MORNING BRIEFING
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Back To The Old Normal?

Check out the accompanying chart collection.

Executive Summary: The unconventional ultra-easy monetary policy that reigned from the Great Financial Crisis to the Great Virus Crisis—a.k.a. the "New Normal"—aimed to stimulate the economy and shore up inflation. Now the "Old Normal" is back, characterized by more conventional tight monetary policy aimed at taming inflation, even if that kickstarts a recession. … But this post-pandemic business cycle isn't following the usual Old Normal script—instead featuring an oddly quick snapback of GDP growth and oddly vigorous comeback of inflation. … Today, we look at what's been happening in various segments of the economy this year and forecast what's in store for 2023.

US Economy I: Orlando. It's good to be back on the road again. I get to visit with our accounts in person, and I also get to see how the economy is doing based on conversations I have with "the locals." I was in Orlando over the weekend speaking at the MoneyShow conference. The city is growing rapidly, as New Yorkers have been pouring into Mickey's and Minnie's neighborhood. Housing and road construction are booming.

I flew into JetBlue's new terminal at Orlando International Airport. A sign indicated that it was built partly with funds provided by last year's Bipartisan Infrastructure Law, which included approximately $1.2 trillion in spending, with $550 billion being newly authorized spending on top of what Congress was planning to authorize regularly.

US Economy II: New Normal, R.I.P. The New Normal is dead. So is TINA (i.e., "there is no alternative" to stocks). So is disinflation. May they all rest in peace. They were alive and well from the Great Financial Crisis (GFC) through the Great Virus Crisis (GVC). Following the GFC, the Fed and other central banks feared deflation. They were frustrated that despite their unconventional ultra-easy monetary policies, they weren't able sustainably to raise their inflation rates to their 2% targets.

So those unconventional policies—including zero-interest-rate and negative-interest-rate policies (ZIRP and NIRP) and the expansion of their balance sheets with quantitative easing (QE)—became all too conventional. Their response to the GVC was to triple and quadruple down on their QE bond purchases. Fiscal authorities, especially in the US, widened their budget deficits dramatically by providing all sorts of pandemic relief programs. Advocates of

this monetary and fiscal extravaganza justified it with Modern Monetary Theory. Others called it a necessary provision of “helicopter money” to avert an economic and financial meltdown.

The result of all the helicopter money was a demand shock that caused a supply shock in global commodity and goods markets. Inflation soared. Supply chains were disrupted as the demand for goods well exceeded what could be manufactured and delivered by factories, shippers, wholesalers, and retailers around the world. Russia’s invasion of Ukraine exacerbated supply-chain disruptions and inflationary pressures, especially in grain, oil, and natural gas commodity markets.

The Fed and other central banks responded by raising their official interest rates and signaling that more hikes and more quantitative tightening to fight inflation lay ahead, which caused interest rates to soar even faster and higher than the official rates. That seems to have caused goods inflation to peak and moderate; but meanwhile, the inflation pandemic has spread to services.

So the New Normal is over. It’s looking more like the Old Normal business cycle is back, with central banks responding to higher inflation by tightening their monetary policies until they cause a recession, which should bring down inflation.

US Economy III: An Odd Old Normal. Debbie and I aren’t convinced that the US economy is about to follow the Old Normal script of the classic business cycle, however. The script it’s been following since the start of the pandemic is quite an odd one. During 2020, the economy fell into a deep lockdown recession that lasted only two months, i.e., March and April. Then only three quarters after real GDP bottomed during Q2-2020, it had fully recovered. Inflation, as noted above, made a remarkable comeback since March 2021, when the headline PCED rose above 2.0% for the first time since fall 2018, peaking at 7.0% this June, the highest since December 1981.

Let’s have a closer look at how GDP has been performing so far this year and assess the outlook for the economy in 2023:

(1) *Real GDP.* Real GDP fell during the first two quarters of this year as follows: Q1 (-1.6%) and Q2 (-0.6%). That led to a widespread view that the economy had experienced a “technical recession,” defined as two consecutive down quarters in real GDP. But then it rose 2.6% during Q3 (*Fig. 1*). However, it is up just 0.1% from Q4-2021 through Q3 of this year and 1.8% y/y (*Fig. 2*).

That's consistent with our view that the economy is in a "growth recession," a.k.a. a "soft landing," "rolling recession" or "mid-cycle slowdown." It's not experiencing a hard landing now nor do we expect it to do so in 2023.

(2) *Net exports.* The pandemic has caused pandemonium in all of our personal and working lives. It certainly had a dramatic impact on the economy in 2020 and 2021. This year, much of Q1's weakness in real GDP was attributable to an unusually large widening of the deficit in net exports of goods and services, which was fully reversed during Q3 (*Fig. 3*). Apparently, US retailers responded to the demand shock by ordering lots more goods from overseas that finally made it through the jammed ports during Q1, and now they are stuck with more merchandise than consumers want to buy after their buying binge of the previous two years.

(3) *Consumers.* There's no recession in consumer spending. On an inflation-adjusted basis, it rose 1.3%, 2.0%, and 1.4% during the first three quarters of this year. That's even though inflation has eroded the purchasing power of personal income. Over the past 12 months through September, real disposable income is down 2.9% (*Fig. 4*).

However, consumers have been able to boost their spending thanks to the excess saving they accumulated during the GVC, which we reckon is at least $1 trillion. That's allowed them to reduce their personal saving rate to boost their consumption (*Fig. 5*).

So real personal consumption expenditures rose 1.9% y/y through September, led by a 3.1% increase in services, while goods fell 0.5% (*Fig. 6*). After satisfying much of their pent-up demand for goods, consumers have been spending more on services. In the real GDP accounts, consumer spending on goods is down 2.4% from its record high during Q2-2021, while outlays on services rose 3.2% y/y to a record high during Q3 (*Fig. 7*).

(4) *Autos.* Personal consumption expenditures on motor vehicles and parts in the real GDP accounts peaked at a record high during Q2-2021 (*Fig. 8*). It was down 16.2% through Q3. There is probably still lots of pent-up demand for cars and light trucks as a result of supply shortages over the past year, but quite a bit of that is likely to be stymied by the tightening of lending conditions in the auto market. In the past, falling auto demand was a major contributor to recessions. This time, it might have a smaller impact.

(5) *Housing.* In the past, the housing industry was also a major contributor to recessions. This time, strength in multi-family housing construction should offset some of the weakness in single-family housing starts, which peaked at 1.22 million units (saar) during November

2021, well below the 1.82 million units record high during January 2006 (*Fig. 9* and *Fig. 10*). Like autos, there is plenty of pent-up demand and migratory demand (as in Orlando), but rapidly tightening lending conditions have seriously depressed affordability.

By the way, also included in the residential component of real GDP are improvements of residential structures and brokers' commissions (*Fig. 11*). They peaked during Q4-2020 and Q1-2021, respectively, and are contributing to the decline in residential investment.

(6) *Capital spending.* Capital spending in real GDP rose to a record high during Q3. It did so even though nonresidential investment in structures has dropped 26.9% from Q4-2019 (just before the pandemic) through Q3 (*Fig. 12*). Meanwhile, investment in equipment and intellectual property products both rose to new highs during Q3.

The weakness in structures has been widespread (*Fig. 13*). So this segment of capital spending is already in a recession. Meanwhile, real outlays on industrial, information processing, and transportation equipment remain relatively strong (*Fig. 14*). Leading intellectual property products to new record highs have been software and research & development (*Fig. 15*).

(7) *Inventories.* Inventory investment turns negative during recessions, clearing the decks for a big recovery in real GDP when production ramps up to meet rebounding demand and to restock inventories. During the first three quarters, inventory investment has been positive but falling. That has weighed on GDP growth (*Fig. 16*). Inventory investment may continue to weigh on economic growth, especially if it turns negative in coming quarters.

The inventories of manufacturing firms and auto retailers seem to be in line with their businesses (*Fig. 17*). Wholesalers and nonauto retailers seem to have piled up some unintended inventories over the past four quarters and are scrambling to sell surplus goods by discounting their prices.

(8) *Government.* The federal, state, and local governments all are likely to be stimulating the economy with funds already allocated by Congress for infrastructure spending. In addition, many states are sitting on large budget surpluses. A few of them are dropping some of it as helicopter money into the checking accounts of their taxpayers.

An October 18 Pew *report* on states' fiscal health observes: "Rainy day funds in most states and collectively are projected to have reached new highs by the end of fiscal year 2022, building on record gains the year before. Over the last two fiscal years, higher-than-

forecasted revenue and other temporary factors have helped spur widespread growth in rainy day funds, which are an essential fiscal tool that helps states weather the ups and downs of the business cycle."

Calendars

US: Tues: ISM Manufacturing & Price Indexes 49.9/53.0; Construction Spending -0.5%; Job Openings 10.00m; API Weekly Crude Oil Stocks; OPEC Meeting. **Wed:** ADP Nonfarm Employment 193k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Interest Rate Decision 4.00%; FOMC Press Conference. (Bloomberg estimates)

Global: Tues: UK M-PMI 45.8; Buch. **Wed:** Eurozone, Germany, France 46.6/45.7/47.4/46.9/47.5; Germany Unemployment Employment Change & Unemployment Rate 15k/5.5%; Germany Trade Balance 0.7b; China NM-PMI 49.2; Wuermeling; Nagel. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for all three of these indexes for a fourth straight week. LargeCap's forward earnings has fallen in 11 of the 18 weeks since it peaked at a record high in late June. Over the same time period, MidCap's has dropped 12 times, and SmallCap's has moved lower 11 times. For an 18th straight week, none of these three indexes had forward earnings at a record high. LargeCap's is at a seven-month low and 2.7% below its record high at the end of June. MidCap's is at a six-month low and 3.5% below its record high in early June; and SmallCap's is at a six-month low and 3.4% below its record high in mid-June. Forward earnings momentum continues to fade. In the latest week, the yearly rate of change in LargeCap's forward earnings was down to a 19-month low of 7.4% y/y from 8.5%; 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 16.4% y/y from 16.8%. 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 20-month low of 12.9% y/y from 13.9%. 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 (6.3%, 6.6%), MidCap (14.3, 0.2), and SmallCap (10.8, 6.2).

S&P 500/400/600 Valuation (*link*): Valuations moved higher for a second straight week after falling in six of the prior 10 weeks. LargeCap's forward P/E jumped 0.8pt to 16.8 from 15.9, and is now 1.7pt 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 rose 0.6pt w/w to 12.6 from 12.0, 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 gained 0.8pt w/w to 12.1 from 11.3, up from a 14-year low of 10.6 at the end of September. 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 25% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 115th 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 has been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 72nd 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 36 cents w/w to $54.78 due to negative earnings surprises, and is now 7.9% 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 4.1% 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 (135.7% in Q3-2022 versus 295.5% in Q2-2022), Industrials (19.3, 31.6), Consumer Discretionary (16.7, -12.1), Real Estate (14.1, 13.1), S&P 500 (4.1, 8.4), Consumer Staples (-0.2, 2.2), Information Technology (-1.2, 1.5), Health Care (-2.2, 8.7), Utilities (-7.2, -3.7), Materials (-7.8, 17.5), Financials (-16.1, -19.3), and Communication Services (-20.9, -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, assessed by the four surprise metrics we measure for both earnings and revenues. With over 53% of S&P 500 companies finished reporting revenues and earnings for Q3, revenues are ahead of the consensus forecast by just 1.4%, and earnings have exceeded estimates by only 3.9%. At the same point during the Q2 season, revenues were 1.8% above forecast and earnings had beaten estimates by 5.4%. For the 267 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 267 reporters so far collectively has a y/y revenue gain of 11.4% but an earnings gain of only 3.2%, as higher costs are pressuring profit margins. Just 67% of the Q3 reporters so far has reported a positive revenue surprise, and 72% has beaten earnings forecasts. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q3 (60%) than positive y/y revenue growth (80%). 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-PMIs (*link*): Five Fed districts (New York, Philadelphia, Richmond, Kansas City, and Dallas) have reported on manufacturing activity for October and show the manufacturing sector continued to contract, with manufacturing activity falling at double September's pace, deteriorating from -5.5 to -10.8—the weakest rate since May 2020. *Manufacturing activity* in both the Dallas (to -19.4 from -17.2) and New York (to -9.1 from -

1.5) regions declined at a faster pace, while Philadelphia's (-8.7 from -9.9) activity contracted at a comparable pace to September's, after moving briefly into expansionary territory in August (6.2). Richmond's (-10.0) returned to contractionary territory after improving a bit from -8.0 to 0.0 in September, while Kansas City's (-7.0 from 1.0) fell into contractionary territory for the first time since May 2020. *New orders* (-11.8 from -8.5) was in negative territory for the fifth month, with the decline widening again after narrowing a bit in September. Billings in the Richmond (-22.0 from -11.0) region contracted at double September's pace, while Dallas (-8.8 from -6.4) and Kansas City (-16.0 from -11.0) orders both declined at a faster pace than September's. Meanwhile, orders in the Philadelphia (-15.9 from -17.6) area fell at a slightly slower rate than in September, while New York's (unchanged 3.7) continued to rise at a sluggish pace. *Employment* (11.3 from 9.3) continued to climb in October, holding at a fairly steady pace. Factories in the Philadelphia (28.5 from 12.0) region hired at more than double September's pace, while rates in the Dallas (17.1 from 15.0) and New York (7.7 from 9.7) regions held relatively steady, though Dallas' pace was more than double New York's. Hiring in the Richmond region was at a standstill for the second month, unchanged at 0.0, while Kansas City's (3.0 from 10.0) was at a near standstill.

Regional Prices Paid & Received Measures (*link*): We now have prices-paid and -received data for October from the New York, Philadelphia, Richmond, Dallas, and Kansas City regions. (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* accelerated a bit to 54.2 after easing steadily from 87.5 in April to 50.2 in September. The New York region's index picked up slightly to 48.6 in October after easing from a record-high 86.4 in April to a 21-month low of 39.6 in September, while Philadelphia's moved up to 36.3 after slowing 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. Richmond's measure accelerated to 128.1 after easing to a 15-month low of 103.4 in September; it was at a record high of 150.1 in May. Kansas City's measure eased to a 25-month low of 26.0, down from a recent high of 83.0 in April and a record-high 88.0 last May, while Dallas' (32.0 from 37.1) slowed to a two-year low, down considerably from last November's record high of 83.3. Turning to the prices-received measure, it was unchanged at September's 18-month low of 35.0 in October, down from a recent peak of 60.6 in March. Regionally, Philadelphia's measure picked up for the second month to 30.8 after slowing from November's 62.9 peak to an 18-month low of 23.3 during August, while Richmond's has been volatile just below June's 103.1 record high, climbing to 86.2 after easing from 93.1 to 76.6 in September. In the meantime, New York's *prices-received*

measure slowed to a 21-month low of 22.9, down from its record high of 56.1 in March. Kansas City's gauge slowed to a 22-month low of 13.0 since matching its record high of 57.0 in April, while Dallas' ticked up to 22.2 after easing steadily from 47.8 in April to a 20-month low of 18.1 in September; it was at a record-high 50.9 a year ago.

Global Economic Indicators

Eurozone CPI Flash Estimates (*link*): The headline CPI rate for October is expected to accelerate to yet another new record high of 10.7% y/y, according to its flash estimate, up from 9.9% in September and 6.6ppts above last October's 4.1%. For perspective, the rate was as low as at -0.3% at the end of 2020. Looking at the main components, once again *energy* is forecast to record the largest gain, accelerating for the second month to 41.9% y/y, after slowing from 42.0% in June to 38.6% by August; the rate was at a record high of 44.3% in March. The rate for *food, alcohol & tobacco* is predicted to soar to a record-high 13.1% in October—accelerating steadily from June 2021's 0.5%—while the rate for *non-energy industrial goods* is forecast to reach a new record high of 6.0%. The *services* rate is expected to pick up to 4.4% y/y—the highest since the end of 1993. Of the *top four Eurozone economies*, rates for Italy (12.8% y/y) and Germany (11.6) are forecast to be above the Eurozone's rate of 10.7%, with both accelerating to new record highs. Meanwhile, rates in Spain (7.3) and France (7.1) are predicted to be below the Eurozone's expected rate of 10.7%, with Spain's rate continuing to ease from its record high of 10.7% in July and France's accelerating to a new record high.

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