Yardeni Research

MORNING BRIEFING
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Going Fishing

Check out the accompanying chart collection.

Executive Summary: Our bond market analysis suggests that the 10-year Treasury bond yield might peak at 4.00%-4.25%, probably in November after the Fed raises the federal funds rate by 75bps and possibly in anticipation of one final 75bps hike in December that puts the terminal federal funds rate at 4.50%-4.75%. … Our stock market outlook involves the S&P 500 remaining in a volatile trading range between 3666 and 4305 for the rest of this year. ... Also: Why hasn't the labor-force participation rate snapped back to its pre-pandemic levels now that the pandemic has abated? Melissa explores various reasons. … And: She examines trends perpetuating today's extreme labor shortages.

Strategy I: Fishing (& Wishing) for a Top in the Treasury Bond Yield. Forecasting the cyclical peak in the 10-year US Treasury bond yield is easy. The hard part is getting it right.

We know that historically when the yield spread between the 10-year bond and 2-year note has been inverted, we were approaching a peak in the bond yield (*Fig. 1* and *Fig. 2*). That's because an inverted yield curve signals that the Fed's monetary tightening policy is increasing the risk of a financial crisis that might trigger a credit crunch and a recession (*Fig. 3* and *Fig. 4*). In other words, tightening monetary policy increases the chances that something will break in the financial system, slamming the brakes on economic growth, which forces the Fed to ease and causes the 10-year bond yield to fall (*Fig. 5*).

The daily 10-year versus 2-year yield spread has been inverted since July 8 (*Fig. 6*). Since then, the 10-year bond yield has risen from 3.01% to 4.00%, while the 2-year note yield has risen from 3.03% to 4.48% (*Fig. 7*). We know that the 2-year tends to anticipate the terminal federal funds rate (FFR) during monetary tightening cycles (*Fig. 8*).

So all we have to do is to forecast the terminal FFR. That forecast will tell us when the 2-year yield has peaked. Then all we must do is add the (negative) yield-curve spread to the peak 2-year yield to derive the peak level of the 10-year yield.

Let's assume, as we do now, that the Fed will hike the FFR two more times, by 75bps at each of the November 1-2 and December 13-14 FOMC meetings. That would put the FFR at 4.50%-4.75%, which is our forecast and probably the current consensus forecast as well.

The 2-year yield is currently around 4.40%. So it is very close to our forecast of the terminal rate.

This suggests to us that the 10-year bond yield should peak at 4.00%-4.25% assuming that the yield-curve spread remains around the current -50bps. The bond yield most likely will peak following November's 75bps hike in the FFR. It might do so anticipating that the December hike will be the terminal one.

Strategy II: Fishing (& Wishing) for a Bottom in the S&P 500. The interest-rate outlook above is consistent with the likely scenario for the FFR as outlined in an October 14 Reuters *interview* with St. Louis Fed President James Bullard.

As we observed in yesterday's *Morning Briefing*, Bullard said that he favors "frontloading" hikes in the FFR, with a wait-and-see stance on 2023. In other words, he suggested that the Fed should go ahead with the widely expected 75bps hike in the rate at the November 1-2 meeting of the FOMC and another 75bps hike at the December 13-14 meeting. That would bring the FFR target range up to 4.50%-4.75%. But then Bullard went on to imply that the Fed should pause for a while.

Joe and I think that's one reason that stocks rallied on Monday. Another reason, of course, is that Bank of America reported better-than-expected Q3 earnings. The net interest margins of the S&P 500 Financials (particularly the money center and regional banks) have widened significantly this year.

We are thinking that instead of a V-shaped capitulation bottom, the S&P 500 may very well remain in a volatile trading range around the June 16 low of 3666 for a while longer before moving back toward the August 16 high of 4305 over the rest of this year.

US Labor Market I: Fishing for a Bottom in Labor Supply. Sure, Covid caused many workers to leave the workforce owing to health concerns or for caregiving purposes. But it's not the only reason for the depressed US labor-force participation rate. Now that the pandemic has abated, life has normalized, but labor-force participation hasn't. In September, the participation rate was merely 62.3%, over a full percentage point below the level just before the pandemic, in February 2020, of 63.4% (*Fig. 9*).

One of the main reasons for the lack of a post-pandemic snapback in labor-force participation is that the long expected tsunami of Baby Boomer retirements is here (Boomers, born between 1946 and 1964, are now 58 to 76 years old). Accordingly, the number of people who are not working—and are not looking to—has increased even though job openings are plentiful. The historically low unemployment rate of 3.5% excludes these NILFs (i.e., not-in-the-labor-force) from its in-the-labor-force denominator. Job openings exceeded the number of unemployed workers in the US from the start of 2018 through the start of the pandemic, and since July 2021 (*Fig. 10*).

Here's a deeper look at factors that have been driving up the ranks of NILFs and weighing down the labor-force participation rate:

(1) *Age distribution.* The age distribution of a population can profoundly influence its percentage of NILFs. The participation rate of the prime-working-age population, 25- to 54-year-olds, has recovered from its pandemic-depressed lows (*Fig. 11*). That's not the case, however, for the over-65 cohort (*Fig. 12*). Many Boomers retired during the pandemic. Just as Boomers' outsized impact has been skewing the overall population older, it's been weighing on the overall labor-force participation rate.

(2) *Pandemic retirements.* About 2.5 million people retired earlier than normal during the pandemic, *found* the St. Louis Fed. Fear of Covid complications among older people was one big reason. Another reason was that rising asset prices during the pandemic provided many people with sufficient nest eggs to retire, many of them without even collecting Social Security benefits yet (delaying claims increases the benefit amount up until the maximum collection age of 70). Remarkably, Social Security claims remained *flat* amid this wave of retirements. This raises the possibility that some retirees will reenter the labor force as a result of this year's negative wealth effect on their portfolios.

(3) *Declining population.* Nevertheless, continuing retirements are likely to put additional downward pressure on labor-force participation rates over the next decade. Low labor-force participation compounded by the low growth rate of the working-age population is contributing to labor shortages. The size of the labor force equals the size of the population age 16 and older multiplied by their labor-force participation rate. Kansas City Fed researchers *decomposed* changes in population size and changes in participation rates. They found that population growth helped offset declining labor-force participation in most states between December 2019 and December 2021. But lower birth rates and lower migration trends (as discussed below) also contribute to declining population growth rates and the declining labor force.

(4) *NILF newbies.* Prime-working-age women (aged 25 to 64) faced a slightly larger drop in the labor-force participation rate during 2020, a 1.7ppt decrease compared to a 1.6ppt

decline for men (*Fig. 13*). As many children returned to in-person learning at the start of the 2021-22 school year, the female participation rate rebounded. The current prime-working-age female participation rate is 72.2%, 0.5ppt from its the February 2020 level of 72.7%. The rate for men is 0.4ppt below its pre-pandemic level of 84.9%.

What's been keeping some pandemic-era NILF newbies out of the labor force still? Federal stimulus funds sent to households aimed at boosting economic recovery could have influenced many NILFs to drop out of the labor force. These transfers, the Richmond Fed *found*, are estimated to account for almost 20% of the shortfall in the labor-force participation rate between February 2020 and August 2021. But the labor-force participation rate is expected to increase as many spend down their stimulus funds.

Disability spurred by long-Covid could explain why some prime-working-age NILFs have remained out of the labor force. A July 2022 Census Bureau survey found that 16.3 million people (around 8%) of working-age Americans currently have long-Covid. Of those, 2-4 million are out of work due to long-Covid. Some of their ranks, however, may be *offset* by previous NILFs now able to rejoin the workforce thanks to the growing remote work trend.

Labor Market II: Fishing for More Explanations for Labor Shortages. Here's a closer look at changes in the nature of the labor market since the pandemic:

(1) *Lower paying jobs seeing most labor shortages.* Baby Boomers presumably are mostly retiring from higher paying jobs that require more experience. So many younger folks have had the opportunity to hop into those higher paying positions, leaving a shortage of lower paid labor. Foreign-born workers, discussed below, typically would fill such a gap, but they also have been in short supply. The shortage has been felt especially by employers in lower paying, immigrant-reliant industries such as construction, hospitality, and other services.

(2) *Shortage of teachers is notable too.* Interestingly, educators retired in large numbers during the pandemic. The teaching workforce is now suffering from an incredible labor shortage. According to the U.S. Bureau of Labor Statistics, there were approximately 10.6 million educators working in public education in January 2020. As of February 2022, there were 10.0 million, a net loss of around 600,000, *according* to the National Education Association.

Some educators were motivated to retire by early retirement packages and others by fear of working in schools during the pandemic. The teacher shortage soon could get worse, as more than half of teachers are *over 40*. To address the shortage, some state governments are making it easier for retired school staff to return to work, *according* to edsource.org.

(3) *Inflation may drive some out of retirement.* Determining who is retired versus out of work can be tricky. A May article in the Washington Post *noted* that an estimated 1.5 million retirees have reentered the labor market over the past year, according to an Indeed economist. That means the economy has made up much of the excess loss of retirees since February 2020.

Some returning workers cite difficulty dealing with rising costs on a fixed income as the reason. Some are going back to work until they're eligible for Medicare due to the high cost of private healthcare premiums. A survey from the Nationwide Retirement Institute found that some 13% of Gen Xers and Baby Boomers say they have *postponed* or considered delaying plans to leave the workforce due to soaring costs.

Vanguard *research* observes: "Except for pensioners, those who retired earlier than expected would have had to amass financial assets equal to as much as 10 times their annual income to confidently meet living expenses through at least age 84." That suggests that some retirees may be returning to the workforce for one reason or another. But even if that were the case for many, the trend wouldn't halt the inevitable Boomer-induced labor-force drain, just delay it.

(4) *Immigration problem could be labor-force solution.* "If retiring baby boomers are creating a labor shortage—immigration could be the solution" was the *title* of a September article in *Fast Company*. A July 2021 Peter G. Peterson blog *noted* that foreign born workers made up nearly one-fifth of the US labor force.

Tighter immigration policies and travel restrictions stemming from the Covid-19 pandemic reduced net international immigration to the US from 2016 to 2021, found the Kansas City Fed in a *study*. As of June, there were about 1.7 million fewer working-age immigrants living in the US than there would have been had immigration continued at its pre-2020 pace, *according* to an economist quoted in an October Bloomberg article.

More temporary workers are coming to the US, according to a Pew Research Center analysis cited in the article. But the number of workers still doesn't match the level prior to the pandemic. Moody's Analytics has shown that for every 1% increase in the population made of immigrants, GDP rises 1.15%, the article observed.

(5) *Age wave and inflation.* By the way, the formerly accepted notion that elderly

populations tend to drive inflation down may be challenged in the coming years (*Fig. 14*). Recent research from the International Monetary Fund found that when there are high concentrations of dependent populations relative to the working-age cohort, there is a tendency toward consumption, which inflates inflation. BCA Research also recently highlighted how Baby Boomers control more than half of US household wealth and increasingly will have an outsized influence on consumption over output. That's all according to a September *article* in *Forbes*.

Calendars

US: Tues: Headline & Manufacturing Industrial Production 0.1%/0.3%; Capacity Utilization 80.0%; NAHB Housing Market Index 44; TIC Net Long-Term Transactions; API Weekly Crude Oil Inventories. **Wed:** Housing Starts & Building Permits 1.475mu/1.530mu; MBA Mortgage Applications; Cushing Crude Oil Inventories; Gasoline Production Beige Book; Bullard. (Bloomberg estimates)

Global: Tues: Eurozone ZEW Economic Sentiment -61.2; Germany ZEW Economic Sentiment -66.0; Canada Housing Starts 261.5k; China FDI; Adachi. **Wed:** Eurozone Headline & Core CPI 1.2%m/m/10.0%y/y & 1.0%m/m/4.8%y/y; UK Headline & Core CPI 0.4%m/m/10.0%y/y & 0.5%m/m/6.4%y/y; UK PPI Input & Output -0.4%m/m/18.8%y/y & 0.3%m/m/15.7%y/y; Canada CPI -0.1%mm/6.8%y/y; Japan Merchandise Trade – ¥2,167b; Australia Employment Change 25k; Australia Unemployment & Participation Rates 3.5%/66.6%; China PBoC Loan Prime Rate; Mann. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for all three of these indexes again last week. LargeCap's and SmallCap's forward earnings dropped for a second straight week, and MidCap's fell for a fourth. LargeCap's forward earnings has fallen in nine of the 16 weeks since it peaked at a record high in late June. Over the same time period, MidCap's has dropped 10 times, and SmallCap's moved lower nine times. For a 16th straight week, none of these three indexes had forward earnings at a record high. However, forward earnings levels remain close to their record highs. LargeCap's is at a five-month low, but just 1.6% below its record high at the end of June. MidCap's is at a six-month low and 2.9% below its record high in early June; and SmallCap's is at a four-week low and 2.4% below its record high in mid-June. Forward earnings momentum continues to weaken. In the latest week, the yearly rate of change in LargeCap's forward earnings was down to a 19-month low of 9.0% y/y from 9.7%; 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 a 19-month low of 17.4% y/y from 18.3%. 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 was down w/w to a 19-month low of 14.5% y/y from 15.3%. That's 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 2022 to 2023 to improve instead of decline as is typical, but their forecasts are heading lower now for both years. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (6.9%, 7.7%), MidCap (14.1, 1.1), and SmallCap (10.9, 7.7).

S&P 500/400/600 Valuation (*link*): Valuations were mostly steady last week after falling in six of the prior eight weeks. LargeCap's forward P/E fell 0.2pt to 15.2, and was just 0.1pt above its 30-month low of 15.1 at the end of September. That compares to a 16-week high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E was steady w/w at 11.6, up from a 30-month low of 11.1 at the end of September. That compares to a 16-week high of 13.2 in early August, 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 flat w/w at 10.9, up from a 14-year low of 10.6 three weeks earlier. That's down from a 16-week high of 12.8 in early August and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also 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 24% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 113th 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 70th straight week; the current 6% 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 tumbled 60 cents w/w to $54.83, and is now 7.8% below its $59.49 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken to 1.7% y/y on a frozen actual basis and 3.6% on a pro forma basis. That's down from Q2-2022's 9.9% y/y gain on a frozen actual basis and 8.4% y/y on a pro forma basis. Double- and triple-digit percentage growth is expected for just four sectors in Q3-2022, and y/y declines are expected for seven. 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 blended earnings growth rates for Q3-2022 versus their Q2-2022 growth rates: Energy (121.2% in Q3-2022 versus 295.5% in Q2-2022), Industrials (26.3, 31.6), Consumer Discretionary (12.8, -12.1), Real Estate (10.9, 13.1), S&P 500 (3.6, 8.4), Materials (-5.1, 17.5), Consumer Staples (-2.0, 2.2), Information Technology (-4.0, 1.5), Health Care (-4.8, 8.7), Utilities (-7.3, -3.7), Financials (-11.1, -19.3), and Communication Services (-16.5, -20.3).

S&P 500 Q3 Earnings Season Monitor (*link*): The Q3-2022 earnings season is off to the poorest start of a quarterly reporting season since Q1-2020. With nearly 8% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 0.9%, and earnings have exceeded estimates by 5.1%. At the same point during the Q2 season, revenues were 1.2% above forecast and earnings had beaten estimates by 4.1%. For the 38 companies that have reported Q3 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed from their readings from Q2-2021 to Q2-2022. The small sample of 38 reporters so far collectively has a y/y revenue gain of 9.1%, but an earnings gain of only 0.4%. Just 63% of the Q3 reporters so far has reported a positive revenue surprise, and 68% has beaten earnings forecasts. Furthermore, fewer companies have reported positive y/y earnings growth in Q3 (61%) than positive y/y revenue growth (90%). These figures will change markedly as more Q3-2022 results are reported in the coming weeks, particularly from non-Financial firms with greater exposure to the strong dollar. While we expect y/y growth rates to remain positive in Q3, we think the revenue and earnings surprises will deteriorate q/q due to the slowing economy, missed deliveries, higher costs, and currency translation.

US Economic Indicators

Regional M-PMI (*link*): The New York Fed has provided the first glimpse of manufacturing activity for October and showed growth contracted at a sharper pace than in September after rebounding back near expansionary territory in August. Meanwhile, firms do not expect business conditions to improve over the next six months. October's composite index fell further into contractionary territory, registering -9.1, after jumping 29.8 points in September to -1.5 from -31.3 in August—which was the weakest since May 2020. The shipments measure plunged 19.9 points to -0.3 this month, indicating a levelling off of shipments, after soaring from -24.1 in August to 19.6 in September. The new orders measure continued to point to a modest increase in orders, holding steady at 3.7 in October, while the unfilled orders (to -3.7 from -7.5) gauge climbed closer to the zero breakeven point. Delivery times held steady, with the measure fluctuating around zero the past three months, falling to -0.9 this month from 1.9 and -0.9 the prior two months; inventories (to 4.6 from 9.4) accumulated at a slightly slower pace than last month. As for the labor market, both the employment (to 7.7 from 9.7) and average workweek (3.3 from -0.1) measures pointed to small gains. Looking at prices: The prices-paid index showed an acceleration to 48.6 this month, after easing from April's record high of 86.4 to a 21-month low of 39.6 in September, while the prices-received measure fell to a 21-month low of 22.9 this month—down from a record high of 56.1 in March. Looking ahead, the index of future business conditions dropped 10.0 points to -1.8, indicating that firms aren't expecting conditions to improve over the next six months. Both orders (2.4) and shipments (5.6) indicate subdued growth, while delivery times are expected to shorten. Employment (17.8) is anticipated to continue increasing at a healthy pace. Both the prices-paid (48.6 from 47.2) and prices-received (36.7 from 39.6) measures held fairly steady, down sharply below their record highs of 76.7 and 62.1 during January.

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