MORNING BRIEFING
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Jamie's Hurricane

Check out the accompanying chart collection.

Executive Summary: Jamie Dimon spooked the financial markets last week with his forecast of an economic hurricane headed straight for us. Today, we take a balanced look at Dimon's three big worries—the Fed's quantitative tightening bursting financial asset bubbles, the Ukraine war driving commodity prices skyward, and consumers using up their stimulus savings. … Our perspective: Don't be alarmed by the metaphor; hurricanes come and go. What matters is their magnitude, which Dimon admits is unknown. … However, the term "self-fulfilling prophecy" is bound to apply to some extent when the head of the nation's largest bank says it's going to batten down the credit hatches to prepare for a storm.

US Economy I: 'Brace Yourself.' Last Wednesday, CNBC's Hugh Son *reported* that JPMorgan Chase CEO Jamie Dimon had these words of warning for analysts and investors attending a financial conference in New York: "You know, I said there's storm clouds, but I'm going to change it … it's a hurricane." Son wrote that Dimon went on to say that "[w]hile conditions seem 'fine' at the moment, nobody knows if the hurricane is 'a minor one or Superstorm Sandy,' … 'You'd better brace yourself. … JPMorgan is bracing ourselves, and we're going to be very conservative with our balance sheet.'"

Dimon continued with his weather forecast as follows: "Right now, it's kind of sunny, things are doing fine, everyone thinks the Fed can handle this. That hurricane is right out there, down the road, coming our way."

Dimon is the financial system's Wizard of Oz. He should know better than anyone if a storm is coming since he can have a tremendous impact on the financial weather. After all, he is the CEO of the largest bank in America. By managing his bank's balance sheet more conservatively, he can tighten credit conditions significantly in the US.

What's troubling Dimon? His three main areas of concern are the Fed's quantitative tightening (QT) program, the war in Ukraine, and consumer spending. Here is more on these three issues and what he is doing about them:

(1) *Quantitative tightening and volatility.* As we observed in our June 5 *QuickTakes*, the Fed is starting to reduce its balance sheet by running off maturing securities. From June through

August, that will involve dropping its holdings of Treasury securities by $30.0 billion per month and its holdings of agency debt and mortgage-backed securities by $17.5 billion per month. So that's a decline of $142.5 billion over the next three months. Starting in September, the runoff will be set at $60 billion for Treasury holdings and $35 billion for agency debt and mortgage-backed securities. That's $95 billion per month and $1.14 trillion over a 12-month period (*Fig. 1*).

"We've never had QT like this, so you're looking at something you could be writing history books on for 50 years," Dimon said. The CNBC article explained: "Several aspects of quantitative easing programs 'backfired,' including negative rates, which he called a 'huge mistake.' Central banks 'don't have a choice because there's too much liquidity in the system,' Dimon said, referring to the tightening actions. 'They have to remove some of the liquidity to stop the speculation, reduce home prices and stuff like that.'"

So Dimon is worrying that there is still lots of downside in asset prices now that the major central banks must remove the punch bowls they've provided since the Great Financial Crisis (GFC). In addition, he is anticipating much more volatility in the bond market.

CNBC's Son reported that Dimon observed that "central banks, commercial banks, and foreign exchange trading firms were the three major buyers" of Treasury securities during the GFC. This time, these players won't have the capacity or desire to soak up as many US bonds. "'That's a huge change in the flow of funds around the world,' Dimon said. 'I don't know what the effect of that is, but I'm prepared for, at a minimum, huge volatility.'"

(2) *The Ukraine war and record-high oil prices.* The other major issue worrying Dimon is the impact of the Ukraine war on commodity prices, especially for food and fuel, reported CNBC: "Oil 'almost has to go up in price' because of disruptions caused by the worst European conflict since World War II, potentially hitting $150 or $175 a barrel,' Dimon said. 'Wars go bad, [they] go south in unintended consequences,' Dimon said. 'We're not taking the proper actions to protect Europe from what's going to happen to oil in the short run.'"

(3) *Consumer spending likely to deteriorate.* The head of the nation's biggest bank remained relatively sanguine about the near-term prospects for consumer spending. He said the recent drop in Americans' savings rate hadn't altered his view that the government's pandemic stimulus is still padding consumers' wallets. He estimated that some $2 trillion in extra funds are still waiting to be spent. "That fiscal stimulation is still in the pocketbooks of consumers. They are spending it."

Nevertheless, reported CNBC's Son, "the bank has shied away from servicing a lot of federal FHA loans, Dimon said, because delinquencies could hit 5% or 10% there, 'which is guaranteed to happen in a downturn.'"

(4) *Fortifying the balance sheet.* So what else is Dimon doing to prepare his bank for these shocks? "Banks having a 'fortress balance sheet' and conservative accounting are the best protections for a downturn, Dimon said," CNBC's Son reported. "One step the bank could take to gird itself for a coming hurricane is to push clients to move a type of lower-quality deposit called 'non-operating deposits' into other places, such as money market funds, for example. That would help the bank manage its capital requirements under international rules, potentially helping it absorb a surge in bad loans."

"'With all this capital uncertainty, we're going to have to take actions,' Dimon said. 'I kind of want to shed nonoperating deposits again, which we can do in size, to protect ourselves so we can serve clients in bad times. That's the environment we're dealing with.'"

(5) *Other weather watchers.* I asked two of my favorite short-term weather watchers in the equity market for their assessment of the likelihood of an impending storm. They believe that the recent rebound in stock prices might continue for a while longer. Joe Feshbach correctly called the latest short-term market bottom and still expects that the S&P 500 could work its way to 4300. Michael Brush observes that insiders are back to neutral, though on the edge of bullishness. His reading is not negative: "Markets can move higher while they are neutral."

(6) *Dimon says he isn't 'woke.'* Last, but not least, Dimon felt a need to respond to his critics as follows: "I am a red-blooded free-market capitalist, and I'm not woke. … All we're saying is when we wake up in the morning, we give a s--- about serving customers, earning their respect, earning their repeat business," reported CNBC's Son.

US Economy II: Hurricanes Come and Go. Dimon is certain that a hurricane is coming, but he admitted that he doesn't know how bad it will be: "That hurricane is right out there down the road coming our way." But nobody knows if it's "a minor one or Superstorm Sandy." Let's provide a more balanced view of Dimon's major concerns:

(1) *Quantitative tightening.* The Fed's first round of quantitative tightening (QT1), which lasted from October 1, 2017 to July 31, 2019, pared the Fed's balance sheet by $675 billion to $3.7 trillion. It was initially intended to restore the size of the balance sheet back to where it had been before the GFC. So QT1 projected that the Fed's holdings of mortgage-backed

securities would be reduced from $1.8 trillion during September 2017 back closer to zero by 2024 (*Fig. 2*). The Fed's Treasury portfolio was projected to drop from $2.5 trillion during September 2017 back under $1 trillion by 2022 (*Fig. 3*).

The Fed terminated QT1 well ahead of normalizing its balance sheet as a result of illiquidity problems in the repo market in late 2019 and the pandemic in early 2020.

This time, no one knows how long QT2 will last. It will take a very long time to reduce the Fed's mortgage-backed securities portfolio from $2.7 trillion during May back down to zero, which is the intention suggested by some Fed officials. The same can be said about reducing the Fed's holdings of Treasuries from $5.8 trillion during May to $2.4 trillion, which is where it was during January 2020 just before the pandemic.

If the Fed succeeds in reducing its balance sheet by $2.8 trillion to $5.7 trillion by the end of 2024 under QT2, is that the same as raising the federal funds rate by 100bps, 200bps, 300bps, or more? Fed officials undoubtedly have run their econometric model to come up with some estimates. But they haven't shared the results with the public.

QT2 undoubtedly will lower the federal-funds-rate endpoint of this tightening cycle. But what will that point be? It's conceivable that two more rate hikes of 50bps each at the next two meetings of the FOMC will be enough given the additional tightening of credit conditions attributable to QT2!

(2) *Bond market.* Dimon anticipates that QT2 will lead to more volatility in the bond market, with yields mostly moving higher because the supply of bonds will exceed demand. Let's recall that from January 2021 through May 2022, the Fed purchased $120 billion per month on average in the Treasury and mortgage-backed bond markets. Soon, under QT2, the Fed will be reducing its holdings by $95 billion per month.

The good news is that forecasting the bond market by projecting the supply of and demand for bonds is a very inexact science. If the QT2 credit-tightening impact lowers the endpoint for the Fed's rate hikes to, let's say, 2.50%, that might very well allow the 10-year US Treasury yield to remain around 3.00%.

On the positive side of a funds-flow analysis of the bond market is that private foreign net capital inflows into the US bond market totaled $633.7 billion over the past 12 months through March, the most since January 2011 (*Fig. 4*). Oh and by the way, federal tax receipts are soaring, while outlays are falling (*Fig. 5*). As a result, the federal budget deficit

has narrowed significantly from a 12-month record of $4.1 trillion through March 2021 to $1.2 trillion through April of this year (*Fig. 6*).

(3) *Asset prices.* Dimon suggested that he is also worried that the combination of hikes in the federal funds rate and balance-sheet reductions will burst speculative bubbles with adverse consequences for the financial system and the economy.

Over the past 24 months through April, the 12-month average of the median existing single-family home price has increased 31.5% to a record $366,650 (*Fig. 7*). It exceeds its record high of $224,280 during July 2006 (just before the start of the GFC) by 63.5%.

At the end of Q4-2021, the value of real estate held by households rose to a record $38.1 trillion. The good news is that owners' equity accounted for 69% of the total, while the remaining 31% was levered up with mortgage loans (*Fig. 8*). While home prices are increasingly likely to fall in response to tighter credit conditions, they aren't likely to cause an economy-wide credit crunch and recession as occurred during the GFC. However, they could have a negative wealth effect on consumer spending.

The jury is out on whether the stock market has discounted QT2. Both the S&P 500 and its forward P/E are down sharply since January 3, suggesting that the stock market has discounted QT2 to a certain extent (*Fig. 9* and *Fig. 10*). The *minutes* of the December 14-15 meeting of the FOMC, released on January 5 of this year, spooked investors because it strongly suggested that the Fed was on course to implement QT2 by the middle of this year.

(4) *Commodity prices.* Dimon blamed the Ukraine war for driving up commodity prices. In our opinion, a longer lasting problem is that climate and environment activists are succeeding in reducing the incentives to find, produce, and distribute energy and industrial commodities. The resulting underinvestment in key commodity markets could push commodity prices still higher, boosting both inflation and the risk of a recession caused by shortages.

We discussed this problem for the energy sector in the June 1 *Morning Briefing*. We wrote: "Each of the six past recessions prior to the pandemic was associated with either soaring or at least rapidly rising oil prices. The difference this time is that soaring fossil fuel prices are the intended consequences of the energy policies of the current administration."

Whether rising oil prices should be blamed on climate activists, Putin, or both, if Dimon's forecast of a crude oil price of $150-$175 per barrel is right, that could be what triggers his

hurricane. However, back at the start of this year, had we known that the crude price would get up to the $115-$120 range it's in now, we might have forecast a recession (*Fig. 11*). During April, consumer spending on gasoline and other motor fuels accounted for just 2.4% of disposable personal income (*Fig. 12*).

(5) *Consumer spending.* Meanwhile, as Dimon observed last Wednesday, consumers seem to be pivoting from spending on goods to spending on services. He also noted that helping to offset the weakness in real incomes is that personal saving over the 24 months through April totaled $2.3 trillion, exceeding the comparable pre-pandemic pace by about $1.0 trillion (*Fig. 13* and *Fig. 14*). This is consistent with Dimon's view that "fiscal stimulation is still in the pocketbooks of consumers. They are spending it." However, in our opinion, excess saving over the past two years is more like $1.0 trillion than Dimon's $2.0 trillion suggestion.

(6) *Bank lending.* Debbie and I frequently have opined this year that if a recession is imminent, it will be the most widely anticipated downturn in American economic history. We've been concerned that we might all talk ourselves into a recession. While Dimon is contributing to that chatter, he is also in a position to make that happen. The message he is sending to his bank's loan officers is to tighten their lending standards.

According to the Fed's survey of senior loan officers, credit conditions were getting a bit tighter during H1-2022 but remained relatively easy (*Fig. 15*). Let's see what the Q3-2022 survey will show when it is released on August 2.

Meanwhile, both commercial and industrial bank loans and revolving credit continue to expand (*Fig. 16*). In addition, allowances for losses at all commercial banks have been declining since mid- 2020 (*Fig. 17*). They dropped to $157.1 billion during the May 25 week from a recent high of $220.4 billion during the September 2, 2020 week. They remain $43.1 billion above the pre-pandemic level during the week of February 26, 2020.

Calendars

US: Tues: Trade Balance -$89.3b; Consumer Credit $34.5b; API Weekly Crude Oil Inventories. **Wed:** MBA Mortgage Applications; Wholesale Inventories; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: **Tues:** Eurozone Sentix Investor Confidence -20.0; Germany Factory Orders 0.5%; Spain Industrial Production 2.7% y/y; UK C-PMI & NM-PMI 51.8/51.8; Japan GDP -0.3%q/q/-1.0%y/y; Japan Leading & Coincident Indicators; 3.0b; Trade Balance $RBA Interest Rate Decision 0.60%. **Wed:** Eurozone GDP 0.3%q/q/5.1%y/y; Eurozone Employment Change 0.5%q/q/2.6%y/y; Germany Industrial Production 1.0%; France Trade Balance –€12.2b; Italy Retail Sales; UK Construction PMI 56.6; UK RICS House Price Balance 76%; China Trade Balance ¥58.0b; China Exports & Imports 7.5%/1.5% y/y; Mauderer. (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 returned to a record high after dropping a week earlier for the second time in four weeks. Its latest declines were attributable to Q1 earnings misses and lowered future guidance for Walmart and Amazon. MidCap's was at a record high for a 26th straight week. SmallCap's rose for the 11th time in 12 weeks, and was at a record high for a sixth week. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 100 of the past 106 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings misses for Q1-2022 and Q2-2021, Walmart's Q1-2022 miss, and index changes last September and December. MidCap's forward earnings is up in 100 of the past 104 weeks, and SmallCap's posted 96 gains in the past 105 weeks. SmallCap had been steadily making new highs each week until mid-December, but then dropped 1.4% below its record by early March. 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 69.2% from its lowest level since August 2017; MidCap's is now up 141.2% from its lowest level since May 2015; and SmallCap's has soared 201.2% from its lowest point since August 2013. In the latest week, the yearly rate of change in LargeCap's forward earnings improved to 19.6% y/y from a 13-month low of 19.0%; that's down from a record-high 42.2% at the end of July 2021 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 14-month low of 34.3% y/y from 34.8% a week earlier. 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 ticked down to a 14-month low of 34.9% y/y from 35.5%. It's down from a record high of 124.2% in June 2021 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 to 2023 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (10.0%, 9.9%), MidCap (15.5, 6.0), and SmallCap (13.4, 12.0).

S&P 500/400/600 Valuation (*link*): Valuations mostly dropped for these three indexes last week. LargeCap's forward P/E dropped 0.4pts to 17.2 from 17.6. That's up from a 26-month low of 16.4 the week before that 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 fell 0.1pt to 12.6 from 12.7. That's up from a 26-month low of 12.0 the week before that and down from a 13-week high of 17.1 in early November. It had been at a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's remained steady w/w at 12.3. That's up from a 26-month low of 11.6 the week before that and is down from a 13-week high of 16.1 in early November. That compares to its record high of 26.7 in early June 2020 when forward earnings was depressed and an 11-year low of 11.1 during March 2020. 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 28% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 94th 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 51st 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 Q2-2022 earnings-per-share forecast rose 15 cents w/w to $55.33, and is now down 1.1% from its $55.92 forecast 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 5.3% on a pro forma basis. That's down from Q1-2022's 11.7% y/y on a frozen actual basis and an 11.3% y/y gain on a pro forma basis. Double-digit growth is expected for just three

sectors in Q2-2022, and five are expected to record a y/y decline. That compares to Q1-2022's count of seven sectors with double-digit growth, one with a single-digit gain, and three with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q2-2022 versus their Q1-2022 growth rates: Energy (202.1% in Q2-2022 versus 268.8% in Q1-2022), Industrials (30.1, 40.3), Materials (19.0, 46.2), S&P 500 (5.3, 11.3), Real Estate (4.1, 27.3), Health Care (2.8, 18.3), Information Technology (2.0, 14.2), Consumer Staples (-1.5, 7.2), Consumer Discretionary (-1.7, -27.7), Utilities (-12.1, 24.7), Communication Services (-13.5, -2.8), and Financials (-18.3, -17.1).

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales in April unexpectedly declined—posting its first decline this year. Sales contracted 1.3% (vs a 0.3% expected gain) in April, after advancing 0.9% the first three months of the year—following December's 2.2% drop. Despite April's decline, sales are 3.9% above a year ago and within striking distance of a new record high (2.8%). Food, drinks & tobacco sales was the major drag on April sales, slumping 2.6% to its lowest level since January 2020. Meanwhile, sales of non-food products (excluding fuel) declined for the second month, by a total of 1.3%, following a two-month gain of 2.4%—remaining in record-high territory. Sales of automotive fuel continued its up-and-down pattern, rebounding 1.9% in April after a 1.4% loss and a 2.5% gain—remaining in a volatile flat trend near recent highs. Data are available for three of the four largest Eurozone economies, and it was a mixed bag: Sales in Spain soared 5.3% in April, while Germany's tumbled 5.4%—with France's showing no change. Compared to a year ago, sales in France were up a whopping 10.3%, while Spain's were 1.5% higher and Germany's (-0.3) little changed.

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