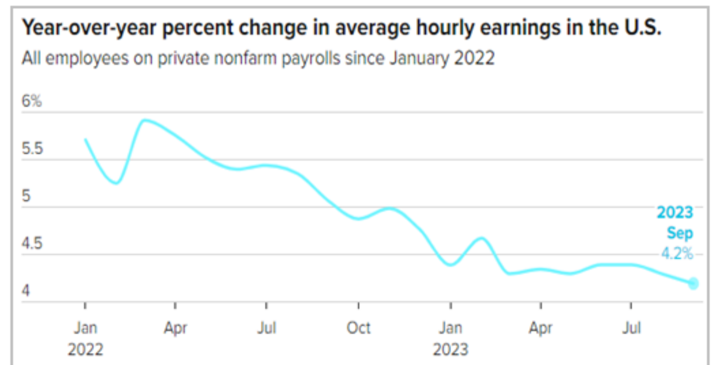
U.S. employers added 336,000 new jobs to the economy in September, well ahead of the 170,000 estimate. The unemployment rate held steady at 3.8%, slightly ahead of the 3.7% forecast. Wage increases, however, were softer than expected, with average hourly earnings up 0.2% for the month and 4.2% from a year ago, compared to respective estimates for 0.3% and 4.3%. Service-related industries contributed 234,000 to the total job growth, while goods-producing industries added just 29,000. From a sector perspective, leisure and hospitality led with 96,000 new jobs. The previous two months saw substantial upward revisions. August's gain is now 227,000, up 40,000 from the prior estimate, while July moved to 236,000, from 157,000. Combined, the two months were 119,000 higher than previously reported. Treasury yields moved higher on the report and the probability of another rate hike before year-end increased to 43%.

Prices increased at a faster-than-expected pace in September, keeping inflation in the spotlight for the Fed. Headline CPI increased 0.4% month-over-month (M/M) in September or 3.7% year-over-year (Y/Y). Core CPI increased 0.3% M/M and 4.1% Y/Y, both in-line with expectations. In keeping with recent trends, shelter costs were the main factor in the inflation increase. The index for shelter, which makes up about one-third of the CPI weighting, accelerated 0.6% M/M and 7.2% Y/Y. The Fed's preferred inflation gauge, the PCE Index, has posted slightly lower readings over the past few months.

Retail sales advance while PMIs send mixed signals about the U.S. economy

Retail sales in the U.S. advanced 0.6% M/M in August 2023, higher than both a downwardly revised 0.5% rise in July and the market's 0.2% August estimate. The data continue to point to robust consumer spending despite high prices and borrowing costs. The increase was driven by spending at gas stations, which advanced 5.2% last month. Excluding sales at gasoline stations, retail spending advanced a more modest 0.2% M/M in August. Spending increased across most categories, including at restaurants and grocery stores.

The U.S. manufacturing sector strengthened in September but remains in contraction territory. The ISM Manufacturing PMI rose to 49.0 (from 47.6) on the heels of strength in production, employment, and new orders – a number below 50 implies contraction. U.S. service sector activity slowed in September led by softness in new orders and employment. Production strengthened and prices were flat.



Source: U.S. Bureau of Labor Statistics via FRED

Economic uncertainty continues in Europe & Japan

The eurozone private sector remained in contraction at the end of the third quarter as waning demand led to a further decline in activity. The overall reduction in output was again led by manufacturing, but the service sector saw an activity decrease for the second straight month. Despite the weak demand environment, input costs continued to rise sharply, and the rate of inflation picked up from August. The headline composite PMI was 47.1 in August with services sitting at 48.4 and manufacturing at 43.4. Based on this data, an economic contraction in Q3 is looking more likely. Annual inflation in the eurozone cooled to its lowest level since October 2021, falling to 4.3% in September from August's 5.2% reading, Month-over-month inflation dipped from 0.5% to 0.3%, while core inflation dropped to 4.5% Y/Y in September from 5.3% in August.

Japan's economy grew at a slower pace than initially estimated in Q2 as businesses and consumers pulled back more than expected. GDP grew at an annualized 4.8% from the previous three months with the expansion almost entirely reliant on overseas demand. That was a smaller gain than the preliminary reading of 6.0% and well below economists' forecast of 5.6%. Capital investment was revised down to a 1.0% decline in Q2, and private consumption fell 0.6% vs. the initial -0.5% estimate.

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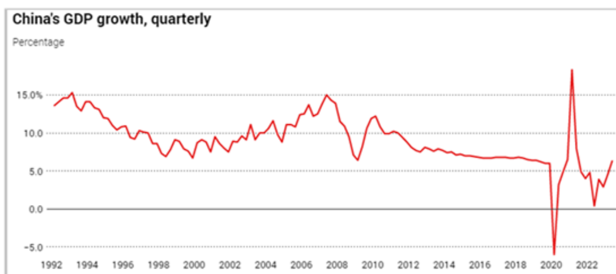
Mixed signals continue on China's economy, signs point to ongoing weakness

China's official manufacturing PMI rose to 50.2 from 49.7 in August, the first reading above 50 since March, according to the National Bureau of Statistics. Activity in services and construction also accelerated last month, according to a separate index that hit 51.7, its best level in three months. The smaller company focused Caixin China Manufacturing PMI slipped to 50.6 in September from 51.0 in August. The Caixin China General Service PMI dropped to 50.2 in September 2023 from 51.8 in August, pointing to the softest increase in services activity since the start of the year as both business activity and new orders showed slow growth. China's official services PMI rose slightly last month to 51.7 from 51.0 in August. Industrial production also increased 4.5% in August Y/Y, accelerating from the 3.7% growth registered in July. Retail sales rose 4.6% in August, the fastest growth since May.

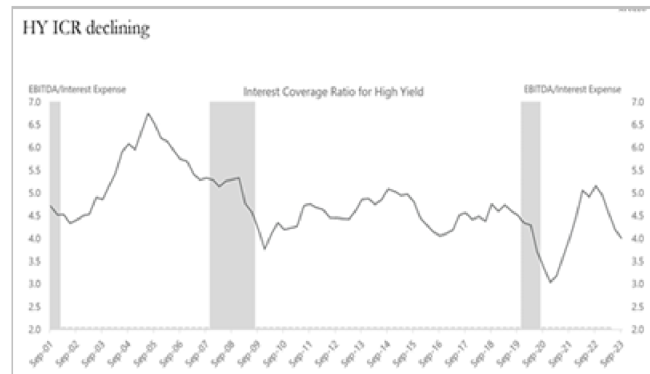
While many global investment banks have ratcheted down their economic growth forecasts for China in recent months, the IMF still believes 5% growth is achievable this year. In addition, the World Bank cut its 2024 forecast for China GDP growth to 4.4% from 4.8%, citing persistent difficulties such as elevated debt, the property market crisis, and an aging population.



Source: Bloomberg, Apollo

Are credit fundamentals deteriorating?

U.S. corporate fundamentals remain solid, but cracks and stress are starting to appear as the impact from higher rates/borrowing costs cut into profitability. Spreads have remained quite tight despite the economic uncertainty and tighter lending standards in place, and defaults have trended higher, albeit from historically low starting levels. The stress ratio has picked up within high yield and loans along and downgrades are outpacing upgrades. High yield has seen the benchmark increase in quality over the past few years while the floating rate loan benchmark quality has deteriorated.



Source: Bloomberg, Apollo

U.S. corporations in general have capitalized on the decade plus zero interest rate environment to shore up their capital structures and push out debt maturities for a few years. High yield interest coverage ratios sit at solid levels today, but they have fallen over the past year.

Have earnings troughed? Watch the concentration!

Economists expect the aggregate S&P 500 index will post flat Y/Y profit growth in the third quarter, while revenues are forecast to grow 2% Y/Y. At the sector level, consensus is most optimistic on Communication Services EPS (+28%) and most pessimistic on Energy EPS (-38%). Earnings have contracted for three consecutive quarters. Excluding the energy sector, S&P 500 earnings are projected to grow 5% Y/Y. Earnings revisions for 2023 and 2024 S&P 500 EPS suggest the profit outlook has stabilized. Analysts expect growth to return in corporate earnings starting in Q4 and full year 2023 estimates sit at +1%. Top-down EPS estimates from several investment banks sit at approximately 5% for both calendar year 2024 and 2025. Bottom-up analyst estimates for 2024 and 2025 are currently 12% and 11%, respectively.

Concentration in the S&P 500 is something to watch moving forward as all the return this year has been driven by just a handful of mega-cap tech/growth stocks. These companies have outperformed on the heels of stronger than expected earnings growth relative to the broader benchmark. The Magnificent 7 (M7) represent 17% of S&P 500 EPS today and that number is expected to grow to 24% by 2025. The other 493 stocks in the S&P 500 are now flat for the year along with the equal weighted index. Valuations have fallen over the past 2 months but the M7 are still up ~55% YTD.

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