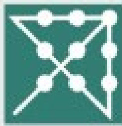
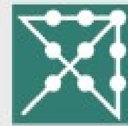
 Yardeni Research 

MORNING BRIEFING
March 15, 2022

Wage-Price Spiral Spiraling

Check out the accompanying chart collection.

Executive Summary: Today we examine Putin's War from several angles: The ceasefire demands that Russia has put to Ukraine, the requests for assistance that Russia has put to China, and reasons for surging US gas prices. … We also examine runaway inflation from several angles: What the Fed could do about it, what it will likely do instead, and why the wage-price spiral won't be stopping anytime soon.

Geopolitics I: Ceasefire? As The Beatles' John Lennon sang: "All we are saying is give peace a chance." Our March 2 *Morning Briefing* was titled "The Case for a Ceasefire."

We observed that Russia's military campaign was experiencing setbacks and that it was starting to lose the economic war launched by the West in retaliation for the invasion of Ukraine. We concluded that Russian President Vladimir Putin's "fallback position might be to withdraw his forces from all but the two 'independent republics' he carved out of eastern Ukraine last week in exchange for a guarantee that Ukraine won't join NATO."

On March 7, Dmitry Peskov, the Kremlin spokesman and a confidant of Vladimir Putin, said Russia had told Ukraine that it is ready to halt military operations "in a moment" if Kyiv meets a list of conditions, *reported* Reuters. Russia was demanding that Ukraine cease military action, change its constitution to enshrine neutrality, acknowledge Crimea as a Russian territory, and recognize the separatist republics of Donetsk and Luhansk as independent states.

The Kremlin spokesman insisted that Russia was not seeking to make any further territorial claims on Ukraine and said it was "not true" that it was demanding that Kyiv be handed over. "We really are finishing the demilitarization of Ukraine. We will finish it. But the main thing is that Ukraine ceases its military action. They should stop their military action and then no one will shoot," he said. On the issue of neutrality, Peskov said: "They should make amendments to the constitution according to which Ukraine would reject any aims to enter any bloc."

Geopolitics II: The Dragon and the Bear. Are there limits to the friendship of the Dragon

and the Bear? In our March 9 *Morning Briefing*, we wrote: “Last month, just before the Winter Olympics started in China, Putin and Xi met in Beijing. Their joint statement declared a new world order, with Moscow and Beijing working together to undermine American power. The new BFFs vowed that their countries’ friendship had ‘no limits.’ The Chinese leader also declared that there would be ‘no wavering’ in their partnership, and he added his weight to Putin’s accusations of western betrayal in Europe.” The *statement* was issued on February 4.

Here are the latest developments that are about to test this partnership:

(1) A March 13 *FT* *article* reported that US officials told the *FT* that Russia had been requesting military equipment and other assistance from China since the start of the invasion. They declined to give details about what Russia had requested. Both Russia and China denied the report.

(2) Jake Sullivan, the national security adviser for President Joe Biden, said on two Sunday March 13 television shows that the US would not just stand by and allow Beijing to undermine US and international sanctions against Russia. Sullivan *said* on CNN’s *State of the Union*, “I’m not going to sit here publicly and brandish threats, but what I will tell you is that we are communicating directly, privately to Beijing that there will absolutely be consequences for large-scale sanctions evasion efforts or support to Russia to backfill them.”

(3) On February 25, the UN Security Council considered a resolution to denounce Russia’s invasion of Ukraine. China and Russia are among the five permanent members of the UN Security Council; the other three are France, the UK, and the US. Because Russia is one of the five powers with a veto, the resolution was not upheld.

(4) Agreeing to a partnership with Russia on the eve of Russia’s invasion was a major foreign policy blunder for Xi. He put China on the wrong side of history, as evidenced by the historic UN General Assembly vote denouncing Russia on March 2. The resolution was supported by 141 of the assembly’s 193 members. The only countries to vote “no” in support of Moscow were Belarus, North Korea, Eritrea, and Syria. Longstanding allies Cuba and Nicaragua joined China in abstaining.

(By the way, I think it may be time to replace the United Nations with a League of Democratic Nations and to stop doing business with nations ruled by tyrants. Obviously, that’s easier said than done, but current events demonstrate the dangers of making them

more powerful and even greater threats to democracies by doing business with them.)

(5) The March 14 *NYT* included an *article* titled "China Sees at Least One Winner Emerging From Ukraine War: China." The article observes that China is scrambling to avoid becoming a pariah nation along with Russia, while benefitting from its partnership with Russia. Playing both sides, President Xi Jinping "reached out to European leaders last week with vague offers of assistance in negotiating a settlement, even as other Chinese officials amplified Russian disinformation campaigns meant to discredit the United States and NATO." China views both Russia and the West, led by the US, as declining powers, and sees an opportunity to rise above them all.

(6) On March 13, Bloomberg *reported*: "Chinese stocks listed in Hong Kong had their worst day since the global financial crisis, as concerns over Beijing's close relationship with Russia and renewed regulatory risks sparked panic selling. The Hang Seng China Enterprises Index closed down 7.2% on Monday, the biggest drop since November 2008. The Hang Sang Tech Index tumbled 11% in its worst decline since the gauge was launched in July 2020, wiping out $2.1 trillion in value since a year-earlier peak."

Contributing to the Chinese stock market selloff is a surge in Covid-19 cases in China. As a result, the government forced lockdowns in manufacturing hubs Shenzhen and Changchun in recent days. That halts production at many electronics and auto factories. It's the latest threat to the world's battered supply chain.

Geopolitics III: Oil's Slippery Slopes. The gasoline price at the pump is higher than ever. The average price of gas across all 50 states and the District of Columbia was $4.33 per gallon as of Friday, according to AAA (*Fig. 1*). During December of last year, the average American household spent almost $3,000, at an annual rate, on gasoline when the price was around $3.00 a gallon. Each dollar above that price adds about $1,000 to Americans' annualized gasoline outlays (*Fig. 2* and *Fig. 3*).

So, what's making gasoline prices soar? Consider the following:

(1) Gasoline prices were rising toward record levels in the US in February, even before Mad Vlad's army invaded Ukraine starting on February 24. However, his military started amassing troops near Ukraine during April of last year. On April 13, US Secretary of State Antony Blinken *said*, "We're now seeing the largest concentration of Russian forces on Ukraine's borders since 2014."

(2) As a presidential candidate in 2020, Biden promised that if elected he would ban issuance of new drilling permits on federal lands and waters to fight global climate change. Indeed, the pace of new permits dropped when Biden first took office; but subsequently the monthly rate has outpaced that during most of Trump's presidency. Still, many of the permits issued don't represent greenlights to begin drilling, as a March 13 *WSJ* *op-ed* by Harold Hamm explained:

"The 9,000 permits the White House keeps touting is misleading at best. Thousands of those sites can't be developed as they are held up in litigation. Others require new permits and leases to make a full unit. Thousands more await approval. Conservatively, our data tells us the number of available permits ready for production today stands closer to 1,500, and many of those are already drilling. No leases have been issued for federal land since 2020."

(3) Senator Elizabeth Warren (D-MA) believes that oil companies are "gouging," and is already working on a windfall profits tax. The *WSJ* Editorial Board has *opined*: "The windfall-tax proposal shows that Democrats don't want U.S. companies to produce more oil so gasoline prices fall. They want higher gas prices so reluctant consumers buy more electric vehicles."

(4) On March 8, oil prices plunged after the UAE's ambassador to Washington *told* CNN that the country wants to increase oil production and will encourage OPEC to ramp up supply (*Fig. 4*). The Biden administration was also hoping to import from Iran after completing a nuke deal with the country that would have allowed it to export more oil. Those prospects might be less likely after Iran's top paramilitary force claimed responsibility for a missile attack early Sunday that slammed into northern Iraq, sending US troops scrambling for shelter.

Inflation I: Expectations Not So Well Anchored. The Fed is hopelessly behind the inflation curve. The CPI inflation rate was 7.9% y/y during February. The last time it was this high was during January 1982 (*Fig. 5*). Back then, the federal funds rate was 13.2%; today it is near zero, where it has been since March 2020. The spread between the federal funds rate and the CPI inflation rate was -7.8% during February, the most negative it has been on record (*Fig. 6*).

Melissa and I doubt that Fed Chair Jerome Powell will do what it takes to bring inflation down as did former Fed Chair Paul Volcker. When Volcker took the helm of the Fed on August 6, 1979, the Great Inflation was well underway. During the summer of 1979, oil

prices were soaring because of the second oil crisis, which started at the beginning of the year when the Shah of Iran was overthrown. Seven months later, in March 1980, the CPI inflation rate peaked at its record high of 14.8%. When Volcker left the Fed during August 1987, he had gotten it back down to 4.3%.

How did he do that? He simply stopped pegging the federal funds rate and let it soar to a record high of 19.1% during June 1981. The real federal funds rate, which fell to -4.9% during June 1980, jumped to a record 9.5% during June 1981. The result was a severe recession that caused inflation to tumble.

The Powell-led Fed is likely to gradually tighten monetary policy. Fed officials no longer use the word "transitory" to describe the rebound in inflation since last March. Instead, they acknowledge that it has turned out to be "persistent." But we don't expect aggressive moves because we believe that most Fed officials still expect (hope) that inflation will moderate once supply-chain disruptions are fixed and Putin's War ends (hopefully soon).

During the Q&A segment of Powell's June 16, 2021 *press conference*, he was asked whether he believes that inflationary expectations remain anchored around 2%. Powell responded in the affirmative: "So the answer is yes, I think they are anchored and they're at a good place right now." In the July 7, 2021 *Morning Briefing*, we asked, "At what point do rising short-term inflationary expectations become a long-term concern?"

Powell's colleagues at the Federal Reserve Bank of New York are tracking inflationary expectations closely in their Survey of Consumer Expectations. The data start in June 2013 and are available through February of this year. Over the one-year- and three-years-ahead periods, consumers expect that inflation will be 6.0% and 3.8% (*Fig. 7*). We wouldn't call those expectations well anchored given that both measures were around 2.5% just before the pandemic.

Inflation II: Inflating Prices & Wages. Keep in mind that the headline CPI inflation rate rose to 7.9% during February, while the headline PCED inflation rate rose to 6.1% during January. The Atlanta Fed's wage growth tracker rose to 5.8% during February, on a three-month-moving-average basis (*Fig. 8*). Wages are increasing at a faster pace than they were pre-pandemic (i.e., 3.7% two years ago), but so are prices, which are offsetting the wage gains. Workers are quitting their jobs at record numbers as many switch to better paying jobs. During February, wages rose 6.6% for switchers and 5.4% for stayers, according to the Atlanta Fed's data (*Fig. 9*).

Debbie and I have become increasingly concerned that inflation is heading higher for longer. Consider the following:

(1) The November 22 *Morning Briefing* was titled "The Genie Is Out of the Bottle." Back then, the Fed chair was saying that higher inflation will remain persistent as long as supply-chain disruptions persist. We wrote: "Looking at the causes of supply-chain disruptions provides no assurance that they'll dissipate anytime soon." Nevertheless, we *wrote* on December 6: "We are not convinced that a widespread wage-price spiral is underway. We expect productivity to avert a 1970s-style spiral. But we continue to monitor the situation closely."

(2) Since then, we have become more concerned that productivity isn't rising fast enough to stop the wage-price spiral anytime soon, though we still expect it to do so in a major way during the 2020s.

Over the near term, we still expect to see moderation in the CPI inflation rate for consumer durable goods during H2-2022, but we are increasingly concerned about rising rent inflation, as we will detail in tomorrow's Morning Briefing. Not surprisingly, wage inflation tends to be highly correlated with rent inflation in the CPI (*Fig. 10*).

Calendars

US: Tues: Headline & Core PPI 0.9%m/m/10.0%y/y & 0.6%m/m/87%y/y; Empire State Manufacturing Index 7.25; TIC Net Long-Term Transactions; Weekly Crude Oil Inventories; OPEC Monthly Report. **Wed:** Retail Sales Total, Core, and Control Group 0.4%/0.9%/0.4%; Import & Export Prices 1/5%/1.6%; Business & Wholesale Inventories 1.1%/3.9%; Crude Oil Inventories; NAHB Housing Market Index 81; MBA Mortgage Applications; Fed Interest Rate Decision 0.50%; EIA Monthly Report. (Bloomberg estimates)

Global: Tues: Eurozone Industrial Production 0.2%m/m/-0.5%y/y; Eurozone ZEW Economic Sentiment; Germany ZEW Economic Sentiment & Current Conditions 10.0/-22.5; France CPI 0.7%m/m/3.6%y/y; UK Average Earnings Including & Excluding Bonus 4.6%/3.7%; UK Claimant Count Change -28k; UK Employment Change 3m/3m -65k; UK Unemployment Rate 4.0%; Enria. **Wed:** Italy CPI 0.9%m/m/5.7%y/y; Canada Headline & Core CPI 5.5%/4.5% y/y; Japan Industrial Production -1.3%; Japan Core Machinery Orders -2.2%m/m/8.1%y/y; Australia Employment Change 37k/Panetta; Australia Unemployment &

Participation Rates 4.1%/66.3%; Elderson. (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 an 11th week after dropping for a week earlier due to index changes. MidCap's was at a record high for a 14th straight week after dropping 0.1% below at the end of November. SmallCap's dropped for a second straight week to 1.4% below its record at the end of February. It had been consistently making new highs until mid-December, but since then it has done so in only five of the 12 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 90 of the past 94 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 88 of the past 92 weeks, and SmallCap's posted 85 gains in the past 93 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 63.6% from its lowest level since August 2017; MidCap's is now up 124.5% from its lowest level since May 2015; and SmallCap's has soared 181.9% 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 an 11-month low of 28.1% y/y from 28.2%; 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 edged down w/w to 44.3% y/y from 44.4%, but remains above its 11-month low of 44.2% in mid-February. 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 an 11-month low of 46.9% y/y from 48.9%. 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' consensus earnings forecasts for 2021 and 2022 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (49.4%, 8.5%), MidCap (86.8, 8.8), and SmallCap (126.4, 10.5).

S&P 500/400/600 Valuation (*link*): Valuations were broadly lower for these three indexes last week. LargeCap's forward P/E fell 0.7pt w/w to a 23-month low of 18.2 from 18.9. 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 January 2021 and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's fell 0.3pt to a 23-month low of 13.8 from 14.1. That's 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 8.8pts below its record high of 22.9 in June 2020. SmallCap's dropped 0.2pt w/w to a 23-month low of 13.5 from 13.7. That's down from a 13-week high of 16.1 in early November and is 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 25% discount to LargeCap is up from a 28% discount on February 2, which was its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 81st week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 26% reading has improved from 32% on February 2, which was its biggest since February 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 37th straight week; SmallCap's current 2% discount to MidCap's is up from a 9% discount in December, but remains near its lows during 2000-01.

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 is nearly final now at $54.06, down 8 cents w/w, and compares to a $51.08 estimate at the beginning of the quarter. That $54.06 actual represents a gain of 26.9% y/y on a frozen actual basis and a 32.0% y/y gain on a pro forma basis. Q4 marked the fourth straight quarter of double-digit percentage earnings growth, but growth slowed for a second straight quarter. Ten of the 11 sectors posted positive y/y earnings growth, down from all 11 doing so during Q2-2021 and Q3-2021. Double-digit growth occurred for nine sectors; that's down from 10 sectors doing so during Q3. Looking ahead to Q1-2022, analysts expect S&P 500 earnings growth to

weaken substantially to 5.2% y/y on a frozen actual basis and 6.4% on a pro forma 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 Q4-2021 growth rates: Energy (213.2% in Q1-2022 versus 12,396.8% in Q4-2021), Industrials (36.7, 43.6), Materials (34.8, 64.2), Real Estate (15.6, 17.7), Health Care (10.4, 28.0), Information Technology (8.4, 24.6), Utilities (6.5, -1.3), S&P 500 (6.4, 32.0), Consumer Staples (1.2, 7.7), Communication Services (-4.5, 16.5), Consumer Discretionary (-9.4, 53.4), and Financials (-20.0, 10.0).

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

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.