MORNING BRIEFING
August 17, 2022

More On The Bulls Vs Bears Debate

Check out the accompanying chart collection.

Executive Summary: Is the stock market rally since June 16 a rally within the bear market or the start of a new bull market? The answer hinges on the economic outlook. We're in the bull camp, believing that inflation is peaking, Fed tightening is nearly over, and a recession won't result; bears may believe the opposite. … Analysts have been cutting their estimates for earnings but not revenues, so expected profit margins have been falling. That suggests they see no recession, just more difficulty passing fast-rising costs on to customers. … Also: Peeks at the MegaCap-8's rally impacts on the S&P 500, Senator Schumer's wrong-headed anti-buyback stance, and alternative measures of inflation.

YRI Media. On Monday, the *Financial Times* posted an op-ed by Dr. Ed titled "Why the Fed might be at 'neutral' already on monetary policy." By the way, you can find exclusive free downloads of Dr. Ed's *Fed Watching for Fun & Profit* on our website, along with his other books. You can also tune into replays of his Monday webcasts on our website.

Strategy I: New Bull Or Old Bear? There is a fierce debate going on between the stock market's bulls and bears. The question under consideration is whether the rally since June 16 is a new bull market or just a rally in the bear market that started on January 3? Over this period, the S&P 500 fell 23.6% from its record high of 4796 to 3666.

Joe and I think a new bull market started on June 16, with the S&P 500 up 17.4% through yesterday's close of 4305 (*Fig. 1* and *Fig. 2*). The S&P 500 is now only 10.2% below its record high on January 3. It rose above its 50-day moving average (dma) on July 19. It is now less than 1% below its 200-dma.

If the S&P 500 fails to rise meaningfully above its 200-dma, the bears undoubtedly will conclude that the next stop will be a retest of the devilish low, possibly on the way to a new low before the bear market finally ends. They have the calendar on their side because September tends to be the worst month for the stock market. Since 1928, the S&P 500 has dropped 1.0% on average during the month (*Fig. 3*).

From a fundamental perspective, the bears expect that inflation will remain elevated, forcing the Fed to raise interest rates much higher, causing a severe recession. The bulls, like us, believe that inflation might have peaked in June and that the Fed is likely to pause for a while following one more rate hike of 50bps-75bps in late September. The bears see lots more downside for earnings and valuation multiples. We see flattening corporate earnings through the end of this year and believe that forward valuation multiples bottomed on June 16. In our bullish narrative, the market could move sideways for a while before moving to new record highs next year.

Bear-market rallies tend to occur during long bear markets, which occur during long recessions when investors' hopes for an end in sight are dashed (*Fig. 4* and *Fig. 5*). Arguably, the S&P 500 discounted a recession during the first half of the year, which so far looks like a short "technical recession," with real GDP down just 1.6% (saar) and 0.9% during Q1 and Q2. The rally since June 16 will turn out to be a sustainable bull market if inflation is peaking, implying that the Fed is almost done tightening and won't have to trigger a recession to bring inflation down. If that happy scenario doesn't play out, the bears will have a field day.

Strategy II: Earnings Up, Down, Or Sideways? Did industry analysts finally get the recession memo? In conference calls with company managements during the Q2 earnings reporting season, they seem to have picked up enough negative guidance to cut their earnings estimates for the rest of this year and all of next year. However, most of the cuts seem to be related to lower estimates for profit margins rather than for revenues. Consider the following:

(1) *Earnings.* Since the start of the latest earnings season, analysts' consensus S&P 500 earnings estimates for each of the next six quarters through the end of next year have been reduced (*Fig. 6* and *Fig. 7*). As a result, since the end of June, their estimates for 2022 and 2023 earnings have been coming down (*Fig. 8*). During the August 11 week, they predicted that S&P 500 operating earnings will be $225.66 this year and $243.81 next year. Joe and I are still projecting $215 and $235. The former would be flat with last year's result.

(2) *Revenues & profit margins.* Interestingly, the analysts' consensus estimates for the revenues of the S&P 500 during 2022 and 2023 edged down during the week of August 4, but both remain on solid uptrends in record-high territory (*Fig. 9*). So earnings expectations have been coming down along with profit margin estimates. Here are the margin estimates during the start of this year and during the August 4 week: 2022 (13.2%, 12.8%) and 2023 (13.8%, 13.2%).

We conclude that there's no recession reflected in consensus revenues estimates, but profit margins are getting squeezed by rapidly rising costs, which are getting harder to pass through to selling prices.

(3) *Forward earnings.* Given our slow-go economic outlook for the rest of this year, we are forecasting that S&P 500 forward earnings per share (the time-weighted average of analysts' consensus earnings-per-share estimates for this year and next year) will flatten around $235 for the rest of this year before moving higher to $255 next year (*Fig. 10*). Forward earnings has been falling since it peaked at a record-high $239.93 during the June 23 week (*Fig. 11*). It edged up during the August 11 week to $236.83.

(4) *Earnings metrics.* So far, the downdraft in earnings expectations isn't signaling a recession, as shown by the percent of S&P 500 companies with positive three-month percent changes in forward earnings (*Fig. 12*). This metric fell from 81.4% at the start of this year to 62.4% during the August 12 week.

In the past, a drop below 50.0% signaled a recession, though that tended to happen after the recession had already started. In other words, as we've observed in the past, analysts don't do a good job of anticipating recessions, because that's not their job.

Then again, the Net Earnings Revisions Index (NERI) for the S&P 500 turned negative (-1.9%) during July for the first time since July 2020 (*Fig. 13*). It turned negative during previous recessions, but it has a history of turning negative even during economic expansions because analysts tend to be too bullish during such periods. By the way, NERI is highly correlated with the M-PMI, which may soon signal that a manufacturing recession is underway.

Expecting forward earnings to remain around current levels rather than to drop, as we do, is probably on the optimistic side of investors' consensus expectations. On the other hand, it's hard to imagine that the forward P/E of the S&P 500 is about to rebound to where it was—21.4—at the start of this year just before the bear market (*Fig. 14*). It fell to 15.3 on June 16 and snapped back to 18.1 on Friday. There are plenty of alternative valuation metrics, such as price-to-sales ratios (a.k.a. Buffett ratios) and the real earnings yield, that remain bearish (*Fig. 15* and *Fig. 16*).

Strategy III: The MegaCaps Again. Of course, the MegaCap-8 stocks (namely, Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla) are still mega, at least collectively, accounting for 24% of the market capitalization of the S&P 500 and 48% of the market cap of the S&P 500 Growth composite (*Fig. 17*).

From June 16 through Friday's close, the market cap of the S&P 500 rose $5.1 trillion (16.3%), while the MegaCap-8's collective market cap rose $2.0 trillion (25.7%). During the August 4 week, the forward P/Es of the S&P 500 and the S&P 500 excluding the MegaCaps were 17.7 and 15.7 (*Fig. 18*). The forward P/E of the MegaCaps was 27.8 that week, up from 22.2 during the June 16 week.

The S&P 500 is relatively cheap excluding the MegaCap-8, which aren't as cheap as they were on June 16 but remain widely and wildly popular investments.

Strategy IV: Attacking & Taxing Buybacks. On August 5, Senate Majority Leader Chuck Schumer (D-NY) said, "I hate stock buybacks. I think they are one of the most self-serving things that corporate America does." That's why the Inflation Reduction Act that he pushed through Congress includes a 1% tax on buybacks, excluding buybacks associated with employee stock compensation plans.

Schumer says companies should be investing in worker training, research, modernizing equipment, and other activities rather than buying back their shares. He doesn't seem to realize that buybacks come out of cash flow, not retained earnings. Many companies are spending their cash in constructive ways but still have enough left to return some of it to shareholders through buybacks.

Congress shouldn't be meddling in matters of corporate finance. However, Congress has a habit of doing so in all aspects of our lives, especially when it sees a new source to tap for tax revenue. Schumer will be very happy with buybacks if taxing them generates lots of revenues, and will raise the tax to get even more.

US Inflation: Alternative Measures. The bond and stock markets seem to be discounting the possibility that the US economy has hit peak inflation. Like everyone else, we track the CPI and PCED and give more weight to the latter, as does the Fed. However, there are alternative measures that are widely followed. I asked Melissa for an update. Here it is:

The Atlanta Federal Reserve Bank's (FRB) *Underlying Inflation Dashboard* shows nine measures of inflation. All nine are in the "red" zone (ranging between 4.3% and 7.0%), significantly exceeding the Fed's 2.0% target. While the CPI and PCED suggest that inflation is peaking, the other measures mostly aren't doing so yet.

During July, the official CPI's headline and core rates were 8.5% and 5.9% y/y, respectively, down from the recent highs of 9.1% (during June) and 6.5% (during March). For June, the

PCED headline rate climbed to 6.8%, the highest since January 1982, while the core rate eased from 5.3% during February to 4.8% in June, which was a slight uptick from May's 4.7%. (Data for July will be released on August 26.) The CPI tends to run a bit hotter than the PCED, mostly because the CPI uses a bigger weight for rents.

Like the CPI and PCED, the alternative inflation measures lurched above 2.0% y/y early in 2021 as excessively stimulative US fiscal and monetary policies caused an inflationary demand shock that overwhelmed global supply chains. But unlike the conventionally used CPI and PCED, the high rates of most alternative measures have yet to show signs of abating, largely because they give more weight to rents. Rent inflation has been soaring owing to current housing market dynamics. (For more on the housing market, see our July 27 *Morning Briefing*.)

Consider these alternative measures of inflation used by various regional FRBs for more insight:

(1) *Sticky vs flexible in Atlanta.* The Atlanta FRB *breaks down* its alternative inflation measures into one of these two categories, namely "sticky" and "flexible." The items in the Sticky CPI show relatively slow price changes; in July, they rose 5.8% y/y on a headline basis. Conversely, items in the Flexible CPI are prone to rapid price changes; its headline rose 16.3% y/y in July. The Atlanta Fed sticks to the notion that the Sticky CPI may be a better indicator of where inflation is heading.

(2) *Sticky easing ahead.* If that's true, then rising inflation is a more persistent problem than the conventional CPI data suggest because the Sticky CPI has continued to rise while the Flexible CPI has eased (*Fig. 19*). But the categories of prices that have kept the Sticky CPI stuck at elevated rates are important to consider, especially given the effects on some categories of unusual current market dynamics.

(3) *Rents are too high.* Moving the Sticky CPI higher are rents, which are weighted heavily in this index and have rising inflation rates that show no signs of peaking (*Fig. 20*). The CPI for Rent of Shelter includes Owner Equivalent Rent (an odd concept that represents what homeowners would pay themselves if they rented their homes from themselves). Rent inflation should cool now that the housing market is in a recession. That should bring home prices down, restoring the affordability of homebuying and reducing rental demand. Household furniture and furnishing prices are weighted heavily in the sticky index, too, and should ease while fewer households are buying homes to decorate (*Fig. 21*).

(4) *Driving the flexible down.* Among the heavily weighted flexible price categories are new and used vehicles. They were down 2.8 and 34.6 percentage points, respectively, from their peaks of 13.2% and 41.2%, respectively, during April and February (*Fig. 22* and *Fig. 23*). Prices for new autos likely will drop even further as global supply-chain pressures ease.

(5) *Trimmed means in Dallas & Cleveland.* For its homegrown trimmed mean inflation rate, the Dallas FRB removes a percentage of weight from the lower and upper tails of the price distribution (*Fig. 24*). That gives more weight to rent and household furnishings. (See the "Components included and excluded from this month's Trimmed Mean" spreadsheet on the Dallas FRB's *website*.)

The FRB Cleveland's 16% Trimmed-Mean CPI likewise overweights owner- and tenant-occupied homes and furnishings (see component calculation details *here*) (*Fig. 25*).

In conclusion, we'll monitor the alternative measures of consumer inflation but continue to focus mainly on the CPI and PCED.

Calendars

US: **Wed:** Retail Sales, Total, Core, and Control Group 0.1%/-0.1%/0.6%; Business Inventories 1.4%; MBA Mortgage Applications; Cushing Crude Oil Inventories; FOMC Minutes; Bowman. **Thurs:** Leading Indicators -0.5%; Philadelphia Fed -5.0; Existing Home Sales 4.89mu; Initial & Continuous Jobless Claims 265k/1.438m; Natural Gas Storage; George. (Bloomberg estimates)

Global: **Wed:** Eurozone GDP 0.7%q/q/4.0%y/y; Eurozone Employment; UK Headline & Core CPI 0.4%m/m/9.8%y/y & 0.2%m/m/5.9%y/y; UK PPI Input & Output 1.4%m/m/23.9%y/y & 0.8%m/m/16.2%y;y; Australia Employment Change 25k; Australia Unemployment & Participation Rates 3.5%/66.8%. **Thurs:** Eurozone Headline & Core CPI 0.1%m/m/8.9%y/y & -0.2%m/m/4.0%y/y; UK Gfk Consumer Confidence -42; Japan CPI; Schnabel. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q2 Earnings Season Monitor (*link*): With over 91% of S&P 500 companies finished reporting revenues and earnings for Q2-2021, the revenue and earnings surprises are historically strong but near their lowest levels since the pandemic recovery began. Revenues are beating the consensus forecast by 2.8%, and earnings have exceeded estimates by 6.1%. At the same point during the Q1 season, revenues were 2.7% above forecast and earnings beat by 7.5%. For the 456 companies that have reported Q2 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed from their Q2-2021 to Q1-2022 readings. Collectively, the companies have a y/y revenue gain of 14.3% and an earnings gain of 11.3%. Just 69% of the Q2 reporters so far has reported a positive revenue surprise, and 77% has beaten earnings forecasts. Markedly fewer companies have reported positive y/y earnings growth in Q2 (60%) than positive y/y revenue growth (82%). These figures are bound to change as more Q2-2022 results are reported in the coming weeks, particularly from the struggling retailers. While we expect y/y growth rates to remain positive in Q2, we think revenue and earnings surprises will moderate q/q going ahead due to the slowing economy, rising inventories, and higher costs.

US Economic Indicators

Housing Starts & Building Permits (*link*): Both housing starts and building permits continued to head south in July, along with homebuilders' optimism—which dropped to its lowest level since May 2020 in August. Housing starts contracted 9.6% in July and have plummeted 19.9% since peaking in April, falling to 1.446mu (saar) in July, the lowest since February 2021. Single-family starts dropped for the fifth consecutive month and the sixth time this year, by 10.1% in July and 24.4% ytd to 916,000 units (saar)—the lowest since June 2020—while volatile multi-family starts sank 8.6% in July to 530,000 units (saar) after rebounding 18.6% in June from May's 22.6% plunge. July's level was 16.1% below its recent peak of 632,000 units in April. Building permits dropped for the third time in four months, slumping 1.3% in July and 10.9% over the period to a 10-month low of 1.674mu (saar). Single-family permits have plummeted steadily during the five months through July, sliding 22.9% over the period to 928,000 units (saar)—the lowest since mid-2020. Meanwhile, multi-family permits rebounded 15.8% during the two months through July to 746,000 units (saar) after sliding 10.1% the prior two months. In July, total housing starts fell 8.1% y/y, while building permits were up 1.2%. In July, housing under construction was little changed at 1.678mu from June's (1.680mu) record high, while completions edged up to

1.424mu from 1.409mu in June.

Industrial Production (*link*): Industrial output is climbing again, reaching a new record high in July, after stalling in May and June. Headline production rebounded 0.6% in July after no change in June and a 0.1% downtick in May—expanding 5.1% ytd. Manufacturing production remains on an uptrend, rebounding 0.7% in July after sliding 0.9% during the two months through June, only fractionally below April's recent high. By market group, business equipment production rebounded 0.6%, more than recovering a brief setback in May and June and climbing 3.4% ytd and 5.1% y/y to its highest level since March 2019. Industrial equipment output was back in the plus column in July after a small downtick in May and June, climbing 0.4% last month and 3.7% ytd. Meanwhile, production of information & processing related equipment remained in a volatile flat trend around record highs in July—within 2.6% of last August's record high—while transit equipment output has fluctuated in a flat trend over the past 19 months, climbing back to the top of that range the past few months. In the meantime, consumer durable goods production is heading back toward April's record high, rebounding 3.5% in July after falling 4.5% during the two months through June, as production of auto products reached a new record high, while home electronics output was little changed around June's record high. Meanwhile, production of appliances & furniture has tumbled 21.4% over the past three months. Consumer nondurable goods production fell for the third month, but was only 0.7% below its recent high during April, which was the highest since fall 2011.

Capacity Utilization (*link*): The headline capacity utilization rate in July was back up to its recent high of 80.3%—which was the highest since summer 2018—after slipping to 79.9% in June. July's move up puts it 0.7ppt above its long-run (1972-2021) average. The manufacturing utilization rate recovered to 79.8%, after falling from 80.1% in April (highest since summer 2000) to 79.3% by June—and was 1.6ppts above its long-run average. Meanwhile, the capacity utilization rate for mining rose for the third month—from 85.9% in April to 88.0% in July—which was the highest since mid-2019, while the utilities rate dipped for the second month, from 75.7% in May to 74.5% in July. The capacity utilization rate for mining was 1.7ppts above its long-term average, while the utilities rate was 10.2ppts below its long-run average.

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