MORNING BRIEFING
June 14, 2022

Bull Market, R.I.P.

Check out the accompanying chart collection.

Executive Summary: The S&P 500 breached bear market territory yesterday, and this week's economic releases could drive the index deeper into bear terrain by highlighting the persistence of the inflation problem. … Bear markets nearly always are accompanied by recessions. But while we did recently raise our odds of recession to 45%, we're still not in the recession camp; notably, analysts' earnings expectations are still rising to record-high levels. Our higher recession odds combined with the unfolding bear market have lowered our sights for the S&P 500's valuation multiple and price index for the rest of 2022 and for 2023.

Strategy I: Equities in Bear Territory. Yesterday, the S&P 500's correction turned into an outright bear market. The index peaked at a record 4796.56 on January 3. It had been down between 10%-20% since April 22 until yesterday, when it closed down 21.8% from its record high.

The correction started on expectations that the Fed would be tightening monetary policy this year in an effort to bring inflation down. There was a growing recognition that unlike the previous 72 short-lived panic attacks (which included five corrections and the lockdown selloff) that occurred during the bull market—which started on March 9, 2009 and ended on January 3, 2022—this time is different (*Fig. 1*). The major difference is that the Fed Put is kaput. The Fed has no choice now but to tighten monetary policy given the persistence of inflation.

Nevertheless, investors also expected that inflation might show some signs of peaking by the middle of the year, which would moderate the Fed's tightening cycle and reduce the risk of a recession. We did too. There were a few signs of that happening in April's CPI report, released on May 11. But hopes for a clear inflation peak were dashed on Friday with the release of May's CPI report. As a result, investors concluded that the Fed would have to tighten more aggressively, thus increasing the odds of a recession. On Friday, the S&P 500 closed down 18.7% from its record high. On Monday, it closed down 21.8% from that peak.

Yesterday, we raised our odds of a mild recession from 40% to 45%, which is partly why we didn't change our forecast that inflation will moderate during the second half of this year—

i.e., a recession would help to moderate it.

The two-year US Treasury yield jumped 23bps on Friday to 3.06% (*Fig. 2*). Yesterday, it rose another 34bps to 3.40%. The 12-month-forward federal funds rate (FFR) futures jumped to 3.34% on Friday. Both have exceeded their 2018 peaks. Both tend to be year-ahead leading indicators for the FFR, which remains at only 0.88%.

It won't remain there for long. The FOMC is widely expected tomorrow to raise the FFR range by 75bps from 0.75%-1.00% currently to 1.50%-1.75%. At his post-meeting press conference tomorrow, Fed Chair Jerome Powell is likely to be more hawkish than usual and indicate that similarly sized hikes following the FOMC's next two meetings, in July and September, could take the range up to 2.25%-2.50% next month and then to 3.00%-3.25% in September, in line with the predictions of both the two-year Treasury bond yield and the 12-month futures rate. Powell may have no choice but to show his inner Volcker.

This week's economic calendar is likely to bring plenty of news that could push the S&P 500 deeper into bear market territory:

(1) *Inflation.* May's PPI will be out today. It was up 11.0% y/y during April (*Fig. 3*). Like May's CPI, it is likely to show that rising energy costs are spreading to lots of other prices. Also coming today, the national survey of small business owners, conducted by the National Federation of Independent Business, will include data on the percentage of them raising their prices last month. The same goes for June's business surveys conducted by the Federal Reserve Banks of New York and Philadelphia, which will be released on Wednesday and Thursday, respectively. All these business surveys are likely to confirm that inflation remains a pesky and persistent problem.

(2) *Regional business activity.* There are five regional surveys conducted by five of the 12 Federal Reserve district banks coming out this month for June, and the average of their composite indexes tends to closely track the yearly percent change in the S&P 500, which is now down 11.9% as of Monday's close (*Fig. 4*). The average of the five regional composite indexes was -0.5% during May and is likely to be more negative in June given the S&P 500's performance.

(3) *Consumers.* May's retail sales report on Wednesday should be weak on an inflation-adjusted basis, especially if consumers are spending less on goods and more on services, as widely believed. While the report may heighten recession fears, Debbie and I believe that consumers actually might continue to keep the economy growing for a while longer.

Granted, they've been forced to spend more on gasoline and food. These essentials accounted for 16.7% of disposable personal income (DPI) during April, the highest since early 2014 (*Fig. 5*). However, to deal with the rapid increases in the prices of gas and groceries, consumers have reduced personal saving as a percentage of DPI to 4.4%, the lowest since late 2008 (*Fig. 6*).

We estimate that consumers accumulated about $1.0 trillion of excess saving since the lockdown recession of 2020. Over the past 24 months, personal saving totaled $2.3 trillion, exceeding the pre-pandemic trend of this series by roughly $1.0 trillion. Much of that was "free" money deposited in consumers' bank accounts by Uncle Sam. Now we are all paying the price for all that free money with rapidly rising inflation, which is eroding inflation-adjusted DPI and forcing consumers to spend less to maintain their spending.

(4) *Housing and production.* Mortgage applications on Wednesday will likely continue to fall. However, Thursday's housing starts might surprise on the upside if builders are scrambling to develop more multi-family rental properties in response to soaring rents (*Fig. 7*). Multi-family building permits jumped 11.2% during the two months through March and were little changed in April.

On Friday, May's industrial production should be up modestly, while the month's Index of Leading Economic Indicators (LEI) is likely to be relatively weak. Among the weakest of the 10 components of the LEI is likely to be the S&P 500 as well as the average of the expectations components of the Consumer Sentiment Index and the Consumer Confidence Index (*Fig. 8*). Both will be even weaker in June's LEI, which will be released next month.

Strategy II: Bear Markets, Recessions & Earnings. Bear markets almost always have been associated with recessions (*Fig. 9* and *Fig. 10*). The one exception was the S&P 500's bear market in late 1987, when the index dropped 33.5%. It didn't last very long (only 101 days) because there was no recession (*Fig. 11*). The S&P 500's forward earnings per share continued to grow back then, but its forward P/E dropped from 14.8 during August to 10.5 during December (*Fig. 12* and *Fig. 13*).

During the current bear market, the S&P 500's forward earnings has continued to rise in record-high territory—and so have analysts' consensus expectations for 2022 and 2023 (*Fig. 14*). However, the forward P/E was much higher on January 3 of this year, at 21.5, than it was just before the 1987 bear market (*Fig. 15*). Now it is down to 15.7 as of Monday's close, which is still above the 15.0 level that is widely deemed to represent fair value during economic expansions. During the recessions since 1935, both the four-quarter trailing P/E and the forward P/E have fallen well below 15.0.

In a recession scenario, there would be more downside in the current bear market as the forward P/E continues to fall along with analysts' earnings projections. Currently, industry analysts are projecting that S&P 500 earnings per share will grow 10.7% this year and 9.5% next year to $229.35 and $251.79 (*Fig. 16*).

We aren't in the recession camp, yet. We did increase our odds of a recession from 30% to 40% earlier this year, and to 45% on Monday in response the May's CPI shocker. This revised assessment has prompted us to change our target ranges for the S&P 500's forward P/E and price level this year:

(1) *Annual earnings outlook.* We continue to project S&P 500 earnings per share of $225 this year and $240 next year (*Fig. 17*). Our growth rates of 7.9% and 6.7% are below the analysts' current expectations, but they are still positive ones. If we conclude that a recession is the most likely scenario, we will have to lower our estimates. If a recession occurs, we won't be the only ones with negative earnings growth projections.

(2) *Forward earnings outlook.* We are still projecting that forward earnings will rise from $238.53 per share currently to $255.00 at the end of this year and $275.00 at the end of next year (*Fig. 18*). The former would match analysts' consensus expectations for 2023, and the latter their expectations for 2024 (since forward earnings are the time-weighted average of analysts' consensus forecasts for this year and next, at year-ends they match analysts' expectations for the upcoming year). In a mild recession scenario, those numbers would probably be closer to $200 to $220.

(3) *Forward P/E outlook.* We are lowering our target forward P/E ranges from 15.0-17.0 to 13.0-16.0 for this year, and from 16.0-18.0 to 15.0-17.0 for next year (*Fig. 19*).

(4) *S&P 500 outlook.* Multiplying our outlook for forward earnings by those forward P/E ranges yields the following S&P 500 stock price target ranges, with the lower ones more likely to precede the higher ones in both years: 3315-4080 (down from our previous estimates of 3825-4335) for 2022 and 4125-4675 (down from 4400-4950) for 2023 (*Fig. 20*).

In other words, it's possible that the S&P 500 will retest its pre-pandemic record high of 3380.16 of February 12, 2020. It's less likely that the S&P 500 will be at a new record high in 2023, as we had been projecting, but it could get close to there by the end of next year.

Calendars

US: Tues: NFIB Small Business Optimism; Headline & Core PPI 0.8%m/m/10.9%y/y & 0.6%y/y/8.6%y/y; API Weekly Crude Oil Inventories; OPEC Monthly Report. **Wed:** Retail Sales Headline, Core, and Control 0.2%/0.8%/0.5%; Empire State Manufacturing Index 3.0; Import & Export Prices 1.1%/1.3%; Business Inventories 1.2%; NAHB Housing Market Index 68; MBA Mortgage Applications; Crude Oil Inventories -1.92m; Gasoline Production; IEA Monthly Report; Fed Interest Rate Decision 1.50%; FOMC Projections; FOMC Press Conference. (Bloomberg estimates)

Global: Tues: Germany CPI 0.8%m/m/7.9%y/y; Germany ZEW Economic Sentiment -31.0; UK Average Earnings Including & Excluding Bonus 7.6%/4.0%; UK Claimant Count Change -42.5k; UK Employment Change 3m/3m & Unemployment Rate 103k/3.6%; Canada Manufacturing Sales 1.6%; Japan Industrial Production & Capacity Utilization; Japan Core Machinery Orders -1.5%m/mm/5.3%y/y; China Industrial Production -0.5%y/y; China Retail Sales -7.3%y/y; China Fixed Assessment 6.0%y/y; Mauderer. **Wed:** Eurozone Industrial Production 0.5%m/m/-1.1%y/y; Eurozone Trade Balance; Germany WPI; Canada Housing Starts 252.6k; Japan Exports & Imports 16.4%/43.6% y/y; Australia Unemployment & Participation Rates 3.8%/66.4%; Australia Employment Change 25k; RBA Bulletin; Lagarde; Panetta; Nagel. (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 was at a record high for a second week 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 27th straight week. SmallCap's rose for the 12th time in 13 weeks, and was at a record high for a seventh week. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 101 of the past 107 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 102 of the past 105 weeks, and SmallCap's posted 97 gains in the past 106 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 69.7% from its lowest level since August 2017; MidCap's is now up 141.4% from its lowest level since May 2015; and SmallCap's has soared 202.5% from its lowest point since August 2013. In the latest week, the 19.4% yearly rate of change in LargeCap's forward earnings remained above its 13-month low of 19.0% at the end of May; 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 34.0% y/y from 34.3% 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 34.7% y/y from 34.9%. 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 (10.2%, 9.8%), MidCap (15.7, 5.7), and SmallCap (13.9, 11.6).

S&P 500/400/600 Valuation (*link*): Valuations fell sharply for these three indexes last week. LargeCap's forward P/E dropped 0.9pts to a 26-month low of 16.3 from 17.2. 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 27-month low of 12.0 from 12.6. That's 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 dropped 0.6pts to 11.7 from 12.3 a week earlier, but remains above its 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 26% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 95th 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 52nd straight week; the current 6% 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 4 cents w/w to $55.37 and is now down 1.0% from its $55.92 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 5.0% y/y on a frozen actual basis and 5.4% on a pro forma basis. That's down from Q1-2022's 11.8% 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 (209.9% in Q2-2022 versus 268.8% in Q1-2022), Industrials (30.5, 40.3), Materials (18.4, 46.2), S&P 500 (5.4, 11.3), Real Estate (3.9, 25.7), Health Care (2.7, 18.3), Information Technology (1.8, 14.2), Consumer Staples (-1.8, 7.5), Consumer Discretionary (-3.5, -27.7), Utilities (-12.3, 24.7), Communication Services (-13.6, -2.8), and Financials (-18.4, -17.1).

Global Economic Indicators

UK GDP (***link***): Real GDP hasn't posted a positive month since January's 0.7% gain, which followed a 0.2% decline the final month of 2021. April GDP contracted 0.3% (the steepest decline since January 2021) after a 0.1% shortfall in March and no growth in February. Despite recent declines, April's real GDP reading remained above its pre-pandemic level by 0.9%. The service sector fell for the second month, sinking 0.3% in April—dragged lower by a 5.6% drop in health spending during the month, reflecting a significant reduction in NHS Test and Trace activity. Wholesale and retail trade rebounded 2.7% in April—not enough to retrace the 4.2% drop during the two months through March. The production sector contracted for the third successive month, by 0.6% in April and 1.1% over the period, led by manufacturing, which slumped 1.0% and 1.7% over the comparable periods, reflecting continued headwinds from rising prices and supply-chain shortages. Construction output dropped for the first time in six months, contracting 0.4% in April; this followed a 1.7% jump in March, which was driven by significant repair and maintenance after late-February storms. Output was up 6.3% during the five months through March.

UK Industrial Production (*link*): As mentioned above, industrial production contracted for the third month in April, by 0.6% m/m and 1.1% over the period, led by manufacturing. Headline production was 2.2% below its pre-pandemic level in April, while manufacturing was 2.0% below. Meanwhile, two of the four remaining production sectors—mining & quarrying (-14.3%) and electricity & gas (-5.5)—were also below pre-pandemic levels, while water supply & sewage (9.9) was above. Looking at the main industrial groups, intermediate goods production declined in April for the second time since reaching a new record high in January, slipping 1.3% over the period. Output of capital goods sank 2.1% in April. This followed a 1.1% gain and a 2.8% loss the prior two months; production has been bouncing in a volatile flat trend the past 15 months. Meanwhile, consumer durable goods production remained on a volatile uptrend, dropping 4.6% in April after climbing 2.1% in March to within 0.8% of January's 26-month high, while production of consumer nondurable goods was unchanged at March's 11-month low—6.1% below its record high at the end of last year.

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