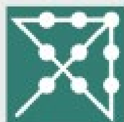

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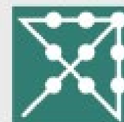

MORNING BRIEFING
July 6, 2022

A Recession: To Be or Not To Be?

Check out the accompanying chart collection.

Executive Summary: The latest batch of leading economic indicators suggests weaker coincident indicators to come. As a result, we're raising our odds of a shallow, short-lived recession in the US economy to 55% (from 45%). That makes a recession now our base-case scenario from which we derive our earnings and stock market forecasts. … Higher recession odds lower our expectations for what S&P 500 companies will earn, what investors will pay for their stocks, and where the S&P 500 price index may stand at year-ends 2022 and 2023. … Also: Melissa looks at the factors contributing to global food inflation and the regions most vulnerable to food shortages.

Strategy: Earnings Forecasts & Market Targets. Yesterday, Debbie and I lowered our outlook for real GDP to reflect a short and shallow recession in the US this year and a recovery next year. We are raising the odds of this scenario from 45% to 55%. So we might still skirt an outright recession. Let's review the implications for the fundamentals of the stock market:

(1) *S&P 500 annual & forward earnings.* Joe and I revised our S&P 500 operating earnings per share downward by $10 to $215 for this year and by $5 to $235 in yesterday's *Morning Briefing* (*Fig. 1*). (We had the correct numbers in yesterday's chart but typos in the text; a corrected version is available *here*.) We also lowered our S&P 500 forward operating earnings per share forecast to $235 per share at the end of this year and $255 per share at the end of next year (*Fig. 2*). Both are down $20 from our previous estimates. Forward earnings stood at $240 per share during the week of June 30. (Forward earnings is the time-weighted average of industry analysts' consensus estimates for the current year and the coming year.)

(2) *S&P 500 valuation & targets.* In our work, the stock market equation (i.e., P = P/E x E) is based on our projections of both forward earnings (determined by analysts) and the forward P/E (determined by investors). When we formulate year-end targets for the S&P 500, we do so by multiplying our projection of analysts' consensus forward earnings by our subjective assessments of a plausible range for the forward P/E at the end of the year.

For 2022, we are using projected forward earnings per share of $235 by the end of this year

and a forward P/E range of 14-17, which yields a year-end S&P 500 target range of 3290-3995 (*Fig. 3* and *Fig. 4*).

For 2023, we are using projected forward earnings per share of $255 by the end of next year and a forward P/E range of 15-18, which yields a year-end S&P 500 target range of 3825-4590.

We conclude that the S&P 500 will recover next year, coming close to its January 3, 2022 record high of 4796.56 but probably not exceeding it until 2024.

(3) *S&P 500 revenues & margins.* For 2022 and 2023, we are still forecasting that S&P 500 revenues per share will increase 11.6% to $1,750, and 7.1% to $1,875 as inflation continues to boost business sales this year and an economic recovery does the same next year (*Fig. 5*). As a result, we are projecting that the profit margin of the S&P 500 will fall from 13.4% last year to 12.3% this year and edge up to 12.5% next year (*Fig. 6*). Industry analysts are currently projecting profit margins of 13.0% this year and 13.5% next year. (See *YRI S&P 500 Earnings Forecast*.)

US Economy: Falling Leading Indicators. Prior to Tuesday's *Morning Briefing*, our subjective probability of a recession was 45% for this year and next year. The latest batch of leading economic indicators suggests that several coincident economic indicators might soon begin to fall. So we now place the odds of a mild recession at 55%, making it our base-case outlook.

Let's review what we have so far for June's Index of Leading Economic Indicators (LEI) and May's Index of Coincident Economic Indicators (CEI):

(1) *Timing issue.* While it is widely believed that the LEI tends to peak three consecutive months prior to recessions, the average lead time between the LEI peak and the CEI peak has been 12 months during the previous eight business cycles, with a range of 2-22 months (*Fig. 7*). The CEI cycle has coincided with both the official peaks and troughs of the previous eight business cycles, as determined by the Dating Committee of the National Bureau of Economic Research.

The CEI tracks the growth rate of real GDP, both on a y/y basis, very closely (*Fig. 8*). The former was up 3.0% during May, while the latter was up 3.5% during Q1.

(2) *Three strikes.* The LEI fell for the third month in a row in May, and that makes four

declines in the last five months. We already know that three of the 10 LEI components were down in June, i.e., the S&P 500, the M-PMI new orders subindex, and the average of the CCI and CSI consumer expectations measures (*Fig. 9*). Also weighing on the LEI during June was an increase in initial unemployment claims. Odds are that nondefense capital goods orders excluding aircraft lowered June's LEI as well.

(3) *Recession or not?* So real GDP apparently fell two quarters in a row during H1-2022. The LEI has dropped for three consecutive months through May. The jury is out on whether this will turn out to be an official recession, especially since the CEI rose to a record high in May and since it peaked 12 months, on average, after the LEI peaked during the past eight business cycles, as noted above. For now, we are raising the odds of a recession from 45% to 55%. In any event, industry analysts are likely to be cutting their earnings estimates during H2-2022.

Global Food I: The Price of a Burger. The soaring price of food no doubt was a big conversation topic at last weekend's Fourth of July barbeques, with a prime example sizzling on the grill. This year's cookout was 17% more expensive than last year's, according to a new *report* from the American Farm Bureau Federation. The price of ground beef rose especially high.

US households are spending $341 more a month to purchase the same goods and services as last year, according to an analysis by Moody's Analytics, *reported* CNBC on May 12. And a lot of that increase is for food. In the US, the Consumer Price Index for food rose 10.1% y/y during May (*Fig. 10*). The increase is the highest seen since the 1980s. Why?

"[T]he broader question is 'What is not contributing to higher food prices?,'" Jennifer Hatcher of The Food Industry Association said at The Heritage Foundation's June 28 *podcast* on inflation across the food supply chain. She attributed rising food prices to energy costs, transportation costs, supply-chain bottlenecks, the labor shortage, and ingredient shortages. According to a June 7 *article* in *Vox*, Tyson Foods, America's largest meat producer, would add two additional items to that list: higher demand for meat and the rise in the price of grain fed to farm animals.

In our view, the problems cited above are mainly attributable to the pandemic and to Russia's war on Ukraine. How long they will be inflating food prices is the question. Melissa and I think the pandemic's inflationary impacts could persist for a while. The impacts of the war on food prices in the US and globally are hard to assess; but the longer the war lasts, the worse the consequences for food prices. While most Americans won't experience a

shortage of bread on our shelves, that's not the case for many developing countries that depend on food supply from the Black Sea region.

Before we delve further into the war's impacts on global food supply, let's explore some of the key challenges impacting the supply of, as well as rising demand for, food, leading to higher prices in the US:

(1) *Food production & inputs.* The US Department of Agriculture (USDA) *expects* wholesale prices for meat, dairy, and flour to be up at rates in the double digits this year. During the pandemic, many food manufacturing plants, meat processing ones in particular, were forced to close due to Covid outbreaks among workers. To keep those workers safe and prevent future closures, many manufacturers are investing more in automated technologies and remote capabilities for workers.

That investment aside, input costs are up overall for manufacturers. In May, the producer's price index (PPI) for final demand goods and services rose 10.8% y/y (*Fig. 11*). Contributing to the rising cost of meat is the rising cost of prepared animal feed—up nearly 13% since last year, according to a Bank of America *analysis*. Farmers are paying more for agricultural chemicals, especially for fertilizers and pesticides. Fertilizers and chemicals represent 10%-20% of US farmers' total costs, Bank of America said. The energy-intensive nature of fertilizer production makes it especially costly.

(2) *Food demand.* Higher meat prices reflect a supply that can barely meet record-setting demand, which remained high even after the pandemic, said Mark Dopp of the North American Meat Institute at the Heritage event. Some of the demand is panic buying, he added. Many consumers continue to buy more than they need, to have supply on hand if stores run out of certain items as during the pandemic. More folks eat more often at home than before the pandemic, which can mean eating more frequently.

(3) *Energy, transport, and labor.* Rising fuel costs and the state of the transportation industry also are boosting food costs across the supply chain. The transportation of freight index, which measures the cost of shipping goods in the US, jumped 25.8% y/y during May (*Fig. 12*). There's a problem when it comes to finding capacity necessary to move product, Tom Madrecki of Consumer Brands Association noted during the Heritage event. Madrecki cited the truck driver shortage as a major contributor to transportation costs; it's difficult to both find and retain drivers.

Global Food II: The Price of War. Outright food shortages are possible in 2023 if Russia

continues to block Ukraine's crop exports, the head of the United Nations World Food Program warned according to an article covering the *WSJ* *Global Food Forum* on June 28. The forum comments suggest—as we did in our April 27 *Morning Briefing*—that most people in the developed world will not suffer from a shortage of food, but many will suffer from the inflated cost of purchasing it, for the reasons discussed above in addition to the war.

However, developing countries, particularly those most dependent on Ukrainian food imports, face a potential humanitarian hunger calamity. Reduced food exports from Ukraine, one of the world's largest harvesters of wheat and food oils, are hitting their food supplies at a time when the supplies are already depressed by climate-change challenges. Here's the latest on the situation:

(1) *Russia blockades.* Russia has been accused of weaponizing food prices and capitalizing on food shortages. Before Russia's invasion, nearly all of Ukraine's grain exports transited through ports on the Black Sea, reported a June 5 *WSJ* *article*. But a Russian naval blockade has stopped traffic at those ports, and key export infrastructure has been targeted by Russian attacks. Not many good options are available for shipping Ukrainian harvested grain through the Black Sea.

Russia has been accused of stealing Ukrainian grain and exporting it, but authorities in Turkey are working with the Ukrainian government to prevent stolen grain from leaving ports. Russia continues to export its own grain, and the Food and Agriculture Organization (FAO) expects it to reap a record wheat crop in September. However, Western financial sanctions on Russia could hinder exports. Fewer shipments than usual are booked to depart Russian Black Sea ports after July.

(2) *Developing dependencies.* Before the war, the Ukraine supplied one-third of global wheat exports; that has been halved, according to USDA, as the June 28 *WSJ* article reported. Four countries imported over 50% of their wheat supplies from the Ukraine, including Lebanon, Pakistan, Djibouti, and Somalia, according to the FAO, observed the June 5 *WSJ*.

Most other countries that depend on Ukraine for 10%–50% of their imports are developing ones in Africa, the Middle East, and Southeast Asia. Turkey, Egypt, and Somalia also depend heavily on wheat exports from Russia, typically the world's largest wheat exporter. But the two countries produce just 7.0% of the world's wheat, *observed* the *WSJ*, so the impact of lower grain exports from Ukraine and Russia shouldn't be exaggerated.

On a hopeful note, in a recent small but significant victory for Ukraine, Russian soldiers *withdrew* last Thursday from Snake Island, an outpost in the Black Sea. The retreat could weaken the Kremlin's Black Sea blockade.

Calendars

US: Wed: ISM NM-PMI 54.5; Job Openings 11.05m; Motor Vehicle Sales; MBA Mortgage Applications; Weekly Crude Oil Inventories; FOMC Meeting Minutes; Williams. **Thurs:** ADP Employment 200k; Initial & Continuous Jobless Claims 230k/1.327m; Trade Balance -$84.9b; Natural Gas Storage; Crude Oil Inventories; Bullard; Waller. (Bloomberg estimates)

Global: Wed: Eurozone Retail Sales 0.4%m/m/1.4%y/y; Germany Factory Orders -0.6%; Spain Industrial Production 3.4%; UK Construction PMI 55.0; Australia Trade Balance $10.6b; Pill; Cunliffe. **Thurs:** Germany Industrial Production 0.4%; UK Halifax Home Price Index; Canada Trade Balance $2.4b; Japan Household Spending 0.8%m/m/2.1%y/y; Japan Current Account; Japan Leading & Coincident Indicators; ECB Publishes Account of Monetary Policy Meeting; Enria; Nagel; McCaul; Jochnick; Lane; Mann**.** (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): None of these three indexes has had forward earnings at a record high in 18 months. SmallCap was the only one to have forward earnings rise last week. LargeCap's dropped for the first time in five weeks to 0.1% below its week-earlier record high and has fallen in three of the past nine weeks. MidCap's dropped for a third straight week to 1.1% below its record high in early June. MidCap's three-week decline is its first since May 2020. SmallCap's rose 0.1% w/w, but is down 1.0% from its record high in mid-June. In what was an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 103 of the past 110 weeks, with the other 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 108 weeks, and SmallCap's posted 99 gains in the past 109 weeks. SmallCap had been steadily making new highs each week until mid-December, but then dropped by as much as 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 70.1% from its lowest level since August 2017; MidCap's is now up 138.7% from its lowest level since May 2015; and SmallCap's has soared 201.5% from its lowest point since August 2013. In the latest week, the rate of change in LargeCap's forward earnings fell to a 15-month low of 18.4% y/y from 18.9%; 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 15-month low of 30.3% y/y from 31.9% 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 31.5% y/y from 31.8%. 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, but their forecasts are likely to head lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (10.0%, 9.5%), MidCap (13.6, 6.4), and SmallCap (12.5, 12.2).

S&P 500/400/600 Valuation (*link*): Valuations fell for these three indexes last week. LargeCap's forward P/E dropped 0.3pts to 16.0 from 16.3 a week earlier, but is up from a 26-month low of 15.3 the week before that. It'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 0.2pts to 11.6 from 11.8, but is up from a 27-month low of 11.1 in mid-June. 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 lost 0.2pts to 11.2 from 11.4 a week earlier. It's 10.7 reading the week before that was 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 98th 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 55th 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 fell 10 cents w/w to $55.35, 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 4.9% y/y on a frozen actual basis and 5.6% on a pro forma basis. That's down from Q1-2022's 11.6% y/y on a frozen actual basis and an 11.4% 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 (222.6% in Q2-2022 versus 269.5% in Q1-2022), Industrials (30.6, 40.5), Materials (18.8, 46.3), S&P 500 (5.6, 11.4), Real Estate (4.3, 25.5), Health Care (2.5, 18.3), Information Technology (2.5, 14.6), Consumer Staples (-1.7, 7.9), Consumer Discretionary (-4.4, -27.9), Utilities (-12.1, 24.6), Communication Services (-14.2, -2.8), and Financials (-19.6, -17.1).

US Economic Indicators

Manufacturing Orders & Shipments (*link*): Factory orders were better than expected in May, and shipments were also strong—the latter climbing to a new record high. Meanwhile, both core capital goods orders and shipments reached new record highs again in May, as companies have been attempting to boost productivity to compete with high inflation and a tight labor market. Nondefense capital goods shipments excluding aircraft (used in calculating GDP) has climbed every month but one since its April 2020 bottom, rising 0.8% in May and 32.3% over the period. Meanwhile, core capital goods orders (a proxy for future business investment) has advanced during all but four months since April 2020, up 0.6% and 32.4% over the comparable periods. Total factory orders climbed for the eighth successive month in May, up 1.6% m/m and 10.5% over the period to its highest level since July 2014 and heading toward a new record high. Machinery billings hit at an all-time high,

with the industrial equipment component near record highs and construction orders on an upswing. Orders also remained on uptrends for the following industries: electrical equipment, appliances & components, computers & electronic products, and motor vehicles & parts. Overall factory shipments continued to reach new record highs in March, jumping 1.8% m/m and 15.1% y/y.

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

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