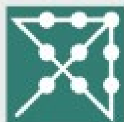

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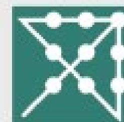

MORNING BRIEFING
January 23, 2023

Another Recession Alarm Ahead

Happy Chinese New Year!

Check out the accompanying chart collection.

Executive Summary: Brace yourself for December's Leading Economic Indicators and Coincident Economic Indicators coming out today. They are likely to trigger another recession alarm. But we still see greater odds of a soft landing (60%) than a hard one (40%). … What can the LEI and CEI tell us about the economy and what can't they? Today, we discuss their usefulness and limitations. … Also: They aren't the only economic indicators worth watching. ... And: Dr. Ed reviews "The Menu" (+ + +).

YRI Weekly Webcast. Join Dr. Ed's live webcast with Q&A on Mondays at 11 a.m. EST. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

US Economy I: Leading Indicators Flashing Recession Signal. This morning at 10:00 a.m., December's Index of Leading Economic Indicators (LEI) and Index of Coincident Economic Indicators (CEI) will be released by the Conference Board. Both are very likely to sound the recession alarm, which has been going off more often recently, unnerving stock investors. Recession fear also has sent interest rates lower, suggesting that the Fed's monetary policy tightening is already restrictive enough to bring down inflation.

If the Fed proceeds with additional interest-rate hikes, the recession alarm would likely sound even louder and more often. We don't like to ignore alarms, but we still aren't alarmed enough to change our 60% odds of a soft landing and 40% odds of a hard landing. Consider the following:

(1) *LEI predicting imminent recession.* The LEI peaked at a record high last year during February (*Fig. 1*). It is down 4.9% since then through November. It probably fell again during December. On average, it has peaked 12 months before the past eight peaks in the CEI, which coincided with the peaks in the business cycle. So the LEI is suggesting that the next recession should begin next month.

The LEI was down 4.5% y/y during November (*Fig. 2*). It turned negative on this basis just

before the peaks of the past eight business cycles. There have been a few previous minor false alarms. But currently, the LEI's recession alarm is sounding loud and clear and is signaling an imminent recession.

(2) *LEI giving too much weight to goods, nothing to services.* The LEI includes 10 economic indicators (*Fig. 3*). The three financial components are the leading credit index, the S&P 500, and the interest spread between the 10-year Treasury bond and the federal funds.

The seven nonfinancial components are initial unemployment claims, consumer expectations, house building permits, the ISM index of new manufacturing orders, average weekly hours in manufacturing, manufacturers' nondefense capital goods orders (estimated), and manufacturers' new orders for consumer goods & materials (estimated). The Conference Board also adds a "trend adjustment factor."

Notice that four of the nonfinancial indicators are related to manufacturing. In the past, manufacturing was among the most cyclical economic sectors. The consumer is represented by three of the nonfinancial indicators. Like manufacturing, housing is also a very cyclical sector of the economy. Notably absent are any variables for services.

(3) *Another LEI decline likely in December.* The LEI probably fell slightly during December. What do we know? Housing permits contracted 1.6% last month (*Fig. 4*). ISM new orders fell sharply from 47.2 in November to 45.2 in December (*Fig. 5*). The yield-curve spread turned negative when the Fed raised the federal funds rate in December to -48bps from 11bps the month before (*Fig. 6*). The S&P 500 averaged 3,912.38 during December, down a bit from 3,917.49 during November. We also know that the average manufacturing workweek edged down from 40.2 hours in November to 40.1 in December (*Fig. 7*).

On the other hand, jobless claims remained very low during December, averaging 217,600 versus 229,000 during November (*Fig. 8*). The job market remains strong. In addition, the consumer expectations index rose to 71.2 during December, up from 66.1 during November (*Fig. 9*).

(4) *Credit crunch is MIA.* The leading credit index is a proprietary component of the LEI compiled by The Conference Board. It is designed to monitor credit conditions, which have gotten tighter in 2022 than in 2021 (*Fig. 10*). However, this index remains relatively low compared to the spikes during the last four recessions.

Our nonproprietary indicators for financial conditions are the yield spread between high-

yield corporate bonds and the US 10-year Treasury and the S&P 500 VIX (*Fig. 11*). Neither of them is signaling a credit crunch and a recession.

One of the major reasons we are not in the recession camp is that we don't anticipate a credit crunch. We think that the financial system is in very good shape and can handle the Fed's aggressive monetary policy tightening without a credit crunch, which occurred during previous tightening rounds and led to recessions.

US Economy II: Defining a Recession With Coincident Indicators. As noted above, it is very likely that the CEI declined during December from its record high the month before. That could mark the start of a recession if the CEI continues to drop in coming months. Data since 1959 show that the CEI's peaks and troughs tended to coincide with the start and end of the nine recessions since then.

The Dating Committee of the National Bureau of Economic Research (NBER) determines the official start and end of recessions. The popular belief is that two consecutive down quarters in real GDP define a recession. The committee doesn't rely on this simple rule of thumb. Instead, it takes a more eclectic approach to declaring recessions:

"The NBER's traditional definition of a recession is that it is a significant decline in economic activity that is spread across the economy and that lasts more than a few months. The committee's view is that while each of the three criteria—depth, diffusion, and duration—needs to be met individually to some degree, extreme conditions revealed by one criterion may partially offset weaker indications from another. For example, in the case of the February 2020 peak in economic activity, we concluded that the drop in activity had been so great and so widely diffused throughout the economy that the downturn should be classified as a recession even if it proved to be quite brief. The committee subsequently determined that the trough occurred two months after the peak, in April 2020. An expansion is a period when the economy is not in a recession. Expansion is the normal state of the economy; most recessions are brief. However, the time that it takes for the economy to return to its previous peak level of activity may be quite extended."

In our opinion, it isn't necessary to have a PhD in economics to be on the Dating Committee. The cyclical peaks and troughs of the CEI define the ups and downs of the business cycle. Indeed, the committee's *FAQ page* acknowledges:

"The determination of the months of peaks and troughs is based on a range of monthly measures of aggregate real economic activity published by the federal statistical agencies.

These include real personal income less transfers (PILT), nonfarm payroll employment, real personal consumption expenditures, wholesale-retail sales adjusted for price changes, employment as measured by the household survey, and industrial production. There is no fixed rule about what measures contribute information to the process or how they are weighted in our decisions."

Nevertheless, that statement explicitly lists the four components of the CEI as particularly relevant to the committee's deliberations. Two mentioned aren't in the CEI, namely real personal consumption expenditures and household employment. The former is highly correlated with PILT, while the latter is just a more volatile alternative to payroll employment.

In this context, consider the following:

(1) *CEI's four components.* The CEI rose to a record high during November. It includes four economic indicators, namely, payroll employment, real personal income less transfer payments (in 2012 dollars), industrial production, and real manufacturing & trade sales (in 2012 dollars). The CEI, like the LEI, gives more weight to goods than to services. While the first two indicators mentioned above are related to consumers' purchases of both goods and services, the last two focus on the production and sales of goods.

(2) *December's CEI should be flat to down.* What do we know about prospects for the December CEI? Payroll employment rose 223,000 during December to a new record high. Last month's personal income won't be released until January 27. However, Debbie and I can derive our Earned Income Proxy (EIP) for private wages and salaries in personal income based on the data provided in December's employment report for payrolls, weekly hours, and average hourly earnings (*Fig. 12*). Our EIP rose only 0.2% m/m during December, implying that adjusted for inflation, it rose 0.1% since the CPI was down 0.1% m/m during the month. So the LEI's personal income component was probably flat in December.

We also know that industrial production fell 0.7% m/m during December and that November's output was revised down from -0.2% to -0.6%. It's hard to assess whether real manufacturing and trade sales will be up or down in December's LEI. We know that nominal retail sales fell 1.1% m/m during the month. So most of the weakness was likely attributable to lower prices. The goods CPI fell 1.1% m/m during December.

(3) *CEI's tracking record.* During the last nine recessions, the CEI declined an average of

5.2% over an average of 12 months. Its y/y growth rate closely tracks the comparable growth rate of real GDP (*Fig. 13*). The former was up 1.9% y/y through November, while the latter was also up 1.9% but through Q3-2022.

During previous recessions, the y/y growth rate in the CEI fell close to zero around the start of the downturns, with the troughs in this growth rate coinciding with the end of the recessions.

US Economy III: Additional Leading Indicators. Debbie and I monitor other economic indicators that also tend to be leading indicators of the business cycle. They provide a mixed outlook:

(1) *S&P 500 forward earnings.* The y/y growth rate of S&P 500 forward earnings tends to closely track the comparable growth rates of both the CEI and real GDP (*Fig. 14* and *Fig. 15*). It's a leading indicator because we use weekly data to calculate forward earnings, so it's a much timelier indicator than the monthly CEI and quarterly GDP. During the January 12 week, forward earnings was up only 2.1% y/y. (FYI: Forward earnings is the time-weighted average of analysts' consensus operating earnings-per-share estimates for this year and next.)

We think that forward earnings growth will remain positive, though low, as occurred during the mid-cycle slowdowns during the mid-1980s, mid-1990s, and 2010s. If it turns decisively negative, then you won't need us to tell you that the economy is in a recession.

(2) *Various payrolls by industries.* Two of our favorite payroll employment series that closely tracked the LEI in the past are the ones for truck transportation and temporary help services (*Fig. 16* and *Fig. 17*). The former rose to a record high during December, while the latter peaked at a record high last year during July and is down 3.5% since then.

(3) *Purchasing managers index.* The ISM's purchasing managers index for manufacturing is highly correlated with the yearly percent change in the LEI (*Fig. 18*). Both are currently in recession territory based on their history during previous downturns.

(4) *FedEx.* Joe and I are also examining the weekly forward earnings of specific S&P 500 companies to see if any might be useful leading indicators. So far, we have our eyes on FedEx: In this context, the freefall in FedEx's forward earnings late last year is unsettling (*Fig. 19*).

FedEx may be more useful as a leading indicator of the global economy than just the US. In recent weeks, the macroeconomic outlook has improved for the world economy, in our opinion. Investors seem to agree with us. FedEx's stock price is up 31% since it bottomed on September 26 last year.

Movie. "The Menu" (+ + +) (*link*) is a pretentious movie about pretentious people, i.e., the connoisseurs of *haute cuisine* and other know-it-alls. It is very clever, funny, and wickedly entertaining. Imagine being stuck on an island with Gordon Ramsey, who vents his temper on you and the other dinner guests at his restaurant before each course rather than at his subservient staff. Ralph Fiennes plays the lead masterfully. He does most of the talking, leaving little room for anyone else to say much more than "Yes, Chef!"

Calendars

US: Mon: Leading Indicators -0.7%. **Tues:** Richmond Fed Manufacturing Index -5; S&P Global M-PMI & NM-PMI Flash Estimates 46.2/45.0. (Bloomberg estimates)

Global: Mon: Eurozone Consumer Confidence -20; German Buba Monthly Report; Lagarde; Panetta. **Tues:** Eurozone, Germany, and France C-PMI Flash Estimates 49.8/49.6/49.5; Eurozone, Germany, and France M-PMI Flash Estimates 48.5/47.8/49.7; Eurozone, Germany, and France NM-PMI Flash Estimates 50.2/49.6/49.8; Germany Gfk -33; Australia CPI 1.6%q/q/7.5%y/y; Lagarde; Jochnick; Schlegel. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index fell 0.6% w/w but remained out of a bear market for a second week at 18.4% below its record high on December 27, 2021, under the 20% bear market threshold. The US MSCI ranked 37th of the 48 global stock markets that we follow in a week when 30 of the 48 countries rose in US dollar terms. The AC World ex-US index outperformed with a gain of 0.2% w/w, and improved to 16.1% below its June 15, 2021 record high. EM Asia was the best regional performer with a gain of 1.0%, followed by BIC (0.7%) and EMEA (0.3). EM Eastern Europe was the worst performing region last week with a decline of 0.8%, followed by EM Latin America (-0.7), EMU (-0.5), and EAFE (0.0). Turkey was the best-performing country last week, with a gain of 10.5%, followed by Egypt (7.3), New Zealand (5.7), Sri Lanka (5.2), and Indonesia (4.3).

Among the 20 countries that underperformed the AC World ex-US MSCI last week, Pakistan's 7.5% decline was the biggest, followed by those of Peru (-4.1), South Africa (-3.5), Morocco (-2.9), and Belgium (-2.3). Looking at 2023's performance so far, the US MSCI is up 3.6% and ranks 34/48 as just four of the 48 countries are down ytd. The AC World ex-US has risen 7.4% ytd with all regions in positive territory. EMU is the best performer, with a gain of 9.9%, followed by EM Asia (9.4), BIC (9.1), and EM Eastern Europe (7.5). The regional laggards so far in 2023: EMEA (1.9), EM Latin America (6.8), and EAFE (7.0). The best ytd country performers: Mexico (15.5), Argentina (14.9), China (13.6), the Netherlands (12.8), and Korea (11.4). Here are the worst-performing countries for the year: Pakistan (-9.1), Egypt (-8.6), Norway (-2.5), Morocco (-1.8), and Turkey (0.9).

S&P 1500/500/400/600 Performance (*link*): All three of these indexes fell for the first time in three weeks. LargeCap dropped 0.7% w/w, less than the 0.9% and 1.3% declines recorded for MidCap and SmallCap. At the week's end, LargeCap finished at 17.2% below its record high on January 3, 2022, MidCap at 12.1% below its record high on November 16, 2021, and SmallCap at 16.6% below its November 8, 2021 record high. Nine of the 33 LargeCap and SMidCap sectors moved higher for the week, down from 31 rising a week earlier. LargeCap Communication Services was the best performer, with an increase of 3.0%, followed by SmallCap Communication Services (1.3%) and MidCap Energy (1.0). Among the worst performers for the week, LargeCap Industrials fell 3.4%, followed by MidCap Utilities (-3.3), LargeCap Utilities (-2.9), and LargeCap Consumer Staples (-2.9). Looking at performances so far in 2023, LargeCap's 3.5% gain is trailing those of SmallCap (5.7) and MidCap (5.3) as 28 of the 33 sectors are higher ytd. The top sector performers in 2023: SmallCap Communication Services (12.6), LargeCap Communication Services (11.1), Smallcap Consumer Discretionary (10.7), MidCap Communication Services (10.2), and SmallCap Materials (9.0). Here are 2023's biggest laggards: LargeCap Consumer Staples (-2.6), LargeCap Utilities (-1.8), LargeCap Health Care (-1.5), MidCap Utilities (-0.7), and SmallCap Utilities (-0.6).

S&P 500 Sectors and Industries Performance (*link*): Three S&P 500 sectors rose last week, and four outperformed the composite index's 0.7% decline. That compares to a 2.7% gain for the S&P 500 a week earlier, when nine sectors rose and five outperformed the index. Communication Services was the best performer, with a gain of 3.0%, followed by Energy (0.7%), Tech (0.7), and Consumer Discretionary (-0.5). Industrials was the worst performer, with a decline of 3.4%, followed by Utilities (2.9), Consumer Staples (-2.9), Financials (-2.1), Materials (-1.2), Health Care (-1.1), and Real Estate (-0.7). Looking at 2023's performance so far, the S&P 500 is up 3.5% ytd, with five sectors outperforming the index and eight higher for the year. The best ytd performers: Communication Services

(11.1), Consumer Discretionary (7.6), Materials (6.6), Real Estate (6.2), and Tech (5.5). These are 2023's worst performers: Consumer Staples (-2.6), Utilities (-1.8), Health Care (-1.5), Industrials (0.8), Financials (3.2), and Energy (3.4).

S&P 500 Technical Indicators (*link*): The S&P 500 weakened last week relative to its 50-day moving average (50-dma) and 200-day moving average (200-dma), but remained above those averages. The index was above its 50-dma and 200-dma for a second week, but has been above its 200-dma only three times in the past 36. It had been above its 200-dma for 81 straight weeks through early February. The S&P 500's 50-dma turned down as the index dropped to 1.0% above its now-falling 50-dma from a five-week high of 1.9% above its rising 50-dma a week earlier. That compares to a recent 15-week low of 10.6% below at the end of September, a 23-month high of 8.7% above the index's rising 50-dma in early August, and a 27-month low of 11.1% below its falling 50-dma in mid-June. The index had been mostly trading above its 50-dma from late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index closed Friday at 0.6% below its falling 200-dma, down from a nine-month high of 1.0% below a week earlier. That's well above its 26-month low of 17.1% below its falling 200-dma in mid-June and down sharply from 10.8% above its rising 200-dma in November 2021. That also compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008. The 200-dma fell for a 37th straight week, but its pace of decline has slowed since October, when it was falling at its fastest rate since July 2009.

S&P 500 Sectors Technical Indicators (*link*): Seven of the 11 S&P 500 sectors are trading above their 50-dmas, down from nine above a week earlier. Industrials and Utilities moved below in the latest week and joined Consumer Staples and Health Care in that club. Just five sectors have a rising 50-dma now, down sharply from ten a week earlier. The five with rising 50-dmas: Communication Services, Health Care, Materials, Real Estate, and Utilities. Looking at the more stable longer-term 200-dmas, Consumer Staples and Utilities turned negative w/w, leaving these five sectors still above that measure: Energy, Financials, Health Care, Industrials, and Materials. While five sectors trade above their 200-dma, Energy is now the only sector with a rising 200-dma, as Industrials turned back down in the latest week.

US Economic Indicators

Existing Home Sales (*link*): "December was another difficult month for buyers, who continue to face limited inventory and high mortgage rates," noted Lawrence Yun, NAR's chief economist. "However, expect sales to pick up again soon since mortgage rates have markedly declined after peaking last year." Existing home sales contracted for the 11th consecutive month, by 1.5% in December and 38.1% over the period, to 4.02mu (saar)—the lowest level since November 2010. *Single-family* sales contracted 1.1% in December and 37.4% over the 11 months through December to 3.60mu (saar), while *multi-family* sales have plummeted during 10 of the past 11 months by 43.2% over the period to 420,000 units. *Regionally*, sales in December fell in three of the four regions on a monthly basis but fell for all four on a yearly basis: South (-2.2% m/m & -33.1% y/y), Northeast (-1.9 & -28.8), Midwest (-1.0 & -30.3), and the West (0.0 & -43.4% y/y). The *median existing* home price increased 2.3% y/y—marking the 130th month of y/y gains and the longest rising streak on record, though the gains have decelerated since peaking at 25.2% in May 2021. Yun notes, "Home price nationwide are still positive, though mildly. Markets in roughly half of the country are likely to offer potential buyers discounted prices compared to last year." Total *housing inventory* at the end of December was 970,000 units—down 13.4% m/m but up 10.2% y/y—with unsold inventory at 2.9 *months' supply* at the current sales rate, down from 3.3 months in November and 1.7 months a year ago. "Inventory levels are still tight, which is why some homes for sale are still receiving multiple offers," according to Yun. "In October, 24% of homes received over the asking price. Conversely, homes sitting on the market for more than 120 days saw prices reduced by an average of 15.8%."

Housing Starts & Building Permits (*link*): Housing starts in December fell for the fourth consecutive month, though was driven by a big drop in volatile multi-family starts—single-family starts soared at a double-digit pace during the month. Total *housing starts* fell a smaller-than-expected 1.4% in December versus an expected decline of 4.7%, sinking 8.4% over the four-month period to 1.382mu (saar). Single-family starts rebounded 11.3% to 909,000 units (saar), after a three-month drop of 11.5%, while multi-family sales plunged 19.0% in December to 473,000 units (saar). *Building permits* fell eight of the 12 months of 2022, dropping 1.6% m/m and 29.8% y/y to 1.330mu (saar)—the lowest since May 2020—with single-family permits down 6.5% and 34.7% over the comparable periods to 730,000 units (saar). Multi-family permits rose 5.3% in December but was down 22.9% y/y to 600,000 units (saar). During December, *housing under construction* rose to a record-high 1.712mu, while *completions* fell 8.4% in December to 1.411mu after a 13.5% surge in November. Last Wednesday, NAHB reported that *homebuilders' confidence* rose for the

first time in a year in January, climbing to 35 after plunging 53 points during the 12 months of 2022 to 31—the lowest since mid-2012 excluding a drop to 30 during the height of the pandemic. All three components of the confidence measure improved during the month.

Regional M-PMIs (*link*): Two Fed districts (New York and Philadelphia) have reported on *manufacturing activity* for January and show activity contracted for the sixth successive month to a 32-month low of -20.9, as activity in the New York (to -32.9 from -11.2) area deteriorated sharply, though was partly offset by a narrowing in the Philadelphia (-8.9 from -13.7) area's decline. *New orders* (-21.0 from -13.0) fell for the eighth month, sliding at its fastest pace since spring 2020, with billings in the New York region (-31.1 from -3.6) plunging, while Philadelphia's (-10.9 from -22.3) fell at half December's pace. *Employment* (6.9 from 6.6) held at a steady rate this month, as hirings in the Philadelphia (10.9 from -0.9) region swung from negative to positive, offsetting the slowdown in New York hirings (2.8 from 14.0) to a near standstill. Looking at *prices-paid* indexes, the New York measure is decelerating again after a brief acceleration, easing to 33.0 this month—its lowest since November 2020—and down sharply from its record-high 86.4 last April. Philadelphia's has been on a decelerating trend since reaching its cyclical high of 83.6 in November (which wasn't far from its record high of 91.1 in the 1970s), easing to a 29-month low of 24.5 this month. *Prices-received* indexes were mixed: New York's prices-received measure eased to 18.8, the lowest since January 2021, after a brief blip up; it was at a record high of 56.1 in March. The Philadelphia measure edged up from 28.1 (which was the lowest since March 2021) to 29.9 this month, down from its record high of 65.8 in November 2021.

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