MORNING BRIEFING
May 11, 2022

More on Inflation & Stocks

Check out the accompanying chart collection.

Executive Summary: The S&P 500 is undergoing a correction more persistent than the 72 panic attacks we've counted during this bull market, but will it become a bear market? The jury is still out. There is precedent for a valuation-led bear market despite stellar corporate fundamentals, during 1987. There was no recession that time, and the bear market was short-lived. … Is the real earnings yield as bearish as it seems? … Also: We look at what stock markets do during inflationary periods. … And: The collective voice of small business suggests the economy is in a stagflationary funk. … Finally: A look at what's happening on Japan's monetary and fiscal policy fronts.

Strategy I: 1987-Style Bear Market? I've recently been asked when was the last time we had a P/E-led bear market while earnings continued to increase. The obvious answer is 1987. Our monthly Blue Angels framework, which starts in late 1978, shows that the S&P 500 dropped 33.5% from August 25, 1987 through December 4, 1987 (*Fig. 1*). From August through December, the forward P/E fell from 14.8 to 10.5. Over that same period, forward earnings rose 6.3%. The bear market lasted just 101 calendar days.

Of course, during the latest bull market, there have been 72 *panic attacks*, by our count, from 2009 through 2021 that included six corrections of 10%-20%. But none of them turned into bear markets because the swoons in the P/Es were quickly reversed once investors got over their fears of an imminent recession, as confirmed by the ongoing uptrend in forward earnings (*Fig. 2* and *Fig. 3*). Arguably, the 33.9% drop in the S&P 500 in early 2020 was a bear market, but it lasted only 32 calendar days. So we included it in our list of panic attacks.

The jury is out on the latest correction. The S&P 500 fell 16.8% from January 3 through May 9. If it falls another 3.9%, the jury would have to come back with the obvious verdict: The correction has turned into a bear market. The selloff so far was triggered by two much more persistent panic attacks than the previous 72. On January 5, the Fed released the minutes of the December 14-15, 2021 FOMC meeting revealing that the committee's members were turning much more hawkish and were discussing quantitative tightening. The consequences of both developments are still ongoing and not in a good way for stocks and bonds.

Nevertheless, even if the current selloff turns into a bear market, it could be short-lived, much as was the 1987 episode. As we've been monitoring every week since the start of the correction, the forward revenues and forward earnings (both on a per-share basis) and the forward profit margins of the S&P 500/400/600 have remained on solid upward trends rising in record high-territory (*Fig. 4*, *Fig. 5*, and *Fig. 6*).

Of course, the big difference between now and 1987 is that inflation is a much more serious problem currently. In response to the 1987 stock crash, then-Fed Chair Alan Greenspan first introduced the Fed Put. This is the first year since then that the markets have been forced to discount that the Fed can't provide the put because it must fight inflation. Hence, market participants have concluded that it's never a good idea to fight the Fed, especially when the Fed is fighting inflation.

While the bulls (including yours truly) have been getting clawed by the bear, we are hoping that there will be less inflation for the Fed to fight in coming months. On Monday, Debbie and I observed that the 3-month inflation rates at annual rates have fallen below their 12-month rates for several key measures of consumer prices and wages.

On Tuesday, the survey of consumers' expectations conducted monthly by the Federal Reserve Bank of New York found a slight downtick in the one-year series of consumers' expected inflation rate from 6.6% in March to 6.4% in April (*Fig. 7* and *Fig. 8*). That's not much, but at least it wasn't an uptick. Not surprisingly, this series closely tracks the actual headline PCED inflation rate.

This morning, we will get to see the April CPI.

Strategy II: Real Earnings Yield. With the benefit of hindsight, one of the valuation measures that signaled imminent trouble for stocks was the real earnings yield (*Fig. 9* and *Fig. 10*). It tends to signal an impending recession when it turns negative, i.e., when the spread between the nominal earnings yield of the S&P 500 and the y/y CPI inflation turns negative. It hasn't called every bear market, but it has called many of them. This time, it first turned slightly negative (-0.2%) during Q2-2021 and significantly negative during Q1-2022 (-3.9%).

Interestingly, the real earnings yield works relatively well as a business-cycle indicator. It tends to turn negative before recessions. Indeed, it is highly correlated with both the Index of Leading Economic Indicators (LEI) on a y/y basis and the spread between the 10-year Treasury yield and the federal funds rate, which is one of the 10 components of the LEI

(*Fig. 11* and *Fig. 12*).

The good news is that neither the LEI nor the yield-curve spread is currently signaling a recession, which reduces the credibility of the signal sent by the negative real earnings yield. This is another reason why the current selloff in the stock market might be more like 1987 than like deeper and longer-lasting bear markets. There was no recession in 1987.

Strategy III: Stock Prices During Great Inflations. What does the S&P 500 do during inflationary periods? Since the early 1920s, the CPI inflation rate, on a y/y basis, has had a tendency to spike up before recessions and to spike down during and after recessions (*Fig. 13*). So, not surprisingly, the inflation rate has a similar relationship with bear markets in the S&P 500 (*Fig. 14*).

The Great Inflation of the 1970s, which actually started in 1965, weighed greatly on the S&P 500 (*Fig. 15*). In nominal terms, the index increased just 27.4% over the entire period. Adjusted for inflation using the CPI, it fell 48.2% over this entire period.

We continue to expect the current decade will turn out to be more like the Roaring 2020s than the Great Inflation of the 2020s. If so, then the outlook remains bright for the S&P 500.

US Economy: Small Business Owners in Foul Mood. April's survey of small business owners was released yesterday by the National Association of Independent Business (NFIB). Collectively, they are reporting that the economy is in a stagflationary funk.

On balance, 50.0% of them expect that business conditions will be worse rather than better six months from now (*Fig. 16*). That's the most pessimistic respondents have been since the start of the survey in 1974! The percentage of them planning to raise average selling prices was 46.0%. The percentage raising average selling prices was 70.0% (*Fig. 17*).

If they are right, we will be wrong: Inflation will remain high, and a recession may be already underway.

Global Central Banks: BOJ in Neverland. "I trust that many of you are familiar with the story of Peter Pan, in which it says, 'The moment you doubt whether you can fly, you cease forever to be able to do it,'" *said* Bank of Japan Governor Haruhiko Kuroda in 2015. Fast forward to 2022, and Kuroda now finds himself with nothing left in his monetary policy toolkit but wishful thinking. And he still can't fly.

The BOJ has been hoping to revive Japan's economy since it first set negative short-term rates during 2016. It has been experimenting with yield-curve control since September 2016, buying up as many 10-year Japanese government bonds (JGBs) as necessary to hold longer-term rates near 0%.

Now with rates still near negative, a balance sheet of over $5 trillion, and inflation just beginning to show possible signs of reaching the bank's 2.0% target while the global economy is on the brink, the bank does not have much left it can do to stimulate domestic animal spirits. Kuroda and his associates may very well be grounded in negative-interest-rate-land for the foreseeable future. While the Federal Reserve and European Central Bank are moving toward monetary tightening, the BOJ likely will remain an outlier with its continued easy stance. The policy focus in Japan is likely to turn to fiscal stimulus. Consider the following:

(1) *Uninteresting rates.* Japan's short-term interest rates have been set at a negative level of -0.1% since February 2016 (*Fig. 18*). The bank has aimed to achieve 0% yields on 10-year JGBs by upping its annual purchases from a pace of about 80 trillion yen during 2016 to an uncapped amount at present. Nevertheless, the bank did clarify in its latest April 28 *monetary policy statement* that it would "offer to purchase 10-year JGBs at 0.25 percent every business day through fixed-rate purchase operations, unless it is highly likely that no bids will be submitted."

(2) *Drowning in assets.* Likely, the bank felt the need to clarify its purchases as such because the market for such purchases has become limited by the bank's own behemoth balance sheet. In other words, if purchases were to slow, the bank would not want investors to mistake that for a tapering signal. Total assets on the bank's balance sheet have climbed to 739 trillion yen ($5.8 trillion) from 457 trillion yen ($4.5 trillion) during September 2016 (*Fig. 19* and *Fig. 20*).

The bank not only has gobbled up JGBs but also has continued to purchase exchange-traded funds and Japan real estate investment trusts (with current upper limits of about 12 trillion yen and about 180 trillion yen, respectively) in addition to commercial paper and corporate bonds (at current amounts outstanding of 2 trillion yen and 3 trillion yen, respectively).

(3) *Inflation doldrums.* Since introducing its Quantitative and Qualitative Monetary Easing with Yield Curve Control program, the bank has held to its policy aiming to achieve the price stability target of 2.0%. It has pledged to expand the monetary base until the y/y rate of

increase in the observed core CPI (all items except fresh food) exceeds 2.0% and stays stably above the target.

The *Minutes* of the bank's March policy meeting released on Monday (preceded by the bank's March 29 *Summary of Opinions*) showed that bank officials remained steadfast in their resolve to maintain easy monetary policy. That's even though "some" members suggested that large firms were raising wages.

Most others on the board were more concerned that the risks to Japan's economy from Russia's war on Ukraine would keep inflationary pressures subdued, the Minutes showed. One member said that overseas economies could be pushed down due to central banks' policy responses to a rise in inflation brought about by the surge in commodity and grain prices.

According to the Minutes, "a few" BOJ members noted: "Unlike the United States and the United Kingdom, Japan was not in a situation where the inflation rate would likely exceed the price stability target of 2 percent in a continuous manner while accompanying a wage-price spiral, and that it was therefore important for the Bank to continue with monetary easing to support the economic recovery from the pandemic." March data released on Monday showed that real wages decreased for the first time in three months. Japan's core CPI has remained at 1.0% or below since April 2015 (*Fig. 21*).

Nevertheless, Japan's core CPI has risen since the pandemic pushed the rate down to -1.0% during December 2020 and is widely expected by analysts to exceed 2.0% from April onward, mainly reflecting rising fuel costs, *reported* Reuters. However, the BOJ has said it won't tighten policy unless rising energy costs lead to price increases more broadly and along with wage increases. According to the March Summary of Opinions, the risk of recent import prices leading to a sustained increase in consumer inflation is low largely because household budgets remain constrained with wages not yet rising.

(4) *Zombie dissent.* The sole BOJ board member of the nine to dissent to the latest vote, Goushi Kataoka, favors lowering short- and long-term interest rates to encourage business' fixed investment for the post-Covid era and wants to see better coordinated fiscal and monetary policy.

Indeed, zombies have overtaken the animal spirits when it comes to business investment in Japan. The yearly percent change in Japan's real GDP eked out mere 0.4% growth during Q4 (*Fig. 22*). Gross fixed capital formation (-3.0%) weighed on the Q4 quarterly percent

change in real GDP (4.6) on a seasonally adjusted annual basis (*Fig. 23*).

The animal spirits on the consumer front also are weak, with a marked decline in consumer confidence during March to a point well below what is considered expansionary. (For more, see our *Country Briefing: Japan*.)

(5) *Fiscal fairy dust.* With central bank policy now less able to revive the country's animal spirits, the task falls to Prime Minister Fumio Kishida. Kishida's latest emergency economic package comprises four pillars: curbing oil prices, ensuring a stable food supply, providing support for small and medium-sized enterprises, and helping struggling households.

To stem rising energy and food prices, government sources said Friday that Japan will raise the upper limit of subsidies for oil wholesalers and provide handouts of 50,000 yen ($390) per child for low-income households. "Around 1.5 trillion yen from the government's reserve fund of 5.5 trillion yen will be allocated to finance the envisaged package, which will also draw from a supplementary budget for fiscal 2022," *according* to *Kyodo News*. Support will also be provided to industries that rely on fuel as well as small and medium-sized entities that switch to less costly domestic alternatives for foreign wheat and lumber. Struggling households will be eligible to receive cash handouts.

The BOJ may be out of fairy dust, but the fiscal helicopters certainly are flying.

Calendars

US: Wed: Headline & Core CPI 0.2%m/m/8.1%y/y & 0.4%m/m/6.0%y/y; Real Earnings -0.6%; Fed Budget Balance $220.6b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** Headline & Core PPI 0.5%m/m/10.7%y/y & 0.6%m/m/8.9%y/y; Initial & Continuous Jobless Claims 195k/1.38m; Natural Gas Storage; IEA Monthly Report; OPEC Monthly Report. (Bloomberg estimates)

Global: Wed: Germany CPI 0.8%m/m/7.4%y/y; UK RICS House Price Balance 70%; Japan Leading & Coincident Indicators; Lagarde; Schnabel; Elderson; Nagel; Buch. **Thurs:** UK GDP 1.0%q/q/9.0%y/y; NIESR Monthly GDP Tracker; UK Headline & Manufacturing Industrial Production 0.1%m/m/0.5%y/y & -0.5%m/m/2.3%y/y; UK Trade Balance -£18.5b; China New Loans & M2. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q1 Earnings Season Monitor (*link*): With nearly 89% of S&P 500 companies finished reporting revenues and earnings for Q1-2021, revenues are beating the consensus forecast by 2.7%, and earnings have exceeded estimates by 7.8%. We don't expect these figures to change markedly as the remaining companies report Q1 results. At the same point during the Q4 season, revenues were a lower 2.2% above forecast, and earnings beat by a lower 6.0%. For the 443 companies that have reported Q1 earnings through mid-day Tuesday, the aggregate y/y revenue growth rate remains strong, but the earnings growth rate has decelerated considerably from their high 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 14.4% and an earnings gain of 12.4%. While just 75% 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 (66%) than positive y/y revenue growth (85%).

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Small business owners are struggling to deal with inflation pressures," noted Bill Dunkelberg, NFIB's chief economist. "The labor supply is not responding strongly to small businesses' high wage offers and the impact of inflation has significantly disrupted business operations." April's Small Business Optimism Index (SBOI) held steady at 93.2 after a three-month slide of 5.7 points from 98.9 at the end of last year through March. It was its fourth consecutive month below the 48-year average of 98.0. In April, two components rose, five declined, while three were unchanged—hirings (20%), current job openings (47), and earnings trends (-17). Sales expectations (to -12% from -18%) improved last month, though remained in contractionary territory, while plans to increase capital outlays (27 from 26) made a small move up, back toward its recent high of 31% in October. Offsetting these gains were declines in current inventory (6 from 9), now's a good time to expand (4 from 6), expect economy to improve (-50 from -49), plans to increase inventories (1 from 2), and expected credit conditions (-5 from -4). Meanwhile, 32% of owners reported inflation as their biggest problem—the highest percentage since Q4-1980 and up from 2% just 14 months ago. Labor quality is the number-two biggest problem, edging up from 22% to 23% last month but down from its record high of 29% in

November. The report highlights that the net percent of owners raising average selling prices eased to 70% (sa) in April from March's survey high of 72%, while those planning to raise selling prices fell from 50% to 46%; it was at record high of 54% in November. The percent of firms raising compensation was at 45% in April, easing from January's record high of 50%, while firms planning to raise compensation was at 27%, down from the record high of 32% posted in each of the three months of Q4-2021.

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