**MORNING BRIEFING**
**September 26, 2022**

## 'Keeping At It'

*Check out the accompanying chart collection.*

**Executive Summary:** We're in a period of global gloom, with pessimism blanketing different countries for different reasons. In the US, measures of consumer, investor, and business sentiment all have sunk recently, which the stock market mirrors. America's despondency stems much from the Fed's words and deeds as it attempts to corral inflation at all costs. … Today, we offer a brief review of Fed Chair Powell's public statements over recent months, tracing his increasing hawkishness. … And: How's the economy been holding up in the face of Fed hawkishness? So far, so good. The latest data jibe with our growth recession scenario, but the risks of a full-blown recession are obviously increasing.

**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. This week's webcast will be prerecorded and available *here*.

**Sentiment: The Lower Depths.** *The Lower Depths* is a play by Russian author Maxim Gorky written in 1902. It was criticized for its pessimism, but is a classic of Russian social realism.

The play's pessimistic mood certainly resonates today given the lower depths that President Vladimir Putin has taken his country by starting a war with Ukraine. The war has resulted in an energy crisis in Europe, where pessimism also is widespread. Here in the US too, pessimism is widespread, because inflation has remained high and the Fed has turned increasingly hawkish since late August. That's when Fed officials first indicated that they are willing to risk a recession if that's what it takes to subdue inflation. Consider the following:

(1) *Consumer and business confidence.* The Consumer Sentiment Index rebounded during the first half of September but remained near the lows of the Great Financial Crisis and the Volcker recessions of the early 1980s (*Fig. 1*). It's also well below the lockdown recession low.

The CEO Outlook index dropped in Q3 to 84.2, down from its recent peak of 123.5 during Q4-2021 (*Fig. 2*). The Small Business Optimism Index edged up in August but remained near the lockdown recession low (*Fig. 3*).

(2) *Investor sentiment.* Investors Intelligence Bull/Bear Ratio dropped back below 1.00 last week (*Fig. 4*). The CBOT Put/Call Ratio jumped to 1.02 on Friday, the highest reading since the lockdown recession of 2020 (*Fig. 5*).

(3) *Stock market.* The S&P 500 is down 14.2% since its most recent peak on August 16 through Friday (*Fig. 6*). It closed at 3693 after falling intraday just below the June 16 low of 3666. The DJIA briefly flirted with a bear market on Friday but closed at a 22-month low of 29590 and down 19.6% from its record high on January 4. The S&P 500 is down 23.0% since it peaked at a record high on January 3.

The S&P 500's forward P/E was back down to 15.5 on Friday, the lowest since June 20 (*Fig. 7*). It is inversely correlated with the 10-year TIPS yield, which has soared from a recent low of 0.09% on August 1, 2022 to 1.32% on Friday.

The reversal in breadth measures has been breathtaking. The percent of S&P 500 companies trading above their 50-day moving averages plunged from 92.9% on August 12 to 2.8% on Friday (*Fig. 8*).

(4) *The Fed's talking heads.* From a contrarian perspective, such widespread pessimism is creating buying opportunities. Admittedly, though, it is getting harder to be optimistic about the economy. It is also getting harder to be bullish on stocks when the Fed is turning more hawkish on monetary policy. Now that the FOMC's blackout period is over, we can look forward to all the Fed's talking heads talking up their more "restrictive" stance, as already explained to us all by Fed Chair Jerome Powell last Wednesday.

**The Fed I: Powell Channels Volcker.** It seems that Powell recently read former Fed Chair Paul Volcker's autobiography, *Keeping At It* (2018). Amazon's summary states: "As chairman of the Federal Reserve (1979-1987), Paul Volcker slayed the inflation dragon that was consuming the American economy and restored the world's faith in central bankers."

At his *press conference* last Wednesday, Powell mentioned "keep" or "keep at it" in the context of staying the tightening course a total of six times:

(1) "We will keep at it until we are confident the job is done."

(2) "The FOMC is strongly resolved to bring inflation down to 2%, and we will keep at it until the job is done."

(3) “We want to act aggressively now and get this job done and keep at it until it’s done.”

(4) “And in light of the high inflation we’re seeing, we think we’ll need to … bring our funds rate to a restrictive level and to keep it there for some time.”

(5) “So, what that tells us is that we need to continue, and we can keep doing these, and—[as] we did today—do another large increase as we approach the level that we think we need to get to, and we’re still discovering what that level is.”

(6) “And we have to get back to that [i.e., 2% inflation rate] and keep it for another long period of time … [T]he record shows that if you postpone that, the delay is only likely to lead to more pain.”

In Friday’s *QuickTakes*, we noted that Powell mentioned the words “pain” or “painful” seven times in his presser. He did so in the context that bringing inflation down with tight monetary policy might cause a recession, but the pain will only be worse later if the Fed doesn’t step on the monetary brakes now.

Furthermore, Powell mentioned the word “restrictive” 12 times in his presser, in the context that, at 3.00%-3.25%, the federal funds rate is “probably into the very lowest level of what might be restrictive.” He warned that “there’s a ways to go.” He stated that the FOMC needs “to move our policy rate to a restrictive level that’s restrictive enough to bring inflation down to 2%, where we have confidence of that.” He said that once the federal funds rate is at a restrictive level, the FOMC will have “to keep it there for some time.”

During his previous *presser*, on July 27, Powell mentioned the word “restrictive” just three times, and he stated (once) that restrictive monetary policy would mean a federal funds rate “somewhere in the range of 3 to 3½ percent” by year-end.

By the way, at that July press conference, Powell sounded relatively dovish: “As the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases while we assess how our cumulative policy adjustments are affecting the economy and inflation.” Likewise, at his June *presser*, Powell said, “Clearly, today’s 75 basis point increase [in the federal funds rate] is an unusually large one, and I do not expect moves of this size to be common.”

But the FOMC raised the federal funds rate by 75bps at the June, July, and September meetings of the committee, to 3.00%-3.25%. Another 75bps hike at the November meeting

would take the range up to 3.75%-4.00%.

Powell now has completely crossed over to the dark side.

**The Fed II: What About QT2?** During Powell's prepared remarks at his latest presser, he said, "[W]e are continuing the process of significantly reducing the size of our balance sheet." He didn't acknowledge that QT2 has already had a very restrictive impact on the housing market by widening the spread between the mortgage rate and the 10-year US Treasury yield. Consider the following:

(1) *Mortgage rate.* The mortgage rate has risen from 3.32% at the start of this year to 6.67% on Thursday (*Fig. 9* and *Fig. 10*). It rose faster than the 10-year Treasury bond yield because Fed officials have said that the Fed should get out of the mortgage market by getting rid of all its mortgage-backed securities over time. Under QT2, the Fed projects that its holdings of mortgage-backed securities will fall from $2.7 trillion at the start of June to $1.7 trillion by the end of 2024 (*Fig. 11*).

(2) *Housing indicators.* The four-week average of weekly mortgage applications is down 31% since the start of this year through the September 16 week (*Fig. 12*). The sum of new and existing single-family home sales plunged 27% from 6.58 million units (saar) during January to 4.83 million units during July.

(3) *Treasury yield.* Under QT2, the Fed is also planning to reduce its holdings of US Treasury securities from $5.8 trillion at the start of June to $4.0 trillion by the end of 2024 (*Fig. 13*). It increased the pace of running off maturing securities from $22.7 billion per month from June through August to an estimated $34 billion during September. That has certainly contributed to the rebound in the 10-year Treasury yield from a recent low of 2.60% during August 1st to 3.69% on Friday (*Fig. 14*).

(4) *Treasury market.* Keep in mind that before QT2, QE4Ever started on March 23, 2020 and lasted through May 2022. Over this period, the Fed's holdings of Treasuries increased $3.3 trillion, which financed 58% of the $5.7 trillion cumulative federal budget deficits back then. Over the past 12 months through August, the Fed's holdings of Treasuries increased by $0.4 trillion, the lowest since February 2020 (*Fig. 15*).

The 12-month federal budget deficit was $1.0 trillion through August, down sharply from a record $4.1 trillion through March 2021. On a consolidated basis, the Treasury and the Fed had a deficit of $650 billion over the past 12 months through August (*Fig. 16*). Last week,

we noted that over the past 12 months through July, the *Treasury International Capital* report showed net foreign capital inflows into US Treasury notes and bonds totaled $634.5 billion. Their net purchases of Treasury bills was only $1.5 billion.

**US Economy: Growth Recession Update.** Following the release of August's housing starts last Tuesday, the Atlanta Fed's *GDPNow* tracking model's estimate for Q3-2022 real GDP growth was reduced from 0.5% (saar) to 0.3%. That result would follow modest declines in real GDP of -1.6% during Q1 and -0.6% during Q2. The model's estimate for Q3 residential investment in real GDP was lowered from -20.8% to -24.5%, following -16.2% during Q2, which was mostly attributable to declines in spending on home improvements and reduced real estate commissions.

It all still adds up to a growth recession (a.k.a. a soft landing, rolling recession, or mid-cycle slowdown) rather than an outright old-fashioned recession. So far. By the end of last week, following Powell's hawkish presser, fears of a hard landing increased significantly, as reflected by the 4.6% drop in the S&P 500 last week.

Even as Powell was heightening recession fears during his latest presser, he also observed that "people have savings on their balance sheet from the period when they couldn't spend and where they were getting government transfers." He said that these excess savings could "support growth." He also noted "that the states are very flush with cash." He concluded, "[S]o there's good reason to think that this will continue to be a reasonably strong economy."

The latest economic readings still are consistent with our growth recession scenario. The latest housing indicators show that the industry is experiencing a hard landing. August's Index of Leading Economic Indicators was down for the sixth month in a row.

On the side of strength, however, the Index of Coincident Economic Indicators rose to a new record high during August, led by a solid increase in payroll employment. Initial unemployment claims remained low at 213,000 during the September 17 week. Continuing claims fell 22,000 to only 1.379 million during the September 10 week. S&P Global's *Flash US Manufacturing PMI* edged up in September to 51.8 from 51.5 in August. The S&P Global Flash US Services Business Activity Index was 49.2 in September, up notably from 43.7 in August, signaling a much slower decline in output.

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## Calendars

**US: Mon:** Chicago Fed National Activity Index; Dallas Fed Manufacturing Index; Mester; Rosengren. **Tues:** Consumer Confidence 104.0; New Home Sales 500k; Durable Goods Total, Core, Nondefense Capital Goods Orders Less Aircraft -0.5%/0.2%/0.3%; Richmond Fed Manufacturing Index; S&PCS HPI 20 City Composite Index 0.3%m/m/17.0%y/y; API Weekly Crude Oil Inventories; Powell; Bullard. (Bloomberg estimates)

**Global: Mon:** Germany Ifo Business Climate Index, Current Assessment, and Expectations 87.0/96.0/79.0; Germany GDP 0.1%q/q/1.8%y/y; China Industrial Profits; Lagarde; Nagel; De Guindos; Panetta; Beerman; Balz; Kuroda; Amamiya. **Tues:** Australia Retail Sales 0.3%; BOJ Monetary Policy Meeting Minutes; Lagarde; De Guindos; Pill. (Bloomberg estimates)

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## Strategy Indicators

**Global Stock Markets Performance** (*link*): The US MSCI index dropped 4.8% last week as the index moved deeper into bear market territory again and finished the week at 24.0% below its record high on December 27. The US MSCI ranked 18th of the 48 global stock markets that we follow in a week when just two countries rose in US dollar terms. The AC World ex-US index tumbled 5.3% to a 28-month low and fell deeper into a bear market at 29.9% below its June 15, 2021 record high as all regions fell last week. EM Latin America was the best performer, albeit with a drop of 0.1%, followed by EMEA (-3.9%), BIC (-3.9), and EM Asia (-4.4). EMU (-7.8) was the worst performing region last week, followed by EM Eastern Europe (-6.8) and EAFE (-5.6). Brazil was the best-performing country last week with a gain of 2.7%, followed by Egypt (0.3), Indonesia (-0.1), Morocco (-0.5), and Thailand (-1.2). Among the 29 countries that underperformed the AC World ex-US MSCI last week, the 10.3% decline for Chile was the biggest, followed by Austria (-9.8), Ireland (-9.4), and Norway (-8.8). The US MSCI's ytd ranking rose two places to 23/49. After lagging for much of year through July, the US MSCI's ytd decline of 23.5% remains less than the AC World ex-US's 26.7% drop. EM Latin America is now down 0.4% ytd and is the only region outperforming the AC World ex-US. The laggards: EM Eastern Europe (-86.8), EMEA (-36.6), EMU (-34.5), EAFE (-27.7), EM Asia (-27.5), and BIC (-27.5). The best country performers so far in 2022: Turkey (18.7), Jordan (16.7), Chile (10.9), Indonesia (6.7), and Brazil (6.3). Apart from Russia, in which investors have lost 100.0% of their investment this year, here are the worst-performing countries ytd: Sri Lanka (-60.6), Poland (-48.8),

Hungary (-48.5), Austria (-45.4), and Pakistan (-44.6).

**S&P 1500/500/400/600 Performance** (*link*): All three of these indexes moved lower for the fifth time in six weeks. LargeCap fell 4.8%, less than the declines for SmallCap (-5.6%) and MidCap (-5.9). SmallCap marked its second week back in a bear market. LargeCap and MidCap dropped back into a bear market in the latest week. LargeCap finished the week at 23.0% below its record high on January 3; MidCap is 23.1% below its record high on November 16; and SmallCap is 26.3% below its November 8 record high. All 33 sectors moved lower for a second straight week. SmallCap Utilities was the best performer, albeit with a decline of 1.8%, followed by LargeCap Consumer Staples (-2.1), SmallCap Consumer Staples (-2.3), LargeCap Utilities (-3.0), and MidCap Utilities (-3.3). SmallCap Energy (-13.8) was the biggest underperformer last week, followed by MidCap Energy (-11.4), LargeCap Energy (-9.0), SmallCap Real Estate (-8.3), and MidCap Health Care (-7.8). In terms of 2022's ytd performance, LargeCap's 22.5% decline continues to trail MidCap's (-21.2) as SmallCap (-22.9) moved behind LargeCap in the latest week. Four of the 33 sectors are positive so far in 2022, unchanged from a week earlier. Energy continues to dominate the top performers: LargeCap Energy (28.4), MidCap Energy (19.5), SmallCap Energy (14.4), LargeCap Utilities (0.3), and MidCap Utilities (-5.6). The biggest ytd laggards: LargeCap Communication Services (-37.5), SmallCap Consumer Discretionary (-34.4), SmallCap Real Estate (-34.0), SmallCap Communication Services (-31.8), and MidCap Consumer Discretionary (-30.0).

**S&P 500 Sectors and Industries Performance** (*link*): All 11 S&P 500 sectors fell last week, and six outperformed the composite index's 4.8% gain. That compares to a 3.6% gain for the S&P 500 a week earlier, when all 11 sectors rose and five outperformed the index. Consumer Staples was the top performer, albeit with a decline of 2.1%, followed by Utilities (-3.0%), Health Care (-3.4), Tech (-3.6), and Industrials (-4.5). Energy was the worst performer with a decline of 9.0%, followed by Consumer Discretionary (-7.0), Real Estate (-6.4), Materials (-5.7), Financials (-5.6), and Communication Services (-5.1). The S&P 500 is down 22.5% 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 (28.4), Utilities (0.3), Consumer Staples (-10.0), Health Care (-12.9), Industrials (-19.8), and Financials (-20.5). The ytd laggards: Communication Services (-37.5), Tech (-29.0), Consumer Discretionary (-28.6), Real Estate (-27.6), and Materials (-24.4).

**S&P 500 Technical Indicators** (*link*): The S&P 500 tumbled 4.8% last week and weakened considerably relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index was below its 50-dma for a second week after rising for a

week before that for the first time in seven weeks. It closed below its 200-dma for the 31st time in 34 weeks. It had been above its 200-dma for 81 straight weeks through early February. The S&P 500's 50-dma moved lower for the 15th time in 21 weeks as the index dropped to a 14-week low of 8.6% below its falling 50-dma from 4.2% below a week earlier. That compares to a 23-month high of 8.7% above its rising 50-dma the week in early August and 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 a 10-week low of 12.5% below its falling 200-dma, down from 8.7% below a week earlier and an 18-week high of 0.8% below in early August. It remains above its 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 21st straight week and at its fastest rate since July 2009.

**S&P 500 Sectors Technical Indicators** (*link*): All 11 S&P 500 sectors are trading below their 50-dmas, down from just two sectors above a week earlier. Utilities fell below for the first time in nine weeks and Energy for the first time in seven. Three sectors had a rising 50-dma: Consumer Discretionary, Energy, and Utilities. That's down from five sectors a week earlier and all 11 sectors the week before that. Looking at the more stable longer-term 200-dmas, Utilities is the only sector trading above now as Energy fell below for the first time in 54 weeks. For perspective, at the depths of the Great Virus Crisis in April 2020, Health Care was the only sector trading above its 200-dma. Energy and Utilities are the only two sectors with a rising 200-dma, unchanged from a week earlier.

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## US Economic Indicators

**Leading Indicators** (*link*): Leading economic indicators (LEI) in August contracted for the sixth successive month since reaching a new record high in February of this year, sinking 0.3% m/m and 2.7% over the period. Ataman Ozyildirim, senior director of economic research at The Conference Board warns, "Economic activity will continue slowing more

broadly throughout the US economy and is likely to contract. A major driver of this slowdown has been the Federal Reserve's rapid tightening of monetary policy to counter inflationary pressures." In August, four of the 10 components of the LEI fell, while five rose; real consumer goods orders was unchanged. Dragging the index down were building permits (-0.32ppt), consumer expectations (-0.25), the average workweek (-0.12), and the ISM new orders diffusion index (-0.10). These declines were partially offset by positive contributions from jobless claims (+0.27), S&P 500 stock prices (+0.26), interest rate spread (+0.07), leading credit index (+0.04), and real core capital goods orders (+0.01). The report notes that only jobless claims and the yield curve spread has contributed positively over the last six months, with the contribution from the latter narrowing recently.

**Coincident Indicators** (*link*): The Coincident Economic Index (CEI) climbed to yet another record high in August after posting only three negligible declines over the past 11 months. The CEI rose 0.1% in August and 2.2% over the past 11 months—after showing no growth last August and September. Three of the four components contributed positively to August's CEI: 1) Real personal income less transfer payments (+0.08ppt) was the biggest positive contributor in August, increasing four of the past five months, up 0.3% m/m and 0.8% over the period to a new record high. 2) Payroll employment (+0.07) rose 315,000 in August, slowing from July's 526,000 (first reported at 528,000), while a big downward revision to June payrolls (to 293,000 from 398,000) resulted in a net loss of 107,000 over the two-month period. 3) Real manufacturing & trade sales (+0.04) climbed in August for the second month, by a total of 0.6%, after contracting 1.1% during the two months through June, fluctuating in a volatile flat trend just below last March's record high. 4) Industrial production (-0.03) ticked down 0.2% in August after climbing 0.5% in July to a new record high, which was its only gain since April. Production increased only 0.3% during the four months through August after expanding 2.5% during the first four months of this year. Manufacturing output increased 0.1% in August following a 0.6% gain, though lacks momentum, bouncing in a volatile flat trend just below April's recent peak.

**Regional M-PMIs** (*link*): Three Fed districts (New York, Philadelphia, and Kansas City) have reported on manufacturing activity for September and show the manufacturing sector remained in contractionary territory, though the decline narrowed a bit, with the measure climbing to -3.5 from -7.3 in August. *Manufacturing activity* in the New York (to -1.5 from -31.1) region snapped back near expansionary territory in September after falling deep into contractionary territory in August, while manufacturing activity in the Philadelphia (-9.9 from 6.2) area moved back into negative territory after a brief move above zero in August. Meanwhile, growth in Kansas City's (to 1.0 from 3.0) manufacturing sector is fast approaching negative territory, falling steadily from March's 37.0. *New orders* (-8.3 from –

16.9) contracted for the fourth month in September, though moved off recent lows, contracting at half August's pace. Billings in New York (3.7 from -29.6) factories returned to growth, though barely, while Kansas City (-11.0 from -16.0) orders contracted at a slightly slower pace. Meanwhile, Philadelphia (-17.6 from -5.1) orders growth fell at a considerably faster pace than last month. *Employment* (10.6 from 13.8) continued to climb this month, but the pace slowed for the fourth successive month (from 24.5 in May), as factories in the Philadelphia (12.0 from 24.1) region hired at half August's pace, while New York's (9.7 from 7.4) pace held relatively steady and Kansas City's measure was unchanged at 10.0. Turning to *prices*, the prices-paid index in the New York region eased further from April's record-high 86.4, slowing to a 21-month low of 39.6 this month, while Philadelphia's eased from a cyclical high of 84.6 in April (which wasn't far from its record high of 91.1 in the 1970s) to 29.8 in September, the lowest since December 2020. Kansas City's measure edged up to 41.0 this month from August's 21-month low of 38.0; it was at a record high of 88.0 last May. New York's prices-received measure slowed to a 19-month low of 23.6, down from its record high of 56.1 in March, while the Philadelphia measure picked up a bit to 29.6 after slowing to an 18-month low of 23.3 last month from November's 62.9 peak, while Kansas City's also rose, climbing to 27.0 after sliding to a 19-month low of 25.0 last month; it was at a record high of 57.0 in April.

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