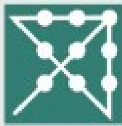

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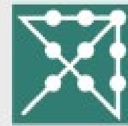

MORNING BRIEFING
February 8, 2022

Anatomy of a Correction

Check out the accompanying chart collection.

(1) Invitation to register for video podcast on "Predicting Inflation." (2) The latest mini-correction lasted 24 days. (3) Fed fooled by a few weak employment gains last year that were revised much higher. (4) When in doubt, predict volatility. (5) The most negative real fed funds rate since start of data in 1960. (6) Will the inflation curve bend? (7) Wage-price spiral would be nightmare scenario for the Fed, and investors. (8) Sentiment: more in correction camp than bear camp. (9) Lots of cash to fuel another record year for M&A. (10) Assessing the valuation correction.

Predicting the Markets: Video Podcasts. In 2018, I published *Predicting the Markets: A Professional Autobiography*. I've followed that up with a series of *Topical Studies* examining the issues that I discussed in my book but in greater detail and on a more current basis. My next venture is to create a series of video podcasts based on the 2018 book and the spinoffs. The subject of the first one is "Predicting Inflation." It will be webcast on Tuesday, February 22 at 2:00 p.m. EST. I invite you to register for it *here*.

Strategy I: The Latest Stock Price Correction. Joe and I still believe that the latest correction in the S&P 500 started the day after January 3, when the S&P 500 rose to a record high of 4796.56. On Monday, January 24, the index experienced a violent selloff, falling to an intraday low of 4222.62. That intraday low was down 12.0% from the January 3 peak, but the market recovered to close 8.1% below the record high. On January 27, the market had its lowest close of 4326.51, down 9.8% from the January 3 peak (*Fig. 1*). It was a mini-correction, which we define as a drop between 5% and 10% based on closing prices of the S&P 500.

We won't be surprised if the S&P 500 spends the next several months trading in a volatile fashion between January's record closing high and intraday low. Consider the following:

(1) *Fed-induced volatility.* The main source of the volatility is likely to be the Fed. The FOMC's U-turn from ultra-easy to tight monetary policy should have started sooner last year. It was delayed by a few weaker-than-expected payroll employment reports that have been subsequently revised significantly higher (*Fig. 2*).

Last year, the headline PCED inflation rate rose from a low of 1.4% y/y at the start of the year to a high of 5.8% during December (*Fig. 3*). Yet the federal funds rate remained at zero, making the real federal funds rate -5.7% during December, the most negative it has been since the start of the data during January 1960 (*Fig. 4*).

(2) *Inflation.* In other words, the Fed is way behind the so-called "inflation curve." To remain bullish on stocks, one has to believe, as we do, that the inflation curve will bend over as pent-up consumer demand for goods abates and supply-chain disruptions ease.

On the other hand, the longer it takes the Fed to tighten, the easier it is to be bearish as wage pressures push prices higher. The result could be a wage-price spiral, which would require the Fed to tighten more aggressively, raising the risks of a financial crisis that could trigger a credit crunch and a recession, as we discussed in yesterday's *Morning Briefing*.

There's evidence of such a spiral already, in December's survey of small business owners conducted by the National Federation of Independent Business (NFIB). The percentage of them raising prices and planning to do so was 57% and 49%, matching or exceeding the 1970s peaks (*Fig. 5*). The percentage planning to raise worker compensation was 32% during December, the highest on record starting in 1986. NFIB's advance jobs report showed this rate eased a bit to 27% in January. (We'll get a look at all of last month's data this morning when NFIB releases its January report.) On a yearly percent-change basis, the Employment Cost Index for wages and salaries of civilian workers closely tracks the NFIB compensation series (*Fig. 6*).

Another source of inflationary pressure is that crude oil prices continue to move higher, as we also discussed yesterday. Geopolitical tensions between Russia and Ukraine and between Iran and Israel are mounting. If either or both crises turn into military clashes, the price of oil is bound to go higher.

(3) *Sentiment.* The good news is that stock market sentiment has turned quite bearish since the start of the year, which is bullish from a contrarian perspective. The Investors Intelligence Bull/Bear Ratio edged up slightly during the February 1 week to 1.43 from 1.31 (*Fig. 7*). Bullish sentiment remained relatively low at 35.7%, while bearishness was at 25.0%. The biggest contingent was the correction crowd at 39.3%.

(4) *Liquidity and M&A activity.* We estimate that there is roughly $3 trillion in excess M2 liquidity in the economy based on the spread between December's M2 and its pre-pandemic trend (*Fig. 8*). Much of this liquidity seems to be on corporate balance sheets, as

we discussed yesterday. Over the past 24 months through December 2021, nonfinancial corporations raised a record $2.5 trillion in the bond market (*Fig. 9*).

So while the “Fed Put” may be kaput, the “CFO Put” could very well continue to boost valuation multiples if M&A activity and stock buybacks remain as strong as their record paces last year. The Fed’s data show that over the four quarters through Q3-2021, nonfinancial corporations retired a whopping $1.0 trillion in equity as a result of M&A activity and stock repurchases (*Fig. 10* and *Fig. 11*).

We expect liquidity-fueled M&A activity and share buybacks to continue to support the high valuation multiples of the S&P 500 LargeCaps and S&P 500 Growth stock price indexes, though we are puzzled by why that hasn’t been the case for the S&P 400 and S&P 600 indexes (a.k.a. the MidCaps and the SmallCaps, or collectively the SMidCaps) (*Fig. 12* and *Fig. 13*).

Strategy II: The Valuation Correction. Our Blue Angels analysis tracks the stock market equation P = P/E x E, where P = the stock price index, E = forward earnings over the coming 52 weeks, and P/E = the forward valuation multiple (*Fig. 14*). (FYI: “Forward earnings” is the time-weighted average of analysts’ consensus earnings estimates for this year and next, and the “forward valuation multiple” is the P/E based on forward earnings.)

The selloffs in the S&P 500/400/600 indexes since the start of this year have been triggered by the Fed’s U-turn from easy to tight monetary policies. All three indexes’ corrections have been attributable to the declines in their respective forward P/Es.

For all three, forward earnings remain on steep upward trends and were at record highs during the February 3 week. Bear markets tend to occur when both the P/E and E are falling. Corrections occur when the P/E is falling even though E is still growing.

Below, Joe observes about forward earnings that “LargeCap’s was at a record high for a sixth week after dropping for a week earlier due to index changes. MidCap’s was at a record high for a ninth straight week. SmallCap’s was back in record-high territory for a third week after being below for four weeks due to index changes. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap’s forward earnings has risen during 85 of the past 89 weeks, with the down weeks due to Tesla’s addition to the index in December 2020, Amazon’s earnings shortfall last August, and index changes in September and December. MidCap’s forward earnings is up in 83 of the past 87 weeks, and SmallCap’s posted 83 gains in the past 88 weeks.”

We conclude that the S&P 500/400/600 are experiencing corrections, not bear markets, because we don't expect a recession that will depress E this year. Now let's assess the declines in the forward valuation multiples:

(1) The forward P/E on the S&P 500 fell to 19.5 as of January 27, down from 21.8 a year earlier and a peak of 23.1 on September 3, 2020. Forward P/Es were dragged down by a few sectors, like Information Technology and Consumer Discretionary, which contain technology stocks that fell but forward earnings that held up. Other sectors with diminished forward P/Es include cyclical areas, like Energy and Materials, which benefited from the earnings effects of higher commodity prices over the past year.

(2) Here are the forward P/Es as of January 27 and as of one year prior for the S&P 500 and its sectors: Real Estate (46.1, 52.8), Consumer Discretionary (26.9, 35.7), Information Technology (24.4, 26.7), Consumer Staples (21.0, 19.9), Industrials (19.8, 23.6), S&P 500 (19.5, 21.8), Utilities (19.2, 18.4), Communication Services (18.3, 22.6), Materials (15.4, 20.1), Health Care (15.4, 16.1), Financials (14.4, 13.3), and Energy (12.3, 24.8) (*Table 1*).

(3) The 10 industries in the S&P 500 that saw the largest percentage drops in their forward P/Es are largely cyclical: Oil & Gas Refining and Marketing (13.0 as of January 27, 56.1 one year prior), Steel (5.4, 13.3), Oil & Gas Exploration & Production (9.9, 23.2), Publishing (22.4, 49.0), Integrated Oil & Gas (12.4, 25.2), Fertilizers & Agricultural Chemicals (9.7, 18.9), Commodity Chemicals (7.5, 14.5), Movies & Entertainment (31.1, 59.2), Health Care Supplies (26.2, 40.5), and Broadcasting (8.9, 13.6) (*Table 2*).

Calendars

US: Tues: Merchandise Trade Balance -$83.0b; NFIB Small Business Optimism Index. **Wed:** MBA Mortgage Applications; Crude Oil Inventories 1.525m; WASDE Report; Bowman; Mester. (Bloomberg estimates)

Global: Tues: Italy Retail Sales; Spain Industrial Production 0.6%; Canada Trade Balance $2.62b; Westpac Consumer Sentiment. **Wed:** Germany Trade Balance €10.4b; Italy Industrial Production -0.7%; UK RICS House Price Balance 68%; Japan PPI 0.4%m/m/8.2%y/y; Japan Machine Tool Orders; Pill; Macklem.(Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): All three of these indexes had forward earnings at a record high last week. LargeCap's was at a record high for a sixth week after dropping for a week earlier due to index changes. MidCap's was at a record high for a ninth straight week after dropping 0.1% below at the end of November. SmallCap's was back in record-high territory for a third week after being below for four weeks due to index changes. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 85 of the past 89 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings shortfall last August, and index changes in September and December. MidCap's forward earnings is up in 83 of the past 87 weeks, and SmallCap's posted 83 gains in the past 88 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 61.2% from its lowest level since August 2017; MidCap's is now up 118.0% from its lowest level since May 2015; and SmallCap's has soared 180.9% 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 29.4% y/y from 29.9%; that's down from a record-high 42.2% at the end of July, though 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 45.2% y/y from 47.2%; 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 53.3% y/y from 55.2%; 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 (48.7%, 8.4%), MidCap (82.9, 8.8), and SmallCap (123.9, 12.7).

S&P 500/400/600 Valuation (*link*): Valuations edged higher across the board for these three indexes last week. LargeCap's forward P/E edged up 0.1pt w/w to 19.8 and is up from a 21-month low of 19.6 in late January. That's down from a six-month high of 21.5 in early November, and compares to its prior 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 rose 0.2pt to 14.5 from a 22-month low of 14.3, 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 March 2021 and is 8.4pts below its record high of 22.9 in June 2020. SmallCap's rose 0.1pt to 13.6 from a 22-month low of 13.5. That 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 13.2pts 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 27% discount to LargeCap is its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 76th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 31% reading is 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 32nd straight week; SmallCap's current 7% 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 $1.21 w/w to $53.12, and is up from $51.08 at the beginning of the quarter. That $53.12 estimate represents a gain of 24.7% y/y on a frozen actual basis and a 27.2% 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 eight sectors; that's down from 10 sectors doing so during Q3. For Q1-2022, analysts expect S&P 500 earnings growth to weaken to 6.0% y/y on a frozen actual basis and 7.0% on a proforma basis. Double-digit growth is expected for just five sectors in Q1-2022, and three are expected to record a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q1-2022 versus their blended Q4-2021 growth rates: Energy (190.5% in Q1-2022 versus 11,180.4% in Q4-2021), Industrials (38.8, 40.6), Materials (34.7, 64.1), Real Estate (14.5, 14.9), Health Care (11.4, 23.8), Information Technology (7.6, 23.3), Utilities (7.1, 1.6), S&P 500 (7.0, 27.2), Consumer Staples (3.2, 4.6), Consumer Discretionary (-2.2, 11.9), Communication Services (-3.1, 15.7), and Financials (-19.1, 8.3).

Global Economic Indicators

Global Composite PMIs (*link*): Global demand slowed to an 18-month low at the start of 2022, with both the manufacturing and service sectors contributing to the slowdown. The C-PMI eased for the second month to 51.4, after increasing steadily the prior three months from 52.5 in August to 54.8 in November. The NM-PMI retreated for the second month to 51.3, the weakest since July 2020, with the report noting consumer-facing companies were most affected and with consumer services activity contracting for the first time in nine months. Meanwhile, the M-PMI fell for the second time in three months to a 15-month low of 53.2. The C-PMI for the advanced economies eased for the second successive month from 55.8 in November to 51.3 in January, the weakest since July 2020, while the C-PMI for emerging economies slowed to 50.8 in January—the lowest since last August's 49.3. According to the report, of the 13 countries for which January data are available, nine saw activity expand, with Ireland and the UK the strongest, while growth in the US was below the global average for the first time in 18 months. Meanwhile, Japan, Spain, Australia, and Kazakhstan saw a contraction in growth.

Eurozone Retail Sales (*link*): Eurozone retail sales contracted for the first time in five months, dropping 3.0% in December—though was within 3.1% of June 2021's record high. Nonfood products (excluding fuel) accounted for nearly the entire decline, plunging 5.2% after a two-month gain of 2.0%. Sales of food, drinks & tobacco slipped 0.3% during the month, while sales of auto fuels (0.1%) were little changed. On a year-over-year basis, sales for automotive fuels (14.2%) and non-food products excluding fuel (3.1) were in the plus column—with the former getting a big boost from pricing—while sales of food, drinks & tobacco (-1.1) were below a year ago. Data are available for three of the top four Eurozone economies, with all in the red, led by big declines in Spain and Germany. Spain's retail sales plunged 5.7% in December, more than reversing November's 5.4% jump, pushing sales 3.0% below year-ago levels; only Ireland's (-3.2) yearly decline was steeper. Sales in Germany contracted for the first time in three months, by 5.5%, with its growth rate flat with the year-ago level. Meanwhile, France's (-0.2) decline was negligible in December and followed a four-month spurt of 2.4% to a new record high. These sales were 1.1% above a year ago.

Germany Manufacturing Orders (*link*): German factory orders beat expectations in December, despite supply-chain disruptions. Orders recovered for the second month, by 2.8% m/m and 6.5% over the period, more than reversing October 5.8% drop. Domestic

demand pushed December orders higher, climbing for the second time in three months; domestic orders soared 11.7% m/m and 14.7% over the period to within 3.0% of a new record high. Meanwhile, foreign orders declined 3.1% in December, after a 6.5% rise and an 11.3% fall the previous two months—with orders from both inside (-4.2) and outside (-2.3) the Eurozone contracting during the final month of 2021. Here's a look at movements in domestic orders along with the breakdown from both inside and outside the Eurozone for the main industry groupings during December, both m/m and y/y: capital goods (16.1%, -7.8%, -5.0% m/m & 19.1%, 11.8%, -4.5% y/y), consumer nondurable goods (14.0, -3.7, -0.8 & 23.2, 0.1, -1.2), consumer durable goods (11.7, 9.6, 1.0 & -4.5, 8.9, 25.5), and intermediate goods (6.3, -0.1, 4.0 & 1.7, 0.5, 6.0).

Germany Industrial Production (*link*): Germany's industrial output declined in December, dragged down by a 7.3% plunge in construction output. The headline number, which includes construction, slumped 0.3% after rising 0.3% and 2.3% the previous two months, while the measure excluding construction increased for the third month, by 1.1% m/m and 4.3% over the period. Production including construction is 6.9% below its pre-pandemic level, while the measure excluding construction is 6.2% below. Three of the four main industrial groupings are showing signs of a pickup in growth. Capital goods production expanded for the second time in three months, by 2.6% in December and 10.1% over the period, while production of consumer durable goods rebounded 4.6% and 6.8% over the comparable periods. Intermediate goods production increased the final three months of 2021 by 1.7% over the period, not as impressive as the upswing in capital and consumer durable goods output. Meanwhile, production of consumer nondurable goods remains in a volatile flat trend, falling 1.6% in December after a 2.0% gain and a 1.6% loss the prior two months.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102

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