MORNING BRIEFING
April 26, 2022

Waiting for a Break

Check out the accompanying chart collection.

Executive Summary: Investors are fretting that the Fed will slam on the monetary brakes, sending the economy hurtling down a ravine, but how legit are their concerns? Historical behavior of stock valuations and earnings estimates prior to feared and actual recessions offers perspective. Corrections usually reflect false alarms about impending recessions, whereas sustained bear markets reflect the real thing. … We also check more conventional leading economic indicators for perspective. … Plus: Fresh supply-chain disruptions resulting from China's widespread lockdowns could trigger a recession there and potentially weigh on growth here. … And: We examine the latest stats on another of China's homegrown problems: its birth dearth.

Strategy: Valuation Multiples as Leading Indicators. Why does the P/E of the S&P 500 tend to rise (fall) when bond yields and inflation rates fall (rise) (*Fig. 1* and *Fig. 2*)? Yes, we know that future dividends and earnings streams are worth more (less) when discounted by lower (higher) bond yields. However, there is a more compelling reason for the inverse correlation between the valuation multiple and both bond yields and inflation rates.

Rising inflation tends to cause the Fed to raise the federal funds rate, which drives the bond yield higher as well. Investors anticipate that at some point rising interest rates will trigger a financial crisis and cause a credit crunch and a recession. Previously, we've observed that the consensus earnings forecasts of industry analysts make a good leading indicator of actual earnings, but they don't anticipate recessions. That leaves it up to investors to do so—and to lower the valuation multiple of those consensus earnings estimates when they believe that the analysts are overly optimistic.

History shows that investors often start to cut the valuation multiple just before recessions, and certainly cut it as they unfold (*Fig. 3* and *Fig. 4*). On those occasions when recessions don't occur as anticipated, valuation multiples tend to rebound as they get back in sync with earnings—reflecting investors' restored confidence in analysts' earnings estimates. That's what always happens during the downs and ups of corrections.

The main difference between a correction, defined as a 10%-20% drop in the S&P 500, and a bear market, defined as a 20%-plus drop, is that earnings continue to grow during the former, while they take a dive during the latter. Corrections are false alarms about impending recessions, while bear markets are caused by alarming recessions. Of course, in a bear market, a 20%-plus drop in the S&P 500 can reflect a 20%-plus drop in the valuation multiple. But the bear market won't last very long if earnings continue to grow because the feared recession doesn't happen.

US Recession Watch I: A History of Bad Breaks. If a recession does occur soon, it will be the most widely anticipated recession on record. In the past, periods of monetary tightening by the Fed caused the federal funds rate to rise until a financial crisis occurred (*Fig. 5*). These past crises tended quickly to turn into credit crunches, which caused recessions. In the past, the initial crisis was not widely anticipated.

What's different today is that the Fed has raised the federal funds rate target range by only 25bps to 0.25%-0.50% so far this year; yet everyone is convinced that continuing to raise it will cause something in the financial system to break. The fact that the FOMC is likely to accelerate the pace of tightening because it's so far behind the inflation curve makes people all the more convinced.

Interestingly, the 10-year US Treasury bond yield also tends to peak at the same time as the federal funds rate, i.e., when financial crises occur (*Fig. 6*). However, as the periods of monetary tightening progressed, the 10-year yield rose less rapidly than the federal funds rate, as bond investors might have started to anticipate that something would break in the financial system and cause a recession (*Fig. 7*). That explains why the yield-curve spread between the 10-year yield and the federal funds rate has tended to peak and to start narrowing prior to financial crises (*Fig. 8*).

By the way, while the Fed's monetary tightening certainly is going to reduce liquidity in the financial system, there is plenty still left over from the past two years of "helicopter money." M2 remains about $3.0 trillion above its pre-pandemic trend line (*Fig. 9*). The same can be said about the demand deposit component of M2. Over the past 24 months through February, nonfinancial corporations raised a near-record $2.4 trillion in the bond market (*Fig. 10*). They used the proceeds to refinance their debts at record-low interest rates. Their balance sheets have lots of liquid assets.

So the fear that it won't take much Fed tightening before something breaks may be unwarranted. While there is a great deal of bearishness showing up in the Investors Intelligence and the AAII Investor Sentiment *surveys*, we aren't seeing much in the credit markets based on the high-yield corporate yield spread relative to the 10-year US Treasury.

US Recession Watch II: Where Are Leading Indicators Leading? Investors seem to have raised the odds of a recession last week after Fed Chair Jerome Powell's hawkish remarks on Thursday in a panel *discussion* at an International Monetary Fund seminar. He asserted that "getting inflation back to the 2% goal" is a key policy imperative right now. He added that it is "absolutely essential to get price stability" in order to assure labor market stability and overall economic stability. He said, "So it is appropriate, in my view, to be moving a little more quickly." The forward P/E of the S&P 500 dropped from 19.1 on Wednesday to 18.2 on Friday (*Fig. 11*).

Investors' jitters about the next recession might have started early last year, according to the forward P/Es of the S&P 400/600 SMidCaps. They dropped from 19.7 and 19.2 at the start of last year to 13.5 and 13.0 during the April 22 week of this year.

Now let's conduct a reality check by examining whether more conventional leading indicators are confirming the fears of investors:

(1) *S&P 500 forward earnings.* Forward earnings per share is the time-weighted average of analysts' earnings estimates for the current year and coming year. It tends to lead actual operating earnings by about 12 months (*Fig. 12*). Forward earnings can go up even when analysts are lowering their annual estimates, as long as the coming year's expectations continue to exceed those of the current year. But forward earnings always plunges during recessions, indicating massive downward estimate revisions and confirming that analysts don't see recessions coming.

On the other hand, analysts are quite good at calling recession troughs, when forward earnings tends to bottom. Currently, forward earnings is at a record high, having risen to yet another new high, of $234.80 per share, during the April 21 week.

(2) *Index of Leading Economic Indicators (LEI).* The LEI increased 0.3% in March, following an upwardly revised 0.6% advance in February (double the initial 0.3% increase) and a 0.4% decline in January—which was only its second decline since April 2020 and the first since February 2021 (*Fig. 13*). April's increase pushed the LEI up to a new record high, with seven of its 10 components increasing and three decreasing.

The interest-rate spread (+0.24ppt) once again was the biggest positive contributor to the LEI, followed by jobless claims (+0.18) and the leading credit index (+0.09), while the average workweek (+0.06), real core capital goods orders (+0.04), real consumer goods orders (+0.01), and building permits (+0.01) were more modest contributors. Meanwhile, consumer expectations (-0.26) was the major drag again last month, with stock prices (-0.04) and the ISM orders index (-0.04) exerting minor drags.

The yield-curve spread is one of the 10 components of the LEI. It is the difference between the 10-year Treasury yield and the federal funds rate (*Fig. 14*). In March, it rose to 193bps. On a weekly basis, it jumped to 256bps during the April 22 week, the highest since the week of May 2, 2014. In the past, the spread has typically peaked between 300bps-400bps before it started narrowing again. It clearly isn't forecasting a recession currently.

(3) *Consumer expectations.* The Consumer Sentiment Expectations index is averaged with the Consumer Confidence Expectations index to derive another component of the LEI. It was a negative contributor in March but edged higher during the first two weeks of April (*Fig. 15*).

(4) *Initial unemployment claims.* Consumer confidence has been depressed by rising inflation, more than offsetting all the good news coming out of the labor market. Initial unemployment claims could be a positive contributor to the LEI again in April as it was in March. On a weekly basis, jobless claims have been below 200,000 for 10 of the past 11 weeks through the April 16 week (*Fig. 16*).

The recession risk is that despite the strong labor market, consumers reduce their spending. The problem is that inflation is eating away at the nominal gains in personal income. In fact, real personal income during February was the lowest since December 2020 (*Fig. 17*).

(5) *Building permits.* The building permits components of the LEI ticked higher in March (*Fig. 18*). It is likely to continue to move higher given the strong demand for housing, even though affordability is down as a result of soaring home prices and mortgage rates. Soaring rents should certainly provide a strong incentive to build more multifamily housing units.

(6) *Transportation indicators.* The LEI does not include any transportation indicators. However, Debbie and I like to monitor a few of them as useful leading indicators, or at least as good coincident indicators. We take comfort in the fact that the ATA truck tonnage index rose 2.3% m/m and 3.8% y/y during March (*Fig. 19*). Payroll employment in truck transportation downshifted in March but remained near February's record high (*Fig. 20*). We've heard some chatter about a recent drop in trucking freight rates. If so, that was after they soared 24.5% y/y during March (*Fig. 21*).

China I: Spreading Lockdowns. Commodity prices and agriculture-related stock prices dropped over the past few days on fears that China's pandemic lockdowns are spreading as Covid-19 spreads. These lockdowns soon will start another wave of supply-chain disruptions. They could cause a recession in China and slow the US economy if shortages of goods and parts weigh on US retailers and factories.

The April 25 *NYT* *reported*: "China's economy is a giant, sophisticated machine that requires numerous parts to work together. Behind its 1.4 billion consumers are 150 million registered businesses that provide jobs, food and everything that keeps the machine humming. Now, in the name of pandemic control, the Chinese government is meddling with the economy in ways that the country hasn't seen for decades, wreaking havoc on business." Around 344 million people, or a quarter of the country's population, are under some kind of lockdown.

While much of the world is opening up, the Chinese government is doubling down on its zero Covid policy, making low death and infection rates central to its legitimacy. The Chinese Communist Party's congress meets late this year when China's top leader, Xi Jinping, is expecting to secure a third term. Xi has not budged from his zero Covid position. "Perseverance is victory," he said on April 13.

China II: Birth Dearth. The latest release from the National Statistics Bureau of China shows births fell from 12.02 million in 2020 to only 10.62 million in 2021. Meanwhile, China's population stagnated at around 1.41 billion people (*Fig. 22*). That's because births barely outnumbered the 10.14 million deaths last year, suggesting the day may be near when China's population starts to shrink. Here's more on China's increasingly geriatric demographic profile:

(1) China's fertility rate—the number of children a woman has over her lifetime—dropped below replacement levels in the early 1990s. In 2020, it came in at 1.69. For perspective, Japan's 1.37 rate is among the world's lowest (*Fig. 23*).

(2) Since an uptick in 2016, when China scrapped the four-decade one-child policy and allowed married couples to have two children, the number of births has slipped every year. The birthrate was already the lowest in the country's modern history in 2019. Beijing last year said all couples could have three children, and local governments have tried measures including cash rewards and longer maternity leaves to boost births. To facilitate marriages, local officials have organized matchmaking events and discouraged the use of dowries.

(3) The latest data show that the percentage of the Chinese population 60 years or older rose to 18.9% in 2021 from 18.7% in 2020. Nearly one in five Chinese is 60 or older. China is rapidly becoming the world's largest nursing home.

(4) In the late '90s, there were roughly equal numbers of Chinese men and women in their 20s, but by 2020 there were about 111 men for every 100 women, according to official data. Among Chinese aged 20 to 40, men outnumber women by 17.5 million.

(5) Retail sales fell 3.5% y/y through March in China (*Fig. 24*). On an inflation-adjusted basis, retail sales fell 5.0%. The underlying growth rate in real retail sales fell from the mid-teens ten years ago to around 3.0% currently (*Fig. 25*). Debbie and I attribute this downward trend to China's rapidly aging population and near-zero population growth.

Calendars

US: Tues: Consumer Confidence 108.0; Durable Goods Orders Total, Core, and Core Nondefense Capital Goods 1.0%/0.6%/0.4%; S&P/CS HPI 20-City Composite Index 1.5%m/m/18.9%y/y; Richmond Fed Manufacturing Index; New Home Sales 765k. **Wed:** Goods Trade Balance; Wholesale Inventories; Pending Home Sales -1.5%; Crude Oil Inventories; MBA Mortgage Applications. (Bloomberg estimates)

Global: Tues: Japan CPI, Japan Industrial Production -5.0%m/m/2.2%y/y; Australia CPI 1/7%q/q/4.6%y/y; China Industrial Orders; Mauderer. **Wed:** Germany Gfk Consumer Climate -16.0; France Consumer Confidence 92; Italy Trade Balance; Japan Retail Sales 0.4%; BOJ Rate Decision -0.10%; Lagarde; Beerman; Rogers. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three these indexes had forward earnings at a record high last week. LargeCap's was at a record high for a 17th week after dropping for a week earlier due to index changes. MidCap's was at a record high for a 20th straight week after dropping 0.1% below at the end of November. SmallCap's rose for the fifth time in six weeks, but remains 0.04% below its record high three weeks ago. 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 96 of the past 100 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 94 of the past 98 weeks, and SmallCap's posted 90 gains in the past 99 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 66.5% from its lowest level since August 2017; MidCap's is now up 131.7% from its lowest level since May 2015; and SmallCap's has soared 187.9% from its lowest point since August 2013. In the latest week, the yearly rate of change in LargeCap's forward earnings weakened to a 12-month low of 25.2% y/y from 26.2%; that's down from a record-high 42.2% at the end of July and up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings dropped to a 12-month low of 39.5% y/y from 40.6%. 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 13-month low of 43.9% y/y from 45.0%. 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 (9.5%, 10.0%), MidCap (10.8, 8.9), and SmallCap (9.6, 12.6).

S&P 500/400/600 Valuation (*link*): Valuations were mixed for these three indexes last week. LargeCap's forward P/E fell 0.6pts to a 24-month low of 18.2 from 18.8. That's 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 fell 0.2pts to a 24-month low of 13.5 from 13.7. That's down from a 13-week high of 17.1 in early November and is 8.7pts below its record high of 22.9 in June 2020. SmallCap's fell 0.2pt w/w to a 25-month low of 13.1 from 13.3. That's down from a 13-week high of 16.1 in early November and is now down 13.6pts 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 near its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 88th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 28% reading is near its biggest discount 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 45th straight week; the current 3% 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 officially ended with Q1-2022. In the latest week, the Q1-2022 earnings-per-share forecast rose 69 cents w/w to $51.99, and is down 0.4% from $52.22 at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 4.4% y/y on a frozen actual basis and 7.3% on a pro forma basis. That's down from Q4-2021's 26.9% y/y on a frozen actual basis and a 32.1% 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 (244.8% in Q1-2022 versus 12,611.0% in Q4-2021), Industrials (38.0, 43.8), Materials (38.3, 64.2), Real Estate (18.4, 17.6), Health Care (10.6, 28.0), Information Technology (8.6, 24.6), Utilities (8.1, -1.3), S&P 500 (7.3, 32.1), Consumer Staples (2.8, 7.7), Communication Services (-6.7, 16.6), Consumer Discretionary (-9.9, 54.1), and Financials (-19.6, 9.9).

S&P 500 Q1 Earnings Season Monitor (*link*): With over 20% of S&P 500 companies finished reporting revenues and earnings for Q1-2021, revenues are beating the consensus forecast by 1.4%, and earnings have exceeded estimates by 8.3%. We expect these figures to change markedly beginning later this week because companies in the Financials sector typically weigh more heavily on the early season results. At the same point during the Q4 season, revenues were 1.7% above forecast, and earnings beat by 3.0%. For the 102 companies that have reported Q1 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their double-digit percentage readings from Q2-2021 to Q4-2021. The current sample of Q1 reporters so far collectively has a y/y revenue gain of 9.1% but an earnings gain just of 0.7%. We expect the aggregate Q1 earnings growth reported will turn positive as more non-financial firms report. While just 69% of the Q1 reporters so far has reported a positive revenue surprise, 78% has beaten earnings forecasts. However, fewer companies have reported positive y/y earnings growth in Q1 (59%) than positive y/y revenue growth (78%). We expect to see revenue and earnings surprises moderate q/q due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

US Economic Indicators

Regional M-PMIs (*link*): Three Fed districts (New York, Philadelphia, and Dallas) now have reported on manufacturing activity for April and show it remains in a relative flat trend, though did accelerate slightly this month. The composite index climbed to 14.4 this month after easing from 11.0 to 8.1 last month, as growth in the New York (to 24.6 from -11.8) region moved from contraction to expansion, while growth in the Philadelphia (17.6 to 27.4) area slowed though remained robust. Meanwhile, growth in the Dallas (1.1 to 8.7) area was at a near standstill. The new orders (18.3 from 8.4) picked up steam this month, expanding at more than double March's pace, also led by a swing in New York (25.1 to -11.2) orders growth from contraction to expansion. Billings in the Dallas (12.1 from 10.5) region showed a slight acceleration, while Philadelphia's (17.8 from 25.8) eased, though were stronger than Dallas'. Meanwhile, jobs' (24.4 from 26.3) growth continued at a healthy pace, with factory hirings in the Philadelphia (41.4 from 38.9) region accelerating at a record rate and those in the Dallas (24.6 from 25.5) area holding at a steady robust pace. Factories in the New York (7.3 from 14.5) region grew at half March's pace and one-third of recent highs. Turning to prices, the prices-paid measure in the New York (to 86.4 from 73.8) area shot up to a new record high, while Philadelphia's (84.6 from 81.0) accelerated at its fastest pace since 1979—closing in on its record high of 91.1 during March 1974. Dallas' prices-paid (61.5 from 74.0) measure has eased from November's record-high 83.3. Meanwhile, New York's (49.1 from 56.1) prices-received index slowed this month from March's record high, while Philadelphia's (55.0 from 54.4) accelerated for the third month, moving back toward November's 62.9, which was close to its record high of 63.8 in the mid-1970s. Dallas' prices-received measure (43.5 from 47.8) followed a trend similar to that of its prices-paid measure, easing from its record high of 50.9 in October.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "Sentiment in the German economy has stabilized at a low level," noted Ifo's President Clemens Fuest. "After the initial shock of the Russian attack, the German economy has shown its resilience." The business climate index improved from March's 20-month low, advancing to 91.8 this month after plunging 7.9 points in March—from 98.7 to 90.8. The expectations component (to 86.7 from 84.9) accounted for this month's gain, after plunging a record 13.8 points in March to its lowest level since May 2020. The current situation component (97.2 from 97.1) barely budged this month after dipping 1.6 points in March. The measure for the manufacturing sector improved to -1.0 after plunging a record 26.7 points (-3.6 from 23.1) in March, with the expectations component (-23.5 from -30.1) accounting for the this month's gain—though remaining steep in contractionary territory. The current situation measure fell for the second month, from 35.9 in February to 24.4 this month—still a relatively high reading. Confidence within the service sector improved to 5.4 this month after dropping from 13.6 to 0.8 in March, with companies more optimistic about the current situation (23.1 from 19.4) and less pessimistic about the future (-10.9 from -16.3) this month. Sentiment in the trade sector dropped for the second month, from 6.6 in February to -13.3 this month, with the current situation component dropping from 18.2 to 13.5 over the period. The expectations component (-36.7 from -37.8) remained strongly pessimistic. The business climate index in the construction sector plunged 27.7 points the past two months—from 7.7 to -20.0—the lowest reading since May 2010, with this sector especially burdened by bottlenecks in materials supply. The current situation component sank 18.0 points (15.7 from 33.7) over the two-month period, while expectations dropped 34.5 points (-49.8 from -15.3) over the comparable period—the most pessimistic reading since reunification.

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