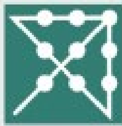
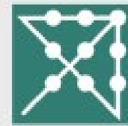
 Yardeni Research 

MORNING BRIEFING
February 8, 2023

The Third & Fourth Scenarios

Check out the accompanying chart collection.

Executive Summary: Strong economic releases last week raise new uncertainties for financial markets. No longer is the economic debate limited to the hard-or-soft-landing question. Two no-landing scenarios are in the running now—one bearish for stocks (if inflation can't be controlled) and one bullish (if inflation moderates). We still forecast a soft landing with moderating inflation, which would be bullish. Minneapolis Fed President Neel Kashkari seems to be concerned about the inflationary-no-landing scenario. … Also: Fixed-income markets have sent interest rates higher in response to the robust economic data. … And: A look at the European Central Bank's tightening course ahead.

The Fed I: The Plot Thickens. While we all have been debating whether the US economy will experience a soft landing or hard landing, the economy remains airborne. Last week's batch of economic indicators were consistent with the no-landing scenario, of which there are two versions. In the first version, the economy continues to grow and inflation continues to moderate. In the second scenario, the economy continues to grow, but inflation accelerates. We will spare you an exercise in assigning subjective probabilities to these four scenarios for now. We still think that the most likely scenario is a soft landing with moderating inflation.

For the stock market, the bullish scenarios are the soft-landing and no-landing scenarios if inflation continues to moderate in both. The hard-landing scenario would be bearish. Even more bearish would be the no-landing scenario with rebounding inflation. In that fourth scenario, the Fed would be forced to raise interest rates high enough to cause a recession to bring inflation down. Earnings and valuation multiples would be crushed, and stock prices would fall well below last year's October 12 low.

The fourth scenario, i.e., the inflationary no-landing one, seems to be especially worrisome to Minneapolis Federal Reserve President Neel Kashkari. On Tuesday morning, in a CNBC "Squawk Box" *interview*, he said: "We need to raise rates aggressively to put a ceiling on inflation, then let monetary policy work its way through the economy."

Kashkari added that the data "tells me that so far we're not seeing much of an imprint of our tightening to date on the labor market. There's some evidence that it's having some effect,

but it's pretty muted so far." Last week's batch of labor market indicators was strong, with payroll employment jumping 517,000 during January to yet another record high.

Kashkari concluded: "I haven't seen anything yet to lower my rate path, but I'm obviously keeping my eyes open and we'll see how the data comes in." He thinks that the terminal federal funds rate needs to be raised to 5.4%. The FOMC's December *Summary of Economic Projections* (SEP) showed that his colleagues on the committee see this rate at around 5.1%. That's not a big difference, but Kashkari is clearly willing to do more if the labor market remains strong. This year, Kashkari is a voting member of the FOMC, which sets the federal funds rate.

Fed Chair Jerome Powell, at his *press conference* last Wednesday, seemed to endorse the 5.1% terminal (or pause) target for the federal funds rate. He said that the FOMC will vote on "a couple of more rate hikes to get to that level we think is appropriately restrictive." That would put the federal funds rate range at 5.00%-5.25% by early May assuming (as Powell suggested) two more 25bps hikes at the next two FOMC meetings. The FOMC then intends to keep it there until inflation falls to 2.0%. Powell said that before Friday's employment report, which might have turned him more hawkish.

However, Powell didn't change his tune in his *interview* yesterday at the Economic Club of Washington, D.C., with Carlyle Group co-founder David Rubenstein. When asked about Friday's strong employment report, he said, "The reality is we're going to react to the data." He added, "So if we continue to get, for example, strong labor market reports or higher inflation reports, it may well be the case that we have do more and raise rates more than is priced in."

Regarding inflation, Powell said, "We expect 2023 to be a year of significant declines in inflation. It's actually our job to make sure that that's the case." He added, "My guess is it will take certainly into not just this year, but next year to get down close to 2%."

By the way, the FOMC's December SEP shows that the committee expected that the headline PCED inflation rate would fall from 5.6% last year to 3.1% this year, 2.5% next year, and 2.1% in 2025. They also expected that the federal funds rate would remain restrictive this year around 5.1%, but then would be gradually reduced to 4.1% next year and 3.1% in 2025. (See our *FOMC Economic Projections*.)

The Fed II: Interest Rates Rising. Last week's strong batch of economic indicators caused interest rates to move higher. Consider the following:

(1) *Cash yields.* The FOMC raised the federal funds rate range by 25bps on February 1 to 4.50%-4.75% (*Fig. 1*). That day, the yields on 2-year and 10-year Treasuries were 4.09% and 3.39%, On Monday, they were 4.44% and 3.63% (*Fig. 2*).

(2) *Futures.* Here are the federal funds futures on Wednesday and on Monday: nearby (4.57%, 4.84%), 3-month (4.78, 4.83), 6-month (4.89, 5.11), and 12-month (4.39, 4.79) (*Fig. 3*).

(3) *Yield curve.* The yield-curve spread between the 10-year and 2-year Treasuries widened from -70bps to -81bps from Wednesday through Monday (*Fig. 4*).

(4) *Bottom line.* On balance, we conclude from these numbers that fixed-income markets are more convinced that the terminal federal funds rate—at which the Fed's tightening stops—will be 5.25% and that the rate will get there within the next six months.

ECB: Staying the Course. On February 2, the European Central Bank (ECB) again increased its three key interest rates by 50bps (*Fig. 5*). And "expects to raise them further," said the monetary policy decision *statement*. Furthermore, the Governing Council "intends to raise interest rates by another 50 basis points at its next monetary policy meeting in March and it will then evaluate the subsequent path of its monetary policy."

And after March? Melissa and I think the ECB then may pause to consider future rate increases but still be tightening monetary policy via its balance-sheet reductions. In December, the ECB announced that it would reduce its holdings of bonds by €15 billion per month on average from the beginning of March until the end of June 2023. During the pandemic, the assets on the ECB's balance sheet grew by €4.1 trillion to a peak of €8.8 trillion. Through January, the assets totaled €7.9 trillion (*Fig. 6*).

Following the ECB's latest decision, ECB President Christine Lagarde spoke and took questions. She wasted no time plugging Next Generation EU, an EU-backed fiscal stimulus program in which maturing securities reinvestments on the ECB's balance sheet will target the building of climate-friendly infrastructure. The ECB is committed to promoting climate-friendly policies, she emphasized.

So far, the ECB has raised the interest rates on the main refinancing operations, the marginal lending facility, and the deposit facility five times by 300 basis points each since July 27, 2022 to 3.00%, 3.25%, and 2.50% from 0.00%, 0.25%, and -0.50%, respectively.

Over this period, Eurozone headline inflation fell from 8.9% y/y to 8.5% this January, according to the flash estimate, but not before peaking at 10.6% during October (*Fig. 7*). But that hasn't been entirely the work of the ECB, it has also been the work of the warmer weather and lower consumption leading to sharply dropping energy prices (*Fig. 8*).

Nonetheless, Lagarde stressed that the ECB is not bluffing about further restricting policy. Lagarde said: "Our determination to reach 2% medium-term inflation should not be doubted, and our determination to raise rates sufficiently significantly in order to move into restrictive territory should not be doubted." She pounded her fist on the table (figuratively), saying three times, "we are not done [tightening]."

We did hear a hint of impending dovishness near the end of the ECB president's presser when she said: "I'm not suggesting that [rate increases] will be [made at a] steady pace for an ongoing basis." As for increases after March, she said: "It might be 50, it might be 25 [basis points]."

Regarding inflation, Lagarde confirmed that headline inflation had fallen more than the ECB had expected, but added that "underlying inflation pressure is there, alive and kicking." She pinpointed three areas of domestic inflation and one international one of concern:

(1) *Energy.* "[E]nergy has been a key driver when inflation went up massively, and went far too high. It is still far too high, by the way. So, we have to look at energy costs, because it might transmit—and at which pace we don't know and we will be observing that very carefully—into underlying inflation elements."

(2) *Wages.* "Wages will be a significant component of inflation pressure in the months to come."

(3) *Fiscal.* "[O]n the fiscal front we have seen a lot of measures that were decided in part of the 2023 budgets of euro area members. Some of them are going to try to recalibrate; others might not." She added: "[T]he Eurogroup at finance ministers' level is … going to look at recommending recalibration, in order to make sure that fiscal support will be adjusted to the lower energy prices, which we do not see at the moment yet."

(4) *China.* "The consequences of the Chinese authorities' decision in December to do away with zero-COVID, to reopen the economy come what may, are going to come with consequences. Consequences on demand, consequences on demand addressed to the rest of the world, consequences on exports, but also consequences on the price of

commodities. If you start looking at the price of metals, in particular, there has already been an anticipation of how commodities are going to rise as a result of the Chinese reopening."

Calendars

US: Wed: Wholesale Sales & Inventories -0.3%/0.1%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; WASDE Report; Williams; Barr; Waller. **Thurs:** Initial & Continuous Jobless Claims 190k/1.658m; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: France Non-Farm Payrolls 0.2%q/q/; Italy Retail Sales -0.8%; UK RICS House Price Balance -45%; Australia Building Approvals; Elderson; Balz. **Thurs:** Germany CPI 0.8%m/m/8.9%y/y; Japan PPI 0.3%m/m/9.6%y/y; Japan Machine Tool Orders; China CPI 0.7%m/m/2.1%y/y; China PPI -0.5% y/y; RBA Monetary Policy; BOE MPC Treasury Committee Hearings; European Union Economic Forecasts; De Guindos; Nagel; Mauderer. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): Last Thursday, the S&P 500 Value price index hit a record high for the first time in just over a year. At the same time, the S&P 500 Growth index remained in a deep bear market at 25.5% below its record high. As of Monday's close, the S&P 500 Value index has soared 21.4% from its September 30 low and is just 2.1% below its February 2 record high. The S&P 500 Growth price index is up just 9.4% from its October 12 low and remains in a deep bear market, down 26.4% from its December 27, 2021 record high. Growth's underperformance relative to Value began on November 30, 2021 when their relative price index peaked at a record high. Since then, Value's price index has risen 6.4%, while Growth's is down 23.6%. Looking at their ytd performance through Monday's close, Growth is up 6.6%, behind the 7.5% gain for the S&P 500 Value index. Looking at the fundamentals, Growth is expected to deliver slower revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Growth has 1.9% forecasted for STRG and 0.0% for STEG, while Value has forecasted STRG and STEG of 3.1% and 7.0%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021 before tumbling 42% to a 33-month low of 17.6 on January 5. It was back up to 19.4 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 since has

risen to 17.1 as of Monday's close. Regarding NERI, Growth's and Value's were negative for a seventh straight month in January following 26 positive monthly readings. Growth's improved m/m for a second month to a four-month high of -10.04% from -16.5% in December. Value's NERI improved to -10.4% from a 30-month low of -14.8%. Growth's forward profit margin of 16.0% is down 3.1ppts from its record high of 19.1% in February 2022 and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 1.1ppt to 10.3% from its record high of 11.4% in December 2021.

Earnings Season Monitor (*link*): With the Q4-2022 earnings season now past the halfway mark, it's off to a poor start as assessed by the four surprise metrics we measure for both earnings and revenues. Revenue and earnings surprises are deteriorating q/q due to the slowing economy, higher costs, and currency translation. With over 54% of S&P 500 companies finished reporting for Q4, revenues are ahead of the consensus forecast by just 0.8%, and earnings have exceeded estimates by only 1.4%. The surprises are tracking to be the weakest since Q4-2008 for earnings and since Q1-2020 for revenues. At the same point during the Q3 season, revenues were 1.4% above forecast and earnings had beaten estimates by 3.9%. For the 254 companies that have reported Q4 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings of Q2-2021 to Q3-2022. The collective y/y revenue gain for the 272 reporters so far has slowed from double-digit percentage gains in the prior seven quarters to 5.2%, and earnings are down 1.9% y/y as higher costs and increased loan-loss provisions continue to pressure profit margins. Just 66% of the Q4 reporters so far has reported a positive revenue surprise, and 69% has beaten earnings forecasts. Those are the weakest readings since the Great Virus Crisis in H1-2020. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q4 (61%) than positive y/y revenue growth (71%). These figures will change markedly as more Q4-2022 results are reported in the coming weeks. While we expect y/y revenue growth rates to remain positive in Q4, earnings are expected to decline for the first time since Q2-2020.

US Economic Indicators

Merchandise Trade (*link*): The *real merchandise trade deficit* widened to $98.6 billion in December after narrowing from $112.4 billion in October to $96.1 billion in November; it was at a record-high $135.2 billion during March 2022. Real exports rose 1.6% in December after a three-month slide of 5.6%, while real imports rebounded 2.0% after plunging 7.3% in November. For all of 2022, real exports rose 5.9% while real imports advanced 6.5%.

Looking at *real exports* for the total year 2022, exports of nonfood consumer goods ex autos (8.4%) posted the biggest gain, followed by industrial supplies & materials (7.1), automotive vehicles, parts & engines (5.6), and capital goods ex autos (5.2), while foods, feeds & beverages (-4.4) was in the red. As for *real imports*, both automotive vehicle, parts & engines (11.0) and capital goods (10.0) imports posted double-digit gains during 2022, followed by nonfood consumer goods ex autos (7.5), foods, feeds & beverages (6.3), and industrial supplies & materials (1.8). In nominal terms, US merchandise trade topped $5 trillion last year for the first time, with total exports surpassing $2 trillion and imports surpassing $3 trillion.

Global Economic Indicators

Germany Industrial Production (*link*): Output posted its weakest performance in nine months as 2022 drew to an end, declining at more than four times the anticipated loss, as intermediate goods production tumbled. Germany's *headline production, which includes construction*, slumped 3.1% in December (vs a 0.7% expected decline), after a 0.4% gain and a 0.4% loss the previous two months. Meanwhile, *production excluding construction* (which the overall Eurozone uses) sank 2.1% following a 0.8% increase and a 0.9% decrease during November and October, respectively. Looking at the main industrial groupings, *output of intermediate goods* contracted in four of the final six months of last year, by a whopping 5.8% in December and 9.7% over the period, to its lowest level since July 2020, while *consumer durable goods production* plunged for the fourth successive month, by 1.2% m/m and 6.3% over the period, after climbing to its highest level since March 2019 in August. Meanwhile, *capital goods output* was unchanged in December after climbing seven of the prior eight months, by 14.1%, more than recovering from the 9.5% slump during the two months through March—with output holding at its highest level since November 2020. *Consumer nondurable goods production* edged higher for the second month in December, by a total of 0.7%, after dropping 3.4% in October; output was 1.7% below December 2021's level.

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