MORNING BRIEFING
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Yes! We Have No Bananas

Check out the accompanying chart collection.

Executive Summary: With the Fed far behind the inflation curve and the yield curve spread rapidly narrowing, are fears of an imminent recession (a.k.a. "banana") justified? For now, we're singing the 1923 hit song with the ambivalent message "Yes! We Have No Bananas." That's because most indicators don't point toward the prospect of a recession but a couple do: the fastest business cycle in history and inflation rates that could lead to a Volcker 2.0 scenario. We also consider what's up with this yield curve. And we explain why we're maintaining our long-standing recommendation to overweight US stocks in global portfolios.

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*.

US Economy I: The 'B' Word. "Between 1973 and 1975 we had the deepest banana that we had in 35 years, and yet inflation dipped only very briefly," the economist Alfred Kahn, who headed the Carter administration's task force against inflation, once said. He used "banana" for the word "recession." The reason, he amiably explained, was that references to recessions seemed to make people nervous and irritable. Of course, one of the people made most irritable was his boss, President Jimmy Carter.

The Fed hasn't even started to tighten monetary policy, and more Fed watchers already are getting anxious about a recession. Some of them believe that the Fed is so far behind the inflation curve that Fed Chair Jerome Powell will have to channel his inner Paul Volcker and let interest rates soar to whatever level it takes to bring inflation down. In this Volcker 2.0 scenario, a severe recession is virtually inevitable. Other Fed watchers are claiming that the yield curve tells them that the Fed won't have to raise the federal funds rate much to unwind inflation, but that doing so might also result in a recession, though a milder one.

Debbie and I have been thinking more about the banana scenario. For now, we are singing the 1923 hit song with the ambivalent message "*Yes! We Have No Bananas*." Consider the

following mixed-message indicators, a couple of which point toward the prospect of a near-term recession (#1 and #2) and the rest not so much:

(1) *Business cycle on speed and steroids.* We've been thinking about the recession scenario for a while. That's because we started to write about the possibility of a V-shaped economic recovery in the March 23, 2020 *Morning Briefing*. Over the following weeks, we concluded that the lockdown recession, while extremely severe, would last only two months. We also anticipated that real GDP might fully recover by early 2021, which it did (*Fig. 1*). We didn't anticipate that the headline CPI inflation rate would soar from 1.4% during January 2021 to 7.5% by January of this year (*Fig. 2*). Our economy has experienced an inflationary boom for the past year.

Indeed, this has been the fastest business cycle in history so far, thanks to the excessively stimulative fiscal and monetary policies in response to the pandemic. Policymakers saw a serious crisis and decided not to let it go to waste. It logically follows that the rest of this business cycle may also be on the fast track. That means that the economic expansion won't last very long, so the recession that follows it naturally will come sooner rather than later.

(2) *The prices of bananas.* If the prices of bananas continue to soar along with other food prices and most items in the CPI, then the Fed will have no choice but to implement Volcker's solution, ushering in the Volcker 2.0 scenario. If CPI inflation moderates on its own, as we continue to expect, then the economy is likely to continue to grow this year and next year.

(3) *Leading and coincident indicators.* December's Index of Leading Economic Indicators (LEI) rose 0.8% m/m to yet another record high (*Fig. 3*). As a rule-of-thumb, it takes three consecutive months of decline in the LEI to signal an imminent recession.

The Index of Coincident Economic Indicators (CEI) also rose to an all-time high during December, just barely exceeding the previous record high of 106.8, when the pandemic started. Debbie and I have found that the average length of the past six economic expansions, following full recoveries in the CEI, is 67 months (*Fig. 4*). Using that average as a guide would place the start of the next recession during January 2026. The shortest of those six expansions lasted for 30 months.

(4) *Consumers in relatively good shape.* Consumers are in good financial shape, but inflation is eroding their purchasing power and confidence. Personal income excluding

government social benefits rose to a record high at the end of last year (*Fig. 5*). However, on an inflation-adjusted basis, this measure of income has been flat at a record high during the final half of 2021. Consumers accumulated $2.3 trillion in personal savings last year (*Fig. 6*).

There's been a significant divergence between the Consumer Sentiment Index (CSI) and the Consumer Confidence Index (CCI) in recent months, with the former much weaker than the latter (*Fig. 7*). We believe that's because the CSI gives more weight to inflation, which is depressing consumers. The CEI gives more weight to the employment situation, which is very strong.

In any event, consumers have plenty of pent-up demand for autos and services that should boost their spending as the pandemic continues to abate.

(5) *Ship-shape corporations.* Melissa and I have observed in recent months that nonfinancial corporations are in great shape. Corporate cash flow is at a record high. So is the amount of liquid assets on corporate balance sheets. Their collective profit margin is at a record high too despite rising costs and shortages of labor and some parts. They are responding to chronic labor shortages by spending more on capital equipment and technology. Durable goods orders excluding transportation has been rising to record highs since December 2020 through December of last year (*Fig. 8*).

(6) *Low risk of credit crunch.* As we also previously observed, there is about $3 trillion of excess M2 available. That's the difference between December's M2 and its pre-pandemic trend line. As noted above, all that liquidity is sitting on the balance sheets of both consumers and corporations. So the risk of a credit crunch resulting from Fed tightening is quite low for now, in our opinion.

(7) *Orderly deflation of bubbles.* We have also observed that air has been coming out of several speculative bubbles without any significant adverse impact on the financial markets or the economy.

US Economy II: Perverse Yield Curve. So what's the matter with the yield curve? Will it soon invert, signaling a recession? The yield spread between the 10-year and 2-year US Treasury notes has been narrowing significantly since the start of the year, as the 2-year yield has soared faster than the 10-year yield (*Fig. 9* and *Fig. 10*). The rapidly flattening yield curve is raising concerns that it might invert, which in the past has been a harbinger of recessions.

The 2-year yield, which soared from 0.25% during mid-2021 to 1.50% on Friday, tends to be a useful indicator of the fixed-income market's forecast for the federal funds rate a year ahead. The narrowing of the 10- to 2-year yield spread suggests that the Fed might not need to hike the federal funds rate much higher than 1.50% to bring down inflation and slow the economy. Here are a few counterpoints to consider:

(1) *One of 10 leading indicators.* The LEI comprises 10 components. One is the yield curve spread between the 10-year Treasury and the federal funds rate. The nine other indicators are: average weekly hours in manufacturing, jobless claims, manufacturers' real new orders for consumer goods & materials, the ISM new orders index, manufacturers' real nondefense capital goods orders excluding aircraft, building permits, the S&P 500, average consumer expectations for business conditions, and the leading credit index. Collectively, they continue to signal economic growth ahead, as noted above.

Unlike the 10- to 2-year yield spread, the LEI's yield curve spread has been moving mostly sideways around 150bps over the past six months because the Fed has yet to raise the federal funds rate, while the 2-year yield is already up to 1.50% (*Fig. 11*). The LEI's yield curve spread did turn negative just before the previous eight recessions. Interestingly, it is highly correlated with the overall M-PMI, which is not one of the LEI's components (*Fig. 12*).

In our 2019 *Topical Study* titled "The Yield Curve: What Is It Predicting?," we concluded that inverted yield curves predict financial crises triggered by tightening monetary policy. These crises tend to become widespread credit crunches, which cause recessions (*Fig. 13*). As discussed above, we don't see a credit crunch developing or a financial bubble bursting anytime soon.

(2) *Fed still rigging yield curve.* The Fed continued to increase its holdings of both Treasury notes and bonds to record highs through the February 9 week (*Fig. 14*). In other words, the Treasury market's pricing mechanism continues to be distorted by the Fed's purchases. In addition, while 10-year government bond yields have moved higher so far this year, they remain close to zero in Japan and Germany, providing some gravitational pull on US yields (*Fig. 15*).

Strategy: Lots of Reasons To Stay Home. Joe and I continue to recommend overweighting US stocks in global portfolios, as we have since the start of the bull market in 2009. It hasn't been a winning way so far this year, but it has been the way to go since 2009, as evidenced by the upward trends in the ratios of the US MSCI to the World ex-US MSCI in dollars and in local currencies (*Fig. 16* and *Fig. 17*). Consider the following:

(1) *Europe.* Europe's economic growth is getting hammered by soaring energy prices. The situation will only get worse if Russia invades Ukraine. The region's Economic Sentiment Indicator fell in January but remains relatively high (*Fig. 18*). The Eurozone's C-PMI fell to 52.3 during January from last year's high of 60.2 during July (*Fig. 19*).

(2) *Asia.* In Asia, China's economic growth is slowing. A rapidly aging demographic profile is weighing on consumer spending. The government's zero-Covid policy entails widespread lockdowns of cities whenever and wherever infections are found. Other Asian economies—especially Japan, South Korea, and those in Southeast Asia—depend on both their exports to China and imports from the country.

(3) *Global sectors.* It is widely believed that the global outperformance of the US MSCI has been mostly attributable to the Information Technology sector. That's not correct. Here is the performance derby of the 11 sectors of the MSCI in the US and overseas in local currencies since the week of March 5, 2009—just before the start of the current bull market—through Friday, February 11: MSCI US and World ex-US (557%, 163%), Communication Services (223, 55), Consumer Discretionary (1,131, 232), Consumer Staples (286, 192), Energy (65, 32), Financials (564, 155), Health Care (528, 199), Industrials (543, 217), Information Technology (1,256, 516), Materials (396, 133), Real Estate (419, 101), and Utilities (193, 21). (See our chart book *US MSCI vs All Country World ex-US MSCI Sectors*.)

It's a clean sweep: America has beat the rest of the world in all 11 sectors.

Calendars

US: Tues: Headline & Core PPI 0.5%m/m/9.1%y/y & 0.5%m/m/7.9%y/y; Empire State Manufacturing Index 12.0; TIC Net Long-Term Transactions; Weekly Crude Oil Inventories. **Wed:** Retail Sales Total, Core, and Control Group 2.0%/0.8%/1.0%; Headline & Manufacturing Industrial Production 0.4%/0.3%; Capacity Utilization 76.8%; Business Inventories 2.1%; Import & Export Prices 1.3%/1.3%; NAHB Housing Market Index 83; MBA Mortgage Applications; Crude Oil & Gasoline Inventories; FOMC Minutes. (Bloomberg estimates)

Global: Tues: Eurozone GDP 0.3%q/q/4.6%y/y; Eurozone Employment Report; Eurozone Trade Balance; Eurozone ZEW Economic Sentiment; Germany ZEW Economic Sentiment

53.5; UK Claimant Count Change -36.2; Average Hourly Earnings Including & Excluding Bonus 3.9%/3.6% UK Unemployment Rate 4.1%; Spain CPI; China CPI & PPI 1.0% & 9.4% y/y. **Wed:** Eurozone Industrial Production 0.5%m/m/-0.5%y/y; UK Headline & Core CPI -0.2%m/m/5.4%y/y & -0.4%m/m/4.3%y/y; UK PPI 0.9%m/m/13.1%y/y; Japan Core Machinery Orders -1.8%m/m/0.6%y/y; Australia Employment Change -15k; Australia Unemployment & Participation Rates 4.2%/66.0%; Wuermeling; Debelle. (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 seventh week after dropping for a week earlier due to index changes. MidCap's was at a record high for a tenth straight week after dropping 0.1% below at the end of November. SmallCap's was back in record-high territory for a fourth 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 86 of the past 90 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 84 of the past 88 weeks, and SmallCap's posted 84 gains in the past 89 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 118.4% from its lowest level since May 2015; and SmallCap's has soared 181.7% 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 28.6% y/y from 29.4%; 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 44.3% y/y from 45.2%; 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 50.5% y/y from 53.3%; 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 (49.1%, 8.0%), MidCap (83.9, 8.2), and SmallCap (122.9, 13.3).

S&P 500/400/600 Valuation (*link*): Valuations edged higher for two of these three indexes last week. LargeCap's forward P/E fell 0.4pt w/w to 19.4, but remains above its 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 0.1pt to 14.6 from 14.5. That's up from a 22-month low of 14.3, and is down from a 13-week high of 17.1 in early November. That also 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 13.7 from 13.6 a week earlier and is up from a 22-month low of 13.5 the week before that. 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 13.0pts 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 up from 27% a week earlier, which was its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 77th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% reading has improved from 31% a week earlier, which was 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 33rd straight week; SmallCap's current 6% discount to MidCap's is near its biggest since July 2001.

S&P 500 Q4 Earnings Season Monitor (*link*): With nearly 72% of S&P 500 companies finished reporting revenues and earnings for Q4-2021, revenues have beat the consensus forecast by 2.5% and earnings by 5.8%. The earnings surprise is substantially weaker than those seen since Q1-2020. At the same point during the Q3 season, revenues were 2.8% above forecast and earnings beat by 11.2%. For the 358 companies that have reported Q4 earnings through mid-day Monday, 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 16.1% and

an earnings gain of 26.3%. 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 (75%) than positive y/y revenue growth (87). These figures will change less markedly as more Q4-2021 results are reported in the coming weeks. The y/y growth rates have eased in Q4 compared to Q2 and Q3. The revenues and earnings surprises have eased q/q due to increased company guidance ahead of the earnings season as well as supply-chain issues that have resulted in missed deliveries and higher costs.

Global Economic Indicators

UK GDP (*link*): The Omicron variant caused real GDP to dip in December, but that didn't prevent the UK from posting its best annual growth rate since the end of World War II. For all of 2021, the economy grew 7.5% following a 9.4% plunge during 2020—which was dragged down by the fallout from the first wave of the pandemic. The UK recorded the fastest growth among the G7 economies last year. Despite December's 0.2% downtick, real GDP rose 1.0% during Q4, matching Q3's rate, putting GDP within 0.4% of its pre-pandemic level, while the December reading was back up at its pre-pandemic level. The report notes that the largest contributors to Q4 growth were human health and social work activities—most prominently, increased doctor visits early in the quarter, a big increase in Covid-19 testing and tracing activities, and the extension of the vaccination program.

UK Industrial Production (*link*): Production remained in a volatile flat trend in December, where it spent all of 2021. Output expanded 1.1% during the two months ending December after contracting 1.4% during the two months through October. It barely budged from the December 2020 level, up only 0.4% y/y in December 2021. Headline production was 2.6% below its pre-pandemic level at the end of 2021. Meanwhile, manufacturing production also lacked momentum last year, increasing 0.9% during the two months ending December following a two-month fall of 0.6%; it was up 1.3% y/y in December—and was 2.4% below its pre-pandemic level. Looking at the main industrial groups, only consumer nondurable goods production has been showing strength, soaring 20.1% since bottoming in April 2020 to a new record high by the end of 2021! Intermediate goods production, in the meantime, has fluctuated in a volatile flat trend since reaching a new record high in April 2021, falling to the low end of the range by December—2.7% below. Consumer durable goods production showed little growth the final 10 months of 2021 after rebounding 7.1% during the first two months of the year. Capital goods production, on the other hand, has been on a

downtrend since its recent peak in November 2020, falling 7.0% by the final month of 2021.

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