MORNING BRIEFING
August 15, 2022

Waiting For Godot

Check out the accompanying chart collection.

Executive Summary: Today, we sift through the recent economic data and recent Fed head chatter for clues to the critical question: Now that recession fears have abated for 2022, what are the odds of one in 2023? … We give 60% odds to a slow-growth scenario, with GDP growing 1.5% in H2-2022 and 2.5% in 2023; 35% odds to a recession next year precipitated by the Fed's inflation battle; and 5% odds to a boom scenario. … Critical to the recession question is whether inflation is peaking. We think so but need to see more evidence to be sure. … And: Dr. Ed reviews "Elvis" (+ + +).

YRI Monday Webcast. Join Dr. Ed's live Q&A webinar on Mondays at 11 a.m. EST. You will receive an email with the link to the webinar one hour before showtime. Replays of the Monday webinars are available *here*.

US Economy I: Is The Recession (Risk) Over Yet? The S&P 500 fell 23.6% from its record high on January 3 through June 16. It did so on fears that the Fed's increasing hawkishness, sparked when inflation turned out to be persistent rather than transitory, would end in a recession. The S&P 500 is now up 16.7% since June 16 through Friday's close. Does that mean that investors no longer fear a recession? Apparently so, but Debbie and I think that fears of a recession might make a comeback later this year or early next year. After all, this is the most widely anticipated recession ever, which is why it might be like waiting for Godot!

Consider the following:

(1) *A "technical" recession?* Everyone not working in the Biden administration seems to agree that the US experienced a "technical" recession during the first half of this year simply because real GDP dropped for two consecutive quarters during Q1 (-1.6%) and Q2 (-0.9%). In last Monday's *Morning Briefing*, we explained that there is a good chance that one or both of these quarters will be revised up because the spread between Gross Domestic Income and Gross Domestic Product has been widening significantly in recent quarters, with the former growing faster than the latter (*Fig. 1* and *Fig. 2*).

(2) *Coincident indicators.* We also explained last Monday that there is no recession evident

in the Index of Coincident Economic Indicators (CEI), which rose to a record high in June and probably continued to do so in July (*Fig. 3*). That's because payroll employment is one of the four components of the CEI, and it rose every single month during the first seven months of this year by a cumulative 3.3 million to a record 152.5 million during July (*Fig. 4*).

(By the way, over this same period, the household measure of employment rose by 2.3 million. The household measure counts the number of people with one or more jobs including the self-employed, while the payroll measure counts the number of jobs excluding the self-employed.)

Another component of the CEI is real personal income excluding government transfer payments. From July's employment report, we know that our Earned Income Proxy (EIP) for private wages and salaries in personal income rose 0.8% m/m and 9.6% y/y during July to a new record high (*Fig. 5*). However, on an inflation-adjusted basis, it was up just 2.9% y/y through June.

Nevertheless, July's CPI, which was unchanged during the month, suggests that both our EIP and real private wages and salaries in personal income rose solidly last month. Indeed, a separate Labor Department report last Wednesday showed real average weekly earnings rose 0.5% in July, the first monthly increase since last September and the largest gain since January 2021. This suggests that July's real retail sales, which will be released on Wednesday, should show a solid gain and boost the real manufacturing and trade component of the CEI.

The fourth component of the CEI is industrial production. From July's employment report, we know that aggregate weekly hours edged up 0.4% during July, suggesting that industrial production was a positive contributor to the CEI last month (*Fig. 6*). We will find out on Tuesday what it actually did.

(3) *Leading indicators.* The bad news is that the Index of Leading Economic Indicators (LEI) peaked at a record high during February and is down 1.9% through June, with four consecutive monthly declines through June. Such weakness in the LEI has been a fairly reliable early warning signal of a recession, with an average lead time of 14 months prior to the past seven business cycle peaks, excluding the peak just before the lockdown recession of 2020. The lead time from the LEI's peaks and the peaks of subsequent economic activity has been nine to 22 months. This suggests that the next recession might start next spring but could begin as early as the end of this year.

Then again, we might learn that July's LEI was up but not enough to match February's peak. After all, the S&P 500 is one of the 10 components of the LEI, and its monthly average of daily data rose 0.3% m/m during July after falling 3.5% in June (*Fig. 7*). On average, it has peaked five months before the previous 11 business cycle peaks excluding the 2020 pandemic cycle. This time, it peaked on January 3, arguably anticipating the technical recession of H1-2022. If so, then the rally since June 16 may be signaling better times ahead for the economy, unless it turns out to be a bear-market rally.

What else do we know so far about the components of July's LEI? Initial unemployment claims will likely be a negative contributor. It recently bottomed at 166,000 during the March 19 week and rose to 262,000 during the August 6 week (*Fig. 8*). We know that the expectations component of the Consumer Sentiment Index, which is included in the LEI, jumped from 47.3 during July—which was the lowest reading since spring 1980—to 54.9 in early August (*Fig. 9*).

The yield-curve spread between the 10-year US Treasury bond yield and the federal funds rate should be a big negative LEI contributor in either July or August because it narrowed dramatically when the Fed raised the federal funds rate by 75bps on July 27 (*Fig. 10*).

By the way, a useful leading indicator for this spread is the one between the 10-year and 2-year yields, which turned negative in early July, signaling that a recession is still possible in coming months. Melissa and I believe that the 2-year yield mirrors the market's prediction for the federal funds rate over the next 12 months. It currently shows a peak rate around 3.25%.

(4) *Hawkish Fed heads.* Ever since Fed Chair Jerome Powell's July 27 *press conference*, Fed officials have been scrambling to clarify his comment that the federal funds rate range of 2.25%-2.50% is "right in the range of what we think is neutral." He added, "now that we're at neutral, as the process goes on, at some point, it will be appropriate to slow down" the pace of rate hikes. The financial markets optimistically interpreted that to mean that the Fed may even cut interest rates next year. The other Fed officials have been walking back Powell's suggestion that the Fed is nearly done tightening and trying to stick a pin in the market's notion that the Fed may be cutting interest rates next year.

Following last Wednesday's news of a drop in the CPI inflation rate, Minneapolis Federal Reserve Bank President Neel Kashkari said that despite the "welcome" news in the CPI report, the Fed is "far, far away from declaring victory" on inflation. Kashkari, who has always been among the most dovish Fed officials, said he hasn't "seen anything that

changes" the need to raise the Fed's policy rate to 3.90% by year-end and to 4.40% by the end of 2023. That probably makes him the most hawkish member of the FOMC.

Kashkari did acknowledge that raising rates so quickly could push the economy into recession, and that a recession could even occur in the "near future." But most of Kashkari's 18 colleagues think a little less policy tightening may be enough to bring prices under better control without causing a recession.

Among them is Chicago Fed President Charles Evans. While calling inflation "unacceptably high," he set his target rate hikes at 3.25%-3.50% this year and 3.75%-4.00% by the end of next year, still somewhat higher than Powell signaled after the Fed's latest meeting in July.

(5) *The Chair's guidance.* Powell did offer a bit of guidance during his July 27 presser. He said, "And I think you can still think of the destination as broadly in line with the June SEP. Because it's only six weeks old."

"SEP" stands for the "Summary of Economic Projections," which shows the consensus forecasts of the FOMC participants for the federal funds rate, the unemployment rate, real GDP, headline PCED inflation, and core PCED inflation. Back in June, they expected the federal funds rate would be raised to 3.40% by the end of this year and 3.80% by the end of next year. (See our *FOMC Economic Projections*.)

According to the SEP, that's restrictive enough to bring inflation down but without causing a recession. More specifically, real GDP is expected to grow 1.7% this year and next year, with the unemployment rate rising to only 3.9% next year. The PCED inflation rate is expected to fall from 5.2% this year to 2.6% in 2023 and 2.2% in 2024.

(6) *Dr. Copper.* The CRB all commodities and raw industrials spot price indexes peaked at record highs on May 4 and April 4, respectively, and are down 8.3% and 11.3% through Friday (*Fig. 11*). For now, we think that's a better omen of lower inflation than an imminent recession.

The price of copper is widely watched as an indicator of economic activity. So its plunge during the first half of the year seemed to confirm recession fears (*Fig. 12*). However, it is a better measure of economic activity in China than in the US. China's economy was depressed during the first half of this year by renewed pandemic lockdowns and the popping of its property bubble. The price of copper has rallied in recent days.

(7) *Money supply and QT.* What about M2? It has declined for two of the past three months by a total of $72.4 billion, while the total deposits of all commercial banks has decreased by $146 billion from its record high during the April 13 week through the August 3 week (*Fig. 13*).

That doesn't worry us, for now. M2 remains about $2 trillion above its pre-pandemic trend. We might get more concerned if it were to fall too rapidly toward that trend or below it. It is falling because the Fed pivoted from QE to QT (quantitative easing to quantitative tightening) starting in June. Meanwhile, commercial bank loans have been rising in record-high territory recently, with new loans funded by the banks' sale of securities such as Treasury bonds (*Fig. 14*).

(8) *Recession odds.* So what are the recession odds now? They've been reduced, in our opinion, by the easing of financial conditions in the capital markets. The labor market remains strong. Consumers still have about $2 trillion in excess savings, and their real wages may be starting to get a lift from lower price inflation. Capital spending is slowing but not falling. Residential investment is in a recession, led by the single-family housing market, while the multi-family sector remains solid. Europe faces an energy crisis this winter but is still growing currently.

So Debbie and I are more sanguine about the economic outlook now than we have been in recent months. We think that economic growth will be weak during H2-2022 but positive around 1.5% (saar). Next year should be a year of recovery (not recession) from this year's mid-cycle slowdown. Real GDP next year should be up 2.5%.

So here are our new subjective probabilities: We place 60% odds on this slow-go scenario and 35% odds on a recession, more likely next year than this year. We give 5% to a boom scenario. In the recession scenario, inflation remains persistently high, forcing the Fed to raise rates to levels that cause a recession.

US Economy II: Has Inflation Peaked? Of course, notwithstanding the favorable response last week to the apparent peaking in the CPI and PPI inflation rates, the jury is still out on whether they've actually peaked. We've been predicting that inflation would moderate during H2-2022. So far so good, but we need to see more evidence to know definitively that's the case.

Movie. "Elvis" (+ + +) (*link*) is a long movie about the all-too-short life of Elvis Presley and his convoluted relationship with his manager, Colonel Tom Parker. Austin Butler plays Elvis

brilliantly. Tom Hanks' performance as the Colonel is a bit annoying, but that's the way the Colonel was apparently. During the 1950s, Elvis started a musical revolution by popularizing traditional genres such as blues, country, and bluegrass. His vocal energy and then-scandalous hip swings and body contortions drove his concert audiences into a frenzy. He was without a doubt "The King of Rock & Roll."

Calendars

US: Mon: Empire State Manufacturing Index 5.50; NAHB Housing Market Index 55. **Tues:** Headline & Manufacturing Industrial Production 0.3%/-0.1%; Capacity Utilization Rate 80.1%; Housing Starts & Building Permits 1.54mu/1.64mu; API Crude Oil Inventories. (Bloomberg estimates)

Global: Mon: Japan Industrial Production & Capacity Utilization; China FDI; RBA Meeting. **Tues:** ZEW Eurozone Economic Sentiment; Germany ZEW Economic Sentiment & Current Conditions -52.7/-48.0; UK Average Earnings Including & Excluding Bonus 4.5%/4.5%; UK Employment Change & Unemployment Rate 253k 3m/3m/3.8%; Canada CPI 0.1%m/m/76%y/y; Canada Housing Starts 265k; Japan Core Machinery Orders 1.3%m/m/7.5%y/y; Japan Trade Balance -¥1.405b; Australia Wage Price Index 0.8%q/q/2.7%y/y. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index rose 3.3% last week in its fourth straight weekly gain as the index moved further away from bear market territory again to end the week at 11.6% below its record high on December 27. The US MSCI ranked 19th of the 48 global stock markets that we follow in a week when an astounding 47 countries rose in US dollar terms—all but China. The AC World ex-US index rose 2.0% and left the bear market to end the week at 19.3% below its June 15, 2021 record high. All regions rose last week, but EM Eastern Europe was the best-performer with a gain of 5.6%, followed by EM Latin America (5.3%), EMEA (2.8), EMU (2.2), and EAFE (2.1). EM Asia and BIC were the worst performing regions last week, albeit with gains of 0.6%. Sri Lanka was the best-performing country last week with a gain of 10.8%, followed by Chile (8.8), Colombia (8.2), Mexico (7.4), and Ireland (6.9). Among the 14 countries that underperformed the AC World

ex-US MSCI last week, China's 0.1% decline was the worst, followed by small gains for Korea (0.2), Hong Kong (0.4), Malaysia (0.4), and Singapore (0.6). The US MSCI's ytd ranking dropped one place w/w to 23/49. After lagging for much of year, the US MSCI's ytd decline of 11.1% is now less than the AC World ex-US's 15.7% drop. EM Latin America is up 6.1% ytd and is the only region outperforming the AC World ex-US. The laggards: EM Eastern Europe (-83.4), EMEA (-30.3), EMU (-21.6), BIC (-20.3), EM Asia (-18.3), and EAFE (-15.9). The best country performers so far in 2022: Chile (27.5), Jordan (20.6), Brazil (10.6), Turkey (8.0), and Indonesia (6.1). Apart from Russia, in which investors have lost 100.0% of their investment this year, here are the worst-performing countries ytd: Sri Lanka (-61.3), Egypt (-38.5), Hungary (-36.5), Austria (-34.8), and Poland (-34.3).

S&P 1500/500/400/600 Performance (*link*): LargeCap rose 3.3% w/w for its fourth straight rise, but was outpaced by the gains for MidCap (4.4%) and SmallCap (3.9). All three of these indexes are out of a bear market, but remain in a correction. LargeCap finished the week at 10.8% below its record high on January 3. MidCap is 10.2% below its record high on November 16, while SmallCap is 12.2% below its November 8 record high. All 33 sectors moved higher for the week, up from 16 sectors rising a week earlier. MidCap Energy was the best performer with a gain of 9.7%, followed by SmallCap Energy (9.4%), SmallCap Materials (7.6), LargeCap Energy (7.1), and SmallCap Consumer Discretionary (6.1). SmallCap Tech and SmallCap Health Care were the biggest underperformers last week, albeit with gains of 0.2%, followed by LargeCap Consumer Staples (1.2), and MidCap Consumer Staples (1.3). In terms of 2022's ytd performance, LargeCap's 10.2% decline continues to trail MidCap (-8.0) and SmallCap (-8.1). Just five of the 33 sectors are positive so far in 2022, unchanged from a week earlier. Energy continues to dominate the top performers: SmallCap Energy (42.5), LargeCap Energy (41.5), MidCap Energy (39.4), LargeCap Utilities (6.8), and MidCap Utilities (3.8). The biggest ytd laggards: LargeCap Communication Services (-23.9), SmallCap Consumer Discretionary (-18.8), SmallCap Real Estate (-18.2), LargeCap Consumer Discretionary (-16.9), and MidCap Consumer Discretionary (-15.5).

S&P 500 Sectors and Industries Performance (*link*): All 11 S&P 500 sectors rose last week, and six outperformed the composite index's 3.3% gain. That compares to a 0.4% gain for the S&P 500 a week earlier, when six sectors rose and five outperformed the index. Energy was the top performer with a gain of 7.1%, followed by Financials (5.5%), Materials (5.1), Communication Services (4.5), Real Estate (4.1), and Industrials (3.7). The worst performers, albeit with gains: Consumer Staples (-1.2), Health Care (1.6), Tech (2.4), Utilities (3.1), and Consumer Discretionary (3.2). The S&P 500 is down 10.2% so far in 2022 with six sectors ahead of the index, and just two in positive territory. The best

performers in 2022 to date: Energy (41.4), Utilities (6.8), Consumer Staples (-2.6), Health Care (-5.3), Industrials (-5.8), and Financials (-9.2). The ytd laggards: Communication Services (-23.9), Consumer Discretionary (-16.9), Tech (-13.8), Real Estate (-12.2), and Materials (-10.5).

S&P 500 Technical Indicators (*link*): The S&P 500 rose 3.3% last week and improved relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index closed above its 50-dma for a fourth straight week after 14 weeks below, but closed below its 200-dma for the 25th time in 27 weeks. It had been above its 200-dma for 81 straight weeks through early February. The S&P 500’s 50-dma moved higher for just the second time in 17 weeks as the index improved to a 23-month high of 8.7% above its rising 50-dma from 5.3% above its falling 50-dma a week earlier. That’s up from a 27-month low of 11.1% below its falling 50-dma in mid-June. The index had been mostly trading above its 50-dma from late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index closed Friday at an 18-week high of 0.8% below its falling 200-dma, up from 4.2% below a week earlier and from a 26-month low of 17.1% below its falling 200-dma in mid-June. The latest reading is down sharply from 10.8% above its rising 200-dma in early November. That compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008. The 200-dma declined for a 16th straight week.

S&P 500 Sectors Technical Indicators (*link*): The S&P 500 rose 3.3% last week and improved relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index closed above its 50-dma for a fourth straight week after 14 weeks below, but closed below its 200-dma for the 25th time in 27 weeks. It had been above its 200-dma for 81 straight weeks through early February. The S&P 500’s 50-dma moved higher for just the second time in 17 weeks as the index improved to a 23-month high of 8.7% above its rising 50-dma from 5.3% above its falling 50-dma a week earlier. That’s up from a 27-month low of 11.1% below its falling 50-dma in mid-June. The index had been mostly trading above its 50-dma from late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index closed Friday at an 18-week high of

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US Economic Indicators

Producer Price Index (*link*): The final demand PPI in July fell for the first time since April 2020, dropping 0.5% after averaging monthly gains of 1.1% the first half of this year. The yearly rate was in single digits for the first time in eight months, easing to 9.8%, down from March's record high of 11.7%. Meanwhile, core prices—which excludes food, energy, and trade services—edged up only 0.2%, with the yearly rate slowing from a record-high 7.1% in March to a 13-month low of 5.8%. Final demand goods dropped 1.8% in July, the biggest decline since April 2020—with 80% of the decline attributable of a 16.7% plunge in gasoline prices. The yearly rate for final demand goods dropped 3ppts to 14.8% from June's record high of 17.8%. In the meantime, prices for final demand services ticked up 0.1%, slowing from 0.3% and 0.5% the prior two months, with the yearly rate easing for the fourth month since reaching a record-high 9.4% in March—slowing to a nine-month low of 6.9% in July. The PPI for personal consumption sank 0.7%, with the yearly rate slowing to 8.7% from March's record-high 10.4%. Looking at pipeline prices, pressures remain elevated, though have eased from recent highs. The yearly rate for intermediate goods prices eased to a 16-month low of 17.3% from a cyclical high of 26.5% in November, while the crude goods rate eased to 27.6% from last April's near record high of 59.0%.

Import Prices (*link*): Import prices fell in July for the first time this year as petroleum prices plunged. Import prices sank 1.4% last month, the first decline since December's 0.4% downtick and the largest decline since April 2020's 2.6% fall. Import prices' yearly rate eased to 8.8% from a recent high of 13.0% in March, as the yearly rate in fuel prices slowed to 56.1% y/y—at the bottom of its recent volatile flat trend; it peaked at 130.1% last April. Nonpetroleum import prices declined for the third successive month, by 0.7% in July and 1.3% over the period, with the yearly rate falling to a 16-month low of 4.6% from a cyclical high of 8.1% in March. Yearly rates are slowing for the following import prices from their

recent respective peak rates: industrial supplies—which includes fuels & lubricants—(to 23.7% from 55.2%), foods, feeds & beverages (7.0 from 15.7), and consumer goods ex autos (1.8 from 3.2). Meanwhile, the capital goods rate edged down for the second month to 3.7% y/y from a recent peak of 4.2% in May, while the rate for auto imports accelerated 3.7%—its highest rate since summer 2011.

Consumer Sentiment Index (*link*): Consumer sentiment in early August increased as all components of the expectations measure improved, most notably among low- and middle-income consumers, as gasoline prices fell. The recent move down in energy prices pushed the median one-year expected rate down to a six-month low of 5.0% in early August—though it was still above last August's 4.6%. The five-year rate ticked up to 3.0% this month, remaining within its narrow range of 2.9% to 3.1% the past 13 months. Joanne Hse, the survey's director, noted "the share of consumers blaming inflation for eroding their living standards remained near 48%." The consumer sentiment index climbed for the second month this month to 55.1 after sliding five of the first six months of this year from 70.6 in December to a record-low 50.0 in June. Expectations climbed 7.6 points in early August to 54.9 after plummeting six of the prior seven months by 21.0 points to 47.3—which was the lowest reading since spring 1980. The present situation component slipped to 55.5 this month after climbing 4.3 points in July to 58.1; it had dropped 20.4 points the first half of the year to a record-low 53.8.

Global Economic Indicators

Eurozone Industrial Production (*link*): Headline production, which excludes construction, climbed in June to its highest level since the end of 2017. It advanced for the third month, by 0.7% m/m and 3.3% over the period. The advance was led by a rebound in capital goods production, which shot up 2.6% in June and 6.2% during the two months through June, more than reversing the 4.4% drop the first four months of the year. Energy output was also in the plus column in June, though by only 0.6% after May's 3.4% plunge. Meanwhile, consumer nondurable goods consumption contracted 3.2% in June after rising four of the first five months of the year by 6.4%, while consumer durable goods production was little changed from May's level—which was the highest since fall 2008. Intermediate goods production remains in a volatile flat trend. Compared to a year ago, headline production was up 2.4%, led by gains in capital (7.6% y/y) and consumer durable (4.0) goods output, which were partially offset by declines in consumer nondurable (-1.1) and intermediate (-0.5) goods production; energy output was flat. Production data are available for the top four

Eurozone economies and show only Italy (-2.1) posted a decline, while France (1.3), Spain (1.0), and Germany (0.6) were in the plus column. Over the 12 months through June, production was 7.3% higher in Spain and up 1.7% in France, while output was flat in Germany and 1.2% lower in Italy.

UK GDP (*link*): Real GDP contracted 0.6% in June after a 0.4% gain and a 0.2% loss the prior two months, pushing the quarterly percent change into negative territory for the first time since Q1-2021. Real GDP contracted 0.3% (saar) during Q2, after expanding 3.1% during Q1, and was 0.6% above its pre-pandemic level. According to ONS, "Health was the biggest reason the economy contracted as both the test and trace and vaccine programs were wound down, while many retailers also had a tough quarter. These were partially offset by growth in hotels, bars, hairdressers, and outdoor events across the quarter, partly as a result of people celebrating the Platinum Jubilee." On the expenditure side, household spending (-0.6%, saar) and government spending (-11.3) contracted during Q2, while business investment (2.3) and trade were positive contributors. Looking at the monthly GDP data, the 0.6% drop in June real GDP was fairly widespread, led by a 0.5% decline in the services sector—which accounts for roughly 80% of UK output—while construction and production contracted 1.4% and 0.9%, respectively. The 0.9% decline in industrial production during June was led by the manufacturing sector, which sank 1.6% after a solid 1.7% gain in May. On a year-over-year basis, headline and manufacturing production were up 2.4% and 1.3%, respectively. Within manufacturing, intermediate goods output plunged 4.1% from May's record high, with consumer nondurable goods (-1.2%) production also subtracting from growth during the month. Meanwhile, capital goods output expanded for the second month, by 1.1% in June and 3.7% over the period, while consumer durable goods production advanced 2.5% and 4.5% over the comparable periods. Energy output increased 1.1% in June after a 0.8% loss and a 1.2% gain the prior two months.

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