MORNING BRIEFING
August 23, 2022

Raging Debate

Check out the accompanying chart collection.

Executive Summary: Today, we examine stock market sentiment—where it's been this year and why, as well as where it might be headed. … The bulls had a good two-month run, for a host of reasons we discuss, but it might be ending as they go on the defensive for a while for a host of other reasons. … And: QE lifted the Fed's securities holdings and the stock market followed suit during the bull market years. But does that necessarily mean the opposite will happen when QT starts to unwind those holdings in September? The bears think so, but we see reasons to differ.

YRI Resources. Join Dr. Ed's live Q&A webinar on Mondays at 11 a.m. EST. Replays of the Monday webinars are available *here*. Exclusive free downloads of his books are available *here*.

Strategy I: The Tug-Of-War Continues. The latest bear market started on January 3, 2022, when the S&P 500 peaked at a record-high 4796.56. That's undisputable. But whether the bear market ended on June 16 at a closing low of 3666.77 is a question of great dispute. The bulls, including Joe and me, think so. The bears believe that the bear market isn't over and that new lows are ahead.

The bears were on the defensive from Thursday, June 16 through Tuesday, August 16; over those two months, the S&P 500 rallied 17.4% to 4305. But the rally wasn't robust enough to breach the index's 200-day moving average, which was 4306 on Friday (*Fig. 1*). The S&P 500 stock price index relative to its 200-dma bottomed at a 26-month low of -17.1% on June 16 and rose to -0.2% on August 16 (*Fig. 2*). It closed at -3.8% on Monday.

Now let's review why the bulls enjoyed such a good bull run from mid-June through mid-August and then consider why the bears might have a good bear run for a few weeks:

(1) There were mounting signs this summer that inflation might be peaking and doing so within the context of a soft, rather than hard, landing of the economy. The major commodity price indexes peaked in mid-June, led by energy (especially gasoline) and agricultural (especially grain) commodities (*Fig. 3* and *Fig. 4*). An easing of price inflation would lift consumers' purchasing power at a time that payroll employment has been rising; it jumped

by 926,000 during June and July.

(2) During the Q2 earnings reporting season, the results turned out to be better than expected. With 95% of the S&P 500 companies reporting, Q2 earnings growth for the companies that have reported is 10.6% y/y, twice as fast as was expected at the start of the earnings reporting season (*Fig. 5* and *Fig. 6*).

(3) At his *press conference* on July 27, Fed Chair Jerome Powell said that the federal funds rate, which had just been raised 75bps to 2.25%-2.50% by the FOMC, was now at neutral, suggesting that the monetary tightening cycle might be over sooner rather than later. Both stock and bond prices rallied. The foreign-exchange value of the dollar remained strong, suggesting that foreign investors were purchasing dollars to buy US securities (*Fig. 7*).

(4) Sentiment was extremely bearish in mid-June, suggesting that sellers had mostly capitulated (*Fig. 8*). Back then, the bull/bear ratio, a contrary indicator, had bottomed at 0.60, representing the fewest bulls relative to bears since early March 2009.

Now the bulls are likely to be on the defensive for a while. Consider the following:

(1) From a technical perspective, the bears gained ground in their tug-of-war with the bulls when the S&P 500 failed to rise above its 200-dma last week.

(2) During the recent bear market, investors slashed the valuation multiples that they were willing to pay for analysts' consensus earnings expectations, which were rising to record highs. Perversely, the latest rally occurred as analysts finally started to cut their earnings estimates. They've been doing so since late June, lowering estimates for the remaining two quarters of this year and all four quarters of next year (*Fig. 9* and *Fig. 10*).

(3) "Don't fight the Fed" has been good advice for investors to follow over the years. Arguably, they've been doing just that from mid-June through mid-August. Since Powell's presser, several Fed officials continued to squawk hawkishly. They've been pushing back on the idea that the Fed may soon slow the pace of interest-rate increases and start cutting rates early next year.

Most recently, in an August 19 *WSJ* *interview*, Federal Reserve Bank of St. Louis President James Bullard said he expects the economy to be "stronger in the second half than we were in the first half." On inflation, he said: "[I]t's far too high." He wants to raise the federal funds rate quickly to a level "that'll put significant downward pressure on inflation." He favors a

75bps hike at the September meeting of the FOMC. He said that "the idea that inflation has peaked is a hope" rather than a reality.

(4) In our opinion, the financial markets have discounted a 75bps rate hike in the federal funds rate to a range of 3.00%-3.25% at the September meeting of the FOMC. So there may be a debate within the FOMC between those (like Bullard) who want to front-load future rate increases and those (like Powell, perhaps) who would prefer to pause rate hiking for a while.

July's CPI, which will be released on September 13, may resolve the debate in favor of the more hawkish FOMC members even if it shows insufficient further moderation of inflation to justify a pause. The bears are expecting to hear more squawking hawks on the committee in coming months. Then again, in our opinion, the inflation news may continue to show that inflation is heading lower, as the bulls expect.

(5) When he was asked about quantitative tightening, Bullard noted that he wants to see how QT2 works over the next six months before evaluating how it's going. He wasn't asked and didn't volunteer whether QT2 is equivalent to a significant rate hike, which might reduce the terminal federal funds rate for the current tightening monetary policy cycle.

(6) Winter is coming, and Europe is getting closer to a severe recession resulting from an energy crisis as Russia cuts off natural gas supplies to the region. European gas prices soared on Monday after Russia's state-owned energy giant Gazprom said it would shut down the Nord Stream 1 pipeline for three days at the end of the month.

The unscheduled maintenance work on the pipeline, which runs from Russia to Germany via the Baltic Sea, is heightening fears of a total shutdown. A severe recession in Europe might not cause a recession in the US, but it certainly would depress the earnings of many US corporations that do business in the region. It would strengthen the US dollar further, which would also depress earnings of US companies with sales in Europe.

Strategy II: The Ugliest Chart Of Them All. We've saved the worst for last. It's probably the most oft-shown and most compelling chart included in the PowerPoint presentations of the bears to make their case. It shows the S&P 500 stock price index versus the Fed's holdings of US Treasuries, agency debt, and mortgage-backed securities (*Fig. 11*).

Joe and I added a dotted line to track the Fed's QT2, which ramps up in September and will reduce the Fed's holdings by $95 billion per month, on average.

We certainly agree that all the QE programs that expanded the Fed's holdings of securities contributed to the bull market from 2009 through 2021. But they weren't its only support. The S&P 500 always rises along with earnings during economic expansions, and the economy was mostly expanding over this period (except for a severe but short-lived recession in early 2020).

The fourth round of QE undoubtedly boosted the S&P 500's valuation multiple (*Fig. 12*). But the forward P/E has already corrected significantly, falling from 22.5 at the beginning of 2021 to a low of 15.3 on June 16, and back up to 17.5 on Friday.

The question is whether there will be enough other buyers of Treasuries, agencies, and mortgage-backed securities to offset the Fed's QT2. Keep in mind that before QT2's $95 billion-per-month paring of the Fed's balance sheet, QE4Ever expanded it by $4.7 trillion from February 2020 through May 2022.

Who might fill the void in the bond markets left by the Fed? Consider the following:

(1) *US Treasury.* The good news is that the federal government's budget deficit has been shrinking significantly as pandemic-related outlays have decreased while tax revenues have been boosted by inflation (*Fig. 13* and *Fig. 14*). Over the past 12 months through July, the deficit is down to $1.0 trillion from $2.9 trillion a year ago on the same basis.

(2) *Commercial banks.* So far this year, commercial banks have seen their deposits increase by $172 billion through the August 10 week, while their collective loan portfolio has expanded by $786 billion (*Fig. 15*). They've stopped accumulating securities and have sold $84 billion ytd.

(3) *Bond funds.* Bond mutual funds and bond ETFs have purchased just $87.4 billion of these securities over the 12 months through June, down from a comparable record high of $1.1 trillion during April 2021 (*Fig. 16*). As it turns out, there was an alternative to stocks, namely bonds, but they incurred huge capital losses over the past 12 months as yields soared. So it may take some time to bring investors back to the bond market at scale.

(4) *Foreign investors.* The most aggressive buyers of bonds in the US capital markets have been foreign investors. Over the past 12 months through June, they purchased $840.9 billion in the US bond market, led by $618.8 billion in Treasury notes and bonds (*Fig. 17* and *Fig. 18*).

Calendars

US: Tues: New Home Sales 575k; Richmond Fed Manufacturing Index; M-PMI & NM-PMI Flash Estimates 51.9/49.1; API Weekly Crude Oil Inventories; Kashkari. **Wed:** Durable Goods Orders Total, Core, and Core Nondefense Capital Goods Orders 0.5%/0.2%/0.3%; Pending Home Sales -3.8%; MBA Mortgage Applications. (Bloomberg estimates)

Global: Tues: Eurozone, Germany, and France C-PMI Flash Estimates 49.0/47.4/50.8; Eurozone, Germany, and France M-PMI Flash Estimates 49.0/48.3/48.9; Eurozone, Germany, and France NM-PMI Flash Estimates 50.50/49.0/52.5; Eurozone Consumer Confidence -28; UK C-PMI, M-PMI, and NM-PMI Flash Estimates 51.3/51.3/52.0; Panetta; Kearns. **Wed:** Nakamura. (Bloomberg estimates).

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Last week, forward earnings fell w/w for SmallCap for a third straight week, but rose for LargeCap and MidCap. LargeCap's gain was its second following four weeks of declines, and MidCap's was its third following three straight declines. For a seventh straight week, none of these three indexes had forward earnings at a record high. LargeCap's forward earnings is now 1.2% below its record high at the end of June. MidCap's is 0.3% below its record high in early June, and SmallCap's latest decline puts it 2.5% below its record high in mid-June. In the latest week, the rate of change in LargeCap's forward earnings fell to a 17-month low of 11.2% y/y from 11.4%; 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 w/w to a 17-month low of 23.1% y/y from 23.6%. 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 17-month low of 17.7% y/y from 19.9%. It's down from a record high of 124.2% in June 2021 and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' consensus earnings forecasts for 2021 to 2023 to improve instead of decline as is typical, but their forecasts are likely to head lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (8.4%, 8.1%), MidCap (16.3, 2.6), and SmallCap (11.5, 8.5).

S&P 500/400/600 Valuation (*link*): Valuations eased last week for all three of these indexes from their highest levels since late April. LargeCap's forward P/E fell 0.3pts to 17.8 from 18.1, which compares to a 26-month low of 15.3 in mid-June and a six-month high of 21.5 in early November. LargeCap's forward P/E also compares to an 11-year low of 11.1 during March 2020. MidCap's was down 0.3pts w/w to 12.9 from 13.2, which 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 was down 0.1pt w/w to 12.7 from 12.8, up from its mid-June reading of 10.7, which 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 105th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% 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 62nd straight week; the current 2% 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, and the declines have accelerated for Q3-2022. In the latest week, the Q3-2022 S&P 500 earnings-per-share forecast fell 24 cents w/w to $56.42, and is now 5.2% below its $59.49 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken to 4.7% y/y on a frozen actual basis and 5.5% on a pro forma basis. That's down from Q2-2022's blended actual/estimate of a 10.1% y/y gain on a frozen actual basis and 8.8% y/y on a pro forma basis. Double-digit percentage growth is expected for just four sectors in Q3-2022, and y/y declines are expected for six. That compares to Q2-2022's count of four sectors with double-digit growth, three with a single-digit gain, and four with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q3-2022 versus their blended Q2-2022 growth rates: Energy (120.2% in Q3-2022 versus 296.8% in Q2-2022), Industrials (28.2, 31.5), Consumer Discretionary (18.9, -12.6), Real Estate (10.4, 13.0), Materials (6.7, 17.4), S&P 500 (5.5, 8.8), Information Technology (-2.2, 3.2), Consumer Staples (-2.7, 1.8), Health Care (-3.9, 8.6), Utilities (-7.4, -3.7), Financials (-9.1, -19.1), and Communication Services (-15.4, -20.3).

S&P 500 Q2 Earnings Season Monitor (*link*): With nearly 95% 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 2.6%, and earnings have exceeded estimates by 5.9%. At the same point during the Q1 season, revenues were 2.5% above forecast and earnings beat by 7.3%. For the 474 companies that have reported Q2 earnings through mid-day Monday, 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 13.5% and an earnings gain of 10.6%. Just 70% 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 (81%). These figures are not bound to change much as the remaining 26 companies report Q2-2022 results in the coming weeks.

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