Wellington Shields

DO EARNINGS AND INTEREST RATES STILL MATTER?

Contrary to many predictions at the beginning of the year, stocks have advanced nicely for the first half of 2023. While gains in the second quarter were still concentrated in large technology companies, market breadth broadened. On an equally weighted basis, the S&P 500 total return was 7% for the first half of the year.

Financial markets react not only to the level of economic data, but also to the direction and rate of change—and a lot has improved in the U.S. this year. To date, the percentage of people employed increased by 1% to an all-time high of 156 million, while unemployment hovers near the multi-decade low of 3.5%. With inflation falling, real disposable income increased 2.5% through May. Contributing to the current robust employment situation are many areas of the economy that are thriving, including fossil fuel production, new homes under construction, reshoring of manufacturing, and the beneficiaries of the $280B CHIPS Act and the $437B Inflation Reduction Act.

There are risks this current economic strength could diminish. The U.S. Bureau of Labor Statistics reported 209,000 jobs were created in June, which fell short of estimates. More importantly, the rate of growth in private sector job creation continues to slow, reaching 159,000 in June. This figure has consistently slowed for the past 12 months. The U.S. labor market does not appear to have rolled over enough to remove concerns about wage inflation yet, and the Federal Reserve has forecast additional interest rate increases. Price inflation likely peaked in mid-2022, however core inflation was still 4.8% on a year-over-year basis in June.

For these and other reasons, aggregate earnings expectations for both fiscal year 2023 and 2024 have been revised significantly lower since early 2022. The U.S. Treasury yield curve remains inverted, and the Conference Board's Leading Economic Index has been in decline for 14 consecutive months, all while interest rates have been rising.

We believe the stock market is trading at one-year highs based upon the assumptions that there will only be a mild economic slowdown, a consistent drop in inflation, and the Fed will not hike rates more than expected. To extend the gains meaningfully from here, however, we think we will have to see interest rates falling, economic growth re-accelerating, or an increase in S&P 500 earnings estimates. As to earnings and interest rates—both continue to matter.

July 2023