MORNING BRIEFING
January 24, 2023

Market Timing

Check out the accompanying chart collection.

Executive Summary: Both the stock market's and the bond market's October bottoms have held so far—following the script we outlined as a possibility back that month. It involved moderating inflation, which we've seen, an end to Fed tightening, which we should see soon, and better GDP growth than we had expected, i.e., no landing so far. On the other hand, yesterday's LEI report suggests a hard landing, while the CEI suggests a soft landing. … Also: We share insights from market maven Joe Feshbach, who notes some auspicious signs in measures of breadth. … And: We look at some total-return statistics to emphasize the importance of dividends to returns.

Strategy I: Revisiting the Bottoms. During 2022, the S&P 500 bottomed on October 12, and the 10-year Treasury yield peaked on October 24. Our October 18, 2022 *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 also concluded that the June 16 low might provide support for the S&P 500 after all.

In the October 31, 2022 *Morning Briefing*, Joe and I wrote: "The stock market has been working on forming a bottom since September, finding support around the June 16 low of 3666 … That bottom should hold if real GDP growth, on a y/y basis, hovers between 0.5% and 1.5% through the first half of next year and then recovers to more normal growth during the second half of next year… In addition, it should hold if the Fed delivers two more hikes in the federal funds rate by the end of this year (as is widely expected) and then pauses rate-hiking during the first few months of next year. Furthermore, the bottom should hold if inflation shows clear signs of moderating in coming months, as we continue to expect."

How is this scenario working out? Consider the following:

(1) *Three hikes and a pause.* The Fed hiked the federal funds rate by 75bps on November 2 and 50bps on December 14 to a range of 4.25%-4.50%. It is widely expected that the Fed will increase the federal funds rate by 25bps at each of the next three meetings of the FOMC to 5.00%-5.25% (on February 1, March 22, and May 3) and then pause during the

June and July meetings.

(2) *The bond market dissents*. Interestingly, as the FOMC voted to raise the federal funds rate at each of its meetings last year, there were no dissenters on the committee. (See our searchable *archive* of FOMC statements since 1997.) However, the 2-year US Treasury yield started to dissent following the December 14 meeting. This yield has been a great leading indicator of the federal funds rate (*Fig. 1*). It anticipated the Fed's rate hikes last year by rising from 0.25% in mid-2021 to peak at 4.72% on November 7, 2022 (*Fig. 2*). Since then, it dropped to 4.14% last Friday.

The 2-year yield is clearly signaling that the end of the Fed's monetary policy tightening is near and that the federal funds rate won't stay above 5.00% for long, notwithstanding recent protestations by Fed officials that they have no intentions of lowering the federal funds rate this year. The widening inversion of the yield-curve spread also is at odds with the Fed's current official stance (*Fig. 3* and *Fig. 4*).

(3) *Inflation falling.* Inflation has moderated significantly in recent months. Leading the way higher during 2021 and 2022 was the durable goods inflation component of the CPI (*Fig. 5*). It peaked at a record 18.7% y/y during February 2022, falling to -0.1% during December. We've previously observed that durable goods prices have tended to fall since the mid-1990s until the recent pandemic-related spike. They could resume their deflationary tendency this year.

The CPI's nondurable goods inflation component also soared during 2020 and 2021, peaking at 16.2% during June 2022. It was down to 7.3% at the end of last year. It is volatile and hard to predict. Nevertheless, we predict that it will continue to moderate. Both petroleum and food prices are likely to remain high, but not likely to go higher this year.

That leaves us with CPI services inflation, which shows no sign of peaking, rising to 7.5% at the end of 2022. Actually, services inflation has peaked according to the final demand PPI for consumption services (*Fig. 6*). This series, which reflects the prices received by providers of consumer services, is down from a high of 8.1% during March 2022 to 4.4% at the end of the year. Unlike CPI services, the PPI for consumption services does not include rent, which tends to lag rents on new leases by 12-24 months; on new leases, rent inflation has been falling significantly in recent months (*Fig. 7*).

(4) *No landing so far.* So far, the economy has proven to be remarkably resilient in the face of the Fed's extraordinary tightening of monetary policy. Real GDP rose around 3% (saar)

during H2-2022. There was no landing last year. Yesterday's release of December's leading and coincident economic indicators (LEI and CEI) showed that the former fell 1.0% (down 6.0% since last February's record high), while the latter edged up 0.1% to a new record high, after no change in November (*Fig. 8*). Only the industrial production index contributed negatively to the CEI in December—the same as in November.

The LEI's weakness last year suggests a hard landing this year, but it might be partly attributable to its strength during 2021, when it was boosted by pandemic-related factors. In yesterday's *Morning Briefing*, we discussed a few other reasons why we aren't alarmed by the LEI's fall. The recent flattening of the CEI at a record-high level is consistent with our soft-landing scenario. On a y/y basis, the CEI was up 1.8% during December, also consistent with our soft-landing outlook (*Fig. 9*).

Strategy II: Two Tough Decisions. The problem with timing corrections and bear markets in stock prices is that it requires two great calls—namely, when to get out and when to get back in again. We've had more great calls calling bottoms than calling tops. Nevertheless, we tend to agree with both Warren Buffett and Jeremy Siegel that investors do best when they hold stocks for the long run. We don't mind being in the same camp with these two "permabulls."

Nevertheless, here are a few market-timing notions:

(1) *Feshbach's latest trading call.* One of the best market timers we know is Joe Feshbach. We were colleagues at Prudential-Bache Securities during the 1980s. I've been summarizing his views on a weekly basis since the beginning of last year. Here are his latest thoughts he shared with me, this past weekend:

"The good news is the market got bumpy as predicted, and it lasted a whole two days. The chart I've been alluding to still remains short-term bullish, and I still believe the S&P 500 has a shot at 4100+. However, the sentiment indicators are not great at this time, and thus that's all I see for this rally phase."

(2) *Great breadth*. Joe was impressed with Friday's rally "with great breadth." He likes to track the New York Stock Exchange's advance/decline lines by the number of securities (up or down) and by their volumes (up or down), as well as the ratio of the equal-weighted (EW) S&P 500 index to the market-cap-weighted (MW) index (*Fig. 10* and *Fig. 11*). The first two may be on the verge of breaking out to the upside of downward channels that started in 2021. The third ratio is at its highest since February 2019, a year before the pandemic

caused the ratio to plunge when the MegaCap-8 stocks outperformed for a short while (*Fig. 12*).

(3) *Don't forget about dividends!* Finally, Joe Abbott and I continue to work on comparing the relative returns of the S&P 500's EW and MW indexes. We've broadened our analysis to include the total return versions of the two (*Fig. 13*). Our preliminary conclusion is an obvious one: Don't forget about the positive contribution that dividends make to investing in stocks over the long run!

Over the short term, dividends may not be as important as getting the market-cap weighting right:

The S&P 500 LargeCap index is down 17.2% since last year's January 3 peak (through Friday's close). The total return index is down 15.7%. The LargeCap EW index is down 9.4%. The LargeCap EW total return index is down 7.6%. Diversification and dividends cushioned the downside.

Since last year's October 12 low, all have done well, some more than others: The S&P 500 is up 11.1% and the total return index is up 11.6%, while the EW index is up 15.2% and the EW total return index is up 15.8%.

Calendars

US: Tues: Richmond Fed Manufacturing Index -5; S&P Global M-PMI & NM-PMI Flash Estimates 46.2/45.0. Wed: MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: 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. **Wed:** Germany Ifo Business Climate Index Headline, Current Assessment & Expectations 90.2/95.0/85.0; UK Headline & Core PPI & Input & Output Prices -0.6%m/m/18.0%y/y & 0.3%m/m/16.4%y/y; Japan Leading Index; BOC Interest Rate Decision 4.50%; BOJ Summary Opinions; European Central Bank Non-Monetary Policy Meeting; Balz. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell w/w for all three of these indexes as analysts' revision activity began to accelerate with the release of Q4 results. LargeCap's dropped to a 48-week low and is down in 11 of the past 16 weeks. MidCap's fell to a 46-week low and has dropped in 16 of the past 18 weeks. SmallCap's was down to a four-week low, but that's not much above its 13-month low in mid-December. For a 30th straight week, none of these three indexes had forward earnings at a record high. However, forward earnings remains on a modest downtrend for these three indexes compared to their deep declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is 4.7% below its record high at the end of June; MidCap's is 7.1% below its record high in early June; and SmallCap's is 9.7% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was down to a 22-month low of 1.6% y/y; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of 3.4% y/y is near a 23-month low, down from a record high of 78.8% in May 2021, and compares to a record low of -32.7% in May 2020. SmallCap's rate of -1.2% y/y is at a 25-month low, down from a record high of 124.2% in June 2021. It had been at a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 have been heading lower since June. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (5.3%, 3.6%), MidCap (15.3, -5.1), and SmallCap (5.0, 2.8).

S&P 500/400/600 Valuation (*link*): Valuations edged lower w/w for these three indexes. LargeCap's forward P/E dropped less than 0.1pt to 17.4 from a six-week high to 0.3pt below its four-month high of 17.7 in early December. It's up 2.3pts from its 30-month low of 15.1 at the end of September, which compares to a four-month high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.1pt to 13.8 from a nine-month high of 13.9. That's up 2.7pts from a 30-month low of 11.1 at the end of September and compares to 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 dropped 0.2pt w/w to 13.2 from a nine-month high of 13.4. That's 2.6pts above its 14-year low of 10.6 at the end of September 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. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's current 21% discount to LargeCap is near its biggest since September 2000. SmallCap's current 24% 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 an 84th straight week; the current 4% discount is an improvement from its 9% discount in December 2021 but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. The S&P 500's earnings growth rate weakened q/q in Q3 to 4.0% y/y from 9.9% in Q2 on a frozen actual basis, and to 4.4% from 8.4% on a pro forma basis. Just four sectors recorded double- and triple-digit percentage growth in Q3-2022, two have a single-digit gain, and five have y/y declines. Looking ahead to Q4, analysts expect further deterioration; a 2.9% y/y decline is expected for the S&P 500, with just four sectors expected to record positive y/y earnings growth and seven expected to decline. Here are the S&P 500 sectors' latest expected earnings growth rates for Q4-2022 versus their Q3-2022 growth rates: Energy (61.0% in Q4-2022 versus 140.9% in Q3-2022), Industrials (42.3, 19.6), Real Estate (7.0, 14.8), Utilities (1.9, -7.1), Consumer Staples (-2.8, 1.3), S&P 500 (-2.9, 4.4), Health Care (-6.5, 1.5), Information Technology (-9.1, -0.2), Financials (-10.2, -16.4), Consumer Discretionary (-16.1, 13.3), Communication Services (-22.2, -26.1), and Materials (-22.3, -7.8).

US Economic Indicators

Leading Indicators (*link*): "The US LEI fell sharply again in December—continuing to signal recession for the US economy in the near term," according to the Conference Board. Leading indicators has dropped every month since reaching a record high last February (which matched December 2021's level), posting its biggest declines the last three months of 2022. The LEI contracted 1.0% last month following losses of 1.1% and 1.0% the prior two months, sinking 6.0% from its record high and posting its lowest level since February 2021. The yearly rate was the steepest since mid-2020, down from April 2021's recent peak of 11.8%. There was widespread weakness, with eight of the 10 components of the LEI falling last month; the only positive contributors were real core capital goods (+0.02ppt) and real consumer goods orders (+0.01). The biggest negative contributions were recorded by the new orders diffusion index (-0.23), consumer expectations (-0.19), the average workweek (-0.18), and jobless claims (-0.15), followed by the leading credit index (-0.09), interest-rate spread (-0.06), building permits (-0.05), and stock prices (-0.01).

Coincident Indicators (*link*): The Coincident Economic Index (CEI) hasn't posted a decline in six months, increasing 0.1% in December and 1.4% over the period, as the labor market-related indicators of employment and personal income both continued to reach new record highs. Three of the four components contributed positively to December's CEI: 1) *Real personal income less transfer payments (+0.08ppt)* was once again the biggest positive contributor in December, increasing the final six months of last year, by 0.3% in December and 1.6% over the period. 2) *Payroll employment (+0.05)* rose a larger-than-expected 223,000 (vs an estimated 202,000) in December, following gains of 256,000 and 263,000 the prior two months. For all of 2022, 4.5 million jobs were added, the second highest tally behind 2021's 6.7 million, as it recovered from the record job losses recorded during the height of the pandemic. 3) *Real manufacturing & trade sales (+0.04)* climbed 0.2% last month and 3.2% over the six months through December, to within a fraction (0.1%) of last January's record high. 4) *Industrial production (-0.14)* was a big drag on the CEI for the second month, slumping 0.7% m/m and 1.3% over the three months through December; it hasn't posted a gain since reaching a record high in September.

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