Yardeni Research

MORNING BRIEFING
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Booms & Busts

Check out the accompanying chart collection.

(1) The next recession. (2) Big blow to Big Oil. (3) US oil field output remains depressed, as does the rig count. (4) US oil demand almost fully recovered. (5) Iran is a wild card. (6) Demand and supply shocks. (7) A business cycle on fast forward. (8) Inflationary pressures galore. (9) Great for profits and capital spending, for now. (10) Booms are followed by bananas. (11) Lots of reasons for labor shortages.

US Economy I: Beware of What They Wish For. Everyone is talking about inflation. Is it temporary or will it last longer than widely expected? We've had lots to say about this issue and have more to say below. But first, for a change, let's talk about the next recession. No one is doing so, as far as we know. However, last week's historic events could set the stage for it.

We are referring to the big blow inflicted on Big Oil by climate-change activists that we wrote about yesterday. On May 26, a Dutch court found that Shell is partially responsible for climate change and ordered the company to sharply reduce its carbon emissions. The very same day, Engine No. 1, an upstart hedge fund that owns only about 0.02% of Exxon's shares, may have won two seats on the 12-member board of the company. The fund aims to force the oil giant to diversify away from fossil fuels. It pulled off the coup with the help of Blackrock, Exxon's largest shareholder, and a few other large money managers. Blackrock's CEO Larry Fink has maintained that "climate risk is investment risk."

Previously, I've often observed that recessions are usually caused when the tightening of monetary policy triggers a financial crisis, which turns into a widespread credit crunch and results in a recession (*Fig. 1*). Arguably, some recessions were caused by, or else exacerbated by, spikes in oil prices. Interestingly, every recession since 1973 except for last year's was preceded by a jump in oil prices. Most notably, the Great Recession of 2008, which was mostly attributed to the bursting of the housing bubble, was led by almost a tripling in the price of West Texas Intermediate crude oil to a record $145.66 per barrel (*Fig. 2*).

If climate-change activists continue to succeed in forcing Big Oil to cut back on exploring, drilling, extracting, and refining oil, then the big winners will be the OPEC+ producers. Saudi Energy Minister Prince Abdulaziz predicted earlier this year that "drill-baby-drill is gone forever." He might be right now that investing in higher oil production is illegal, at least according to one Dutch court. Consider the following related developments:

(1) *US oil production.* The price of a barrel of Brent crude oil has rebounded from last year's low of $19.33 on April 21 to $69.63 a barrel on Friday (*Fig. 3*). That matches the price on March 11, which was the highest price since May 28, 2019. Yet during the May 21 week, US crude oil field production remained 2.1mbd below its record high of 13.0mbd during the April 11, 2019 week (*Fig. 4*). During the May 21 week, the US rig count was down 57% over the comparable period (*Fig. 5*).

(2) *US oil trade.* Thanks to the fracking revolution in the US, net imports of crude oil and petroleum products has been fluctuating around 0.0mbd since mid-2019, a remarkable drop from a peak of around 13.0mbd during 2007 (*Fig. 6*). However, the US could become a net importer again, as the US economy continues to expand while climate-change activists force Big Oil to produce less in the US.

(3) *US oil consumption*. US petroleum usage has almost fully recovered from last year's recession. Here is the current usage during the week of May 21 compared to the comparable week of 2019, i.e., before the pandemic: total (19.1mbd, 20.2), gasoline (9.1, 9.5), distillate (4.2, 4.0), and all other (5.9, 6.8) (*Fig. 7*). Petroleum usage could climb to a record high this summer in the US, as Americans are driving and flying more.

The retail price of a gallon of gasoline rose to $3.11 during the May 24 week, the highest since the week of October 27, 2014 (*Fig. 8*). American consumers spent $307 billion (saar) on gasoline during April, almost as much as they did just before the start of the pandemic (*Fig. 9*). On average, households spent $2,500 (saar) on gasoline during March, well below the record high of $3,800 during July 2008 (*Fig. 10*).

(4) *Oil price and the dollar.* The trade-weighted dollar is inversely correlated with the price of oil (*Fig. 11*). In other words, if oil prices move higher as a result of more successes by climate-change activists, the inflationary consequences would most likely be exacerbated by a drop in the dollar. A similar scenario played out for the price of oil and the dollar from 2009 through 2011 without a significant pickup in overall inflation. However, the economic recovery coming out of the Great Financial Crisis was much weaker than the current one following the Great Virus Crisis.

(5) *Iran.* There are always plenty of wild cards when gambling on the direction of the price of oil. On Monday, Bloomberg *reported* that Iran and world powers have started what could be their final negotiations to revive a 2015 nuclear accord. If a deal is struck, the US would probably ease sanctions on Iran's oil, banking, and shipping sectors, though it is unclear to what extent or how

quickly that would happen. Iran holds presidential elections on June 18, and Tehran is keen to conclude the talks before then. Iran has been preparing for the lifting of US sanctions for months now, boosting its oil production and preparing to boost exports as well. The country is ramping up output, planning to return to a production level of 4.0mbd.

US Economy II: Business Cycle on Fast Forward. Even if the price of oil and the dollar remain steady, the policy-fueled demand shock during the current recovery has triggered a supply shock that is causing shortages, longer delivery times, and rapidly rising prices. An oil price shock with a weaker dollar would only exacerbate the current situation, lowering the odds of the Roaring 2020s scenario while raising the odds of The Great Inflation 2.0. In fact, just yesterday in our *Morning Briefing*, we changed the odds from 70/30 to 65/35. Consider the following:

(1) *Prices-paid and prices-received indexes.* The prices-paid index included in May's national survey of manufacturing purchasing managers (M-PMI) remained near April's reading, which was the highest since July 2008 (*Fig. 12*). That's not a surprise since the average of the May prices-paid indexes reported in the regional business surveys conducted by five Federal Reserve Banks jumped to the highest reading on record (*Fig. 13*). The average of the five regional prices-received indexes also jumped to a record high in May. All 10 regional prices-paid and prices-received indexes are at or near record highs (*Fig. 14*). (The data for the regional surveys start in 2005.)

(2) *Backlogs for the record books.* May's national M-PMI survey showed that supplier deliveries and backlog of orders rose to record highs last month (*Fig. 15*). In addition, the customer inventories index fell to another record low (*Fig. 16*). The average of the five regional indexes for either unfilled orders or delivery times rose to a record high in May (*Fig. 17*).

(3) *Capital spending.* The good news is that the inflationary economic boom is great for corporate profits, which is great for capital spending. The y/y growth rate in weekly S&P 500 forward earnings is an excellent coincident indicator of the y/y growth rate in nondefense capital goods orders excluding aircraft (*Fig. 18*). Sure enough, the latter measure of capital spending on equipment and machinery jumped 0.9% m/m and 22.0% y/y to a fresh record high during April (*Fig. 19*).

(4) *Bottom line.* What the economy is experiencing may simply be a business cycle set to "fast forward" by the insanely stimulative combination of fiscal and monetary policies. We had a terrible recession last year that lasted only two months. Twelve months later, the economy had fully recovered, based on most macroeconomic indicators. Booms usually occur at the tail ends of expansions. This time, one started during the tail end of the recovery and continues at the beginning of the expansion.

That's all great until it isn't—because, as we all know, booms are followed by bananas. Economist Alfred Kahn, an economic adviser to former President Jimmy Carter, warned lawmakers in the '70s that if they didn't get inflation under control, the nation was heading for a recession or a depression. To avoid scaring the public during his testimony at the Capitol, instead of saying "recession" or "depression," he simply said "banana."

Labor Market: Buddy, Can You Spare Some Time? President Joe Biden's critics claim that the enhanced federal unemployment benefits in his American Rescue Plan, enacted March 18, are to blame for labor shortages that are forcing businesses to raise their minimum hourly wage. We've been in the critics' camp since the February 10 *Morning Briefing* titled "Help Wanted."

Right now, at least 22 states are responding to severe labor shortages around the country by no longer paying $300 per week in enhanced federal unemployment benefits. That's even though the program expires in September, which will affect more than 3.6 million people. Its expiration should encourage more of the unemployed to get back to work. After all, during March, there were a record 8.1 million job openings, not far below the 9.8 million number of unemployed workers (*Fig. 20* and *Fig. 21*).

Other factors are contributing to the labor shortage as well. Consider the following:

(1) *Population.* The growth rate of the working-age population, 16 years old and older, is slowing. It was up just 0.5% y/y during April (*Fig. 22*). Excluding people 65 years old and older, it was actually down 0.2% y/y.

(2) *Labor force.* The growth rate of the labor force is mostly determined by the growth rate of the working-age population (*Fig. 23*). To smooth out some of the volatility in the two series, let's focus on the y/y growth rates of the 12-month averages of these two series. During April, the working-age population was up just 0.4%, the slowest pace since October 1952. Covid-related factors caused a 1.8% drop in the labor force growth.

(3) *Retiring seniors.* Baby Boom seniors accounted for 21.4% of the working-age population during April, up from 16.5% ten years earlier during April 2011, when the oldest of them turned 65 years old (*Fig. 24*). Their percentage of the labor force increased from 4.6% during April 2011 to 6.5% during April of this year. Their percentage in the population will continue to increase as they age, but their percentage of the labor force may have peaked, partly as a result of the pandemic and partly because Boomers are retiring, as the oldest are now 75 years old.

Seniors were particularly hard hit by the pandemic. Since 2011, seniors have been dropping out of the labor force at a faster pace, which may have been accelerated by the pandemic and by simply getting older (*Fig. 25*). Over the past 10 years, the number of seniors not in the labor force increased by 12.9 million compared to 3.1 million during the previous ten years.

(4) *Parents.* The labor force participation rate of people 25 to 54 years old rebounded from 79.8% last April to 81.3% this April but remains below its pre-pandemic reading of 83.0% during January 2020. That may be partly attributable to the closing of schools and childcare facilities during the pandemic. Parents had to stay home with their kids. But more of them should be able to reenter the labor force as schools and childcare facilities open.

(5) *Jobs are plentiful, workers are not.* Given the tightness of the labor market, with help-wanted signs everywhere, it's not surprising that the Conference Board's survey of jobs availability found that the percentage of respondents saying that jobs are plentiful jumped to 46.8% during May, back to the readings in the months before the pandemic, when the unemployment rate was below 4.0% (*Fig. 26*). Only 12.2% said that jobs were hard to get.

The business survey conducted by the Federal Reserve Bank of Richmond found that the net percentages of employers reporting that they can find skilled workers fell to record lows during May in manufacturing (-44.0%) and services (-30.0) (*Fig. 27*). The net percentages of employers raising wages were back to pre-pandemic readings in both manufacturing (31.0) and services (40.0) (*Fig. 28*).

Calendars

US: Wed: MBA Mortgage Applications, API Crude Oil Inventories, Beige Book, Bostic, Brainard, Evans. **Thurs:** ADP Employment Change 650k, Initial & Continuous Jobless Claims 390k/3.62k, Nonfarm Productivity & Unit Labor Costs 5.5%/-0.4%, ISM NM-PMI 63.0, IHS Markit C-PMI & NM-PMI 68.1/70.1, EIA Natural Gas Inventories, Bostic, Quarles. (DailyFX estimates)

Global: Wed: Germany Retail Sales -2.0%m/m/10.1%y/y, Weidmann, Lagarde. **Thurs:** Eurozone, Germany, and France, C-PMIs 56.9/56.2/57.0, Eurozone, Germany, and France NM-PMIs 55.1/52.8/56.6, UK C-PMI & NM-PMI 62.0/61.8, Japan Household Spending -2.2%m/m & 9.3%y/y, Bailey. (DailyFX estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes last week and were at record highs simultaneously for a 12th week and the first time since October 2018. LargeCap's was at a record high for a 13th straight week; MidCap's was at a record for a 16th week; and SmallCap's posted its 16th gain in 17 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 53 of the past 54 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 50 of the past 52 weeks, and SmallCap's posted 50 gains in the past 53 weeks. LargeCap's forward earnings is now up 40.9% from its lowest level since August 2017; MidCap's has risen 78.8% from its lowest level since May 2015; and SmallCap's is up 122.1% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings improved to a record high of 40.4% y/y from 40.0%. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings rose w/w to a record high of 78.8% y/y from 76.2% y/y and is up from a record low of -32.7% in May 2020. SmallCap's rate turned down though, slipping to 117.0% y/y from a record high of 118.9%; it is up from a record low of -41.5% in June 2020. Companies have been easily beating consensus estimates since the Q2-2020 earnings season, causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (35.8%, 11.9%), MidCap (58.3, 9.9), and SmallCap (89.3, 16.5).

S&P 500/400/600 Valuation (*link*): Valuations rose slightly for these three indexes last week. LargeCap's forward P/E rose 0.2pt to 21.2 from a 29-week low of 21.0. That's down from a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's gained 0.1pt to 18.4 from a 28-week low of 18.3, and is down from a seven-month high of 20.5 in early March. Its current level is 4.7pts below its record high of 22.9 in early June. SmallCap's rose 0.3pts w/w to 18.4 from a 28-week low of 18.1. It's now down 8.3pts from its record high of 26.7 in early June 2020. That compares to MidCap's 10.7 and SmallCap's 11.1 in March 2020, which were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August

2017. SmallCap's P/E was below LargeCap's for a 38th week. That's the longest stretch at a discount since last May and during 2002-03. SmallCap's P/E had been mostly below from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a discount to MidCap's for a second week and for the first time since early January, when it had been at a discount for 10 straight weeks.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. In the latest week, the S&P 500's Q1-2021 estimate showed another upside hook as Q1 earnings from the retailers boosted it another 16 cents to $49.90. That $48.90 estimate for Q1-2021 represents a gain of 47.9% y/y on a frozen actual basis and a 52.5% y/y gain on a pro forma basis. That marks the first quarter of double-digit percentage growth since Q4-2018 and compares to a pro forma 3.8% gain in Q4-2020. All 11 sectors are expected to post positive y/y earnings growth in Q2-2021, up from 10 during Q1-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q2-2021 versus their final Q1-2021 growth rates: Industrials (542.2% in Q2-2021 versus 3.1% in Q1-2021), Consumer Discretionary (233.5, 223.6), Energy (217.1, 25.4), Materials (109.7, 62.3), Financials (98.2, 137.4), S&P 500 (63.0, 52.5), Communication Services (40.1, 53.5), Information Technology (29.6, 44.7), Real Estate (23.3, 5.7), Health Care (12.2, 26.7), Consumer Staples (8.8, 10.4), and Utilities (1.0, -0.9).

US Economic Indicators

Construction Spending (*link*): Construction expenditures advanced in April for the ninth time in 11 months to a fresh record high. Total spending edged up 0.2% last month, following an upwardly revised 1.0% (from 0.2%) jump in March—climbing 11.3% during the 11 months through April. Private construction spending expanded 0.4% and 16.8% over the comparable periods—also to a new record high, while public construction spending contracted over the first four months of this year by a total of 3.5%. Within private construction, residential spending expanded for the 10th time in 11 months, by 1.0% m/m and 35.2% over the period to a new series high, while nonresidential construction declined 0.6% during the two months through April after rising 0.8% the first two months of the year; it had contracted 5.1% during the final six months of 2020. The rebound in residential construction has been widespread: Single-family (48.8%), multi-family (24.6), and home-improvement (20.8) spending all posted big upswings during the 11 months through April—with single-family construction soaring to a new cyclical high and multi-family to a new record high. Meanwhile, home-improvement spending weakened a bit the first two months of this year after reaching a record high in December, though did move higher again in March and April.

Global Economic Indicators

Global Manufacturing PMIs (*link*): “Strong upswing in global manufacturing sector led by solid expansions in the Eurozone, UK, and US,” was the headline of May’s report. The JP Morgan M-PMI accelerated for the fourth month to just over an 11-year high of 56.0 last month, after dipping slightly in January to 53.6. The index is up 16.4 points since bottoming at 39.6 last April. The M-PMI for the advanced economies has increased all 13 months since bottoming in last April by 23.0 points (to 59.8 from 36.8 in April), while the M-PMI for the emerging economies dipped to 52.0 after rising in April for the first time in five months to 52.2; it had dropped from 53.9 in November to 51.3 by March. Geographically, 24 out of the 30 nations for which May data were available had an M-PMI reading above the 50.0 mark, with the six top-ranked countries—the Netherlands, Austria, UK, Germany, Ireland, and Italy—all in Europe; the US finished 7th. Growth in Japan, China, Russia, and India was subdued, while the Philippines, Turkey, Thailand, Mexico, Colombia, and Myanmar all recorded contractions. Here’s a country ranking of May M-PMIs from highest to lowest: Netherlands (69.4), Austria (66.4), UK (65.6), Germany (64.4), Ireland (64.1), EUROZONE (63.1), Italy (62.3), US (62.1), Taiwan (62.0), Czech Republic (61.8), Australia (60.4) France (59.4), Spain (59.4), Greece (58.0), Poland (57.2), Canada (57.0), WORLD (56.0), Brazil (53.7), South Korea (53.7), Vietnam (53.1), Japan (53.0), China (52.0), Russia (51.9), Malaysia (51.3), India (50.8) Kazakhstan (50.6), Turkey (49.3), Thailand (47.6), Mexico (47.6), Colombia (46.7), and Myanmar (39.7).

US Manufacturing PMIs (*link*): Manufacturing activity in May remained robust according to both the ISM and IHS Markit M-PMI measures, with the latter reaching a new record high; price pressures continued to intensify. ISM’s M-PMI (to 61.2 from 60.7) showed the manufacturing sector continued to expand in May at a strong pace, moving back toward March’s 64.7—which was its best reading since 1983! The new orders (to 67.0 from 64.3) measure was just a hair below March’s 68.0 reading, which was the strongest since January 2004. The new export orders (to 55.4 from 54.9) sub-index continued to bounce in a volatile flat trend around recent highs. Meanwhile, the production gauge slowed for the second month to 58.5 in May from 68.1 in March—which was its best reading since the start of 2004; it was the first reading below 60.0 since mid-2020. Hirings in the manufacturing sector also slowed for the second month, with the employment index falling from a three-year high of 59.6 in March to 50.9 in May. The supplier deliveries component of the M-PMI climbed to 78.8—the highest since the mid-1970s, reflecting the difficulties suppliers continue to experience due to Covid-19 impacts. The inventories (to 50.8 from 46.5) gauge continues to bounce around the breakeven point (50.0) between expansion and contraction. ISM's price (to 88.0 from 89.6) index held around April's pace, which was the fastest since July 2008; it was at 40.8 a year ago. In the meantime, IHS Markit's M-PMI (to 62.1 from 60.5) shows manufacturers enjoying their best year in the 14-year history of this series. According to the report, new orders accelerated at a record rate, boosted by a revival in domestic demand and record export sales as economies reopened from Covid-related restrictions. Meanwhile, supply-chain disruptions continued, causing a marked accumulation of backlog orders—which has triggered the fastest acceleration in input prices in the history of the series going back to May 2007.

Eurozone CPI Flash Estimate (*link*): May's CPI headline rate is expected to accelerate to a 30-month high of 2.0% y/y, according to flash estimates, while the core rate is expected to accelerate a bit, to 0.9% y/y, after slowing steadily from 1.4% in January to 0.7% by April. Looking at the main components, once again energy (to 13.1% from 10.4% y/y) is expected to swing further into positive territory, after moving above zero in March for the first time since January 2020. The services inflation rate is expected to accelerate to 1.1% y/y after slowing from 1.4% to 0.9% the prior three months, while the non-energy industrial goods rate is forecast to pick up for the second month, to 0.7%, after easing from 1.5% in January to 0.3% in March. The price measure for food, alcohol & tobacco is expected to hold at 0.6% y/y, down from 1.5% at the start of the year. Of the top four Eurozone economies, rates for Germany (2.4% y/y) and Spain (2.4) are expected to be above the May's headline rate of 2.0%, while rates for France (1.8) and Italy (1.3) are expected to be below. Spain's rate was negative in every month but one from October through February.

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