MORNING BRIEFING
April 5, 2022

Certainly Lots of Uncertainties

Check out the accompanying chart collection.

Executive Summary: There's lots of uncertainty about what's going to happen next in a slew of areas pertinent to investing, including whether the US economy is heading for a recession, how high inflation will go and what the Fed will do about it, how the world order is changing, and how to value stocks amid all this flux. The many unknowns have made for a volatile stock market so far this year. Today, we run through nine uncertainties that have been keeping investors guessing, sharing our analysis of each to shed what light we can. ...Also: More on the "CFO Put"—the notion that corporations flush with cash are providing stock market support via buybacks, dividends, and M&A.

Strategy I: Nine Known Unknowns. The stock market has been having a volatile year so far because there isn't a consensus on the economic and geopolitical outlooks. In other words, there is lots of uncertainty. That's reflected in our recent decision to provide annual ranges rather than year-end point estimates for the S&P 500. In yesterday's Morning Briefing, we updated our forecasting model to derive 4200-5000 for this year and 4800-5700 for next year (Fig. 1).

We also raised our 2022 and 2023 outlooks for both S&P 500 revenues and S&P 500 earnings to reflect higher-for-longer inflation. We applied a forward P/E range of 16.0-19.0 to our forward earnings-per-share estimates for both years. The wide range for this variable reflects our assessment of uncertainty. (See YRI S&P 500 Earnings Forecast.) Let's review some of the more important sources of uncertainty:

(1) *Uncertainty about a recession.* There's widespread puzzlement over the yield-curve spread. That's because the spread between the 10-year and 2-year Treasury notes has turned slightly negative, presumably signaling a recession within the next few months (Fig. 2).

However, the official spread—that's one of the 10 components of the Index of Leading Indicators (LEI)—is the one between the 10-year yield and the federal funds rate. It has continued to widen from around zero just after the end of the lockdown recession in 2020 to about 250bps now. As Melissa and I concluded in our 2019 study on the yield curve, this spread tends to anticipate credit crunches, which then cause recessions. We don't see any

evidence of an impending credit crunch in the credit-quality yield spread between the corporate high-yield composite and the 10-year Treasury (Fig. 3).

(2) *Uncertainty about the consumer.* Another more troubling component of the LEI is the average of the expectations components of the Consumer Confidence Index and the Consumer Sentiment Index (Fig. 4). (This average is the same as the expectations component of our Consumer Optimism Index [COI].) Rising inflation has weighed on consumer expectations. The COI expectations series fell from 95.8 a year ago to 65.5 during March, the lowest reading since January 2013. Given that this series is an LEI component, it is concerning to see it drop last month in much the same way as it has in the past prior to and during recessions.

Consumer spending is certainly the main driver of the business cycle. Adding to our concern is that the apparent strength in both personal income and personal consumption expenditures in recent months actually dissolves to very little, if any, growth when adjusted for inflation (Fig. 5 and Fig. 6).

On the other hand, the labor market is red hot. Initial unemployment claims is also included in the LEI, and it is down to previous cyclical lows. The unemployment rate fell to 3.6% during March, the lowest since its 3.5% pre-pandemic rate, which was the lowest since the end of 1969. The ratio of unemployed workers to job openings was at a record-low 0.6 during February (Fig. 7). In the consumer confidence survey compiled by the Conference Board, the percent of respondents agreeing that jobs are plentiful rose to a record high of 57.2%, while the percent agreeing that jobs are hard to get fell to 9.8%, only a couple of ticks away from its record low of 9.6% in July 2000 (Fig. 8).

As we noted yesterday, full-time household employment rose to a record high during March. The number of prime-age workers (25-54 years old) also rose to a record high during March. Even the number of senior-age workers (65 years or older) has almost fully recovered to the pre-pandemic record high.

(3) *Uncertainty about housing.* Another component of the LEI is building permits. It fell 1.9% during February but remains on a solid uptrend (Fig. 9). The significant increase in home prices over the past two years and the recent jump in mortgage rates may soon slow demand for new homes. However, rapidly rising rents should boost construction of multi-family units.

(4) *Uncertainty about capital spending.* Another component of the LEI is inflation-adjusted

nondefense capital goods orders excluding aircraft (*Fig. 10*). This series has been flatlining over the past 11 months through February, while the current-dollar series has been soaring. The inflation-adjusted measure has been a good indicator of private nonresidential investment on equipment in the real GDP accounts (*Fig. 11*).

Debbie and I continue to expect that businesses will respond to chronic labor shortages by boosting their capital spending, particularly on equipment and technologies, to increase the manual and mental productivity of the available labor force. We've found a reasonably close correlation between the growth rates in productivity and in real capital spending on equipment, both based on the 20-quarter percent change at an annual rate (*Fig. 12*).

(5) *Uncertainty about higher-for-longer inflation.* We are forecasting that the PCED headline and core inflation rates will peak between 6.0%-7.0% by the middle of this year before declining to 4.0%-5.0% by H2-2022 and 3.0%-4.0% next year. Our key assumption is that inflation will moderate significantly for consumer durable goods. The consumer durable goods measures in the CPI and PCED rose 18.7% y/y and 11.4% y/y through February (*Fig. 13*). From the mid-1990s until 2020, these prices typically fell at a gradual pace.

On the other hand, we expect that the 33.4% increase in the median existing home price over the past 24 months through February will lead to higher rent inflation (*Fig. 14* and *Fig. 15*). Rent of primary residence is already up to 4.1% y/y in the PCED to the highest pace since November 2007. We expect it to peak during H2-2023 around 6%-8%.

(6) *Uncertainty about the Fed.* The Fed's talking heads will keep talking until the next "blackout period" from April 23-May 5. They are likely to reinforce widespread expectations of a 50bps rate hike. Melissa and I view the 2-year US Treasury note yield as an indicator of the market's expectation for the federal funds rate a year ahead. It rose to 2.43% yesterday. Let's round that off to 2.50%, which implies that the Fed will raise the federal funds rate by another 200bps by April 2023.

The 10- to 2-year yield curve spread discussed above suggests that's all it will take either to bring inflation down in a soft-landing scenario or to trigger a hard- landing outcome that also brings inflation down. For now, stock investors are betting on a soft landing. For now, we agree with them.

(7) *Uncertainty about the world order.* Russia's war with Ukraine does not appear to be close to a ceasefire, let alone any sort of peace agreement. It appears that Russian President Vladimir Putin is scaling back his ambitions from a quick overthrow of the

Ukrainian government to annexing territory in eastern Ukraine. However, it is unlikely that Ukrainian President Volodymyr Zelensky will acquiesce or that Putin will be overthrown. So a protracted war now seems likely.

Just about the only good news coming out of that theater recently was that the Ukrainian flag was raised over the Chernobyl nuclear plant on Saturday after Russian forces completely withdrew, according to Ukraine's state nuclear agency.

(8) *Uncertainty about earnings.* The prospect of slower economic growth with more inflation makes forecasting S&P 500 earnings trickier than usual. As we discussed yesterday, weaker growth is likely to be more than offset by higher inflation, which is why we raised our outlook for both revenues and earnings. Industry analysts seem to agree, since they continue to raise their 2022 and 2023 estimates for both. The index of confidence in their earnings estimates for this year is relatively high, but next year's outlook is the most uncertain since the early readings for their 2009-11 and 2021 estimates.

(9) *Uncertainty about valuation.* Among the biggest uncertainties is the valuation multiple. It is a tug-of-war between the Fed's hawkishness and all the liquidity accumulated over the past two years as a result of the Fed's dovishness. It is also a tug-of-war between the MegaCap-8 and the remaining S&P 492. Most of the market's overvaluation is in the former eight stocks. But maybe they deserve to be highly valued given their size, market power, growth rates, and uniqueness.

Strategy II: The CFO Put. Joe and I have been writing about the "CFO Put" since February 1. The idea is that corporations have lots of cash for buybacks, dividends, and M&A activity. The "CFO Put" has replaced the "Fed Put."

Let me explain: Fed officials no longer are in a position to provide the stock market with a put since bringing down inflation is their number-one priority. Any swoon in the stock market is unlikely to result in any soothing words from any of them. Instead, they will have to reiterate their commitment to subduing inflation. Their motto now is: "We are all hawks now." So the "Fed Put" is kaput.

However, market swoons are likely to be cushioned by lots of corporate cash used to pay for stock buybacks, dividends, and M&A. I asked Joe to add up S&P 500 buybacks and S&P 500 dividends during Q4 for the S&P 500 as a whole and its 11 sectors. About half of the totals are at or near record highs.

Here are the numbers: S&P 500 ($403.7 billion, record high), Information Technology ($97.8 billion, record high), Financials ($72.0 billion, near Q3's record high), Communication Services ($51.4 billion), Consumer Discretionary ($38.5 billion, record high), Health Care ($39.8 billion), Industrials ($27.8 billion), Consumer Staples ($26.9 billion), Energy ($19.8 billion), Materials ($13.6 billion, near record high), Utilities ($8.5 billion), and Real Estate ($7.5 billion, record high).

Calendars

US: Tues: Trade Balance -$88.5b; S&P Global C-PMI & NM-PMI 58.5/58.9; ISM NM-PMI 58.0; API Crude Oil Inventories; Williams; Brainard. **Wed:** MBA Mortgage Applications; Crude Oil Inventories; FOMC Meeting Minutes. (Bloomberg estimates)

Global: Tues: S&P Global C-PMI Eurozone, Germany, and France 54.5/54.6/56.2; S&P Global NM-PMI Eurozone, Germany, France, and Italy 54.5/55.0/57.4; European Car Registrations; France Industrial Production 0.5%; UK C-PMI & NM-PMI 59.7/61.0; RBA Rate Decision 0.10%. **Wed:** Eurozone PPI 1.3%m/m/31.5%y/y; Germany Factory Orders -0.2%; DeGuindos; Panetta; Lane; Noguchi. (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 14th week after dropping for a week earlier due to index changes. MidCap's was at a record high for a 17th straight week after dropping 0.1% below at the end of November. SmallCap's rose for a third week to its first record high in five weeks. It had been steadily making new highs until mid-December, but then dropped 1.4% below its record by early March. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 93 of the past 97 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 91 of the past 95 weeks, and SmallCap's posted 88 gains in the past 96 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

65.3% from its lowest level since August 2017; MidCap's is now up 127.9% from its lowest level since May 2015; and SmallCap's has soared 187.1% 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 weakened to a 12-month low of 27.9% y/y from 28.1%; 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 rose to 40.4% y/y from an 11-month low of 39.9%. 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 fell to a 12-month low of 46.2% y/y from 46.9%. 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 2022 and 2023: LargeCap (9.3%, 9.9%), MidCap (10.0, 8.6), and SmallCap (10.6, 12.9).

S&P 500/400/600 Valuation (*link*): Valuations mostly edged down for these three indexes last week. LargeCap's forward P/E remained steady w/w at 19.5. That's up from a 23-month low of 18.2 in early March and down from a six-month high of 21.5 in early November. 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 ticked down 0.1pt w/w to 14.4, but remains above its 23-month low of 13.8 in early March. 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 8.5pts below its record high of 22.9 in June 2020. SmallCap's edged down 0.1pt w/w to 13.8, but remains above its 23-month low of 13.5 in early March. That's down from a 13-week high of 16.1 in early November and is now down 13.4pts 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 26% 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 84th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% 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 40th straight week; the current 4% discount 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 Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. That six-quarter streak of positive revisions throughout the quarter has officially ended with Q1-2022. In the latest week, the Q1-2022 earnings-per-share forecast dropped 8 cents w/w to $51.54, and is down 1.3% from $52.22 at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 4.9% y/y on a frozen actual basis and 6.4% on a pro forma basis. That's down from Q4-2021's 26.9% y/y on a frozen actual basis and a 32.0% y/y gain 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. That compares to Q4-2021's count of eight sectors with double-digit growth and one sector with 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 (233.5% in Q1-2022 versus 12,611.0% in Q4-2021), Industrials (36.8, 43.8), Materials (35.0, 64.2), Real Estate (16.0, 17.6), Health Care (10.2, 28.0), Information Technology (8.7, 24.6), Utilities (6.7, -1.3), S&P 500 (6.4, 32.1), Consumer Staples (1.9, 7.7), Communication Services (-5.2, 16.6), Consumer Discretionary (-11.9, 54.1), and Financials (-21.4, 9.9).

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.