MORNING BRIEFING
January 19, 2022

A Very Brief US History of the Postwar 1940s

Check out the accompanying chart collection.

(1) Winston Churchill and Mark Twain on history. (2) The best of times or the worst of times? (3) Factions, partisanship, and the Constitution. (4) The system works best when it doesn't work for any one faction. (5) WWII was followed by labor strife, racial strife, and a red scare. (6) Inflation soared during the second half of 1940s. (7) Comparative inflations. (8) Meet Joe Manchin, again. (9) Sinema is in the same opposition party as Manchin. (10) Alternative outcomes for BBB.

US Economy: History Rhymes. In a 1948 speech to the House of Commons, former British Prime Minister Winston Churchill warned that "those who fail to learn from history are condemned to repeat it." On a related note, American humorist Mark Twain once quipped, "History does not repeat itself, but it often rhymes."

Today, we hear lots of people claiming that the US has never been so divided between the Left and the Right. Both sides of the political spectrum seem to be dominated by extremists more so than ever, allowing for no room for compromise. Both sides are convinced that "our democracy" has never been more at risk of turning into totalitarianism. Race relations have never been worse, we are told. Hostile foreign powers are manipulating our elections. The basic message is: "Be afraid, be very afraid" (as Geena Davis somberly intoned in the 1986 horror film "*The Fly*").

Many of the alarmists apparently haven't read American history. Indeed, the Founding Fathers of our country anticipated that "factions" inevitably would fight one another to gain power. That's why they designed a system of checks and balances to make it very hard for any one faction to permanently dominate our government. In *The Federalist Papers, No. 10*, James Madison explained why a democracy is incapable of controlling factions, which is why the US Constitution was written for a federal republic uniting America's states.

In many ways, the system of checks and balances exacerbated partisanship by making compromise necessary but elusive. America's various factions often have been unable to compromise. In other words, the system was designed by the Founders to frustrate the factions when they couldn't agree on legislation. So the system works best when it doesn't allow any one faction to impose its will on the other factions. It works best when it doesn't work for any one faction to take control of the government for very long!

American history is a tale of ongoing and often bitter partisanship. Recall that one of the earliest armed insurrections was Shay's Rebellion during 1786 and 1787. Obviously, the issue of slavery was very contentious and led to the Civil War. But the republic was reunited after the war, and the Constitution once again became the law of the land.

To those alarmists who believe that now is the most perilous time for the US since the end of the Civil War, I recommend reading A.J. Baime's *Dewey Defeats Truman: The 1948 Election and the Battle for America's Soul* (2020). Here are some highlights based on the book and Wikipedia:

(1) *Economy.* Harry S. Truman assumed the presidency on April 12, 1945, after President Franklin D. Roosevelt died in office. When World War II (WWII) ended later that year, there were widespread fears that the economy would slide back into a deflationary depression. Strikes crippled major industries as workers pushed for wage increases. In January 1946, a steel strike involving 800,000 laborers became the largest in the nation's history. It was followed by a coal strike in April and a rail strike in May. Truman seized the railroads in an attempt to contain the issue, but two key railway unions struck anyway. The entire national railroad system was shut down for several days.

After the war, there was a severe shortage of housing. Consumer goods were hard to find, and their prices soared when wartime price controls were terminated. The elimination of price controls, supply shortages, and pent-up demand caused the CPI inflation rate to soar.

WWII ended on V-J (Victory over Japan) Day, August 15, 1945. The CPI inflation rate on a y/y basis jumped from 1.7% during February 1946 to peak at 19.7% during March 1947 (*Fig. 1*). It then plunged to zero in early 1949 and ended the decade in negative territory. Industrial production plummeted during 1945 and early 1946 as manufacturers scrambled to retool to produce consumer goods rather than armaments (*Fig. 2*). Then production rebounded dramatically in late 1946 and 1947, helping to bring down inflation by boosting supplies of consumer goods.

(2) *Politics.* President Truman's approval rating dropped from 82% in January 1946 to 32% by the end of the year. In the 1946 midterm elections, the Republicans took control of Congress for the first time since 1930.

(3) *Civil rights.* Truman proposed numerous liberal domestic reforms, but few were enacted by the conservatives who dominated the Congress. In 1948, he submitted the first comprehensive civil rights legislation. It didn't pass, so he instead issued Executive Orders

9980 and 9981 to promote racial equality in federal agencies and the military. The southern states rejected civil rights and continued to enforce segregation.

(4) *Soviet Union.* After the war, the Soviet Union expanded its political control of Eastern Europe. Truman and his foreign policy advisors took a hard line against the USSR. The US public increasingly feared that the Soviet Union's aggressions would trigger a World War III. Instead, the Truman administration adopted a policy of containment by rebuilding Western Europe with the Marshall Plan. The Cold War resulted.

(5) *Red scare.* At home, a "red scare" spread immediately after WWII. The widespread public perception was that national or foreign communists were infiltrating or subverting US society and the federal government. During the 1948 presidential campaign, Truman ran against New York's Republican Governor Thomas Dewey. Truman had fired Secretary of Commerce Henry Wallace for urging conciliatory policies toward the Soviet Union. Wallace and his supporters then established the nationwide Progressive Party and launched a third-party campaign for president. Wallace lost badly, as he was dogged by accusations of being a communist. There were fears that the Soviets were trying to influence the election.

(6) *Stocks.* And what did the S&P 500 do in the midst of all the turmoil during the 1940s? After mostly falling during the second half of the 1930s, which included the second of the two recessions that composed the Great Depression, the index actually bottomed during April 1942, just before America's victory over Japan in the Battle of Midway (*Fig. 3*). It then soared 157.7% through mid-1946. All the strikes and rapidly rising inflation caused the S&P 500 to fall 29.6% through June 1949. But then the bull market resumed during the 1950s.

(7) *Now and then.* As we have previously observed, there are similarities between the current bout of inflation and the Great Inflation of the 1970s. There are also similarities between today's bout and the inflationary experience of the years immediately following the end of WWII.

Of the two former incidences of inflation, the postwar inflation is the more likely to be repeating now. While inflation exceeded that of the 1970s, it lasted only a couple of years as opposed to an entire decade.

The biggest difference between now and the past two episodes of inflation is that now there is a severe and chronic labor shortage, as we have often discussed. After WWII, soldiers returned home and boosted employment (*Fig. 4*). During the 1970s, the Baby Boomers poured into the labor markets. This time, we believe that employers will respond to labor

shortages by spending more on capital equipment and technology to boost productivity. (Also see bonus *Fig. 5* and *Fig. 6*.)

US Fiscal Policy: Senators' Checks & Balances. Melissa and I first introduced Joe Manchin, the Democratic senator from West Virginia, as potentially the most important person in America in our November 16, 2020 *Morning Briefing*. He is viewed as a conservative Democrat and has championed bipartisanship. Larry Kudlow, former Trump economic advisor, has even *called* the man a hero. Indeed, Manchin is the last man standing in support of checks and balances in the Senate.

On November 9, 2020, he was *interviewed* by Fox News. He said: "50-50 [control] means that if one senator does not vote on the Democratic side, there is no tie and there is no bill." That night, he committed to fight the far-left agenda, including ending the filibuster. Simply, he said: "I will not vote to do that."

Manchin is a man who keeps his word. Despite recent pressure all the way from the top, Manchin has refused to support Democratic US President Joe Biden's $2 trillion Build Back Better (BBB) human infrastructure and climate agenda. He also has refused to change Senate rules requiring a 60-40 vote to pass the bill through the upper chamber of Congress. Here's more:

(1) *Reconciliation refresher.* Budget reconciliation is a special procedure of US Congress intended to expedite the passage of certain legislation in the Senate. It overrides the filibuster rules in the Senate, which otherwise could require a 60-vote supermajority for passage. Reconciliation bills can pass the Senate with a simple majority of 51 votes or 50 votes plus the vice president's as the tiebreaker. Without a reconciliation bill, unanimous agreement is needed among Democratic senators plus support from 10 Republican senators.

(2) *Manchin's counteroffer.* So far, Biden's bill has failed to capture the required number of supporters. *The Washington Post* *reported* on January 8 that the West Virginian senator had pulled a proposed a counteroffer to the House bill passed last year on *November 19*. "There [are] no negotiations going on at this time, OK?," he said.

In his compromise proposal, Manchin included funding for universal pre-K, an ObamaCare expansion, and a tax on billionaires, *reported* the January 10 *New York Post*. Reportedly, Manchin said he would support spending as much as $600 billion on climate change initiatives, despite representing a state that is a major producer of coal.

(3) *Sinema too.* Senator Kyrsten Sinema (D-AZ) has opposed parts of the bill too. In December, a spokesperson for Sinema *told* Politico that she "continues to support the Senate's 60-vote threshold, to protect the country from repeated radical reversals in federal policy which would cement uncertainty, deepen divisions, and further erode Americans' confidence in our government."

As we wrote in our December 20, 2021 *Morning Briefing*, to get Sinema's vote for BBB, she has demanded no corporate rate hike, no individual rate hike, no capital gains rate hike, and no broad based tax increase of any kind. The result would be a bill with $1.5 trillion in other revenue raisers.

(4) *Deal breakers.* Manchin and Sinema's main *sticking point* against passing the bill as it stood relates to the expanded child tax credit (CTC). The two want to add a work requirement to collect the CTC. That would exclude families having no other income.

With the CTC, the Democrats also have attempted to utilize a *gimmick* routinely turned to for passing bills: enact a version of a proposal that is temporary but paves the way to become permanent. In the House version of the bill, the CTC expansion ends after *just one year*. But many say that so many Americans would grow dependent on the credit that Congress would be hard-pressed not to continue it. Manchin also has opposed some climate portions of the bill, specifically anti-fossil fuel provisions, arguing against a *methane gas tax* that could inflate gas prices and stating that "the bill will also risk the reliability of our electric grid and increase our dependence on foreign supply chains."

(5) *No holiday for Dems.* On Monday, January 3, Senate Majority Leader Chuck Schumer (D-NY) *asserted* that he will force a vote on a measure to change the upper chamber's rules by Martin Luther King Day on January 17. That day came and went without a vote. Schumer *announced* on January 13 that the Senate would not take up the rule change by the federal holiday.

Creating a carveout that would exempt specific legislation from the 60-vote obstacle but leave it in place for other matters also has been discussed among senators and rejected by Manchin. He has pointed out that there is no such thing as an exception, saying: "Any time there's a carveout, you eat the whole turkey, there's nothing left."

A Fox News *opinion piece* this week discussed the reason that Manchin is so opposed to a change to the Senate rules: "[T]here is 2024 to consider. A Republican president with a Congress of his own party could check off their wish list of legislation like a rich kid on

Christmas morning."

(6) *Mid-terms in jeopardy.* Biden may have hoped that the bill could pass the Senate by his State of the Union address set for March 1 so that he could tout its success. Not passing the plan in the Senate could cost the Democrats the 2022 mid-term elections, as the *Washington Post* recently *discussed*. If only Democrats had a few extra seats, "Manchin and Sinema would no longer hold the balance of power; the party could reform the filibuster, pass voting rights legislation, pass the BBB bill and do a bunch more besides. It's as simple as that." It added: "But it's hard to say to your supporters, 'I know we didn't give you what we said we would, but if you just turn out for one more election, I promise we'll deliver next time!'"

(7) *Alternative scenarios.* E&E News, a publication owned by Politico, *painted* four alternate scenarios on January 3 for the outcome of the bill: 1) Schumer and House Speaker Nancy Pelosi (D-CA) could negotiate a smaller package with Manchin—not an impossibility given that "Democratic leaders and the White House have already twice scaled back their ambitions." 2) If Manchin's opposition is too hard to overcome, a no-deal scenario could occur and compromise the Democrats' chances of succeeding during the mid-terms. 3) The situation could be salvaged by breaking the BBB into chunks (e.g., separating out climate spending from the rest of the package). 4) If all else fails, Democratic lawmakers might have to rely on annual spending bills to advance their agenda.

James Lucier of *Capital Alpha Partners* in a December 20, 2021 note set out three equally weighted scenarios: "a one-third chance that nothing passes, a one-third chance that a successor bill with less than $1 trillion pay-fors passes, and a one-third chance that a bill with up to $1.5 trillion in pay-fors passes." The note was titled: "Triple-B: Not Dead Yet." But since Manchin's latest refusal to negotiate, the chances that nothing passes have risen.

(8) *Manchin's power.* It's too bad for the Democrats, who could have better managed Manchin's counteroffer. Jim reckons that "Manchin didn't say he was a no on everything, for Pete's sake. He just said that he was a no on the bill as it stood." An element of "Manchin's power," Jim says, is that he is "willing to walk away and let nothing pass. … Another element of Manchin's power is that he and Sinema are not alone. We can count at least six other Democratic senators who would have similar preferences for a small bill or no bill at all."

Calendars

US: Wed: Housing Starts & Building Permits 1.650mu/1.701mu; MBA Mortgage Applications; EIA Monthly Report. **Thurs:** Initial & Continuous Job Claims 220k/1.58m; Philadelphia Fed Manufacturing Index 20.0; Existing Home Sales 6.44mu; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Eurozone Current Account; Germany CPI 0.5%m/m/5.3%y/y; UK Headline & Core CPI 0.3%m/m/5.2%y/y & 0.2%m/m/4.0%y/y; UK PPI Input & Output 0.7%m/m/13.7%y/y & 0.6%m/m/9.6%y/y; Canada Headline & Core CPI 4.7%/3.6% y/y; China PBOC Loan Price Rate; Japan Trade Balance; Australia Employment Change 30k; Australia Unemployment & Participation Rates 4.5%/66.2%; Bailey; Cunliffe. **Thurs:** Eurozone Headline & Core CPI 0.4%m/m/5.0%y/y & 0.4%m/m/2.6%y/y; Germany PPI 0.8%m/m/19.4%y/y; France Business Survey 111; UK Gfk Consumer Confidence -15; ECB Publishes Account of Monetary Policy Meeting. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings at a record high last week. LargeCap's was at a record high for a third week after dropping a week earlier due to index changes. MidCap's was at a record high for a sixth straight week after dropping 0.1% below at the end of November. SmallCap's was out of record-high territory for a fourth week due to index changes, but improved to less than 0.1% below its peak. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 82 of the past 86 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings shortfall in August, and index changes in late December and September. MidCap's forward earnings is up in 80 of the past 84 weeks, and SmallCap's posted 80 gains in the past 85 weeks. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 59.2% from its lowest level since August 2017; MidCap's is now up 115.7% from its lowest level since May 2015; and SmallCap's has soared 177.8% from its lowest point since August 2013. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act 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 dropped to 32.4% y/y

from 33.1% in the latest week; that's down from a record-high 42.2% at the end of July. 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 fell w/w to 48.5% y/y from 51.0%; that's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate dropped to 59.1% y/y from 59.8%; it's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily 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 (47.6%, 8.6%), MidCap (83.3, 8.0), and SmallCap (121.4, 13.6).

S&P 500/400/600 Forward Valuation (*link*): Valuations fell for two of these three indexes last week. LargeCap's forward P/E dropped 0.1pt w/w to 20.8. That's down from a six-month high of 21.5 in early November, and compares to an 11-month low of 20.3 in early October. LargeCap's forward P/E also compares to 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 fell 0.1pt to a 21-month low of 15.6 and is down from a 13-week high of 17.1 in early November. That compares to a seven-month high of 20.5 in early March and is 7.3pts below its record high of 22.9 in June 2020. SmallCap's ticked up 0.1pt to 14.9. That's compares to mid-December's 20-month low of 14.4 and is down from a 13-week high of 16.1 in early November. It's now down 11.8pts from its record high of 26.7 in early June 2020 when forward earnings was depressed. During March 2020, MidCap's 10.7 and SmallCap's 11.1 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; MidCap's current 25% discount to LargeCap is its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 73rd week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 28% reading is near its biggest since April 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 30th straight week; SmallCap's current 5% discount to MidCap's is near its biggest since July 2001.

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. Those gains endured through the latest Q4 earnings warnings season, when forecasts typically decline. The S&P 500's Q4-2021 earnings-per-share estimate rose 13 cents w/w to $51.29, and is up from $51.08 at the beginning of the quarter. That $51.29 estimate represents a gain of 20.4% y/y on a frozen actual basis and a 23.1% y/y gain on a pro forma basis. Q4 is on pace to mark the fourth straight quarter of double-digit percentage earnings growth, but growth is slowing for a second straight quarter. All 11 sectors are expected to post positive y/y earnings growth for a third straight quarter during Q4-2021, but double-digit growth is expected for only six sectors; that's down from 10 sectors doing so during Q3. Here are the S&P 500 sectors' latest earnings growth rates for Q4-2021 versus their blended Q3-2021 growth rates: Energy (10,679.8% in Q4-2021 versus 1,798.0% in Q3-2021), Materials (63.9, 89.1), Industrials (52.4, 88.4), S&P 500 (23.1, 42.6), Health Care (19.9, 29.0), Information Technology (15.6, 38.2), Real Estate (13.9, 34.4), Communication Services (9.6, 35.6), Consumer Discretionary (8.5, 19.4), Financials (4.9, 35.9), Consumer Staples (3.5, 7.4), and Utilities (0.7, 10.3).

S&P 500 Q4 Earnings Season Monitor (*link*): With just over 6% of S&P 500 companies finished reporting revenues and earnings for Q4-2021, revenues have beaten the consensus forecast by a well-above-trend 3.0% and earnings have exceeded estimates by 5.6%. At the same point during the Q3 season, revenues were 2.1% above forecast and earnings 3.9% above. For the 32 companies that have reported Q4 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings during Q2 and Q3. The small sample of Q4 reporters so far collectively has a y/y revenue gain of 12.5% and an earnings gain of only 14.3%. Just 72% of the Q4 reporters so far has reported a positive earnings surprise, but 84% has beaten revenues forecasts. Fewer companies have reported positive y/y earnings growth in Q4 (75%) than positive y/y revenue growth (91). These figures will change markedly as more Q4-2021 results are reported in the coming weeks, but the early read on earnings is disappointing compared to the previous six quarters. We expect the y/y growth rates to continue easing in Q4 compared to Q2 and Q3. We also think that revenue and earnings surprises will moderate q/q due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

US Economic Indicators

Regional M-PMI (*link*): The New York Fed has provided the first glimpse of manufacturing activity in January and shows business activity in the region abruptly stalled—after 18

months of positive readings. Meanwhile, both price indexes eased though remained at elevated levels. January's composite index dropped to -0.7 from 31.9 in December and 27.5 for all of Q4. New orders (to -5 from 27.1) contracted slightly this month, and shipments (1.0 from 27.1) held steady after both posted robust growth at the end of last year. Labor market indicators showed employment (16.1 from 24.1) continued to expand at a healthy though slower pace than in December, while the average workweek (10.3 from 12.1) continued to lengthen. Meanwhile, delivery times (21.6 from 23.1) continued to lengthen, and unfilled orders (12.1 from 19.0) advanced. The prices-paid measure eased for the second month from 83.0 in November to 76.7 this month; it was at a record-high 83.5 last May. The prices-received gauge also eased for the second month from November's record high of 50.8 to 37.1 this month. For the most part, firms were optimistic about the six-month outlook, with future business conditions (35.1 from 36.4) holding steady, though both the prices-paid (76.7) and prices-received (62.1) measures accelerated to new record highs this month. The report notes that the capital expenditures index climbed from 38.0 to 39.7 this month—not far from its record high of 42.3 at the end of 2003—while technology spending (31.9) held steady at a robust pace, suggesting a significant increase in both capital and technology spending going forward.

Global Economic Indicators

European Car Sales (*link*): New car registrations, a proxy for sales, fell 22.8% y/y in December, the sixth consecutive drop. The report notes that most of the region's markets posted double-digit declines over the period, including four big ones, Italy (-27.5% y/y), Germany (-26.9), Spain (-18.7), and France (-15.1). Only a handful of countries—Bulgaria, Croatia, Latvia, and Slovenia—recorded gains. For all of 2021, sales of new cars in the EU sank by 2.4% to 9.7 million units, despite the record-low base of comparison of 2020. Looking at sales in the four major Eurozone markets for the full year, Germany (-10.1%) posted a decline, while Italy (+5.5), Spain (+1.0), and France (+0.5) recorded gains, though modest ones for the latter two. A semiconductor shortage impacted car production throughout 2021, but most prominently during the second half of the year. EU car registrations finished 2021 at 3.3 million units below pre-crisis sales in 2019.

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