MORNING BRIEFING
August 30, 2022

Anatomy Of A Rolling Recession

Check out the accompanying chart collection.

Executive Summary: In an eight-minute talk at Jackson Hole last week, the Fed chair squawked like a true hawk and obliterated $1.2 trillion in S&P 500 market capitalization. He said bringing inflation down will be painful. He didn't say how painful. … We don't see an "official" recession, but a "growth recession" that rolls through economic sectors in succession while still allowing real GDP to grow overall, albeit slowly. … In fact, such a rolling recession is likely underway already. We look at how vulnerable areas of the economy are holding up.

US Economy I: Powell's New Path. It was a cold morning in Jackson Hole, Wyoming this past Friday. I joined the *Bloomberg Surveillance* team on a Zoom interview at 8:00 a.m. EST. They were sitting outdoors with the Grand Teton mountains behind them. It was still dark in their time zone, so the mountains weren't visible just yet. But it was easy to see that they were shivering in the cold. Co-host Lisa Abramowicz said it was 39 degrees.

That morning at 10 a.m. EST, the financial markets were hit by a cold blast when Fed Chair Jerome Powell gave the *opening remarks* at the Kansas City Fed's annual conference at Jackson Hole. Delivering a carefully scripted eight-minute speech, he sounded more hawkish than the markets had expected. Less than a month earlier, at his July 27 press conference, Powell seemed to pivot toward a more dovish stance. He obviously concluded that he needed to walk that back. So he turned the other way, stressing that the Fed's top priority is to bring inflation back down by pushing interest rates up quickly, even if doing so risks causing a recession.

Powell no longer claimed that the Fed had a path to bring inflation down without causing a recession, as he had at the end of July. Instead, he acknowledged that there will be some pain: "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."

Powell channeled his inner Volcker by saying: "As former Chairman Paul Volcker put it at the height of the Great Inflation in 1979, 'Inflation feeds in part on itself, so part of the job of returning to a more stable and more productive economy must be to break the grip of inflationary expectations.'"

The Fed chair's short speech managed to wipe out $1.2 trillion of the market capitalization of the S&P 500 stock price index, which fell 3.4% on Friday. He clearly felt that he needed to set the record straight by talking much more hawkishly than he had at his July presser.

Ironically, Powell established the precedent of holding a presser after every FOMC meeting instead of on a quarterly basis, starting in January 2019. Back then, he *explained*, "Having twice as many press conferences does not signal anything about the timing or pace of future interest rate changes. This is only about improving communication." It's not clear to Melissa and me that communication has improved. Volcker rarely talked to the press but got his intentions across loud and clear.

By the way, before 1982, the Kansas City Fed's symposium was held in different towns in the district. It was a low-key, academic sort of event. Fed Chair Paul Volcker was invited in 1982 to enhance the gathering's stature. To convince him to come, Jackson Hole was picked because it has lots of good fly fishing, which Volcker enjoyed greatly. Volcker accepted the invitation, and tradition has kept the conference at Jackson Hole ever since.

US Economy II: The Path Forward. So is the only path forward a painful one, as Powell suggested? Is a recession inevitable now that Powell may be channeling his inner Volcker? Debbie and I still don't expect that any economic downturn over the rest of this year and/or next year will be severe enough to qualify it as an official recession, i.e., meeting the criteria of the Dating Committee of the National Bureau of Economic Research.

We believe that the economy has been in a "rolling recession" since the start of this year that may continue through the end of this year. The idea is that different economic sectors experience downturns at different times, resulting in a "growth recession" for the broad economy with no significant contraction of GDP—thus skirting a broad-based official recession.

During the first half of this year, real GDP fell slightly led by a recession in the housing industry, a shortage of new autos, and weakness in capital spending on structures. During the second half of the year, housing will still weigh on economic growth, and retailers' unintended inventory building is already forcing them to cut their prices to clear the excess merchandise. Consider the following:

(1) *Residential investment.* Among the most interest-rate sensitive sectors of the economy is housing. The 30-year mortgage rate soared 262bps from 3.29% at the start of the year to 5.91% on Friday (*Fig. 1*). It did so because the 10-year US Treasury yield jumped 152bps and the spread between the mortgage rate and the bond yield widened by 110bps to 287bps over this period (*Fig. 2*).

This spread widened as fixed-income traders and investors anticipated that the Fed would start reducing its portfolio of mortgage-backed securities during H2-2022 once it had implemented its QT2 program.

Residential investment in real GDP fell 16.2% (saar) during Q2 (*Fig. 3*). That's not surprising since this series is mostly determined by housing starts, which dropped from 1.67 million units (saar) in January to 1.45 million units in July led by a plunge in single-family starts (*Fig. 4*). Multi-family housing starts remained strong during July at 530,000 units because rapidly rising rents are providing a big incentive to develop such properties.

By the way, according to the Bureau of Economic Analysis (BEA), the decrease in residential fixed investment was actually led by a decrease in "other" structures, specifically real estate brokers' commissions! This suggests that there is more weakness ahead in residential investment to reflect the recent drop in housing starts.

(2) *Motor vehicles.* In the past, rising interest rates depressed auto sales and production. This time, auto production has been depressed by shortages of parts. Domestic motor vehicle output dropped sharply from a July 2020 peak of 11.9 million units (saar) to a September 2021 low of 7.7 million units (*Fig. 5*). It was back up at 11.0 million units during July. Demand still well exceeds supply, as reflected in rapidly rising motor vehicle prices and the industry's inventory-to-sales ratio, which has remained around half a month's supply since the start of this year through June (*Fig. 6*). In the past, auto dealers typically had 2.5 months' worth of inventory on their lots.

(3) *Capital spending on structures.* Capital spending on nonresidential structures dropped 13.2% (saar) in Q2 to the lowest level since Q2-2011 (*Fig. 7*). The weakness was widespread, with declines in commercial and health, power and communications, and manufacturing structures (*Fig. 8*). Some of that weakness was offset by strength in mining exploration, shafts, and wells structures.

During Q2, capital spending on nonresidential equipment edged down 2.7% (saar) from Q1's record high. The same can be said about information processing equipment and industrial equipment (*Fig. 9*). Spending on transportation equipment ticked higher during Q2 after falling sharply during the previous three quarters.

We construct current and future capital spending indexes based on the regional business surveys conducted by Fed district banks. The current capital spending measure is based on three of the regional banks, while future capital spending covers five banks (*Fig. 10*). Both are down from their peaks early this year but remained relatively high during August, improving over the past two months.

A major driver of capital spending is corporate profits. Yesterday, we observed that S&P 500 aggregate earnings rose to a record high during Q2. And so did the broadest measure of profits in the National Income & Product Accounts.

(4) *Inventories.* During Q4-2021 and Q1-2022, inflation-adjusted inventories piled up among wholesalers and non-auto retailers (*Fig. 11*). Major retailers are dealing with a glut of goods they need to clear out. A lot of items, especially summer items, have been on sale and will continue to go on sale. Consumers are paring back their spending on a lot of discretionary goods, like apparel or a new TV. Instead, they're focused on filling up their car with gasoline and buying groceries. They are also spending more on services.

(5) *Consumer spending.* Personal consumption expenditures rose during Q1 and Q2 by 1.8% (saar) and 1.5%, respectively. There's no recession in consumer spending, though both growth rates are relatively low. The Q2 pace reflected an increase in spending on services (led by food services and accommodations as well as "other" services) that was partly offset by a decrease in goods (led by food and beverages) (*Fig. 12*).

Consumers' purchasing power has been eroded by rapidly rising prices (*Fig. 13*). As a result, consumers have tapped into the excess saving they accumulated during the pandemic. That's not sustainable. However, we expect that price inflation will moderate faster than wage inflation during H2-2022 and in 2023, resulting in rising purchasing power for consumers.

(6) *Government spending.* In the real GDP accounts for Q2, federal government spending declined by 3.9% (saar), while state & local government spending fell 0.6% (*Fig. 14*).

The decrease in federal government spending reflected a decrease in nondefense spending that was partly offset by an increase in defense spending. The decrease in nondefense spending reflected the sale of crude oil from the Strategic Petroleum Reserve, which results in a corresponding decrease in consumption expenditures. Because the oil sold by the government enters private inventories, there is no direct net effect on GDP. The decrease in state and local government spending was led by a decrease in investment in structures.

This year, the Biden administration has succeeded in passing bills through Congress that entail spending lots of money on public infrastructure, semiconductor manufacturing capacity, and all sorts of "green" projects.

(7) *Trade.* Jackie, Melissa, and I believe that Europe is the most at risk of falling into a recession later this year and early next year because of the energy crisis resulting from the Ukraine war. In retaliation for imposing sanctions on Russia, the Kremlin is likely to shut off the natural gas that the country exports to Europe.

US exports to Europe account for around 23.5% of total US merchandise exports (*Fig. 15*). China's exports to the European Union account for 15.6% of that country's exports currently.

Calendars

US: Tues: Consumer Confidence Index 97.5; JOLTS 11.0m; S&P/CS HPI Composite 20 Index 1.0%m/m/19.4%y/y; API Weekly Crude Oil Inventories; Williams. **Wed:** MBA Mortgage Applications; Chicago PMI 52.0; Crude Oil Inventories, Gasoline Production; Mester. (Bloomberg estimates)

Global: Tues: Eurozone Business & Consumer Survey 97.7; Germany CPI 0.4%m/m/7.8%y/y; Germany Import Price Index 1.0%m/m/29.9%y/y; Spain CPI; Spain Retail Sales; Japan Industrial Production -0.5%; Japan Retail Sales 1.9% y/y; China C-PMI & M-PMI 52.3/49.2; Nakagawa. **Wed:** Eurozone Headline & Core CPI 9.0%/4.0% y/y; Germany Import Price Index 1.5%m/m/29.4%y/y; Germany Unemployment Change & Unemployment Rate 28k/5.5%; France GDP 0.5%q/q/4.2%y/y; Italy CPI 0.6%m/m/8.1%y/y; Japan Household Confidence 29.4; Japan Housing Starts -4.1%. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Last week, forward earnings fell w/w for SmallCap for a fourth straight week, but rose for LargeCap and MidCap. LargeCap's gain was its third following four weeks of declines, and MidCap's was its fourth following three straight declines. For an eighth straight week, none of these three indexes had forward earnings at a record high. LargeCap's forward earnings is now 1.1% 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 2.8% below its record high in mid-June. In the latest week, the yearly rate of change in LargeCap's forward earnings fell to a 17-month low of 10.9% y/y from 11.2%; 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 22.6% y/y from 23.1%. 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 16.1% y/y from 17.7%. 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, but their forecasts are likely to head lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (8.3%, 8.1%), MidCap (16.5, 2.4), and SmallCap (10.9, 8.7).

S&P 500/400/600 Valuation (*link*): Valuations fell again last week for all three of these indexes from their highest levels since late April. LargeCap's forward P/E fell 0.7pt to a five-week low of 17.1 from 17.8, which compares to a 16-week high of 18.1 the week before that, a 26-month low of 15.3 in mid-June, and an 11-year low of 11.1 during March 2020. MidCap's forward P/E was down 0.4pt w/w to a five-week low of 12.5 from 12.9, which compares to a 16-week high of 13.2 the week before that, a 27-month low of 11.1 in mid-June, a record high of 22.9 in June 2020, and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was also down 0.4pt w/w last week, to a three-week low of 12.3 from 12.7. That's down from a 16-week high of 12.8 the week before that and 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 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 106th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 28% 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 63rd 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 11 cents w/w to $56.31, and is now 5.3% below its $59.49 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken to 4.5% y/y on a frozen actual basis and 5.3% on a pro forma basis. That's down from Q2-2022's blended actual/estimate of a 9.5% y/y gain on a frozen actual basis and 8.5% 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 triple- and 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 (120.0% in Q3-2022 versus 296.7% in Q2-2022), Industrials (28.2, 31.5), Consumer Discretionary (18.1, -12.4), Real Estate (10.6, 13.0), Materials (6.8, 17.4), S&P 500 (5.3, 8.5), Information Technology (-3.0, 1.4), Consumer Staples (-2.9, 1.9), Health Care (-4.0, 8.7), Utilities (-7.1, -3.7), Financials (-8.9, -19.1), and Communication Services (-15.8, -20.3).

US Economic Indicators

Regional M-PMIs (*link*): Regional M-PMIs (link): Five Fed districts (New York, Philadelphia, Richmond, Kansas City, and Dallas) have reported on manufacturing activity for August and show the manufacturing sector fell further into contractionary territory, sinking to -8.6 (weakest since May 2020) this month from -0.5 in June—which was the first negative reading since the pandemic. Manufacturing activity in both the New York (to -31.3 from

11.1) and Richmond (-8.0 from 0.0) areas returned to negative territory, while Dallas' (-12.9 from -22.6) also contracted, though at roughly half July's rate. Meanwhile, manufacturing activity in the Philadelphia (6.2 from -12.3) area moved from contraction to expansion, while Kansas City's (3.0 from 13.0) slowed to a near standstill. New orders (-15.0 from -8.0) have been in a freefall since climbing to 13.9 in March, with billings in New York (-29.6 from 6.2) factories posting the weakest month since the pandemic, while new orders in both the Richmond (-20.0 from -10.0) and Kansas City (-16.0 from -2.0) regions contracted at a rapid rate. Meanwhile, orders growth in both the Philadelphia (-5.1 from -24.8) and Dallas (-4.4 from -9.2) regions also declined, though at a slower pace. Employment (13.6 from 16.1) slowed a bit but continued its solid readings, as factories in the Philadelphia (24.1 from 19.4) and Richmond (11.0 from 8.0) regions hired at a faster pace, while the rate of growth in both the New York (7.4 from 18.0) and Kansas City (10.0 from 17.0) factories continued to slow. Meanwhile, hirings in the Dallas (15.6 from 17.9) held at a steady pace.

Regional Prices Paid & Received Measures (*link*): We now have prices-paid and -received data for August from the New York, Philadelphia, Richmond, Dallas, and Kansas City regions, and all are showing a noticeable easing of inflationary pressures. (Note: The New York, Philadelphia, Dallas, and Kansas City measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.) The prices-paid measure eased again in August to 59.2 from 64.2 in July, after holding in a volatile flat trend between 80.0 and 88.5 since mid-2021. Prices-paid indexes in the New York region eased further from April's record-high 86.4, falling to a 19-month low of 55.5 this month, while Dallas' saw its prices-paid measure sink to a 22-month low of 34.4, down sharply from November's 83.3 record high; Kansas City's plummeted to 38.0 in August from 71.0 in June and a record high of 88.0 last May. Philadelphia's slowed from a cyclical high of 84.6 in April (which wasn't far from its record high of 91.1 in the 1970s) to a 20-month low of 43.6 in August, while Richmond's (124.7 from 124.9) gauge was virtually unchanged, down from its record high of 150.1 in May. Turning to the prices-received measure, it eased to a 17-month low of 40.2 in August from a recent peak of 60.6 in March. New York's (32.7) was little changed from July's 16-month low of 31.3, down from its record high of 56.1 in March, while the Philadelphia measure slowed to an 18-month low of 23.3 from November's 62.9 peak, and Kansas City's eased to 25.0 from its record high of 57.0 during both this April and last August. Richmond's (93.1 from 89.2) accelerated a bit, though remained below its record high of 103.1 in June, while Dallas' eased to an 18-month low of 26.8 from its record-high 50.9 in October.

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