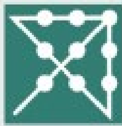

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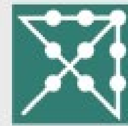

September 25, 2024

Morning Briefing

On Productivity Growth, SMidCaps & India

Check out the accompanying chart collection.

Executive Summary: Our Roaring 2020s scenario for the economy is our base case, to which we assign a 50% probability. Its linchpin: robust productivity growth and the bevy of benefits it brings to corporate America and the economy at large. By our favored measure, productivity growth is accelerating. Today, Eric corroborates that using Joe's data on S&P 500 companies' collective earnings and margin fundamentals. … Also: Joe looks at how the earnings of companies in the three S&P capitalization-sized indexes fared during the Fed's recent tightening cycle. … Finally, Melissa reports on India's resilient economy and an ambitious proposal to reform national elections processes there.

Strategy I: The Productivity Story as Told by the S&P 500. Our Roaring 2020s scenario is our highest probability scenario (at 50%) for the US economy due to our outlook for strong productivity growth. The other two scenarios are a 1990s-style stock market meltup (30%) and a 1970s-style inflation calamity (20%).

We have been beating the drum on the benefits of increased productivity growth: It widens corporate profit margins, supports real wage growth while suppressing unit labor costs (ULC), and boosts real GDP. It's like fairy dust for the economy. But it can be difficult to see. Based on our favored measure—nonfarm business output per aggregate hours worked—productivity rose 2.7% y/y in Q2 (*Fig. 1*).

Let's see if stock market fundamentals corroborate the recent productivity gains:

(1) *Don't fight forward earnings.* S&P 500 forward earnings per share (EPS) rose to a record-high $268.89 during the September 19 week (*Fig. 2*). We expect it to reach our year-end target of $275 by the end of Q4.

Forward EPS is a year-ahead leading indicator of four-quarter trailing earnings, which was $243.12 through Q2 (we calculate forward earnings as a time-weighted average of analysts'

annual EPS consensus estimates for the current and coming year). It should continue to be a bullish leading indicator for actual EPS as well as for the labor market, as profitable companies tend to hire more workers (*Fig. 3* and *Fig. 4*). That said, the labor market has been cooling, as evidenced by slower monthly payroll growth (*Fig. 5*).

Weaker payroll growth but rising earnings estimates point to productivity gains as driving economic growth, since companies are producing more with fewer workers (*Fig. 6*). Of course, bottoms-up stock analysts tend to be poor predictors of recessions. That's where we come in. There is no recession in our outlook—as we have been describing, the Fed has raised the risk that the US economy overheats rather than freezes.

(2) *Secular margin expansion.* We are more a bit more bullish than the analysts' consensus on S&P 500 profit margins. We expect margins to widen to 14.0% by the end of next year, whereas industry analysts collectively expect 13.6% (*Fig. 7*). Profit margins tend to be cyclical. However, the hyper-scalability of technology and growth of mega-capitalization tech stocks have led to a longer-term uptrend of higher profit margins (*Fig. 8*).

Similarly, unit profits from production for nonfinancial companies have risen to all-time highs in the past two years (*Fig. 9*).

(3) *Use it or lose it.* We believe that all companies are tech companies. They either make technology, use technology, or lose ground to their competition. Indeed, high-tech spending now represents roughly half of total capital spending in nominal GDP (*Fig. 10*). As productivity gains from AI, automation, robotics, and similar technologies expand from the mega-capitalization tech companies to others, we expect productivity growth and stock market performance to broaden. Value stocks are only just starting to expand margins (*Fig. 11*). Meanwhile, the equal-weighted S&P 500 has risen to new highs and outperformed the benchmark market-cap-weighted index since the start of July (up 8.4% versus up 4.7%) (*Fig. 12*).

S&P 500 companies' aggregate EPS rose a healthy 12% y/y in Q2, but guidance for the rest of the year was weak and dragged H2 estimates lower (*Fig. 13*). CEOs' economic outlook declined a bit in Q3 as well. We'll see how much Q3 beats in what we call the "earnings hook" (because analysts' quarterly earnings expectations tend to fall ahead of earnings season, as mostly bad guidance hits headlines ahead of actual reporting; when actual results beat the lowered expectations, this creates a hook in the estimate/actuals data series).

We suspect that management teams, particularly in the "S&P 493" (i.e., the S&P 500 minus the Magnificent-7), are quite enthused by the Fed's 50bps rate cut and commitment to easing further. We aren't so bullish on the SMidCaps (i.e., the SmallCaps and MidCaps), however, as earnings expectations for those companies pale in comparison to LargeCaps' (*Fig. 14*).

Strategy II: LargeCaps Versus SMidCaps. Let the party begin! On September 18, the Fed ended its two-year rate-hiking cycle with a 50bps cut in the federal funds rate. The timing of the Fed's new rate cut cycle is unusual, beginning just as the S&P 500's EPS hit a new record high in Q2-2024.

As Oktoberfest approaches, Joe reviews how much the last rate-hiking cycle hurt actual earnings for the companies in the three S&P market-cap style indexes and what's on tap for their Q3 earnings and beyond:

(1) *SMidCaps' EPS lagged the most during the tightening cycle.* When the Fed started hiking rates in 2022, actual quarterly EPS was hitting record highs for all three of the S&P market-cap indexes (*Fig. 15*). The rate hikes of the past two years affected LargeCap earnings the least. The S&P 500 LargeCap's quarterly EPS actual fell only 7.9% from its Q2-2022 peak to its trough in Q1-2023. Aided in great part by the AI-spending boom, LargeCap's EPS returned to a new record high in Q3-2023 after just five quarters below, and did so again in Q2-2024.

However, the SMidCaps' earnings recoveries may be just starting. From their peak EPS in Q2-2022 to their recent lows in Q1-2024, MidCap's quarterly EPS fell 23.8%, and SmallCap's tumbled 30.7%.

(2) *Record-high EPS for SMidCaps not expected anytime soon.* The SMidCaps are climbing a relatively steeper hill back to record EPS, which was boosted in Q2-2022 by cyclically high commodity prices. During Q2-2024, MidCap's EPS was at a two-quarter high but remained 20.1% below its record. SmallCap's EPS was at a four-quarter high in Q2-2024, but still 18.7% below its record. The consensus does not expect SMidCap's quarterly EPS to reach new record highs until the end of 2025 at the earliest, but y/y earnings comparisons will turn positive sooner. Q3 might be the one last quarter of declining EPS y/y for SMidCaps.

(3) *LargeCap earnings growth continues to outpace SMidCap's*. The consensus expects a fifth straight quarter of positive growth for LargeCap in Q3, with earnings rising 4.9% y/y

before accelerating again in Q4 to 12.2% (*Fig. 16*). If achieved, Q4's growth rate would be LargeCap's fastest since Q3-2021.

While the SMidCap's earnings growth rates are expected to be negative again in Q3, the consensus expects positive and single-digit percentage growth to return for those indexes in Q4. Analysts think MidCap's earnings will fall 3.7% in Q3 and rise 5.0% in Q4. SmallCap's earnings is expected to drop 2.9% in Q3 before rising 6.0% in Q4. They also expect SMidCap's growth to lag LargeCap's through Q1-2025 before finally overtaking it.

For all of 2025's quarters, all three of the S&P market-cap indexes are expected to record double-digit percentage y/y EPS increases.

India I: Growth Shines Amid Global Uncertainty. India's economy stands out as a uniquely resilient emerging market in an increasingly volatile global climate. India is set to become the world's third-largest economy by 2030—driven by growth in trade, agriculture, and AI; structural reforms; and rising energy demands—according to a recent S&P Global *report*.

India's stock market has outperformed all the major global market indexes ytd except the US's. The ytd performances of India's NSE Nifty 50 and S&P BSE Sensex trail only the Nasdaq and S&P 500, *reported* Reuters on Friday. India's MSCI is up 26.1% ytd (*Fig. 17*). The runup has lifted the valuation of India's MSCI to historical highs (*Fig. 18*). However, there is support from fundamentals, with forward revenues and earnings also showing positive momentum (*Fig. 19* and *Fig. 20*).

India's 10-year government bond yield is about 7%, offering a premium over similar bonds in developed markets (*Fig. 21*).

The country's growth trajectory, however, isn't without its challenges. Here's more:

(1) *GDP getting hotter*. Analysts at BCG *project* India's GDP growth for fiscal 2025 (ending March) in the 6.8%-7.2% range, driven by robust domestic demand. Real GDP rose 6.7% in Q2 (*Fig. 22*).

(2) *Inflation easing*. Inflation climbed slightly in August, to 3.7% from July's five-year low of 3.5%, *driven* by lower prices for food and fuel (*Fig. 23*). Persistent food inflation concerns India's central bankers. The Reserve Bank of India targets a 4% inflation rate (plus or minus 2%) and has *held* the main policy rate at 6.5% for the nine months through August (*Fig. 24*).

(3) *Labor market mixed*. The unemployment rate has *fallen* to 7.0%, its lowest in 20 months. Labor force participation has been soft, edging down; but the working-age population is *expected* to grow over the next several decades.

(4) *PMIs slowing*. September's composite PMI *showed* the slowest expansion of 2024, reflecting cooling demand and rising input costs; but it remained north of 50, as it has for over three years (*Fig. 25*). Growth in both the services and manufacturing sectors moderated, with new business orders slowing. However, services employment increased the most since August 2022.

(5) *Exports struggling*. Weakening demand from China and rising shipping costs widened the trade deficit in August to a 10-month *high*. While exports have weakened, rising imports have helped the economy navigate global headwinds.

India II: 'One Nation, One Election' Gains Momentum. India's "One Nation, One Election" (ONOE) concept is nothing new. In recent years, Prime Minister Narendra Modi and the Bharatiya Janata Party (BJP) have reignited ONOE efforts, contending that it could substantially reduce election costs, enhance governance, and increase voter participation. Skeptics see it as a calculated strategy by Modi 3.0 to rejuvenate his support base after the BJP's disappointing performance in June's general election, where the party lost its outright majority.

Here's a closer look at the outlook for ONOE:

(1) The Union Cabinet, under Modi's leadership, recently "accepted" an extensive 18,626-page report on ONOE, following a rigorous 191-day consultation process led by former President Ram Nath Kovind.

(2) Implementing ONOE would be challenging, as it demands constitutional amendments requiring a two-thirds majority in both houses of Parliament, highlighted an *article* in *The Week*. That would take support from more than BJP's coalition partners. Moreover, some proposed amendments would necessitate ratification by half of the states, some of which oppose it.

(3) Kovind's report suggests a phased approach to simultaneous elections for the Lok Sabha, state assemblies, and local bodies. Among the 11 *recommendations*: synchronizing elections within 100 days and establishing a single voter roll.

(4) The Union Cabinet has approved the report's recommendations. A bill detailing the required constitutional amendments is anticipated this winter, laying the groundwork for next steps.

(5) The proposal has elicited a spectrum of responses. The BJP and its allies largely favor ONOE, citing potential benefits such as cost efficiency and improved governance stability. Conversely, opposition parties, including Congress and several regional factions, have raised alarms about the possible erosion of federalism and regional representation and the muting of local constituencies' voices in the national dialogue.

Calendars

US: Wed: New Home Sales 693k; MBA Mortgage Application; Crude Oil Inventories & Gasoline Production. **Thurs:** GDP & GDP Price Index 3.0%/2.5%; Corporate Profits 1.7%q/q; Initial Claims 224k; Headline & Core Durable Goods Orders -2.8%/0,1%, Kansas City Manufacturing Index; Pending Home Sales 0.5%; Fed Balance Sheet; Powell; Barr; Williams; Collins; Bowman; Yellen. (FXStreet estimates)

Global: Wed: France Consumer Confidence 92; Japan Core CPI 1.8%y/y; European Central Bank Nonmonetary Policy Meeting; BoJ Monetary Policy Minutes; RBA Financial Stability Report; McCaul. **Thurs:** Germany Gfk Consumer Climate -22.6; Italy Business Confidence; Japan CPI; ECB Economic Bulletin; RBA Financial Stability Review; Lagarde; Schnabel; Buch; Elderson; McCaul; De Guindos. (FXStreet estimates)

US Economic Indicators

Consumer Confidence (*link*): "Consumer confidence dropped in September to near the bottom of the narrow range that has prevailed over the past two years," noted Dana Peterson, chief economist at the Conference Board. *Headline consumer confidence* fell 6.9 points (to 98.7 from 105.6) in September, not far from April's 97.5, which was the lowest reading since July 2022. The *present situation* component tumbled 10.3 points (124.2 from 134.6), while the *expectations* component fell 4.6 points (81.7 from 86.3). Consumers' assessments of *current business conditions* turned negative this month, with 18.8% saying business conditions were good, down from 21.1% in August, while 20.2% viewed business conditions as bad, up from 17.3% in August. *Turning to the labor market*, consumers'

appraisals deteriorated again in September, with 30.9% saying *jobs were plentiful*, down from 32.7% in August, while 18.3% said *jobs are hard to get*, up from August's 16.8%. Consumers were less optimistic on their assessment of *short-term business conditions* six months from now again in September, with 18.5% of consumers expecting business conditions to improve, down from 19.1% in August, while 16.6% expect business conditions to worsen, up from 14.5% in July. Consumers' assessment of the *short-term labor market* was slightly more pessimistic in September, as 16.4% of consumers expected more jobs to be available, little changed from August's 16.3%, but 18.3% anticipated fewer jobs, up from 17.0% in August. Consumers' assessments of their *income prospects* were more pessimistic this month: The percentage of consumers expecting their incomes to improve fell to 18.0% in September from 18.6% in August, while the percentage expecting their incomes to decrease climbed to 13.0%, up from 11.7% in August. As for *inflation expectations*, the 12-month expected inflation rate rose to 5.2% in September from 4.9% in August—which was the lowest since March 2020. September's rate was still well below its peak rate of 7.9% in March 2022. Meanwhile, the share of consumers expecting *higher interest rates* over the next 12 months eased for the fourth straight month to a seven-month low of 46.5%, while the share expecting *lower rates* increased to 33.3%—the highest since April 2020.

Regional M-PMIs (*link*):The *Richmond district* is the third Fed district to release manufacturing data for September, and showed activity improved a bit, but remained solidly in negative territory. New York was the first region to report on manufacturing activity for September, and it revealed that business activity in New York State expanded for the first time in nearly a year—with its general activity index moving to its highest reading since July 2021, followed by the *Philadelphia* region, which showed its general activity index moved from contraction to expansion, though barely. *Turning to the Richmond survey*, its composite manufacturing (to -21 from -19) measure moved deeper into contractionary territory this month. Of its three component indexes, the shipments (to -18 from -15) and employment (-22 from -15) measures both fell at a slightly faster pace than in August, while new orders (-23 from -26) fell at a slightly slower pace. *Turning to prices*, the Richmond Fed price measures are price changes over the past 12 months. The prices paid (to 3.36% from 2.45%) gauge accelerated a bit, while the prices received (1.57 from 1.87) measure decelerated a bit. Looking at local business conditions (-18 from -24), its measure remained solidly in negative territory, while the measure for future local business conditions (-6 from -18) moved closer to the breakeven point of zero.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): German business confidence continues to decline, and the Bundesbank warns that Germany may already be in a recession. The *business climate index* fell for the fourth successive month from 89.3 in May to 85.4 in September, with the *expectations* component sinking from 90.3 to 86.3 over the same period, to a seven-month low. The *current situation* component fell for the fourth time in five months, from 88.9 in April to 84.4 this month—the lowest reading since July 2020. The *manufacturing* index fell to its lowest level since June 2020, as companies assessed both their current situation and expectations to be significantly poorer. The *service sector* index continued to decline, with companies significantly less satisfied with the current situation, though expectations were somewhat less skeptical during the month as sentiment in hospitality and tourism improved. *Trade's* business sentiment is falling again in September, after improving for the first time in three months in August, as businesses assessed their current situation as slightly poorer. *Construction's* business climate index increased due to a decline in pessimistic expectations, while companies viewed their current business situation as "somewhat less satisfied."

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