2

MORNING BRIEFING
June 22, 2022

The Latest Business Cycle

Check out the accompanying chart collection.

Executive Summary: The Census Bureau's monthly "Manufacturing and Trade Inventories and Sales" report is chock-full of valuable information that often goes unnoticed by the media and economists alike. Last week's release, with data through April, shows inventories starting to rise relative to sales, especially among retailers. That implies good and bad news—good for constraining inflation, bad for economic growth, increasing the risk of a goods-led recession. … And: With global inflation surging, are the major global central banks tightening with Fed-like fervor? Not exactly. Melissa examines the unique issues in Europe, Japan, and China that are tempering their monetary policy responses.

US Economy: How's Business? Every month, the Census Bureau releases its "Advance Monthly Sales for Retail and Food Services." The latest report was released on June 15 at 8:30 a.m. An hour and a half later every month, the Census Bureau releases its "Manufacturing and Trade Inventories and Sales" report—for the previous month. In other words, on June 15, Census reported retail sales through May and business sales of goods through April. The retail sales report tends to get all the attention by the media and by economists because it is one month more current than the more comprehensive business sales report. But Debbie and I find that there is a wealth of useful information about the economy in the latter report.

What we see in the business sales report is increasing signs that inflation has been boosting the nominal value of these sales but weighing on their inflation-adjusted value. Real inventories are starting to rise relative to sales, especially among some retailers. These businesses are likely to respond to unintended inventory accumulation as they always do, i.e., by cutting prices to clear them. So the good news is that some of the economy's inflationary pressures should abate. The bad news is that economic growth will suffer, increasing the risks of a typical goods-led recession.

Let's examine the latest business sales and inventories data, both nominal (available through April) and real (through March).

(1) *Business sales.* Manufacturing and trade sales rose 13.8% y/y to a record-high $21.8 trillion (saar) during April (*Fig. 1*). However, real business sales was unchanged on a y/y

basis over the three months through March (*Fig. 2*). That's down from the post-lockdown high of 16.2% during May 2021. This growth rate in real business sales closely tracks the growth rate in real GDP of goods, which was up 4.5% y/y through Q1.

Here are the y/y growth rates in current dollars and inflation-adjusted dollars for the three major components of business sales through March: manufacturing shipments (13.9%, -2.7%), wholesale sales (22.3, 2.5), and retail sales (5.2, -7.0) (*Fig. 3* and *Fig. 4*).

(2) *Business inflation.* The Census Bureau compiles price deflators for business sales and its components. The one for the aggregate measure of business sales rose by an astonishing 16.7% y/y through March, the highest since January 1975 (*Fig. 5*). Data available since 1968 show that this series tends to rise near the end of economic expansions and to fall during recessions. Here are the latest inflation rates through March and their readings a year ago for manufacturing (17.6%, 7.9%), wholesale sales (17.6, 10.4), and retail sales (12.2, 3.3) (*Fig. 6*). These are truly astonishing inflation rates.

(3) *Business inventories.* Manufacturing and trade inventories rose 15.1% y/y to a record high of $2.3 trillion through March (*Fig. 7*). Over this same period, real business inventories rose 2.0% to the highest level since March 2020. Here are the current-dollar and inflation-adjusted growth rates through March of the three major categories of business inventories: manufacturing (10.5%, -2.5%), wholesale (22.5, 9.3), and retail (12.3, 1.2) (*Fig. 8* and *Fig. 9*).

Investors recently have fretted over unintended inventory pileups, especially in the major department stores. It's hard to see much of a problem in the inflation-adjusted inventories-to-sales ratios for overall business or the three major components of the aggregate (*Fig. 10* and *Fig. 11*). All four ratios have jumped during the first three months of this year but are within their normal ranges of recent years. However, the current-dollar ratio for general merchandise stores did make a large jump during April, to 1.58 from 1.19 a year ago (*Fig. 12*).

(4) *Business cycle correlations.* We have often observed that the y/y growth rate in business sales (in current dollars) closely tracks the growth rate in S&P 500 aggregate revenues (*Fig. 13*). The former rose 13.7% through April, while the latter was up 13.4% through Q1. The surge in the inflation rate over the past year has been fully reflected in S&P 500 revenues. Remarkably, S&P 500 earnings have kept pace with inflation too, suggesting that profit margins are holding up well in the face of rapidly rising costs.

Another strong business cycle correlation is the one between the growth rate of real business sales (on a y/y basis using the three-month average of the series) and the level of the M-PMI (*Fig. 14*). A similarly tight fit exists between the growth rate of real business sales and the level of the average of the general business indexes of the regional business surveys conducted by five of the 12 regional Federal Reserve Banks (*Fig. 15*).

May's regional surveys confirmed that the goods sector of the economy has stopped growing. We expect that June's surveys will do so as well. We expect that June's M-PMI will fall close to 50.0 from May's surprisingly robust 56.1.

Global Central Banks: Fighting Their Own Battles. Central bankers' flood-like monetary stimulus during the pandemic sent their balance sheets to dizzying heights and their interest rates close to zero or slightly less (*Fig. 16* and *Fig. 17*). Now that global inflation is surging—owing largely to overly accommodative monetary policy for too long—the Fed and European Central Bank (ECB) are tightening to cool their overheated economies. With the economies of China and Japan still weak, however, the People's Bank of China (PBOC) and Bank of Japan (BOJ) haven't followed suit.

For perspective, the US CPI inflation rate reached 8.6% y/y in May, the highest since December 1981 (*Fig. 18*). The other three economies' most recent inflation readings are as follows: Eurozone (8.1% y/y in May, the highest on record and quadruple the ECB's 2.0% target), Japan (2.5% in April, but with a core rate of just 0.1%), and China (2.1% in May).

Below, we examine the factors influencing each central bank's policy decision-making:

(1) *Fed vs Taylor Rule.* On June 15, the Federal Open Market Committee raised the federal funds rate by 75 bps and indicated that it would push rates higher by another 50-75 bps at its next meeting on July 26-27. Fed Chair Jerome Powell said during his post-meeting press conference on June 15 that the Fed needed to move more aggressively to bring inflation down. Going further, he said that he wouldn't "declare victory" over inflation until inflation has been falling for months.

Fed officials' median projections for the federal funds rate now stand at 3.4% this year and 3.8% in 2023, with the former 150bps above their March projection of 1.9% and the latter 100bps above their 2.8% March projection. Powell emphasized that the Fed continues to target a 2.0% inflation rate while acknowledging that higher interest rates might push the unemployment rate up slightly. The Fed's median projections for the inflation rate, based on the personal consumption deflator, now stand at 5.2% this year and 2.6% in 2023 versus its

March projections of 4.3% and 2.7%, respectively.

“We don’t seek to put people out of work,” Powell said at his presser, adding that the central bank was “not trying to induce a recession.” But that could be the result of its actions: The Fed’s median projections for the unemployment rate were upped to 3.7% this year and 3.9% in 2023 from 3.5% for both back in March. Aiming for a “soft landing” for the US economy despite rising rates, the Fed’s median projections for output were lowered to 1.7% for both 2022 and 2023 from 2.8% and 2.2%, respectively.

Adding to the risk of a bumpy landing, the Fed also is starting to allow maturing securities to run off its balance sheet. This will reduce 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 from June through August—for a combined three-month decline of $142.5 billion. Starting in September, the runoff will be set at $60 billion for Treasury holdings and $35 billion for agency debt and mortgage-backed securities, or $95 billion per month, for a total of $1.14 trillion over a 12-month period.

Financial markets have reacted to these plans with widely anticipated volatility. Likely, the wild ride will continue, as the Fed shows no signs of relenting in its fight against inflation anytime soon.

Notably, Fed officials have long rejected the Taylor Rule, a formula-based approach to setting monetary policy, in favor of a more subjective approach based on a variety of variables (with a recent emphasis on the labor market). Had the Fed given some weight to the Taylor Rule, arguably rates wouldn’t have stayed so low so long and inflation wouldn’t be as great a problem as it is today. (Since its inception in the 1990s, the Taylor Rule has had varying degrees of influence over policy-setting, as discussed in this 2013 CEPR *article*.)

(2) *ECB vs itself.* At its February 3 meeting, the ECB held rates steady, but ECB President Christine Lagarde acknowledged that “the situation has indeed changed,” indicating a rate increase was coming this year. On June 9, the ECB signaled that it would make its first interest rate hike since 2011 at its July 20-21 meeting, with a possible larger move on September 8 followed by further gradual hikes. The ECB also will end its large-scale bond purchasing program on July 1, but reducing its balance sheet isn’t currently on the table.

However, the policy-setting situation in Europe just became much more complicated when the ECB got a wakeup call on how raising rates could impact heavily indebted European economies: Those countries' bond yields suddenly went vertical. On June 15, the ECB held an emergency meeting to address the sharp rise in the Italian 10-year government bond yield to over 4.0%, or nearly 250 bps above Germany's 10-year yield, in advance of the ECB's actions.

As an interim measure, the ECB said it would sell some pandemic-stimulus-purchased bonds and buy up weak Eurozone countries' bonds instead, to stimulate those asset prices and lower yields. Indeed, Italian government bond yields moved lower following the announcement. But that move is seen as incrementally helpful.

Over the longer term, the ECB promised to implement an "anti-fragmentation instrument" to lessen the divergence in yields between the richer and poorer member countries of the monetary union. The ECB faces a challenging policy conundrum: how to lower borrowing costs in troubled economies while raising rates in other countries.

Lagarde tried to temper expectations for the new instrument, however, arguing that the ECB's job is to achieve price stability, not favorable financing conditions or budgets. "We cannot surrender to fiscal dominance," Lagarde said at a forum in London, *reported* Reuters. "Neither can we surrender to finance dominance; we have to deliver on our mandate."

(3) *BOJ vs the Bond Samurais*. Japan is not immune to inflationary pressures but has been less affected by them than other major economies. Yield curve control (YCC), the BOJ's policy to control long-term interest rates, has been in force since 2016. And the BOJ is sticking to it.

On June 17, the BOJ reiterated its firm cap on 10-year Japanese government bond (JGB) yields at 0.25% by purchasing an unlimited number of bonds to prevent rising global yields from pushing up domestic borrowing costs. The BOJ maintained its -0.1% target for short-term rates. "It is not appropriate to tighten monetary policy at this point," said BOJ Governor Haruhiko Kuroda. "If we raise interest rates, the economy will move in a negative direction."

However, it's anticipated that the BOJ eventually will be forced to raise its bond yield ceiling in surrender to the Bond Samurais (a.k.a. Vigilantes) who are pushing yields higher. The 10-year JGB yield hit a six-year high of 0.268% in trading on Friday, before recovering to 0.22% after the BOJ's decision. But to remain successful at its YCC, the BOJ would have to buy up more and more government bonds should investors shun them.

For now, the BOJ is aggressively intervening to enforce the cap. The BOJ bought 10.9 trillion yen in JGBs this week, or more than $82 billion, marking the largest weekly purchase on record, *according* to Bloomberg. For comparison, ECB asset purchases averaged about $27 billion per month this year through May.

The BOJ certainly can defend its policies given the weakness in its economy, but the effectiveness of its policies is not easy to defend. Headline inflation has risen above 2.0% for the first time since 2015, but Japan's core rate remains well below that target. That's with rates near zero and a balance sheet of over $5 trillion. In other words, the bank does not have much left it can do to stimulate domestic "animal spirits." While the Fed and ECB are moving toward monetary tightening, the BOJ likely will remain an outlier in a holding pattern, unless and until it has no choice but to raise its YCC cap.

(4) *PBOC vs the rest of world.* While the Fed and ECB rush to tighten and the BOJ hangs on, the PBOC is the only major central bank with the possibility of future easing on the horizon. China's economy has been battered by its extended authoritarian lockdown measures to contain the pandemic. Chinese central bankers are caught between the risk of further incenting the capital flight that's been occurring and the risk that households and businesses remain wary of taking on new loans.

Nevertheless, China held its benchmark interest rates *unchanged* at its monthly fixing on Monday, June 20. The one-year loan prime rate (LPR) was kept at 3.70%, and the five-year was unchanged at 4.45% Previously, in an unexpected policy move on May 20, the PBOC had cut its LPR.

Divergent policies among the major central banks certainly are creating plenty of volatility in global asset prices and likely will continue to do so.

Calendars

US: Wed: MBA Mortgage Applications; API Weekly Crude Oil Inventories; Powell. **Thurs:** Initial & Continuous Jobless Claims 225k/1.351m; Kansas City Manufacturing Index; S&P Global M-PMI & NM-PMI Flash Estimates 56.4/53.6; Crude Oil Inventories; Natural Gas Storage; Fed Bank Stress Results; Powell. (Bloomberg estimates)

Global: Wed: Eurozone Consumer Confidence -20.8; UK Headline & Core CPI

0.6%m/m/9.1%y/y & 0.6%m/m/5.0%y/y; UK PPI Input 1.1%m/m/19.0%y/y; Canada Headline & Core CPI 1.1%m/m/7.5%y/y & 0.4%m/m/5.4%y/y; European Central Bank Non-Monetary Policy Meeting; Mauderer; De Guindos; Elderson; Cunliffe. **Thurs:** Eurozone, Germany & France C-PMI Flash Estimates 54.0/53.1/56.0; Eurozone, Germany & France M-PMI Flash Estimates 53.9/54.0/53.8; Eurozone, Germany, and France NM-PMI Flash Estimates 55.5/54.5/57.5; France Business Survey 105; UK C-PMI, M-PMI & NM-PMI Flash Estimates 51.8/54.6/51.8; UK Gfk Consumer Confidence -41; Japan CPI 5.5% y/y; ECB Economic Bulletin; EU Leaders Summit; Enria; Nagel. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings at a record high last week. LargeCap's was at a record high for a third 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 dropped for the first time in 28 weeks to a hair below its record a week earlier. SmallCap's rose for the 13th time in 14 weeks, and was at a record high for an eighth week. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 102 of the past 108 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 106 weeks, and SmallCap's posted 98 gains in the past 107 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 70.2% from its lowest level since August 2017; MidCap's is now up 141.3% from its lowest level since May 2015; and SmallCap's has soared 204.6% from its lowest point since August 2013. In the latest week, the 19.4% yearly rate of change in LargeCap's forward earnings was unchanged and 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 33.4% y/y from 34.0% 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 fell to a 15-month low of 34.1% y/y from 34.7%. 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 (10.3%, 9.8%), MidCap (15.4, 6.1), and SmallCap (14.1, 12.2).

S&P 500/400/600 Valuation (*link*): Valuations fell sharply for these three indexes last week. LargeCap's forward P/E dropped 1.0pts to a 26-month low of 15.3 from 16.3. 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 0.9pts to a 27-month low of 11.1 from 12.0. 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 1.0pts to 10.7 from 11.7. That reading is the lowest since it bottomed at a record low of 10.2 in November 2009 during the Great Financial Crisis. That compares to a 13-week high of 16.1 in early November and its record high of 26.7 in early June 2020 when forward earnings was depressed. 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 27% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 96th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 30% 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 53rd 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 Q2-2022 earnings-per-share forecast rose 9 cents w/w to $55.46, and is now down 0.8% from its $55.92 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 5.1% 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).

US Economic Indicators

Existing Home Sales (***link***): "Home sales have essentially returned to the levels seen in 2019—prior to the pandemic—after two years of gangbuster performance," said Lawrence Yun, NAR's chief economist. "Also, the market movements of single-family and condominium sales are nearly equal, possibly implying that the preference towards suburban living over city life that had been present over the past two years is fading with a return to pre-pandemic conditions." Existing home sales contracted for the fourth consecutive month, by 3.4% in May and 16.6% over the period to 5.41mu (saar)—the lowest since mid-2020—with single-family home sales down 3.6% and 16.5% over the comparable periods to 4.80mu (saar), while multi-family sales sank 1.6% and 17.6% to 610,000 units. Regionally, sales in May rose in the Northeast and fell in the other three regions, while all four remained below year-ago levels: Northeast (+1.5% m/m & -9.3% y/y), South (-2.8 & -8.4), Midwest (-5.3 & -7.5), and the West (-5.3 & -10.0). Yun noted further declines in sales are expected up ahead given the "housing affordability challenges." The median existing-home price moved above $400,000 in May to a record $407,600, up 14.8% y/y—marking the 123rd consecutive month of y/y increases, a record streak!. According to Yun, homes priced appropriately are selling quickly (88% of the homes sold in May were on the market for less than a month). He notes that inventory levels need to nearly double to cool home price appreciation enough to provide more options for home buyers.

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