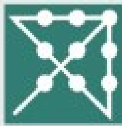

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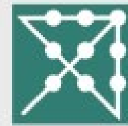

MORNING BRIEFING
November 16, 2022

On Inflation & Financial Stability

Check out the accompanying chart collection.

Executive Summary: The inflation-is-peaking euphoria that's driven the stock market skyward in recent days adds to our confidence that the bear market bottomed on October 12. … The latest batch of inflation indicators was mixed but overall suggests progress in the right direction, which may mean the Fed has done enough tightening already. … Don't fear systemic effects from the bursting of the cryptocurrency bubble—US banks are just fine. … Also: Melissa examines what the Fed thinks about the resilience of the US financial system, recapping points from its latest *Financial Stability Report*.

Strategy: More Peak Inflation Euphoria. Last Thursday's lower-than-expected CPI inflation rate for October was greeted with a huge rally by stock and bond investors. They continued to discount the possibility that inflation has peaked and is heading lower following yesterday's PPI report for October. As a result, they seem to be concluding that the Fed's monetary policy tightening cycle will be peaking sooner rather than later, with a terminal federal funds rate just below 5.00% rather than above that level. Indeed, the two-year US Treasury note yield is down from 4.73% on November 3 to 4.35% yesterday. In addition, they seem to be signaling that the 10-year US Treasury bond yield, which closed at 3.76% yesterday, might have peaked at 4.25% on October 24.

We don't have a problem with any of that since it has been our forecast in recent months and supports our forecast that the bear market in the S&P 500 bottomed on October 12 at 3577. Admittedly, during the summer, we argued that the June 16 low of 3666 might have been the bottom. Our October 31, 2022 *Morning Briefing* was titled "Bear Bottoms." We wrote: "The stock market has been working on forming a bottom since September, finding support around the June 16 low of 3666…" We predicted that the October 12 bottom would hold "if inflation shows clear signs of moderating in coming months, as we continue to expect."

Our October 18 *Morning Briefing* was titled "Going Fishing." We were fishing for reasons to call the bottoms in bond and stock prices. We observed that when the yield curve inverts, it's time to anticipate a peak in the 10-year US Treasury bond yield, which we predicted would be 4.00%-4.25% in early November. We concluded that the June 16 low might provide support for the S&P 500 after all and that a year-end rally could push it back up to

the August 16 high of 4305. So far, so good, with the S&P 500 closing at 3991 yesterday.

Inflation: Ups & Downs. We certainly aren't out of the inflation woods yet, but we do seem to be heading in the right direction to get out of this dark forest, as we wrote in yesterday's *Morning Briefing*. Let's review the latest batch of inflation indicators, starting with two disappointing ones:

(1) *Inflation expectations uptick.* On Monday, the Federal Reserve Bank of New York released its October survey of inflation expectations of Americans. It headed in the wrong direction, rising from 5.4% during September to 5.9% during October for the one-year ahead series (*Fig. 1*). The three-year ahead series also up-ticked for the second month, from 2.8% in August to 3.1% last month.

(2) *New York price indexes uptick.* Yesterday, the NY Fed also released its November regional business survey. The good news is that the general business conditions index edged up to 4.5 and the employment index remained solid at 12.2. However, the new orders index edged down to -3.3.

More troubling is that both the NY regional prices-paid and prices-received indexes, which have been mostly falling in recent months, both edged up during November, remaining relatively high (*Fig. 2*).

(3) *Peaking PPI.* The good news yesterday, of course, was October's PPI. The PPI final demand rose 8.0% y/y (*Fig. 3*). That's down from a record high of 11.7% during March and the lowest since July 2021. The PPI final goods demand has dropped from a record high of 17.6% during June to 10.5% in October. The PPI final services demand is down from a 9.4% peak during March to 6.3% last month.

Among services, it's still troubling to see that the PPI final demand for transportation and warehousing services was so high at 16.1% last month, though that is down from a peak of 23.4% during May (*Fig. 4*).

The PPI final demand for trade services is a measure of business markups. It is down from a peak of 18.9% y/y during March to 11.1%. That's still high and suggests that profit margins are not getting significantly squeezed.

The PPI final demand includes indexes for personal consumption expenditures with and without food and energy (*Fig. 5* and *Fig. 6*). Neither includes rent. They look like they

peaked earlier this year, but they remained well above the Fed's 2.0% inflation target, at 7.2% and 5.8% during October. Fed officials can rightly say that there's a way to go to get inflation down closer to 2.0%. The question is whether they've already done enough given the long lags between changes in monetary policy and their impacts on the economy. We think so.

Financial Stability I: The Cover Curse. *Bloomberg BusinessWeek* "asked the finest finance writer around, Matt Levine of Bloomberg Opinion, to write a cover-to-cover issue" of the magazine, "something a single author has done only one other time in the magazine's 93-year history." The resulting cover-to-cover *article* is titled "The Crypto Story," which appears on the *front cover* in gold lettering on a stark white background. It is a well-balanced guide to the crypto world, dated October 25.

The *BusinessWeek* article once again demonstrates what I call "the curse of the front-cover story"—i.e., once journalists hit on a big cover-worthy theme, all the good or bad news has been discounted by investors and speculators, and now it's time to head in the other direction. That's especially so when the topic fills up an entire issue. Bitcoin closed at $20,305 on October 25. It was down to $16,625 as of late yesterday afternoon.

Earlier last week, crypto exchange FTX had to pause customer withdrawal requests of about $5 billion. FTX lent about $10 billion of customers' funds to Alameda Research for trading purposes. FTX Chief Executive Sam Bankman-Fried is the founder and majority owner of both firms. According to *CoinDesk*, he ran a cabal of roommates in the Bahamas. "All 10 are, or used to be, paired up in romantic relationships with each other. That includes Alameda CEO Caroline Ellison, whose firm played a central role in the company's collapse—and who, at times, has dated Bankman-Fried." His aspiration to become a multibillionaire was motivated by his self-proclaimed commitment to charitable giving. That included being the second biggest donor to the Democratic party!

Here is what I wrote in our May 11, 2021 *Morning Briefing* about cryptocurrencies: "I had been thinking of cryptocurrencies as 'digital tulips,' reminiscent of the 17th century tulip mania in Amsterdam that drove up tulip prices beyond reason. The difference is that cryptocurrencies are traded 24-by-7 around the world. On second thought, they might be more like a financial virus that won't stop until enough speculators have been infected that herd immunity is achieved." Or perhaps, cryptocurrencies are the dotcoms of the 2020s.

The Fed's May 6, 2021 *Financial Stability Report* (*FSR*) mentioned cryptocurrencies just once—as the ninth-greatest risk to US financial stability as determined by a survey of wide-

ranging viewpoints.

Here is an important excerpt on cryptocurrencies from the Fed's most recent November 4, 2022 *FSR*: "The turmoil in the digital assets ecosystem did not have notable effects on the traditional financial system because the digital assets ecosystem does not provide significant financial services and its interconnections with the broader financial system are limited."

This is just one of many speculative bubbles that have burst since early last year (e.g., ARK, SPACs, meme stocks) without causing a credit crunch or a recession, which is consistent with our rolling recession scenario.

Financial Stability II: The Banks Are Alright. So far, there are no signs that the recent bursting of any of the speculative bubbles is stressing out the US financial system in general or the banking system. Consider the following:

(1) *Credit spread.* The yield spread between the high-yield corporate bond composite and the 10-year US Treasury has widened from 279bps at the start of this year to 485bps on Monday (*Fig. 7*). However, it isn't spiking higher the way it did during previous credit crunches.

(2) *Bank loans.* Loans on the balance sheets of all commercial banks in the US are up $1.0 trillion so far this year to a record high of $11.8 trillion during the November 2 week (*Fig. 8*).

(3) *Loan loss provisions.* Melissa and I track the Fed's weekly data on provisions for loan losses at all commercial banks in the US (*Fig. 9*). This year, they bottomed during the June 8 week and are up just $10.8 billion to $167.3 billion through the week of November 2.

Financial Stability III: The Fed's Worry & Not-To-Worry List. The Fed warned in its November 2022 *FSR* (linked above) that rising volatility in the financial markets, diminishing government bond liquidity, and geopolitical tensions threaten the risk of a global economic recession. Tightening by global central bankers combined could further strain the financial system, the report said. But the banking system is more resilient than it was during the global financial crisis. Here's more:

(1) *Liquidity a concern.* "Today's environment of rapid synchronous global monetary policy tightening, elevated inflation, and high uncertainty associated with the pandemic and the war raises the risk that a shock could lead to the amplification of vulnerabilities, for instance

due to strained liquidity in core financial markets or hidden leverage," Fed Vice Chair Lael Brainard said in a statement accompanying the report.

The Fed's *FSR* reports include a survey of the risk assessments of various market participants. None of the Fed's survey respondents in May indicated that liquidity strains and volatility were a concern. However, in November, more than half of contacts perceived these areas as a risk. "Liquidity metrics, such as market depth, suggest that Treasury market liquidity has remained below historical norms," the Fed report observed. "Low liquidity amplifies the volatility of asset prices and may ultimately impair market functioning."

(2) *Geopolitical tensions.* Consequences of Russia's invasion of Ukraine, stresses in China, the strength of the dollar, and other developments abroad could affect US financial stability, the report said. In particular, relations between China and Taiwan were seen as a growing risk to the global economic outlook. The risks from Russia's war on Ukraine were seen as declining, but the energy outcomes from the war are still a significant worry.

(3) *Stretched home price valuations.* The *FSR* implied, but did not say outright, that housing prices may have further to fall. Although year-over-year house price increases have decelerated, a model-based measure highlighted in the report pointed to stretched house price valuations. In any event, the report did not anticipate a 2008-style calamity in the housing market.

(4) *Households and businesses servicing their debts.* Notwithstanding the housing market's troubles, mortgage delinquency rates have remained historically low. Also, the banking system remains stable, and the level of household debt is not concerning. Brainard stated: "Over the period, household and business indebtedness has remained generally stable, and on aggregate households and businesses have maintained the ability to cover debt servicing, despite rising interest rates."

Shadow banking, or bank lending to nonbank financial institutions, has reached "new highs." And not a whole lot is known about "some parts of the nonbank financial sector, where hidden pockets of leverage could amplify adverse shocks." However, regulatory changes after the last financial crisis increased the resiliency and ability of banks and broker dealers to absorb losses.

(5) *Leveraged loans stable.* Investors' appetites for risky debt has weakened so far this year amid market volatility. Institutional leveraged loan issuance fell back to its historical average. Default rates on leveraged loans remained near historically low levels but slightly

edged up. The credit quality of leveraged loans could be pressured by rising interest rates, as these loans feature floating rates. In addition, the net issuance of high-yield and unrated bonds has remained negative so far this year.

(6) *Reasonable valuations.* Asset valuations have come down in riskier segments of the market as the Fed has increased interest rates. "Higher interest rates and a weaker outlook for the economy led prices of financial assets to fall amid heightened volatility, but real estate prices remained elevated. Measures of equity prices relative to expected earnings declined. Risk premiums in equity and corporate bond markets were near the middle of their historical distributions," the report said.

(7) *Pivoting opinions.* In late October, on Bloomberg TV, Mohamed El-Erian made an interesting *point*: "If [the Fed] pivot[s], it will be because of financial stability. It's not going to be because they have decided to not look at inflation anymore." Earlier in the month, former Fed Chairman Ben Bernanke *said* that the Fed should not use its interest-rate policy to "fine-tune" financial stability risks because "I don't think we understand that well enough, except in perhaps extreme conditions." Instead, he said that financial regulations should be the primary financial stability risk prevention mechanism.

In terms of liquidity, Treasury Secretary Janet Yellen said in October that "we do not have a problem at this point … It's not unexpected that in a world of increased volatility that liquidity should diminish somewhat or the cost of transacting might rise a little." An interagency group is working on studying possible reforms to the Treasury market, which could be vulnerable to breakdowns like the one that occurred in March 2020, the *WSJ* *reported*.

Calendars

US: **Wed:** Retail Sales Total, Core, and Control Group 1.0%/0.4%/0.3%; Headline & Manufacturing Industrial Production 0.2%/0.2%; Capacity Utilization 80.4%; Business Inventories 0.5%; NAHB Housing Market Index 36; MBA Mortgage Applications; Import & Export Prices -0.4%/-0.4%; Crude Oil Inventories & Gasoline Production; TIC Net Long-Term Transactions; Williams; Barr; Waller. **Thurs:** Housing Starts & Building Permits 1.410mu/1.512mu; Philadelphia Fed Manufacturing Index -6.2; Kansas City Fed Manufacturing Index; Initial & Continuous Claims 225k/1.50k; Natural Gas Storage; Bullard; Bowman; Mester; Jefferson. (Bloomberg estimates)

Global: **Wed:** Italy CPI 3.5%m/m/11.9%y/y; UK Headline & Core CPI 1.7%m/m/10.7%y/y &

0.6%m/m/6.4%y/y; UK PPI Input & PPI Output 0.3%m/m/18.0%y/y & 0.5%m/m/14.6%y/y; Japan Trade Balance –¥ 2.23t; Canada CPI 0.7%m/m/6.9%y/y; Australia Employment Change 15k; Australia Unemployment & Participation Rates 3.6%/66.6%; ECB Financial Stability Report; UK Inflation Report Hearings; Lagarde; Balz; Fernandez-Bollo; Bailey. **Thurs:** Eurozone Headline & Core CPI 1.5%m/m/10.7%y/y; 0.6%m/m/5.0%y/y; EU Car Registrations; UK Gfk Consumer Confidence -52; UK Autumn Forecast Statement; Pill; Tenreyro; Balz; Maechler. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): As of Monday's close, the S&P 500 Value index was out of a correction at 7.9% below its record high, while the S&P 500 Growth price index was still in a deep 27.3% bear market. Growth's underperformance relative to Value began on November 30, 2021 when its price index peaked at a record high. Since then, Value's price index has dropped 0.2%, while Growth's is down 24.5%. Growth made a new low for the year on October 12, while Value remained above its September 30 bottom. At that October 12 low, Growth was down 20.1% from its recent high on August 15 to 32.8% below its December 27 record high. Value was down a lesser 14.6% on September 30 from its August 16 high to 19.2% below its January 12 record high. Looking at their ytd performance through Monday's close, Growth has tumbled 26.3% ytd, well behind the 6.6% decline for the S&P 500 Value index. Looking at the fundamentals, Growth is expected to deliver stronger revenue growth (STRG) than Value over the next 12 months, but their earnings growth (STEG) is similar now. Growth has 5.5% forecasted for STRG and 4.8% for STEG, while Value has forecasted STRG and STEG of 2.9% and 4.8%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and tumbled 40% to a 27-month low of 18.4 on June 16. After rebounding to 23.3 in mid-August, it tested the June low with its 18.5 reading on October 12. It was back up to 21.0 on Monday. Value's forward P/E fell 24% from 17.6 in January 2021 to 13.4 on June 16. It made a new 30-month low of 13.0 on September 30, and has since risen to 15.0 as of Monday's close. Regarding NERI, Growth's and Value's were negative for a fourth straight month in October following 26 positive monthly readings. Growth's dropped to a 28-month low of -13.4% in October from -9.9% in September, and Value's was down to a 27-month low of -12.2% from -9.1%. Growth's forward profit margin of 17.5% is down 1.6ppts from its record high of 19.1% in mid-February and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping 0.6ppt to 10.8% from its record high of 11.4% in December.

S&P 500 Sectors & Industries Forward Profit Margin Since Peak (*link*): Since the S&P 500's forward profit margin peaked at a record-high 13.4% during the June 9 week, it has fallen 5.4% to 12.7% through the November 3 week. The drop has been paced by three of the 11 sectors, though all but the Energy sector are down since the peak. Here's the sector performance since the June 9 peak: Energy (up 2.6% to 12.2%), Utilities (down 0.5% to 13.8%), Real Estate (down 2.1% to 17.5%), Consumer Staples (down 2.6% to 7.2%), Industrials (down 3.3% to 10.0%), Consumer Discretionary (down 4.6% to 7.4%), Financials (down 5.1% to 18.1%), Information Technology (down 5.3% to 24.1%), S&P 500 (down 5.4% to 12.7%), Health Care (down 5.9% to 10.3%), Communication Services (down 11.0% to 14.3%), and Materials (down 13.6% to 11.7%). These are the best performing industries since the June 9 peak: Wireless Telecommunication Services (up 39.8% to 9.5%), Oil & Gas Refining & Marketing (up 33.0% to 4.5%), Hotels, Resorts & Cruise Lines (up 15.1% to 11.4%), Oil & Gas Equipment & Services (up 13.4% to 10.4%), and Health Care REIT's (up 7.4% to 7.1%). The worst performing industries since the June 9 peak: Copper (down 41.4% to 11.3%), Commodity Chemicals (down 36.2% to 6.5%), Gold (down 34.4% to 12.6%), Home Furnishings (down 32.9% to 6.0%), and Household Appliances (down 27.6% to 4.8%).

US Economic Indicators

Producer Price Index (*link*): October's final demand PPI matched September's 0.2% gain, which followed no change in August and a 0.4% drop in July. The yearly rate eased for the sixth month, since reaching a record high of 11.7% in March, slowing to a 15-month low of 8.0% last month. Meanwhile, core prices—which excluded food, energy, and trade services—advanced 0.2%, fluctuating between 0.2% and 0.3% the past five months, with the yearly rate easing from a record-high 7.1% in March to a 17-month low of 5.4% in October. *Final demand goods* increased for the second month by 0.6% in October and 0.9% over the period following gasoline-related declines of 1.1% in August and 1.8% in July. Meanwhile, 60% of October's increase is attributable to a 5.7% jump in gasoline, while food prices also contributed to the gain. Despite the increase, the yearly rate for final demand goods slowed to 10.5%, 7.1ppts below June's record high of 17.6%. In the meantime, *final demand services* fell for the first time since November 2020, by 0.1%, after gains of 0.2% and 0.5% the previous two months, with the yearly rate easing to a 12-month low of 6.3% from a record high of 9.4% in March. The *PPI for personal consumption* accelerated 0.4% in October after a 0.2% gain in September, no change in August, and a 0.5% decline July; it averaged monthly gains of 1.0% the first half of the year. The yearly rate has eased steadily from March's 10.4% record high, falling to 7.2% by September. The

yearly rate for personal consumption excluding food & energy held at 5.8% in October, down from a record high of 8.1% in March. Looking at *pipeline prices*, pressures remain elevated, though have slowed from recent highs. The yearly rate for intermediate goods prices eased to a 20-month low of 10.0% from a cyclical high of 26.5% last November, while the crude goods rate slowed dramatically to 9.8% y/y from its recent peak of 50.7% in June; was at 59.0% last April—which was only a tick below its record-high 59.1% in August 1973.

Regional M-PMI (*link*): The New York Fed has provided the first glimpse of manufacturing activity for November and showed growth expanded for the first time in four months, and only the second time in seven months. Meanwhile, firms expect business conditions to worsen over the next six months. November's *composite index* improved steadily to 4.5 this month from August's -31.1—which was the weakest since May 2020. The shipments measure increased 8.3 points to 8.0 this month, indicating a slight pickup in shipments, after plunging 19.9 points to -0.3 in September. The new orders measure pointed to a modest decline in billings, falling to -3.3 this month from 3.7 in each of the prior two months, while the unfilled orders gauge moved down to -6.8 (from -3.7), indicating unfilled orders were slightly lower. Delivery times rose to 2.9, showing little change. Meanwhile, inventories advanced significantly from 4.6 to a five-month high of 16.5. As for the *labor market*, the employment (to 12.2 from 7.7) and average workweek (6.9 from 3.3) measures pointed a solid gain in employment and a longer average workweek. Looking at prices: The *prices-paid* index showed an acceleration for the second month to 50.5 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 climbed to 27.2 this month after falling to a 21-month low of 22.9 last month—down from a record high of 56.1 in March. Looking ahead, the index of *future business conditions* dropped for the second month, by a total of 14.3 points to -6.1, indicating that firms are expecting conditions to worsen over the next six months. Both new orders (-6.4) and shipments (-10.0) fell into contractionary territory, though employment (13.0) is expected to continue rising. The *prices-paid* (48.5 from 48.6) measure held steady, while the *prices-received* gauge eased for the third month, by a total of 11.6 points to 32.0, after rising from an 18-month low of 28.7 in July to 43.6 in August. This measure was at a record high of 62.1 at the start of this year.

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