Strategas Investment Strategist Ryan Grabinski breaks down the recent strength in both markets and the economy – including how rising interest rates can actually be a positive – before diving into the nearly-finished second quarter earnings season.

**STRONG PATCH  I  WHERE HIGHER RATES HELP  I  EARNINGS BETTER THAN EXPECTED**

ROSS MAYFIELD: Despite expectations for a recession, the economy has been quite strong. How are you thinking about things?

RYAN GRABINSKI: Obviously, we’re going through a strong patch. In fact, the Atlanta Fed GDPNow “nowcast” for Q3 real GDP is all the way up above 5%. That suggests the economy continues to do well, and a big piece of that is consumption. Our consumer stress indicator, which looks at food prices, gas prices, and mortgage rates, continues to come down, and that’s supportive of spending. Visa also has a spending momentum indicator that we watch, and it’s showing strength in discretionary spending, too.

So, the consumer continues to do well, and a strong labor market is probably responsible for a lot of that.

One thing that’s gone underappreciated is the stimulative side of the Fed raising rates. You know, savers have been repressed for 15 years via an ultra-low interest rate environment, but now, they’re actually getting paid something on that cash (to the tune of 5%+). That’s income they didn’t have in years past, and if you see your savings account growing by doing nothing, you’re probably more likely to spend that. Services industries, in particular, have benefited; consumers have gotten out and spent big on various forms of entertainment (just look at the recent box office numbers). In the corporate sector, extra cash on the balance sheet is also generating more income than in recent history, and that could potentially help firms manage the need to cut costs too aggressively. If you have that new additional income, then maybe the layoffs that might be typical for this part of the cycle aren’t necessary. In the end, we think this dynamic has gone underappreciated in the market, and we think it’s partly why cyclical sectors have continued to hang in.

ROSS: Ultimately, a stronger economy has to translate to earnings growth – how has the second quarter earnings season been?

RYAN: Second quarter earnings have certainly come in better than expected. At the beginning of the earnings season, growth was expected to be down a little over 5.5%, and it’s now only expected to be down 3.8%. So clearly there’s been a significant improvement, and I think Consumer Discretionary is one of the sectors that has been responsible for that. On the flip side, the main laggard has been the Energy sector, but even that makes some sense as we’re lapping those high oil prices from a year ago. So, it’s not really all that surprising for this quarter. Looking forward, we could potentially be at trough earnings for Energy given that oil prices are on the rise, and you might actually see that sector be a positive contributor into 2H23 and 2024.

Another item we look at closely is annual estimates. So, 2023 S&P 500 earnings estimates had been as low as $218 per share (down from ~$240 a year ago), and it’s actually back up to $221. That turn higher is critical. The 2024 estimate is all the way up at $246, which would represent a solid growth rate of 11% for next year. Another way to look at 2023 earnings is to say, “through two quarters we’ve registered $106 of tangible earnings, and historically, the contribution to the full year number from the first half is 48.7%. Extrapolate that $106 at that rate and you end up at ~$218, which is right around current estimates.” That would be flatish growth for the year, so not overly impressive – but also not recessionary. There’s been a lot of talk about recessionary-type earnings, and I think that sort of has to dissipate now because it’s just becoming harder to see 2023 earnings getting to those levels. Obviously, we could face some sort of crisis event, but I don’t think that can be your base case anymore.
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