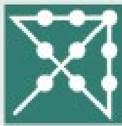

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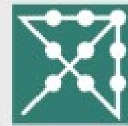

MORNING BRIEFING
February 9, 2022

Europe's Cold Winter War

Check out the accompanying chart collection.

(1) Upward payroll revisions suggest Fed stayed easy for too long. (2) Small businesses facing labor shortages and cost increases. (3) No sign of a peak in NFIB prices index. (4) Europe needs Russian gas, and Russia needs European customers for its gas. (5) Is Germany a weak link? (6) Winter will be followed by spring and summer. (7) Russia likely to make good on contractual deliveries. (8) Nord Stream 2 trump card.

The Fed: Relying on Unreliable Data. Pity the folks at the Fed. They say that they are data dependent. However, the data are undependable, especially the monthly payroll employment numbers. They follow these numbers closely—though perhaps not closely enough. Otherwise, they'd know that the payroll numbers get revised all the time, mostly downward during recessions and upward during expansions (*Fig. 1*).

As a result, the FOMC should have started to tighten monetary policy sooner rather than waiting to do so in March of this year. Here was the streak of mostly disappointing first-reported payroll increases during the final five months of last year and the latest revisions in thousands: August (235, 517), September (194, 424), October (546, 677), November (210, 647), and December (199, 510) (*Fig. 2*). In other words, revisions added 1.4 million to payrolls over those final five months of 2021. This suggests that January's 467,000 gain could be revised up too.

Meanwhile, the Fed's fretting about the slow recovery in the labor market—which revisions subsequently revealed as much stronger—caused the Fed to fall behind the inflation curve.

US Economy: Small Business Blues. Pity small business owners. They can't find workers to fill their open positions. They have to raise their workers' compensation so that employees don't quit for better-paying jobs elsewhere. The small business owners have to increase their capital spending in an effort to boost their workers' productivity. Their customers aren't happy that businesses are raising their prices to offset their costs, but the businesses have no choice.

Consider these takeaways from January's survey of small business owners conducted by

the National Federation of Independent Business (NFIB):

(1) *Down and out.* The NFIB small business optimism index edged down during January to 97.1 but remains above the 90.9 low during April 2020 during the pandemic lockdowns (*Fig. 3*). On the other hand, January's outlook for general business conditions was down to -33.0%, among the worst readings on record, including the ones during the Great Inflation of the 1970s (*Fig. 4*). Debbie and I suppose that business owners have to be natural-born optimists to stay in business, but they are realistic enough about all the challenges they currently face.

(2) *Rising labor costs.* The biggest challenge that many small business owners face is finding workers and paying them enough that they don't quit. During January, 47% of small businesses had job openings, but 55% of them said that they had few or no qualified applicants for those openings (*Fig. 5*). Furthermore, 26% said that they plan to increase hiring over the next three months. Those percentages all are downticks from recent highs in these series but still represent historically high readings.

The percent of small business owners planning to raise worker compensation over the next three months is down from a record high of 32% during November and December to 27.0% during January (*Fig. 6*). That's still in record-high territory. The series is a good leading indicator of the Employment Cost Index for the wages and salaries of civilian workers, which rose 4.5% y/y during Q4-2021, the highest pace since Q2-1990.

(3) *Capital spending strong.* The NFIB survey for January showed that small business owners making capital expenditures over the past six months edged up to 58%, while 29% are planning to do so over the next three to six months (*Fig. 7*). Both are relatively high readings but not exceedingly so.

Interestingly, the percent of small business owners planning capital spending in the months ahead has tended to be highly correlated with the percent saying that now is a good time to expand, which actually fell sharply during the pandemic and remains depressed (*Fig. 8*). The divergence between the two series suggests that small business owners have no choice but to invest in their productivity in response to the chronic labor shortage.

(4) *Passing along costs to prices.* The percent of small business owners planning to raise average selling prices peaked at a record high of 54% during November (*Fig. 9*). This series edged down to 47.0% during January. It is very highly correlated with the percent planning to raise worker compensation. The interaction of these two series is a good way to track the

extent of the wage-price spiral in our economy.

Finally and most importantly, there is no sign of a peak in inflation in the NFIB survey's series on the percent of small business owners who are raising their average selling prices. This series jumped to 61.0% during January (*Fig. 10*). That's the highest reading since the Great Inflation of the 1970s.

Geopolitics I: Putin's War Game. "What happens if [Russian President] Vladimir Putin invades Ukraine, the West hits Russia with sanctions, and Putin retaliates by halting Russian gas to Europe?" That scenario was the focus of an informative January 29 *article* in *The Economist* about how Europe might fare. It concluded: "Better than you might think."

Would Europeans face a colder winter, with gas rationing and rolling blackouts? Or would Europe's toll be mostly financial as it pays up for energy from outside of Russia? Could high prices and limited fuel shutter energy-heavy manufacturers, further damaging supply chains and the global economy? That's all possible, but not inevitable.

Indeed, Putin has a lot of leverage over Europe when it comes to energy. Russia typically supplies around 40% of Europe's gas imports, *according* to the *WSJ*. Already, Russia has sent less gas to Europe this winter, fulfilling its longer-term contracts but cutting off the additional supplies it usually sells on the spot market, observed a February 1 *Foreign Policy analysis*.

Half a century of energy relations suggests that Russia is unlikely not to fulfill its energy contracts, writes *Foreign Policy*. Even at the height of the cold war, the Soviet Union did not shut off gas exports. Further, during Russia's Ukraine gas dispute in 2009, Russia did not turn off all the gas, just what flowed through Ukraine.

Here are a few factors currently working against (and one for) Putin:

(1) *Germany's trump card (against).* If Russia invades Ukraine, President Joe Biden said on Monday in a joint press conference with German Chancellor Olaf Scholz, Putin's pet project, the Nord Stream 2 natural gas pipeline, would be suspended, *reported* the February 7 *WSJ*. The 765-mile-long pipeline will boost Russia's supply of natural gas to Germany once operational later this year. Scholz didn't echo that Russian military aggression against Ukraine would halt the project but did say it would prompt "hard, commonly agreed and wide-reaching sanctions." Berlin, because of its significant energy dependence on Russia, has been accused of being a weak link in the West's resistance against Russia.

(2) *Short window of leverage (against).* Russian gas sales to the EU typically drop in the spring to 60% of January's consumption, reports *The Economist*, so in a few months the EU will need Russian gas much less than it does now. EU gas storage filling levels typically dip below 40% of capacity in the spring but then are restored to above 80% by late summer thanks to lower seasonal depletions combined with imports (see Reuters' *chart*). This year, non-Russian sources of gas could help to offset a potential decline in Russian imports, as discussed below.

(3) *Europe's resiliency (against).* European gas infrastructure likely is resilient enough to handle Russia's shutting off the valves. The European Network of Transmission System Operators reports that Europe's gas infrastructure provides enough flexibility for the EU member states to ensure the security of the region's gas supply under various scenarios, reported *The Economist*.

(4) *Revenue dependence (against).* The Kremlin relies on energy revenues from Europe to fund its budget. The threat of unreliability from Russia's state-owned Gazprom, the largest supplier of natural gas to Europe, could severely harm its credibility. Mike Fulwood of the Oxford Institute for Energy Studies was recently *quoted* in *Politico* saying that even if Gazprom could withstand the revenue loss for a while, "it would throw out the window their reputation as a reliable supplier."

(5) *On the other hand (for).* Nevertheless, Jaime Concha of Energy Intelligence figures that Russia could handle the revenue loss up front. Concha calculates that a complete cutoff of piped gas to Europe for about three months could cost Gazprom about $20 billion in lost sales, according to *The Economist*. Offsetting the loss, higher prices from the mere threat of war are forecast to provide Gazprom with a lift to gross operating profit from $20 billion in 2019 to $90 billion this year, estimates JPMorgan Chase.

Even before the threat of Russia's invasion of Ukraine heated up, Europe was facing a looming energy crisis, with low gas stores from recent brutally cold winters raising prices. The *Foreign Policy* analysis stated: "European natural gas topped $60 per million Btu [late last year], equivalent to an oil price of an astonishing $350 per barrel. (Brent crude sells for around $90 a barrel, and the comparable U.S. gas price is around $4.) European household energy bills will rise another 50[%] this year, according to Bank of America."

Further, Russia is growing its clientele outside of Europe. Gazprom is building gas pipelines to China, notes the *WSJ's* editorial board. So "as Europe becomes more dependent on Russia for gas, Russia is becoming less dependent on Europe for revenue."

Geopolitics II: Europe’s Contingency Plans. Europe’s energy infrastructure has become increasingly resilient. Gas interconnectors now link countries previously isolated. Europe has plenty of regasification capacity and could have access to liquified natural gas (LNG) sources outside of Russia, says *The Economist*. In an emergency, Europe also could lift some of its green regulations to temporarily generate power. And this year’s warmer winter is helping alleviate supply constraints.

Here’s more on Europe’s continency plans:

(1) *Alternative sources.* Finding alternative energy sources is now a top priority of the European Commission, *reports* the *FT*. Lured by higher prices in Europe, US export cargoes of LNG intended for Asia already have been diverted to Europe. US and European diplomats are in the process of engaging other major LNG producers—e.g., from Azerbaijan, Qatar, and possibly Nigeria—to boost Europe’s energy supply.

(2) *What’s in store.* Europe’s cold winter last year depressed its natural gas storage levels to below five-year norms, according to *The Economis*t, but normal winter weather this year could replenish levels by spring—making up for two to four months of lost Russian gas exports. If some regulations on gas storage units were to be lifted in an emergency, then a month’s worth of Russian gas could be offset, the article added.

Geopolitics III: Europe’s Fault. How did Europe become so energy dependent on Russia? Europe’s aggressive pro-climate policies fostered that dependence. Europe’s climate regulations are a gift to Putin because they maintain Europe’s dependence on Russia’s gas. That’s because renewable “clean” resources are not yet ready to fill the energy gaps.

Here are a few examples of how Europe got itself into this cold mess:

(1) *Fracking bans.* Shale gas has revolutionized the energy industry in the US for reasons discussed in a 2021 *article* in *Discover Energy*. In contrast, Europe’s shale story is “one of much talk and little action.” Europe has about “as much technically recoverable shale gas as the US,” according to the Energy Information Administration. But bans on hydraulic shale fracturing have prevented this strategic asset from being developed.

(2) *Greening of Deutschland.* Germany is the most energy vulnerable of the large European countries. Germany is Europe’s largest consumer of natural gas. Russia supplies over half of Germany's natural gas imports. For these reasons, it’s no wonder that Germany has been reluctant to help arm Ukraine.

Germany has retired many coal-fired power stations. According to a *note* from Clean Energy Wire, German officials have planned to phase out coal power by 2038 at the latest but could pull forward that target to 2030. The next coal exit tender will take place in March 2022.

Following Japan's Fukushima disaster, Germany committed to shutting down its nuclear power plants. Three were closed in December, and the remaining three will be closed this year.

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories 1.525m; WASDE Report; Bowman; Mester. **Thurs:** Headline & Core CPI 0.5%m/m/7.3%y/y & 0.5%m/m/5.9%y/y; Initial & Continuous Jobless Claims 230k/1.615m; Federal Budget Balance $25.0n; OPEC Monthly Report. (Bloomberg estimates)

Global: 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. **Thurs:** Elderson; De Guindos; Lane; Wuermeling; Bailey; Lowe. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q4 Earnings Season Monitor (*link*): With nearly 60% of S&P 500 companies finished reporting revenues and earnings for Q4-2021, revenues have beat the consensus forecast by 2.6% and earnings have done so by 5.6%. The earnings surprise is substantially weaker than those seen since Q1-2020. At the same point during the Q3 season, revenues were 2.0% above forecast and earnings beat by 11.3%. For the 298 companies that have reported Q4 earnings through mid-day Tuesday, the aggregate y/y earnings growth rates have slowed considerably from their readings during Q2 and Q3, but revenues growth has remained strong. The sample of Q4 reporters so far collectively has a y/y revenue gain of 16.4% and an earnings gain of 26.8%. Just 79% of the Q4 reporters so far has reported a positive earnings surprise, not much higher than the 76% that has beaten revenues forecasts. However, fewer companies have reported positive y/y earnings growth in Q4

(78%) than positive y/y revenue growth (86). These figures will change markedly as more Q4-2021 results are reported in the coming weeks. We expect the y/y growth rates to continue easing in Q4 compared to Q2 and Q3. We think the revenues and earnings surprises will moderate q/q as well due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "More small business owners started the New Year raising prices in an attempt to pass on higher inventory, supplies, and labor costs," said NFIB Chief Economist Bill Dunkelberg. "In addition to inflation issues, owners are also raising compensation at record high rates to attract qualified employees to their open positions." January's Small Business Optimism Index (SBOI) edged down slightly to an 11-month low of 97.1 after climbing slightly the prior two months from 98.2 during October to 98.9 by the end of the year. Only one of the 10 components of the SBOI improved last month, seven declined, and two—capital outlay plans (29%) and expected credit conditions (-4)—were unchanged. Owners expecting business conditions to improve was the lone positive contributor to January's SBOI, though remains deep in negative territory. It increased for the second month to -33% after sliding 26ppts the prior five months to a record low of -38% in November. The biggest negative contributors were sales expectations (to -3% from +3%) and plans to increase inventories (3 from 8), falling 6ppts and 5ppts, respectively, with the remaining down from 2 to 3ppts: earnings trends (-17 from -14), hirings (26 from 28), job openings (47 from 49), now is a good time to expand (9 from 11), and current inventory (7 from 9). Meanwhile, small business owners once again cited the quality of labor (23) and inflation (22) as their two biggest problems. The former is down from November's record high of 29%, while the latter held at its highest rate since 1981—up 20ppts since February 2021's recent low of 2%; the cost of labor (11) rounded out the top three. The net percent of owners raising average selling prices increased 4ppts to 61% in January—the highest reading since Q4-1974—while the percentage planning to raise selling prices (47) eased for the second month from November's record-high 54%. As reported in NFIB's jobs report, a record-high net 50% reported raising compensation in January, while a net 27% plans to raise compensation in the next three months—easing a bit from December's record-high 32%.

Merchandise Trade (*link*): The real merchandise trade deficit widened to a new record high in December, suggesting trade was likely a drag on Q4 real GDP rather than having no

impact, as reported in the initial GDP estimate. The monthly deficit climbed to a record $111.2 billion, widening for the second month from October's $96.6 billion, though there was lots of strength in the report—with both real exports and real imports jumping to new record highs. Available data show the deficit averaged $105.9 billion during Q4, wider than Q3's average monthly deficit of $103.4 billion, suggesting trade subtracted from real GDP for the sixth successive quarter during Q4. Both real exports (3.2%) and real imports (2.3) climbed in December, with the former up 5.9% y/y and the latter up 9.6%. There was widespread strength in real exports in December, with real exports of autos (6.4) consumer goods ex autos (6.1), industrial supplies & materials (5.8), and capital goods ex autos (1.9) all in the plus column and with real exports of consumer goods ex autos and industrial supplies & materials at new record highs. Real exports of foods, feeds & beverages contracted 7.7% in December after a 23.1% jump the first two months of the quarter. Meanwhile, real imports of autos (8.2), consumer goods ex autos (7.2), and capital goods ex autos (3.5) ended 2021 on an up note—with real imports of consumer and capital goods ex autos both at new record highs. Meanwhile, real imports of foods, feeds & beverages dropped 4.7%, but is stalled in record territory, while real imports of industrial supplies & materials contracted 3.5% in December, but remains on a volatile uptrend—up 16.2% from September 2020's low.

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