Yardeni Research

MORNING BRIEFING
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Powell's Latest Pivot Shocks Markets

Check out the accompanying chart collection.

Executive Summary: Pessimism and bearishness are widespread; from a contrarian standpoint, that spells buying opportunities for the long term. … Meanwhile, monetary tightening appears to be making headway against inflation given the dollar's strength and weakening commodity prices. We think PCED inflation peaked in June and is on track to fall to 3.0%-4.0% next year. One more 75bps rate hike in November may be enough. … We've reassessed our economic and stock market forecasts given renewed Fed hawkishness. We still expect a growth recession and range-bound S&P 500, but with greater short-term downside risk. And we now see the 10-year bond yield peaking at 4.25%. … Also: A dizzying review of Powell's recent pivots.

Video Webcast. You can find a replay of our Monday morning webcast *here*.

Strategy: Revisiting Our Forecasts. The bad news is that everyone is pessimistic and bearish, and rightly so following Fed Chair Jerome Powell's latest pivot. Last Wednesday, September 21, at his post-FOMC *press conference*, Powell essentially embraced his 1970s era predecessor Paul Volcker's approach to dealing with inflation, as we discussed in yesterday's *Morning Briefing*.

Powell said that he will continue to raise interest rates rapidly until he is convinced that they are restrictive enough to bring the inflation rate back down to 2.0%. He is no longer talking about pausing along the way to assess whether the latest hike is doing the job; he'll keep raising rates until he sees the job getting done—however long that takes, so he said. Powell has indicated that he understands that he might cause a recession along the way, but he reckons that the pain of allowing inflation to remain high exceeds the pain of causing a recession sooner rather than later.

Now let's consider the following related developments and revisit our forecasts in light of Powell's increasing hawkishness:

(1) *Foul mood, the dollar & commodity prices.* Like the bad news, the good news is also that everyone is pessimistic and bearish, as Debbie, Joe, and I reviewed in yesterday's *Morning Briefing*. For contrarians, the widespread foul mood creates buying opportunities. More fundamentally, the good news on the inflation front is that the dollar is soaring to new highs

and commodity prices are tumbling, suggesting that the Fed's tougher monetary stance may bring inflation down rapidly.

The JP Morgan trade-weighted dollar is up 11% ytd and 13% y/y (*Fig. 1*). The CRB all commodities price index is down 13% from its record high on May 4 through Friday of last week (*Fig. 2*). On Friday, the nearby futures price of a barrel of Brent crude oil was down to $86.15 from a recent peak of $123.58 (*Fig. 3*). Here are the futures prices for 3, 6, 12, and 24 months ahead: $83.61, $80.37, $76.87, and $72.26.

(2) *Inflation forecasts.* Debbie and I believe that the headline PCED inflation rate peaked at 6.8% y/y during June of this year and that the core rate peaked during February at 5.3% (*Fig. 4*). Their readings during July were 6.3% and 4.6%. We still expect to see both ranging between 4.0%-5.0% over the rest of this year and 3.0%-4.0% next year. In other words, we are not changing our outlook for inflation.

The FOMC's latest *Summary of Economic Projections* (SEP) shows the following medians for the headline and core PCED inflation rates: 2022 (5.2%, 4.5%), 2023 (2.8, 3.1), and 2024 (2.3, 2.3). We doubt that inflation will come down as quickly as the SEP forecasts imply.

(3) *Interest-rate forecasts.* Melissa and I expect that the FOMC will vote to hike the federal funds rate by another 75bps to a range of 3.75%-4.00% at its November 1-2 meeting. That might very well do the trick—i.e., end the tightening round. The top end of this range is still below the 4.4% and 4.6% median forecasts for 2022 and 2023 shown in the FOMC's latest SEP. But it is close enough.

The two-year Treasury note yield rose to 4.31% yesterday. It tends to be a good leading indicator of the federal funds rate over the next 3-6 months (*Fig. 5*). It also tends to overshoot the peaks in the federal funds, i.e., the "terminal" federal funds rates at the end of monetary policy tightening cycles. The nearby federal funds rate future was 3.76% on Friday. Here are the federal funds rate futures for 3, 6, and 12 months ahead: 3.75%, 4.56%, and 4.67% (*Fig. 6*).

We now expect the 10-year Treasury bond yield will peak before the end of this year at 4.00%-4.25%. Admittedly, this yield has been rising faster than we've been raising our forecasts. Ever since the pandemic, the current business and investment cycles in many ways have resembled a video about the 1970s on fast-forward.

(4) *S&P 500 forecasts.* Joe and I have been projecting that the S&P 500 would trade over the rest of this year in a range between its August 16 high of 4035 and June 16 low of 3666. Yesterday, it closed at a new bear-market low of 3655. The next major support level might be at 3386, which was the February 19, 2020 record high just before the pandemic (*Fig. 7*).

Notwithstanding Powell's hawkishness, we aren't ready to change our growth recession forecast for the economy. So we aren't ready to change our forecast of a flat outlook for S&P 500 forward earnings around $235.00 per share for the rest of this year (*Fig. 8*). At year-end, this would also be analysts' consensus expectations for 2023. That's consistent with our forecast that the growth recession of H1-2022 will continue in H2-2022. In a hard-landing scenario, forward earnings would be much lower. Using our $235-per-share estimate, here are the forward P/Es at S&P 500 levels of 4035 (17.2), 3666 (15.6), 3386 (14.4), and 2237 (9.5).

The forward P/E was down to 15.5 on Friday. We've been estimating a range of 15.5-18.0 for the forward P/E over the rest of this year (*Fig. 9*). If forward earnings is $235, the S&P 500's range for the rest of this year would be 3642-4230 (*Fig. 10*).

(5) *Feshbach's trading strategy.* Our friend Joe Feshbach, trading strategist extraordinaire, thinks that the market is getting close to a significant trading bottom even if it drops below the June 16 low. He likes the jump in the CBOT's equity put/call ratio to 1.02 on Friday, the highest reading since March 16, 2020 (*Fig. 11*). He also likes that sentiment indicators turned so bearish again so quickly.

We would add that the rally from June 16 through August 16 corrected an oversold market, which is now just about as oversold as it was before the recent rally, with only 13.5% of the S&P 500 companies trading above their 200-day moving averages (*Fig. 12*). And Investors Intelligence's Bull/Bear Ratio was back below 1.00 last week, a bullish contrarian sign—for long-term investors, not short-term traders (*Fig. 13*).

The Fed: Pragmatic (Serial) Pivoter. In my 2020 book *Fed Watching For Fun & Profit*, the chapter on our current Fed chair is titled "Jerome Powell: The Pragmatic Pivoter." When I have some time, I'll update it to reflect his pivots during the summer of 2020, the fall of 2021, and the summer of 2022. He has become a serial pivoter. Here is a brief review of his most recent pivots:

(1) *Summer 2020.* Under Powell's leadership, the FOMC turned "woke" in 2020. The committee's August *2020 Statement on Longer-Run Goals and Monetary Policy Strategy*

broke with historical precedent by prioritizing “inclusive” maximum employment over its stated 2.0% inflation target. Also in that statement, the Fed embraced flexible average inflation targeting, indicating that it now would tolerate inflation overshoots to compensate for prior inflation shortfalls.

By maintaining ultra-easy monetary policies through the first half of this year, the Fed succeeded in lowering the unemployment rate to a recent low of 3.5% during July. In addition, the ratio of job openings to unemployed workers rose to a record 2.0 during March. The result has been a significant increase in wage inflation, which has spiraled into price inflation, thus eroding the purchasing power of all workers. That has been the unintended consequence of the Fed’s wokeness!

Ironically, only six months after the August statement was issued, the PCED inflation rate jumped above 2.0% during March 2021 and never looked back (*Fig. 14*). The Fed’s new policy caused the PCED inflation rate to jump from its “disappointing” 1.3% annual uptrend that it had maintained since the statement was first issued in January 2012 to its 2.0% “desired” path by April 2022 (*Fig. 15*).

(2) *Fall 2021.* The rebound in inflation from H2-2021 through H1-2022 forced Powell to turn less woke and to refocus on bringing inflation down. In congressional testimony on November 30, 2021, Powell pivoted by conceding that inflation isn’t transitory, but persistent.

The *minutes* of the FOMC’s December 14-15, 2021 meeting were released on January 5. The word “transitory,” which had previously described the Fed’s outlook for inflation, was mentioned once: “As elevated inflation had persisted for longer than they had previously anticipated, members agreed that it was appropriate to remove the reference to ‘transitory’ factors affecting inflation in the post-meeting statement and instead note that supply and demand imbalances have continued to contribute to elevated inflation.”

(3) *Summer 2022.* Powell seemed to be pivoting back toward a more dovish stance at the end of July. Stock prices rallied following his July 27 *press conference* after he said that the federal funds rate was now at “neutral.” He said so right after the FOMC had voted to raise it by 75bps to a range of 2.25%-2.50%. Stock and bond market investors concluded that the Fed was getting closer to a restrictive level of the federal funds rate, implying that the Fed’s monetary tightening cycle might end sooner rather than later and at a lower terminal rate.

Powell scrambled to convince the markets that he was really very hawkish. In his short *speech* at Jackson Hole on August 26, Powell buried the notion that the Fed might lower interest rates next year. He said, “Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy.”

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.’”

In his September 21 presser, Powell characterized the latest federal funds rate range of 3.00%-3.25% as “probably into the very lowest level of what might be restrictive.” Undoubtedly, this won’t be his last pivot.

(By the way, an exclusive free download of my book is available *here*.)

Calendars

US: 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. **Wed:** Pending Home Sales -1.0%; MBA Mortgage Applications; Retail & Wholesale Inventories; Advance Goods Trade Balance; Crude Oil Inventories & Gasoline Production; Powell; Bullard; Bowman. (Bloomberg estimates)

Global: Tues: Australia Retail Sales 0.3%; BOJ Monetary Policy Meeting Minutes; Lagarde; De Guindos; Pill. **Wed:** Germany Gfk Consumer Climate -39; France Consumer Confidence 80; Italy Consumer & Business Confidence 95.8/102.1; Japan Leading & Coincident Indicators; Lagarde; Elderson; Wuermeling; Cunliffe. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for two of these three indexes last week: LargeCap's was down for the first time four weeks, and MidCap's was down for a third time in four weeks. However, SmallCap's forward earnings was up for the third time in four weeks. For a 13th 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 0.5% below its record high in early June, and SmallCap's is 2.1% below its record high in mid-June. In the latest week, the yearly rate of change in LargeCap's forward earnings was down to an 18-month low of 10.5% y/y from 10.9%; 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 eased w/w to an 18-month low of 20.4% y/y from 21.3%. 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 ticked up to 16.0% y/y from 15.9%. That's up from a 17-month low of 16.1% at the end of August and down from a record high of 124.2% in June 2021. It had been at 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 stalling or heading lower now. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (7.5%, 8.2%), MidCap (15.5, 3.0), and SmallCap (11.2, 8.4).

S&P 500/400/600 Valuation (*link*): Valuations fell across the board for the fifth time in six weeks for all three of these indexes and were at their lowest levels since mid-June. LargeCap's forward P/E fell 0.7pt to 15.6 from 16.3, which compares to a 16-week high of 18.1 in early August, 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 0.6pt w/w to 11.3 from 11.9, which compares to a 16-week high of 13.2 in early August, 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 gave up 0.7pt w/w last week to 10.8 from 11.5. That's down from a 16-week high of 12.8 in early August 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 28% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below

LargeCap's for a 110th straight week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 31% 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 67th straight week; the current 4% 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 dropped 0.9% w/w to $55.66, and is now 6.4% below its $59.49 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken to 3.3% y/y on a frozen actual basis and 4.6% on a pro forma basis. That's down from Q2-2022's blended actual/estimate of an 9.9% y/y gain on a frozen actual basis and 8.4% 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 (118.0% in Q3-2022 versus 295.5% in Q2-2022), Industrials (26.4, 31.6), Consumer Discretionary (17.2, -12.1), Real Estate (10.4, 13.1), Materials (2.0, 17.5), S&P 500 (4.6, 8.4), Information Technology (-3.4, 1.5), Consumer Staples (-2.6, 2.2), Health Care (-4.0, 8.7), Utilities (-7.2, -3.7), Financials (-9.2, -19.3), and Communication Services (-15.9, -20.3).

US Economic Indicators

Regional M-PMIs (*link*): Four Fed districts (New York, Philadelphia, Kansas City, and Dallas) 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 -6.9 from -8.7 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, and Dallas' (-17.2 from -12.9) fell further below the breakeven point of 50. 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* (-7.8 from –13.8) contracted for the fourth month in September, though moved off recent lows, contracting at roughly 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, while the decline in Dallas (-6.4 from -4.4) billings was little changed from last month's rate. *Employment* (11.7 from 14.3) 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 hiring rate in both the Dallas (15.0 from 15.6) and New York (9.7 from 7.4) regions held relatively steady and Kansas City's measure was unchanged at 10.0.

Regional Prices Paid & Received Measures (*link*): We now have prices-paid and -received data for September from the New York, Philadelphia, Dallas, and Kansas City regions, and all are showing a noticeable easing of inflationary pressures from recent peaks. (Note: the New York, Philadelphia, Dallas, and Kansas City measures are diffusion indexes.) 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), while Dallas' (37.1 from 34.4) also saw a slight uptick, though is considerably below last November's record high of 83.3. The story is similar for the *prices-received measures*: 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 Dallas measure eased for the sixth successive month from 47.8 in March to 18.1 this month; it was at a record high of 50.9 last October. Meanwhile, Philadelphia's measure picked up a bit to 29.6 this month 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.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "[The] German economy is slipping into recession," noted Ifo President Clemens Fuest as September's business climate index this month tumbled to more than a two-year low. The index hasn't posted an increase since

May, sinking from 93.2 in May to a two-year low of 84.3 this month; it was as high as 101.4 in June 2021. The *expectations component* is in a freefall, plunging 23.4 points—from 98.6 in February to 75.2 this month—the lowest since April 2020; it was at 103.0 last June. Meanwhile, *current conditions*, which had been fluctuating in a volatile flat trend, dropped 3.0 points this month to a 17-month low of 94.5. The downturn was spread across all four sectors of the German economy: The *manufacturing sector* saw its business climate index drop 7.4 points this month to -14.2—the worst performance since the Covid-related downturn, with the expectations component (to -37.9 from -29.1) sinking further into contractionary territory. September's current conditions (to 12.8 from 18.4) measure has been drifting lower since peaking at 41.4 last summer. The *service sector* took a nosedive, with its business climate index falling to -8.9 this month—the first contractionary reading since February 2021, as the expectations (-36.0 from -24.3) component dove deeper into negative territory. Meanwhile, businesses were less satisfied with their current conditions (22.7 from 30.9). Sentiment in the *trade sector* continued to plummet, sinking to -32.3 (the lowest since April 2020), as expectations (-57.6 from -50.6) darkened further. Current conditions (to -2.5 from 3.2) posted the first negative reading since February 2021. The *construction sector* saw a noticeable deterioration, as its business climate index dropped to -21.6, the weakest since March 2010, on widespread weakness. Expectations (-46.1 from -38.8) contracted at a faster pace this month, while businesses continued to be less satisfied with current conditions (6.9 from 12.6); this measure was at 33.4 in February. *Price expectations* keep rising, noted Ifo economist Klaus Wohlrabe: "Price expectations have risen again, with more than one in two companies announcing price increases." Energy-intensive industries are particularly pessimistic about the winter.

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