MORNING BRIEFING
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The Recession Question: Raising the Odds to 40%

Check out the accompanying chart collection.

Executive Summary: Might the only recession we have to fear be one triggered by recession fear itself? It's possible that we could talk ourselves into one. So while we still expect the economy to grow through the end of next year, we are raising the odds we assign to a recession scenario from 30% to 40%. That lowers our stock-market sights for this year and next. … We have new estimates for S&P 500 revenues, earnings, profit margins, P/Es, and price targets, which we still see at a new high late next year. … Also, we explain what has caused recessions in the past and why we don't see those dynamics developing now. We're far from alone in our optimism: Analysts keep raising their earnings estimates, and insider buying has been on fire.

Strategy I: It's Different This Time. The S&P 500 peaked at a record high on January 3 of this year. The index has achieved lots of record highs during the bull market that started on March 9, 2009 and might have ended on January 3 (*Fig. 1*).

Previous selloffs from previous record highs were mostly short-lived panic attacks associated with discreet events that were feared as likely to cause recessions. We've counted 72 such events from 2009 through 2021 (*table*). None led to recessions with the obvious exception of the 2020 lockdown-provoked downturn, and none lasted very long. And over the entire bull-market period, stock investors correctly anticipated that Fed officials would exercise the Fed Put when necessary to avoid a recession. After all, the Fed's inflation difficulty then was getting the rate to move higher and closer to the Fed's official 2.0% target.

January 3 marked the date that stock investors started to conclude that the Fed Put was kaput, as inflation had morphed from a transitory to a persistent problem. The Fed was clearly behind the inflation curve, so the Fed Put was no longer an option for monetary policy. That became increasingly obvious as more Fed officials turned increasingly hawkish. Even the doves morphed into hawks. The Federal Open Market Committee (FOMC) voted to raise the federal funds rate by 25bps on March 16 and 50bps on May 4 to a range of 0.75%-1.00% (*Fig. 2*). At his May 4 press conference, Fed Chair Jerome Powell said that the markets should expect another 50bps hike on June 15 and again on July 27.

Fed officials resorted to increasingly hawkish "forward guidance" to tighten credit conditions.

It worked, as the two-year US Treasury yield soared from 0.14% a year ago to 2.50% currently and the 10-year US Treasury bond yield jumped from 1.56% to 2.76% over the same period (*Fig. 3*). The yield spread between high-yield corporate bonds and the 10-year Treasury widened from 279bps on January 3 to 478bps on Monday (*Fig. 4*).

For stock investors, the biggest shock has been that Fed officials now view a weaker stock market as helpful to the Fed's fight to subdue inflation. Kansas City Federal Reserve President Esther George said on Thursday of last week that higher interest rates are needed now to bring down inflation and that policymakers are not focused on the impact that is having on the stock market. In a *CNBC interview*, she noted that the Fed is looking to tighten financial conditions—of which equities markets are a component—in an effort to tamp down price increases that are running at their fastest pace in more than 40 years.

So the Fed Put is kaput. This explains the market downdraft so far this year, which is cutting deeper and lasting longer than a typical panic attack. But this one won't end until inflation moderates significantly all by itself or with the help of a Fed-induced recession either by design or by accident. We still expect that inflation will moderate from 6%-7% during H1-2022 to 4%-5% during H2-2022 and to 3%-4% during 2023 (*Fig. 5*). We think that can happen without a recession. Nevertheless, we now are raising the odds of a recession from 30% to 40%. Below we explain why.

Strategy II: New S&P 500 Forecasts. But first, here are the changes in our related forecasts for the S&P 500:

(1) *New revenues*. We are lowering our estimates for S&P 500 revenues per share from $1,790 to $1,750 this year (up 11.6% y/y) and from $1,945 to $1,875 next year (up 7.1% y/y) (*Fig. 6*). Those are not recession-assuming forecasts but ones consistent with a soft landing, lower inflation, and an increased risk of a recession. In other words, a recession still isn't the scenario we view as most likely for this year and next year.

(2) *New earnings.* We are lowering our estimates for S&P 500 operating earnings per share from $240 to $225 this year (up 7.9% y/y) and from $260 to $240 next year (up 6.7%) (*Fig. 7*). Both our revenues and earnings estimates still assume boosts from higher inflation this year and next year, but less so than before.

(3) *New margins.* Weighing on earnings are cuts in our profit margin forecasts from 13.4% this year and next year to 12.9% and 12.8%, respectively (*Fig. 8*). We would be forecasting much lower margins if we expected a recession.

(4) *New forward earnings.* We are lowering our targets for S&P 500 forward operating earnings per share at the end of this year and the end of next year from $265 to $255 and from $300 to $275 (*Fig. 9*).

(5) *New forward P/Es.* We also are lowering our S&P 500 forward P/E ranges to 15-17 for the end of 2022 and to 16-18 for the end of 2023 (*Fig. 10*). Again, these estimates reflect our expectations for some moderation of inflation, reducing the likelihood that the Fed will be forced to tighten to the point of causing a recession.

(6) *New S&P 500 targets.* As a result, our target ranges for the S&P 500 stock price index are 3825-4335 at the end of this year and 4400-4950 at the end of next year (*Fig. 11*). We still expect to see a new record high in the S&P 500, but not until late next year.

US Economy I: Upping the Odds of a Recession. We are raising the odds of a recession because of rapidly spreading pessimism about the economic outlook. We could all talk ourselves into a recession. If a recession is about to happen, it will be the most widely anticipated downturn in history. If something breaks in the financial system, as seems to be widely expected, it will be the first time that's happened so early in the Fed tightening cycle.

As we've often noted, the way recessions usually came about in the past is that Fed tightening cycles triggered some discreet financial crisis or other, which turned into a broader credit crunch, which caused a recession (*Fig. 12*). That happened because the credit crunch either depressed borrowing and spending by consumers and businesses and/or burst speculative bubbles, with recessionary consequences for the economy.

The recessions of 2000 and 2008 followed the bursting of the tech bubble and the bursting of the housing bubble, respectively. The recessions of the 1970s and early 1980s were mostly attributable to credit crunches that depressed demand for goods and services. What might push us into a recession this time? Let's see:

(1) *Foul moods.* Investors are in a foul mood for sure. The Investor Intelligence Bull/Bear Ratio has been below 1.00 for the past three weeks (*Fig. 13*). That's a bearish reading and widely considered to be a contrary indicator. Maybe so. But it hasn't been working as one so far, as stock prices remain weak. Consumer and business confidence indexes are also very depressed, and they've tended to be leading indicators of the economic cycle. In other words, they may be signaling an imminent recession.

The Consumer Sentiment Index dropped sharply since the start of the year through the first

half of May (*Fig. 14*). It is down to readings comparable to previous recessions. It is much more sensitive to inflation concerns than is the Consumer Confidence Index. This explains why the latest reading of 59.1 is well below the lockdown recession low of 71.8 during April 2020. Even more depressed and depressing was the record-low reading during April of the business outlook index compiled from the National Federation of Independent Business' survey of small business owners (*Fig. 15*). They are complaining that their costs are soaring and that they can't find workers.

(2) *Depressed regional business surveys.* We now have the May results of three regional business surveys conducted by the Federal Reserve Banks of NY, Philly, and Richmond. They aren't pretty. The averages of both their overall and new orders indexes fell below zero for the first time since the lockdown recession of 2020 (*Fig. 16* and *Fig. 17*). Both are highly correlated with their comparable national M-PMI indexes. Meanwhile, the average of the three regional prices-paid indexes jumped to a new record high during May, while the comparable average of the prices-received indexes remained elevated near its recent record-high readings (*Fig. 18*).

(3) *Consumers losing purchasing power.* We expect to see consumer spending on goods weaken, reflecting the satisfaction of pandemic-related pent-up demand as well as the depletion of all the free "helicopter money" provided by the US Treasury and the Fed during 2020 and 2021. We're all now paying the price for all that not-so-free money via rapidly rising consumer and producer prices. We do expect consumers to spend more on services unless soaring grocery and gasoline outlays force them to cut back their discretionary spending on both goods and services. That could cause a recession, but it would also bring inflation down quickly, in our opinion.

(4) *An old-fashioned credit crunch.* We can't rule out an old-fashioned credit crunch. As noted above, credit-quality yield spreads have been widening since the start of the year. Soaring mortgage rates are weighing on home purchases. Something could break in the financial system. However, as we've previously observed, that's not what we expect given how much excess M2 liquidity there is in the economy, about $3 trillion, and how much corporate debt has been refinanced at record-low interest rates over the past couple of years.

US Economy II: The Optimists. Notwithstanding the widespread pessimism today, a few groups of people collectively remain optimistic. Industry analysts continue to raise their earnings estimates to record highs. Corporate executives are snapping up shares of their own companies. CEOs remain mostly upbeat. Consider the following:

(1) *Are industry analysts delusional?* Investors have been slashing the valuation multiple they are willing to pay for the consensus earnings estimates of industry analysts since the start of this year. At the same time, the analysts have been raising their earnings estimates for 2022 and 2023, as reflected in the forward earnings per share of the S&P 500/400/600 composites (*Fig. 19*). All three rose to fresh record highs during the May 19 week!

Forward earnings, which we derive as a time-weighted average of analysts' current-year and next-year earnings estimates, tend to be great leading indicators of actual earnings over the next 52 weeks. The one important exception is that analysts typically don't see recessions coming. When these events are obvious to everyone, they scramble to slash their estimates. If you agree with us that the economy is likely to dodge the recession bullet over the next 12-18 months, then investors are probably seriously undervaluing the analysts' upbeat earnings outlook.

(2) *Why are insiders buying?* The May 23 Bloomberg included an interesting *article* by Lu Wang titled "Insiders Put Recession Angst Aside to Binge on Their Own Stocks." The story observes: "More than 1,100 corporate executives and officers have snapped up shares of their own firms in May, poised to exceed the number of sellers for the first month since March 2020 marked the pandemic trough two years ago, according to data compiled by the *Washington Service*. The spike in purchases comes as investors pull cash from equity funds. Those tracked by EPFR Global just suffered six weeks of outflows, the longest stretch of withdrawals since 2019. Meanwhile, Wall Street strategists are scrambling to downgrade market outlooks, saying the Federal Reserve's aggressive monetary tightening risks dragging the economy into a recession."

Count us among the strategists downgrading our outlook but staying optimistic nonetheless. We certainly are encouraged by all the insider buying. It represents a strong vote of confidence in insiders' own companies and in the economic outlook.

(3) *Will CEO confidence wilt?* Finally, we note that the Business Roundtable's CEO Economic Outlook Index remained near recent cyclical highs during Q1 (*Fig. 20*). We expect it will remain relatively high during Q2, especially given all the insider buying that occurred during May. If so, then capital spending should continue to rise to new record highs.

Calendars

US: Wed: Durable Goods Orders Total, Core, & Core Nondefense Capital Goods 0.6%/0.6%/0.5%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Meeting Minutes; Brainard. **Thurs:** Real GDP & GDP Price Index -1.3%/8.0%; Core PCED 5.2%; Corporate Profits; Kansas City Fed Manufacturing Index; Initial & Continuous Jobless Claims 215k/1.31m; Pending Home Sales -2.0%; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Germany GDP 0.2%q/q/4.0%y/y; Germany Gfk Consumer Climate -26.0; France Consumer Confidence 89; Japan Leading & Coincident Indicators 0.9%/-0.1%; ECB Financial Stability Review; World Economic Forum Annual Meetings; Lagarde; Lane; Panetta; Beermann; Kuroda. **Thurs:** Italy Business & Consumer Confidence 109.0/100.5; Canada Headline & Core Retail Sales 1.4%/2.0%; Australia Retail Sales 0.9%; China Industrial Profits; World Economic Forum Annual Meetings. (Bloomberg estimates)

Strategy Indicators

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin ticked down last week to 13.3% from its record high of 13.4%. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 3.0ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings were both back at record highs after ticking down briefly in early February. They have both been making new highs since the beginning of March 2021 after peaking just before Covid-19 in February 2020. Since the Q2-2021 earnings season came in way better than expected, analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown period. Prior to this catch-up period, consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth rose 0.1ppt w/w to 8.1%. That's down from a record high of 9.6% growth at the end of May 2021, but compares to its recent 12-month low of 7.1% from early December. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth ticked up 0.1ppt w/w to 9.9%. It remains above its 16-month low of 8.2% in early December. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. So far this year, analysts' revisions to their forecasts for 2022 revenues have outpaced their revisions for 2022

earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts has ticked down 0.2ppt to 13.0%. They expect revenues to rise 11.1% (up 0.2ppt w/w) in 2022 and 4.9% in 2023 (unchanged w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 10.5% in 2022 (unchanged w/w) and 9.7% in 2023 (up 0.1ppt w/w) compared to an earnings gain of 51.0% in 2021. Analysts expect the profit margin to drop in 2022 to 13.0% (down 0.1ppt w/w) compared to 13.1% in 2021 and to improve 0.6ppt y/y to 13.6% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E remained steady w/w at a 25-month low of 16.7. That's down from an eight-month high of 21.7 at the end of 2021 and compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio ticked down 0.01pt w/w to a 22-month low of 2.22 from 2.23. That compares to a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise for eight of the 11 S&P 500 sectors, forward earnings gain for five sectors, and the forward profit margin move higher for one sector. Nearly all sectors are at or near record highs in their forward revenues, earnings, and profit margins. Energy still has forward revenues and earnings well below record highs, but its profit margin rose 0.1ppt w/w to a record high of 11.5%, exceeding its prior 11.2% record from August 2007. Financials and Utilities have forward earnings at or near record highs, but their forward revenues and margins are lagging. Only three sectors posted a higher profit margin y/y in 2020: Consumer Staples, Tech, and Utilities. During 2021, all but the Utilities sector posted a y/y improvement. Five sectors are now expected to see margins decline or remain flat y/y in 2022: Communication Services, Consumer Staples, Financials, Health Care, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.4%, matches its prior record high from late February), Financials (18.9, down from its 19.8 record high in August 2021), Real Estate (16.9, down from its 19.2 record high in 2016), Communication Services (16.0, down from its 17.0 record high in October), Utilities (13.8, down from its 14.8 record high in April 2021), Materials (13.6, record high), S&P 500 (13.2, down from its 13.4 record high a week earlier and during March and April), Health Care (11.0, down from its 11.5 record high in early March), Industrials (10.3, down from its 10.5 record high in December 2019), Energy (11.5, a new record high this week), Consumer Discretionary (7.6, down from its 8.3 record high in 2018), and Consumer Staples (7.4, down from its 7.7 record high in June).

US Economic Indicators

Regional M-PMIs (*link*): Three Fed districts (New York, Philadelphia, and Richmond) have reported on manufacturing activity for May and show the manufacturing sector contracted for the first time since May 2020. The composite index fell to -6.0 in May after accelerating from 6.7 in February to 18.7 in April, with activity in both the New York (to -11.6 from 24.6) and Richmond (-9.0 from 14.0) regions swinging from expansion to contraction, while the Philadelphia (2.6 from 17.6) area experienced a notable slowdown. Meanwhile, orders (-0.9 from 16.3) growth in May dipped into negative territory for the first time since spring 2020, as billings in the New York (-8.8 from 25.1) area contracted for the third time this year, while orders in the Richmond (-16.0 from 6.0) area contracted for the second time; Philadelphia (22.1 from 17.8) billings remained robust. Employment (15.8 from 23.6) growth eased this month, but remains solid, with hirings at New York (14.0 from 7.3) factories double April's pace, while hirings in Philadelphia's (25.5 from 41.4) slowed, though were nearly double New York's rate. Hirings in the Richmond (8.0 from 22.0) region ran at roughly a third of April's rate. Turning to prices, the prices-paid measure for the Richmond (151.3 from 118.3) region soared to a new record high, while the New York (to 73.7 from 86.4) measure slowed from April's record high. Meanwhile, Philadelphia's (78.9 from 84.6) also eased from its April rate—which was the highest since mid-1979 (85.4). It was at a record high of 91.1 during March 1974. As for prices-received indexes, New York's (45.6 from 49.1) gauge eased for the second month from March's record high of 56.1, while Philadelphia's (51.7 from 55.0) slowed for the first time in four months; it was at 62.9 in October—which was close to its record high of 63.8 in the mid-1970s. Richmond's (95.7 from 89.3) accelerated this month, though was below January's record high of 112.7.

New Home Sales (*link*): New home sales (counted at the signing of a contract) contracted in April for the fourth month after a strong finish in 2021, as soaring mortgage rates and home prices reduced affordability. New home sales plunged 16.6% in April and 29.6% over the fourth months through April to 591,000 units (saar). Of the 591,000 homes sold during April, only 164,000 were completed, while 242,000 were under construction and 185,000 were yet to be started. Meanwhile, there were 444,000 new homes for sale at the end of April (the highest since May 2008)—though only 38,000 units were completed, with 288,000 units under construction and 118,000 units yet to be started. At the current sales pace, it would take 9.0 months to run through the supply of new homes, nearly double the 4.7 months' supply in April 2021. Data for May show builders' confidence fell for the fifth time this year—from 84 at the end of 2021 to a 23-month low of 69 this month—on affordability concerns. "The housing market is facing growing challenges," notes Robert Dietz NAHB's chief economist. "Building material costs are up 19% from a year ago, in less than three

months mortgage rates have surged to a 12-year high, and based on current affordability conditions, less than 50% of new and existing home sales are affordable for a typical family." Here's a look at the ytd changes in the three components of NAHB's Housing Market Index: current sales (-12 points to 78 in May), traffic of prospective homebuyers (-19 points to 52), and future sales (-22 points to 63)—with nearly half the decline in the latter (-10 points) occurring in this month alone.

Global Economic Indicators

Eurozone PMI Flash Estimates (*link*): "Eurozone growth remains robust in May thanks to a buoyant service sector. Cost pressures ease for second month but remain elevated," was the headline of S&P Global's May report. The C-PMI (to 54.9 from 55.8) slowed to a two-month low this month, as the M-PMI (54.4 from 55.5) sank to an 18-month low; it peaked at 63.4 last June. Meanwhile, the NM-PMI (56.3 from 57.7) also eased, though it recorded its second strongest performance in the past eight months—and was well above the survey's long-run average. Both sectors continued to report solid hiring—with the service sector's near a 15-month high. Looking at the two largest Eurozone economies, France's C-PMI (57.1 from 57.6) was the strongest among the Eurozone economies this month, easing negligibly from April's 51-month high—and far outpacing the series average. France is showing a two-speed economy, with May's NM-PMI (58.4 from 58.9) exhibiting a robust service sector, while the M-PMI (54.5 from 55.7) exposes a slowing manufacturing sector, with factory output (51.4 from 51.8) easing down toward the demarcation line between expansion and contraction. Germany's C-PMI (54.6 from 54.3) lags that of France, though is running close to its average recorded so far this year. Germany's service sector continued to outpace its manufacturing sector, though the NM-PMI (56.3 from 57.6) eased a bit this month, while the M-PMI (54.7 from 54.6) was at a two-month high—with manufacturing output (51.0 from 47.7) moving from contraction to expansion. The rest of the Eurozone as a whole continued to expand, though the pace was the slowest in four months, reflecting slower growth in services and a near-stalling of factory output growth.

Japan PMI Flash Estimates (*link*): Activity in Japan's private sector improved for the third month, according to flash estimates, with the C-PMI climbing from 45.8 in February to 51.4 this month, as the NM-PMI climbed from 44.2 to 51.7 over the comparable period. Japan's M-PMI slowed for the third time in four months since peaking at 55.4 in January, slipping to 53.2 this month. According to the report, the service sector showed its best growth in five months during May, as pandemic restrictions have been eased. Meanwhile, growth in the

manufacturing sector was the weakest in three months as lockdown measures across China and economic sanctions placed on Russia amid the Ukraine war have intensified supply-chain disruptions—leading to “greater repots of material shortages and severe delivery delays.” In the meantime, inflation and supply concerns have eroded business confidence, which fell to a nine-month low this month.

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