Yardeni Research

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Morning Briefing

Consumers, Tech Infusions & AI

Check out the accompanying chart collection.

Executive Summary: With good incomes and debt that isn't growing faster than incomes, consumers have been spending apace over the past quarter, but selectively. Jackie shares insights into what they've been buying and passing up, gleaned from the quarterly conference calls of two retail giants, Walmart and Home Depot. … Also: Changes to the composition of two Dow Jones indexes—the DJIA and DJTA—bring more technology exposure via Amazon and Uber. Exposure to high-flying tech stocks has given an outsized boost to the performance of several S&P 500 sectors' indexes lately. ... And in our Disruptive Technologies segment: How WPP uses AI to optimize its advertising and marketing services.

Consumer Discretionary: A Mixed Picture. US consumers are definitely picking and choosing where to spend—and not spend—their hard-earned dollars. Walmart reported that US customers had their wallets open, with US same-store-sales (excluding fuel) up 4.0% y/y in fiscal Q4 ending January 31. Conversely, in Home Depot's fiscal Q4 ending January 28, US same-store sales fell 4.0% y/y (-2.7% in November, 0.6% in December, and -9.1% in January).

Much of the disparity can be blamed on lofty interest rates. Higher borrowing costs make consumers less likely to take out a loan to fund a large, expensive renovation on an existing home or a new one. But higher borrowing costs are less likely to dissuade consumers from purchasing a loaf of bread or most other items that Walmart sells.

Let's take a look at some of the important insights that the CEOs of these two giant retailers passed on in their quarterly calls as we take the consumer's temperature:

(1) *Inventories look clean.* Both retailers managed to reduce their inventories, which helped improve their cash flow. Walmart's inventories declined 3.0% y/y in fiscal Q4 to $54.9 billion even as the company's net sales increased 5.6% to $171.9 billion (excluding memberships and other income). Lower inventories helped the company boost its net cash from operating

activities to $35.7 billion in fiscal Q4, up from $28.8 billion in the year-ago quarter.

The change at Home Depot was even more dramatic, with inventories decreasing by 15.7% to $21.0 billion. In Home Depot's quarter net sales declined 2.9% to $34.8 billion, but the decline in inventories helped to boost cash flow from operating activities by $6.6 billion to $21.2 billion. In addition to being hurt by a decline in purchases related to large projects, Home Depot's sales were also depressed by deflation in lumber and copper wire prices.

(2) *Awaiting the housing rebound.* Home Depot CEO Edward Decker is optimistic that the home improvement industry will bounce back from its current downturn. Home prices and home equity are up sharply, while home equity loans are at multiple-year lows. "You have tremendous potential in an untapped balance sheet and equity position in homes," he said on Tuesday's earnings *conference call*.

The need to renovate is as strong as ever, with more than 50% of the housing stock older than 40 years and many people working from home. Meanwhile, there's a shortage of new homes being built, and the turnover of existing homes is at 40-year lows just as millennials reach their prime homeownership ages. If the Federal Reserve starts cutting interest rates in the second half of this year, then next year the housing and renovation markets should normalize.

(3) *Looking ahead.* What are these retail giants anticipating in 2024? At Walmart, more of the same is expected for the rest of the current fiscal year (ending January 2025). Company sales are expected to increase 3.0%-4.0%, operating income should improve a bit more, 4.0%-6.0%, with adjusted earnings of $6.70-$7.12 a share. Wall Street analysts' consensus earnings estimate was $7.06 per share. Earnings per share do not reflect the 3-for-1 stock split that will occur on February 23.

Home Depot's outlook for this year is more muted, with total sales growth of 1% and same store-sales growth of -1%. Consumers are still spending more at Home Depot as a percentage of their personal consumption expenditures than they did before the Covid pandemic, a metric that's slowly reverting to 2019's lower levels. US retail sales of building materials, garden equipment and at supply dealers jumped sharply during the pandemic and has slowly been reverting to the historical trendline (*Fig. 1*).

"[T]he consumer is healthy, and the consumer is engaged. They just [are] engaged at this point in smaller projects," explained Home Depot's Decker.

Walmart shares rose 3.2% on the earnings news, while Home Depot shares were essentially flat. Over the past year through Tuesday's close, Home Depot's shares rose 14.0%, while Walmart's shares jumped 20.1% and the S&P 500 trumped both stocks, gaining 22.0%.

(4) *Jobs plentiful and wages rising.* US consumers with change in their pockets are a retailer's best friend. And right now, consumers have both jobs and rising wages. The unemployment rate, at 3.7% in January, remains near historical lows despite high-profile headlines of layoffs, particularly at technology and financial companies (*Fig. 2*).

Meanwhile, wages as measured by YRI's Earned Income Proxy (EIP)—nonfarm payrolls times average weekly hours times average hourly earnings in private industries times 52—has been climbing both on a nominal and inflation-adjusted basis. The real EIP rose 3.2 y/y in December to $6.8 trillion (*Fig. 3*).

Consumers are still spending, but on specific items. Retail sales excluding motor vehicles and parts and gas stations rose 2.2% y/y in January. Consumers returned to eating out after the pandemic ended and haven't stopped since. Retail sales at food services and drinking establishments rose 6.3% y/y in January (*Fig. 4*). Online sales jumped 6.4% y/y (*Fig. 5*). Spending in general merchandise stores and warehouse clubs has been strong as well.

(5) *An eye on consumer debt.* Consumer debt hit a new record of $5.0 trillion in December, up 2.4% y/y. Driving that increase is a jump in outstanding revolving credit to $1.3 trillion in December, up 8.4% y/y, while nonrevolving debt has been flat over the past year (*Fig. 6*). Auto loans outstanding have been rising sharply along with credit card loan balances. Student loans outstanding peaked in Q1-2023 and have fallen slightly thanks to various debt forgiveness plans. Meanwhile, home mortgage debt has been rising to new record levels, while home equity debt remains near its recent lows (*Fig. 7*, *Fig. 8*, and *Fig. 9*).

Despite the large numbers, consumer debt hasn't grown much faster than consumer income. Consumer debt as a percent of disposable personal income—at 24.3% in December—is right around levels typical of the past 20 years, with a few exceptions (during a few years, it climbed to between 25% and 26%; during the pandemic, it fell to a low of 19.3%) (*Fig. 10*).

The low interest rates of previous years have allowed consumers to refinance their interest payments at more favorable rates. As a result, consumers' debt-service ratio (the ratio of debt-service payments to disposable personal income), at 9.8% in Q3, is near historically low levels, excluding the pandemic-affected years (*Fig. 11*).

Strategy: Dow Gets Techier. News on Tuesday that Amazon will be added to the Dow Jones Industrial Average (DJIA) and Uber Technologies will be added to the Dow Jones Transportation Average (DJTA) underscores how influential technology has become in our economy. Amazon and Uber, with stock prices of $167.08 and $76.60 as of Tuesday's close, will affect the price-weighted Dow indexes much more than the old-school companies they're replacing, Walgreens Boots Alliance ($22.31) and JetBlue Airways ($7.01).

According to S&P Dow Jones Indices, Amazon's addition to the DJIA won't change the index's 19.6% exposure to Information Technology through six of its members (Apple, Cisco Systems, IBM, Intel, Microsoft, and Salesforce) because Amazon resides in the Consumer Discretionary sector. Were Amazon categorized as a tech company, it would bring the Information Technology sector's weighting up to 22.5% of the DJIA.

The other notable change is the above-mentioned three-for-one stock split that Walmart is executing. The split will reduce the stock's weighting in the DJIA from 2.91% to 0.96%.

In last Thursday's *Morning Briefing*, we took a look at transportation companies and noted that the DJTA had yet to reach a new high and therefore hadn't confirmed that the DJIA was in a bull market, per Dow Theory. The DJTA has declined roughly 2.7% ytd; and when it's adjusted to include Uber, the index's ytd performance improves slightly to a 2.2% decline, according to Howard Silverblatt, senior index analyst at S&P Dow Jones Indices.

The upcoming addition of Uber to the DJTA on February 26 comes nearly two months after the company was added to the S&P 500 Transportation Composite on December 18. Since then, Uber's 23.8% gain has helped the S&P 500 Transportation Composite to rise 3.5% through Tuesday's close compared to a 2.2% decline without Uber and a 3.4% decline for the DJTA.

Technology stocks also have been having an outsized impact on several of the S&P 500 sectors' price indexes recently. The S&P 500 Consumer Discretionary sector, which includes Amazon and Tesla, has risen 21.8% y/y; but it would have gained only 4.4% without the two tech members, Joe calculates.

The S&P 500 Industrials sector now contains Uber, which has traded places over the past week with General Electric as the largest market capitalization company in the sector. If the sector had held Uber a year ago, its y/y rise now would be 11.8% y/y. Without Uber, the sector’s price index would be up 9.2% y/y.

The S&P 500 Communications Services stock price index has gained 50.0% y/y; but if Alphabet, Meta, and Netflix were excluded, the index would be up only 0.1% y/y.

The S&P 500 Technology sector has gained 47.8% y/y. The sector’s heavy weights Apple, Microsoft, and Nvidia plus Alphabet, Amazon, Meta, Netflix, Tesla, and Uber collectively represent 31% of S&P 500’s market capitalization.

Disruptive Technologies: AI and Marketing. How important is artificial intelligence (AI) in advertising and marketing? It’s so important that giant ad agency WPP spent much of its *Investor Day* on January 20 talking about AI, how it is embedded in the company’s computer platforms, and how it’s making advertising and marketing campaigns more powerful. The company is spending 250 million pounds a year to maintain its lead in AI capabilities.

Executives noted repeatedly that AI has been used at WPP for years, even though the technology only gained broad public awareness when Chat GPT hit the scene. The presentation made clear the importance of data, which the company has been gathering for years, as well as the importance of having employees with the necessary technical expertise. Here are some of the highlights:

(1) *AI is fast.* It was amazing how quickly the company’s programs could create and revise both copy and visuals. For example, WPP’s Open platform generates a choice of five headlines after employees select the tone desired, the audience to target, and the goal of the headline. With more information fed into the program, such as historical data about the client’s previous ad campaigns, the AI program generates five more headlines that are more relevant and refined. WPP says the program allows its employees to move from ideas to generation faster.

Another example: The system was asked to create a mood board for a Ford F-150 ad campaign at Christmas in the US on Instagram. Open creates a matrix that identifies target audiences (e.g., truck enthusiasts, outdoor adventurers, construction workers, small business owners, and parents) and occasions (ski trip transportation, Christmas tree shopping, home improvement projects, delivery services, family road trip). It also generates headlines for combinations of the two sets—such as a headline that would appeal to a truck enthusiast going on a ski trip. And it did this in seconds.

(2) *Prediction capabilities.* WPP's Satalia division has used AI to understand how people perceive ad content and predict how they will respond. With this information, ad planners can determine when an advertisement should run—e.g., a particular time of day or after a beloved team wins a sports event—to elicit the desired viewer response.

After an ad is created, Satalia's systems can predict how well that ad will work; it then can be optimized by AI accordingly. Satalia also can be used to help clients design their products.

In another example, WPP executives discussed developing product detail pages. Their systems are fed information about a particular product, such as a mascara, and the type of voice the client would like used. The system scans reviews online to learn what customers like and don't like about the product. They know what distribution channels are best suited for the product and can adjust the product description accordingly.

The company is promising potential clients that conversion rates will increase by 25% within three months of using the WPP system. As audacious as that claim seems, it's really not: Clients are actually seeing 40%-50% increases in conversion rates.

(3) *Actors might not be happy.* It's a good bet that AI will help reduce the cost of creating ad campaigns. WPP created an ad for Cadbury that used an extremely popular Bollywood actor, Shah Rukh Khan, who mentions a local store where the product can be purchased. The store mentioned changes based on the viewer's location. The actor didn't shoot different versions of the commercial. Instead, AI was used to recreate his face and voice so that different versions of the commercial could be made. And now we understand why actors in the US went on strike last year!

Calendars

US: Thurs: Initial Claims 217k; S&P Global M-PMI & NM-PMI Flash Estimates 50.1/52.0; Existing Home Sales 3.97mu; Crude Oil Inventories & Natural Gas Storage; Jefferson; Cook; Waller. **Fri:** Baker-Hughes Rig Count. (FXStreet estimates)

Global: Thurs: Eurozone Headline & Core CPI -0.4%m/m/2.8%y/y & -0.9%m//3.3%y/y; Eurozone, Germany, and France C-PMI Flash Estimates 48.5/47.4/45.5; Eurozone, Germany, and France M-PMI Flash Estimates 47.0/46.1/43.5; Eurozone, Germany, and

France NM-PMI Flash Estimates 48.8/48.0/45.7; France Business Survey 99; UK C-PMI, M-PMI, and NM-PMI Flash Estimates 52.7/47.5/54.5; UK Gfk Consumer Confidence -18; ECB Publishes Account of Monetary Policy Meeting. **Fri:** Germany GDP -0.3%q/q/-0.2%y/y; Germany Ifo Business Climate Index, Current Assessment, and Expectations 85.5/87.0/83.8; Eurogroup Meetings; Nagel; Mauderer. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* advanced this week for the second week in a row, to 3.54 (the highest since August 2021), after falling two weeks ago from 3.41 to 3.18. *Bullish* sentiment slipped to 57.3% this week, after rebounding to 58.8% last week—which was the most bulls since summer 2021—after falling 3.4ppts (to 54.3% from 57.7%) two weeks ago. Meanwhile, *bearish* sentiment fell to 16.2% this week, the fewest bears since summer 2021, after edging up the prior two weeks by 0.8ppts, to 17.7% from 16.9%. The *correction count* climbed to 26.5%, after falling from 28.6% to 23.5% last week. Turning to the *AAII Sentiment Survey* (as of February 15), optimism fell this week, while both neutral sentiment and pessimism increased. The *percentage expecting stock prices to rise over the next six months* sank 6.9ppts this week to 42.2%, though remained above its historical average of 37.5% for the 15th straight week. The *percentage expecting stocks to fall over the next six months* climbed 4.2ppts to 26.8%, remaining below its historical average of 31.0% for the 15th straight week. The *percentage expecting stock prices will stay essentially unchanged over the next six months* increased 2.6ppts to 31.1%, though remained below its historical average of 31.5% for the ninth time in 11 weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady w/w at a five-month high of 12.8% during the February 15 week. That's up from a 24-month low of 12.3% during the March 30, 2023 week, but is down 0.6pt from the record high of 13.4% achieved intermittently in 2022 from March to June. The forward margin is now 2.5pts above its seven-year low of 10.3% during April 2020. Forward revenues rose less than 0.1% w/w to a record high. Forward earnings ticked down less than 0.1% w/w from its record high a week earlier. It had hit that mark during the September 21 week for the first time since the June 16, 2022 week. Revenues and earnings had been steadily making new highs from the beginning of March 2021 to June 2022; prior to that, they peaked just before the Covid-19 pandemic in February 2020. The consensus expectations for forward revenues growth rose 0.1ppt w/w to 4.8%. It's now 0.3pt below its 15-month high of 5.1% in early January, but has gained 2.5pts from its 33-month low of 2.3% during the February 23, 2023 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. The forward earnings growth forecast dropped 0.1pt w/w to 10.6%. That's down from a 26-month high of 11.5% in early January and is now 7.2pts above its 31-month low of 3.5% in mid-February. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 4.4% in 2024 (up 0.1pt w/w) and 5.9% in 2025 (up 0.2pt w/w) compared to a forecasted revenues gain of 2.4% in 2023 (down 0.1pt w/w). They expect an earnings gain of 9.6% in 2024 (down 0.2pt w/w) and a 13.5% rise in 2025 (up 0.2pt w/w) compared to a forecasted earnings gain of 2.2% in 2023 (up 0.1pt w/w). Analysts expect the profit margin to rise 0.6ppt y/y to 12.6% in 2024 (unchanged w/w), compared to 12.0% in 2023 (up 0.1pt w/w), and to rise 0.9ppt y/y to 13.5% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.1pt w/w to a 24-month high of 20.4. That up from a 30-month low of 15.3 in October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio was unchanged w/w at a 24-month high of 2.60. That's up from a six-month low of 2.22 during the October 26 week and compares to a 31-month low of 1.98 in October 2022. That also compares to a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Looking at the 11 S&P 500 sectors during the February 15 week, just four had their forward revenues rise w/w, but forward earnings rose for seven sectors. The forward profit margin moved higher w/w for six sectors. Two sectors have forward revenues at a post-pandemic or a record high this week: Health Care and Industrials. Among the remaining nine sectors, only three have forward revenues more than 5.0% below their post-pandemic highs: Energy, Financials, and Materials. Information Technology was the only sector with forward earnings at a record high this week. In that camp a week earlier were Communication Services, Consumer Discretionary, and Consumer Staples. Among the remaining seven sectors, only Energy and Materials have forward earnings down more than 10.0% from their post-pandemic highs, while Financials and Real Estate exited that club in late 2023. Among the 11 sectors, only Industrials has weathered a broad margin retreat from post-pandemic or record highs. Now nearly all of the sectors are showing signs of recovering from their early 2023 lows. Communication Services, Consumer Discretionary, and Information Technology are the only sectors with their forward profit margin at a record high this week. Industrials' forward profit margin remains close to its post-pandemic high. Energy's remains near its 21-month low in early February, while those of Consumer Staples and Health Care remain at or close to their record lows. The annual profit margin is expected to fall y/y in 2024 for Energy, Materials, and Real Estate and improve for the other eight sectors. Here's how the S&P 500 and its 11 sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (26.2%, a new record high this week), Financials (18.4, down from its 19.8 record high in August 2021), Real Estate (16.6, down from its 19.2 record high in 2016), Communication Services (17.0, matching its prior record high in October 2021), Utilities (13.7, down from its 14.8 record high in April 2021), S&P 500 (12.8, down from its record high of 13.4 achieved intermittently in 2022 from March to June), Energy (10.5, down from its 12.8 record high in November 2022), Materials (10.7, down from its 13.6 record high in June 2022), Industrials (10.6, down from its record high 10.8 in September 2023), Health Care (8.8, a record low this week and down from its 11.5 record high in February 2022), Consumer Discretionary (8.7, a record high this week), and Consumer Staples (6.9, down from its 7.7 record high in June 2020).

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