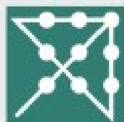
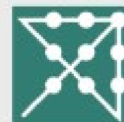
 Yardeni Research 

MORNING BRIEFING
May 3, 2022

Too Much Pessimism?

Check out the accompanying chart collection.

Executive Summary: To look at analysts' record-high and rising estimates for the companies they follow, you'd never guess that investors are sweating bullets over prospects for the US economy. But are their fears of imminent recession justified? Today, we tackle that question, assessing both the negatives that investors are accentuating as well as the positives that some economic indicators are signaling. Importantly, the US economy is shipshape. … And we remind readers: Corrections, such as the S&P 500 is in now, tend to turn into bear markets only when investors' recession fears materialize; when they fail to, valuation multiples tend to rebound.

Strategy I: High Anxiety. I don't recall so much stock-market pessimism in a very long time. I think it's mostly because the Fed Put is kaput. That's because inflation hasn't been as serious a problem as it is today since the Great Inflation of the 1970s. Fed officials finally acknowledged as much late last year and increasingly pivoted away from their dovish stance during 2020 and 2021 to a much more hawkish one starting early this year. Consider the following related developments:

(1) *Hawkish FOMC meetings ahead.* The financial markets expect that at this week's FOMC meeting, Fed officials will vote unanimously to raise the federal funds rate by 50bps to a range of 0.75%-1.00%. They are also expected to signal a 50bps hike to a range of 1.25%-1.50% for their next meeting, on June 14-15. They most likely will reaffirm their commitment to quickly move the range closer to 2.50%, which seems to be the committee's consensus estimate of the so-called "neutral" federal funds rate. They could easily accomplish that at their following three meetings on July 26-27, September 20-21, and November 1-2. They then might pause to see whether they need to go higher than neutral.

(2) *From QE4 to QT2.* In addition, at this week's meeting, they are expected to vote on how much they will reduce the size of the Fed's balance sheet. The *minutes* of their previous meeting—held on March 15-16, with the minutes released on April 6—suggested that the committee will sign off this week on reducing their holdings at the rate of $95 billion per month. The committee "generally agreed" to reducing the Fed's balance sheet by a maximum of $60 billion in Treasuries and $35 billion in mortgage-backed securities per month, phased in over three months and probably starting in May or June.

The first round of quantitative tightening (QT1) lasted from October 1, 2017 to July 31, 2019. The Fed's holdings of securities was pared by $640 billion from $4.2 trillion to $3.6 trillion (*Fig. 1*). QT2 would reduce the Fed's balance sheet at a much faster pace, by about $1.1 trillion over the next 12 months for starters.

Many market participants fear that might be tightening too aggressively.

(3) *Leading the fed funds rate.* The fixed-income markets have been discounting this Fed scenario increasingly since last summer when the 2-year US Treasury note yield was close to zero. It was up to 2.73% yesterday. This yield tends to be a good year-ahead leading indicator of the federal funds rate. It's already higher than the Fed's 2.50% neutral rate and seems headed soon for 3.00% and maybe higher. The 12-month-ahead nearby federal funds rate futures rose to 3.06% last week (*Fig. 2*).

The jump in the 2-year Treasury note yield in less than a year is unprecedented. The iShares 20+ Year Treasury Bond ETF is down 17.2% since January 3 through Friday.

(4) *The yield-curve spread widens.* Meanwhile, despite the big and rapid jump in interest rates over the past year, there's no sign of a recession in the spread between the 10-year government bond yield and the federal funds rate (*Fig. 3*). This monthly spread is one of the 10 components of the Index of Leading Economic Indicators (LEI). The weekly spread rose to 256bps in late April, the highest since early May 2014. During previous business cycles, it has typically peaked between 300bps-400bps.

(5) *A worrisome indicator.* Nevertheless, the S&P 500—also one of the LEI components—is reflecting investors' increasing concerns about an impending recession, if not an imminent one. This stock price index has been in a correction since it peaked at a record high on January 3. It is down 13.4% through yesterday's close.

The correction has been entirely attributable to the plunge in the forward P/Es of the major indexes at the start of this year through Friday: S&P 500 (21.4, 17.5), S&P 500 Growth (28.3, 21.0), S&P 500 Growth's MegaCap-8 (33.8, 25.5), S&P 500 Value (17.1, 15.1), S&P 400 (15.9, 12.9), and S&P 600 (15.1, 12.5) (*Fig. 4* and *Fig. 5*).

Corrections are always caused by falling forward P/Es, as forward earnings continue to rise. The former reflect investors' fears of a recession, while the latter is the time-weighted average of industry analysts' consensus earnings estimates for the current year and the coming one. If the feared recession doesn't occur, investors tend to raise the forward P/E

they are willing to pay for stocks, while analysts continue to raise their earnings estimates. If a recession does occur, investors continue to cut the valuation multiple and analysts slash their earnings estimates, resulting in a bear market. Joe and I track these developments with our Blue Angel's framework (*Fig. 6*).

(6) *Pessimistic sentiment.* Currently, investors fear that the Fed will cause a recession, either by accident or by design, to bring down inflation. We can see this in sentiment indicators. Investor Intelligence Bull/Bear ratio was 1.04 during the April 26 week (*Fig. 7*). It's been hovering around 1.00 for the past nine weeks. This is a low reading, and the ratio historically has been a reliable contrary indicator.

In the latest *AAII Sentiment Survey*, the percentage of individual investors describing their six-month outlook for stocks as "bearish" surged to its highest level since 2009. Bullish sentiment—i.e., expectations that stock prices will rise over the next six months—decreased by 2.4 percentage points to 16.4%. This is just the 35th time in the history of the survey that bullish sentiment dropped below 20%.

(7) *Half-way toward a recession.* Friday's GDP report for Q1 exacerbated recession fears when it showed a 1.4% (saar) inflation-adjusted decline. Technically speaking, if real GDP falls during Q2, making two consecutive quarters of decline, that would mark a recession. However, as we noted in yesterday's *Morning Briefing*, final sales to domestic purchasers rose 2.6%. Final sales to private domestic purchasers rose 3.7%. This strength was offset by a 5.9% drop in federal government spending and a big increase in the trade deficit.

What about the four consecutive quarterly declines in real personal income? That mostly reflects the reduction in fiscal stimulus. Importantly, real personal income, excluding government income support programs, rose 8.6% y/y through March to a new record high.

(8) *How bad might it get?* Also provoking anxiety among investors is uncertainty about the downside for the stock market's valuation multiple. As noted above, it already has dropped significantly so far this year mostly as Fed officials turned more hawkish in their pronouncements. The question is whether investors have fully discounted the Fed tightening that is still ahead. Much will depend on whether the optimistic consensus of industry analysts' outlook for earnings turns out to be right or wrong. For now, we are siding with the analysts.

Strategy II: Take a Deep Breath and Exhale. Now let's turn from focusing on the negatives to accentuating the positives:

(1) *Industry analysts didn't get the recession memo.* Industry analysts continued to increase their consensus outlook for the S&P 500/400/600 indexes' 2022 and 2023 revenues per share into record-high territory during the April 21 week, sending forward revenues per share to new highs. They actually raised their revenues estimates faster than in previous weeks for all three indexes (*Fig. 8*).

The same can be said about forward earnings per share—i.e., they are at record highs for all three indexes (*Fig. 9*). Just as impressive is that the forward profit margins we calculate by dividing analysts' earnings estimates by their revenues estimates remain near recent record highs. On balance, the analysts obviously like what the companies they follow have been saying during the current earnings reporting season (*Fig. 10*).

(2) *The economy is shipshape.* Again, Debbie and I were not alarmed by the small drop in real GDP during Q1. We were encouraged to see that real personal consumption spending rose to a new record high as weakness in spending on goods was more than offset by strength in spending on services (*Fig. 11*).

Private residential spending was basically flat during Q1. Construction of single-family new homes is likely to remain challenged by high home prices, soaring mortgage rates, labor shortages, and high materials costs. But demographics-related demand remains strong. That's especially the case for multi-family rental units.

In the nonresidential fixed investment sector, spending on structures remains weak, but spending on industrial equipment and technology (equipment, software, and R&D) all rose to new record highs recently, and should continue to do so (*Fig. 12* and *Fig. 13*).

(3) *Lots of liquidity.* During March, M2 rose to another record high. It continues to exceed its pre-pandemic trend by about $3.0 trillion (*Fig. 14*). A relatively high 22% of M2 is in demand deposits (*Fig. 15*).

(4) *Technical call.* Last but not least, Joe Feshbach, our go-to trading pro, sent me an email yesterday morning saying that he expected a reversal day that would mark the start of a buying opportunity, at least for a decent trade. So far, so good. Now that dip buying seems to be out of favor, this is certainly a contrarian call, especially since there is so much fear about the upcoming Fed meeting.

Calendars

US: Tues: Job Openings 11.266m; Factory Orders 1.1%; Weekly Crude Oil Inventories. **Wed:** ADP Employment 395k; Motor Vehicle Sales; Trade Balance -$107.0b; ISM N-PMI 58.5; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 1.00%. (Bloomberg estimates)

Global: Tues: Eurozone Unemployment Rate 6.7%; Eurozone PPI 4.9%m/m/36.2%y/y; Germany Unemployment Change & Unemployment Rate -15k/5.0%; UK M-PMI 55.3; Australia Retail Sales 0.5%; RBA Interest Rate Decision 0.25%; Eurogroup Meetings, Rogers. **Wed:** Eurozone, Germany, and France C-PMIs 55.8/54.5/57.5/; Eurozone, Germany, and France NM-PMIs 57.7/57.9/58.8; Eurozone Retail Sales -0.1%m/m/1.4%y/y; Germany Trade Balance, Exports & Imports €9.5b/-1.8%/1.5%; Canada Trade Balance $3.8b; ECB Non-Monetary Policy Meeting; Wuermeling; Balz; Woods. (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 an 18th week after dropping for a week earlier due to index changes. MidCap's was at a record high for a 21st straight week after dropping 0.1% below at the end of November. SmallCap's rose for the sixth time in seven weeks, and was at a record high for the first time in four 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 97 of the past 101 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 95 of the past 99 weeks, and SmallCap's posted 91 gains in the past 100 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 67.4% from its lowest level since August 2017; MidCap's is now up 133.8% from its lowest level since May 2015; and SmallCap's has soared 189.9% from its lowest point since August 2013. In the latest week, the yearly rate of change in LargeCap's forward earnings weakened to a 24-month low of 22.6% y/y from 25.2%; 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 24-month low of 37.6% y/y from 39.5%. 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 25-month low of 41.2% y/y from 43.9%%. 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 (9.9%, 9.8%), MidCap (11.8, 8.6), and SmallCap (10.1, 12.9).

S&P 500/400/600 Valuation (*link*): Valuations tumbled for these three indexes last week. LargeCap's forward P/E fell 0.7pts to a 25-month low of 17.5 from 18.2. 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 0.6pts to a 25-month low of 12.9 from 13.5. That's down from a 13-week high of 17.1 in early November and is 9.3pts below its record high of 22.9 in June 2020. SmallCap's fell 0.5pt w/w to a 25-month low of 12.5 from 13.0. That's down from a 13-week high of 16.1 in early November and is now down 14.1pts 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 near its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 89th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% 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 46th 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 officially ended with Q1-2022. In the

latest week, the Q1-2022 earnings-per-share forecast rose $1.04 w/w to $53.01, and is now 1.6% above its $52.22 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 7.9% y/y on a frozen actual basis and 10.1% 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 six 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 (253.9% in Q1-2022 versus 12,611.0% in Q4-2021), Materials (42.5, 64.2), Industrials (37.9, 43.8), Real Estate (23.6, 17.6), Health Care (14.3, 28.0), Information Technology (12.6, 24.6), S&P 500 (10.1, 32.1), Utilities (9.2, -1.3), Consumer Staples (6.8, 7.7), Communication Services (-6.7, 16.6), Consumer Discretionary (-9.9, 54.1), and Financials (-18.5, 9.9).

US Economic Indicators

Construction Spending (*link*): Total construction spending in March rose less than expected, though continued its streak of new record highs; this measure has posted only one decline in the past 21 months! Total spending climbed 0.1% in March and 20.6% since bottoming in mid-2020. Private construction spending continues to lead the recovery, also reaching another record high in March, as residential investment climbed 1.0% and 49.4% over the comparable periods to new highs. Within private residential investment, single-family construction climbed 1.3% in March and 13.2% over the five months ending March, boosting it to a new record high. Meanwhile, multi-family construction dipped 0.5% last month after climbing to a new record high in February. Home-improvement spending rebounded 1.1% in March after sliding 2.0% in February from January's record high—and is within 1.1% of a new record high. Private nonresidential spending fell for the first time in nine months, by 1.2% in March, after increasing nine of the prior 10 months by 10.2%. Meanwhile, public construction spending fell for the fourth time in five months, down 0.3% in March though only 0.5% over the period; it's up 3.6% from its recent low in mid-2021.

Global Economic Indicators

Global Manufacturing PMIs (*link*): Global manufacturing activity slipped to a 20-month low

in April, with factory production falling for the first time in 22 months, led by a sharp downturn in China. The JP Morgan Global M-PMI (to 52.2 from 52.9) sank to its lowest level since August 2020, as production contracted for the first time in 22 months. The M-PMI for advanced economies (56.3 from 56.5) was little changed again in April—averaging 56.5 the past seven months—while the M-PMI for emerging economies (48.1 from 49.2) contracted for the second month. Due to later release dates, 10 countries were not available for inclusion in the April numbers. Here's a country ranking of April M-PMIs from highest to lowest: Netherlands (59.9), US (59.2), Australia (58.8), Austria (57.9), Canada (56.2), France (55.7), EUROZONE (55.5), India (54.7), Germany (54.6), Italy (54.5), Czech Republic (54.4), Colombia (54.4), Japan (53.5), Spain (53.3), Poland (52.4), WORLD (52.2), South Korea (52.1), Brazil (51.8), Taiwan (51.7), Myanmar (50.4), Mexico (49.3), and China (46.0).

US Manufacturing PMIs (*link*): Manufacturing activity slowed again in April, according to ISM, though still remains considerably above the breakeven-point of 50.0. The M-PMI eased for the fifth time in six months, falling from 60.6 to 55.4 over the period. It peaked at 63.7 last March and averaged 60.6 for all of 2020. The new orders index fell to 53.5 in April after moving back above 60.0 in February (61.7), while the production measure has dropped from 60.2 in November to 53.6 last month; both gauges are at their lowest readings since May 2020. Meanwhile, the employment (50.9 from 56.3) measure showed hirings at a near standstill last month, after posting its best performance in a year in March, while the inventory (51.6 from 55.5) gauge also moved closer to the break-even point. In the meantime, the supplier deliveries (67.2 from 65.4) measure continued to show slower deliveries to factories, with tight supply chains exacerbated by the war in Ukraine, though there are some signs of improvement in supply with the order backlogs' gauge dropping for the second month from 65.0 in February to 56.0 last month. Inflationary pressures eased a bit last month, as ISM's price index slowed to 84.6 after accelerating from a recent low of 68.2 at the end of 2021 to 87.1 in March; it was at 92.1 in June 2021—which was the fastest since summer 1979.

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

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