MORNING BRIEFING
February 13, 2023

Financial Conditions

Check out the accompanying chart collection.

Executive Summary: Perversely, the financial markets' vote of confidence in the Fed's ability to subdue inflation without getting the economy into trouble represents a threat to those very efforts, in Fed officials' eyes, loosening financial conditions as the Fed tightens them. So Fed officials have been trying to squelch investor optimism. … A close look at the data relevant to financial conditions reveals them as tight, but in a good way—tight enough to bring inflation down without a recession but not tight enough to provoke a credit crunch that results in a recession. We continue to stand behind our disinflationary soft-landing forecast. ... Also: Dr. Ed reviews the film "Mr. Jones" (+ + +).

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*.

The Fed I: Fighting the Markets. Fed officials have indicated that they'd rather see stock and bond prices fall than continue to rise, as they've been doing since October of last year. In their opinion, financial markets' strength has eased financial conditions in the economy, offsetting some of their efforts to tighten financial conditions to bring inflation down.

Joe and I question their logic. In our opinion, the drop in bond yields since late last year and the increasing inversion of the yield curve are suggesting that the Fed's monetary tightening policy is likely to work to bring inflation down without much further tightening. The same can be said about the stock market rally since October 12: It implies that investors believe that the federal funds rate is close to its terminal rate and that the Fed might succeed in bringing inflation down without causing a recession. If investors thought that the Fed's tightening had already set the stage for a recession, bond yields would continue to fall and so would stock prices.

In effect, Fed officials have been reminding investors of the adage "Don't fight the Fed." Rhetorically speaking, the Fed heads have been fighting the markets' optimism that the Fed can pull off a disinflationary soft landing. The Fed's campaign to squelch such optimism started early this year. Consider the following:

(1) During his November 2, 2022 *press conference*, Fed Chair Jerome Powell mentioned "financial conditions" 10 times in the context that they were sufficiently tight. For example, he said, "Financial conditions have tightened significantly in response to our policy actions, and we are seeing the effects on demand in the most interest-rate-sensitive sectors of the economy, such as housing. It will take time, however, for the full effects of monetary restraint to be realized, especially on inflation."

Powell said that in the past monetary policy worked with "long and variable lags" and that it worked first on financial conditions, then the economy, and "perhaps later than that even on inflation." What he didn't say is that very often in the past, Fed tightening triggered a credit crunch, which caused a recession that brought down inflation. In any event, he suggested that the lags might be shorter because "financial conditions react well before in expectation of monetary policy [actions]."

(2) During his December 14 *presser*, Powell said that "it is important that over time" financial conditions "reflect the policy restraint that we are putting in place to return inflation to 2 percent." CNBC's Steve Liesman directly asked Powell whether the rallies in the bond and stock markets since the November meeting had eased financial conditions and impeded the Fed's effort to bring down inflation. Powell didn't directly answer the question but reiterated that monetary policy works through financial conditions.

(3) During his February 1 *presser*, Powell also reiterated a point that he had made at his previous one: "[F]inancial conditions have tightened very significantly over the past year. I would say that our focus is not on short-term moves but on sustained changes to broader financial conditions." That implied that he wasn't overly concerned about the rallies in the stock and bond markets.

At this same presser, Greg Robb of MarketWatch noted that the December FOMC *minutes* released on January 4 implied that these rallies were of concern to the committee: "Participants noted that, because monetary policy worked importantly through financial markets, an unwarranted easing in financial conditions, especially if driven by a misperception by the public of the Committee's reaction function, would complicate the Committee's effort to restore price stability."

At first, Powell punted saying, "It's something we monitor carefully." But then he said, "It's important that the markets do reflect the tightening that we're putting in place. As we've discussed a couple of times here, there's a difference in perspective by some market measures on how fast inflation will come down. We're just going to have to see. I mean, I'm not going to try to persuade people to have a different forecast, but our forecast is that it will take some time and some patience and that we'll need to keep rates higher for longer. But we'll see."

(4) In a live *interview* at *The Wall Street Journal*'s CFO Network Summit in New York on February 8, Federal Reserve Bank of New York President John Williams warned, "So looser financial conditions or more supportive financial conditions ... might imply a higher interest rate to make sure that we're getting to the goals that we're trying to achieve."

We have been warned.

The Fed II: Assessing Financial Conditions. Now let's assess the current state of financial conditions. Frankly, we aren't big fans of indexes that purport to measure whether conditions are easy or tight. We much prefer to look at the trees than at the forest in this case. We all know when credit is easy to get and when it is getting harder to get. We are almost always surprised when it suddenly becomes almost impossible to get credit even for borrowers with good credit histories. So let's have a look at some trees:

(1) *Yield-curve spreads.* In the past, we've often tracked the yield-curve spread as a useful measure for assessing credit conditions. In our 2019 study *The Yield Curve: What Is It Really Predicting?*, Melissa and I concluded that inverted yield curves predicted that if the Fed continued to tighten monetary policy by raising the federal funds rate, something would break in the financial system. Sure enough, in the past financial crises occurred soon after yield-curve inversions. Often, they would morph into a widespread credit crunch and a recession, forcing the Fed to reverse course and lower the federal funds rate.

Since the mid-1960s, financial crises occurred at or just before the peaks in the federal funds rate (*Fig. 1*). The yield curve inverted before the crises as well, with the spread between the federal funds rate and the 10-year Treasury yield at its most negative reading just when the crises occurred and marking the end of the tightening cycles (*Fig. 2*).

Melissa and I prefer to monitor the yield spread between the 2-year and 10-year Treasuries, but it is only available since 1976, so it misses the 1970 Penn Central crisis and the 1974 Franklin National Bank crisis (*Fig. 3*). The spread is currently -80bps, which is the most negative since the early 1980s. It first inverted last summer. In the past, inversions occurred near the end of Fed tightening cycles when the 2-year yield rose above the 10-year yield, then both fell in unison for a short while before the 2-year's fall outpaced that of the 10-year (

The yield curve is currently signaling that financial conditions are very tight. However, so far, the recent financial crises have been minor ones (including last year's cryptocurrency, SPAC, and ARKK crashes), and they certainly haven't triggered a credit crunch. That's because the epicenter of previous financial crises tended to be financial intermediaries. However, since the Great Financial Crisis, financial institutions have been more tightly regulated and closely supervised by government regulators.

This raises an interesting question: If there is no credit crunch and therefore no recession just ahead, will the Fed have to raise interest rates much higher to subdue inflation? We think not, as we think inflation is already moderating sufficiently to reduce the risk of the inflationary no-landing scenario. However, the possibility of that scenario does pose risk to our disinflationary soft-landing scenario. That's why we are still assigning a 40% subjective probability to a hard landing and 60% to a soft landing.

(2) *Credit spreads.* Another widely followed indicator of financial conditions is the yield spread between the high-yield corporate bond composite and the 10-year Treasury (*Fig. 5*). It and other credit-quality spreads tend to widen rapidly during credit crunches and recessions. Unlike the yield spread, however, the credit-quality spreads are coincident rather than leading indicators of trouble. In any event, while credit-quality spreads were widening moderately during H1-2022, they've been narrowing since mid-2022.

On the other hand, the spread between the 30-year mortgage rate and the 10-year Treasury yield widened dramatically during 2022, by 130bps from 169bps at the start of the year to 299bps at the end of the year (*Fig. 6*). However, that didn't reflect a credit-quality issue but rather the January 5, 2022 release of the December 2021 FOMC *minutes*, which suggested that the Fed was set on tapering its holdings of mortgage-backed securities down to zero over the next few years. The Fed intends to get out of the mortgage lending business. The spread has narrowed since the end of October, by 15bps through Thursday.

(3) *Interest rates.* Of course, any doubt that financial conditions have tightened dramatically since early 2022 is easily challenged by looking at key interest-rate levels at the start of last year compared to where they currently stand: federal funds (0.13%, 4.63%), 2-year Treasury (0.78, 4.50), 10-year Treasury (1.63, 3.74), 30-year mortgage (3.32, 6.69), BAA-rated seasoned corporate bonds (3.63, 5.48), and high-yield corporate bonds (4.42, 8.03).

(4) *Loans.* There's certainly no sign of a widespread credit crunch in lending to businesses and consumers. Commercial and industrial loans are up 14.4% y/y (or $357 billion) through the February 1 week (*Fig. 7*). Nonfinancial commercial paper is up 27.4% y/y through the

February 8 week. Consumer credit rose 7.8% y/y ($345 billion) to a record $4.8 trillion through December (*Fig. 8*). On the other hand, mortgage applications to purchase a home are down 35.1% y/y through the February 3 week, based on the four-week average (*Fig. 9*).

Loans and leases at all commercial banks are up $1.3 trillion y/y to a record $12.1 trillion during the February 1 week (*Fig. 10*).

(5) *Bank surveys.* Credit has been expanding even though lending officers at major banks have told the Fed that they tightened their lending standards during last year's final three months and saw demand fall as a result across a wide array of business and consumer credit fronts. The Fed reported these findings in its January *Senior Loan Officer Opinion Survey*.

The net percent of domestic survey respondents saying that lending standards tightened for C&I loans was 44.8%, while demand for those loans reportedly was as weak as during the 2020 lockdown (*Fig. 11*). Standards for commercial real estate loans were tightened according to 61.1% of respondents, while demand for such loans was weaker according to 59.8% (*Fig. 12* and *Fig. 13*). Demand for residential mortgage loans is the weakest on record (starting in 1990) according to 88.0% of respondents (*Fig. 14*). Standards on credit cards and auto loans also have been tightened (*Fig. 15*).

(6) *Small business survey.* The NFIB survey of small business owners found that the net percent reporting that "credit was harder to get than last time" rose to just 7% during December, but that's up from around 2% from 2020 to 2021 (*Fig. 16*). Interestingly, only 3% of small business owners said that their most important problem is financial and interest rates (*Fig. 17*). The number-one problem cited for 32% of them was inflation.

(7) *Bond & stock issuance.* Financial conditions certainly have tightened in the markets for new US corporate securities issues. On a 12-month sum basis, gross bond issuance by nonfinancial corporations plunged from a record $1.48 trillion through February 2021 to $562 billion through December of last year (*Fig. 18*). Bond issuance by financial corporations totaled $894 billion through December, down from a recent peak of $1.28 trillion through February 2022. Stock issuance tanked from a record $475 billion through April 2021 to just $71 billion through December 2022.

(8) *The dollar.* Fed officials also have mentioned the foreign exchange value of the dollar as a variable that they monitor to assess financial conditions. A strong (weak) dollar is deemed to be a sign of tight (easy) financial conditions. During 2022, the trade-weighted dollar rose

12.2% from the start of the year through its record high on October 19 (*Fig. 19*). Since that peak, it is down 6.6% through Friday. We've previously observed that the dollar's strength or weakness has more to do with the relative strength or weakness of the global economy outside the US.

(9) *Bottom line.* Our relatively thorough examination of financial conditions suggests that they are tight, but not as tight as would occur during a credit crunch. In our opinion, they are tight enough to bring inflation down without a recession. If Fed officials come to think otherwise, then they would continue to raise interest rates until something breaks in the financial system, causing a credit crunch and a recession. That's not our forecast, but the prospect of it is a risk to our outlook.

Movie. "Mr. Jones" (+ + +) (*link*) is a 2019 film based on real events. Gareth Jones was a Welsh investigative reporter who visited the Soviet Union and surreptitiously traveled to Soviet Ukraine, where he witnessed the *Holodomor,* a man-made famine in the grain-growing region from 1932 to 1933 that killed as many as five million Ukrainians. Stalin subjected them to collectivization and unreasonably high grain quotas, which caused the famine. "*Holodomor*" literally translated from Ukrainian means "death by hunger." The film also focuses on Walter Duranty, who was *The New York Times*' man in Moscow at the time. He won the 1932 Pulitzer Prize for 13 articles written in 1931 analyzing the Soviet Union under Stalin. His reporting was mostly favorable, taking Soviet propaganda at face value. He wrote glowing reports of Stalin's harsh plans for Ukraine and sought to discredit the reporting by Jones. "He was not only the greatest liar among the journalists in Moscow, but he was the greatest liar of any journalist that I ever met in 50 years of journalism," said the late Malcolm Muggeridge in 1982. George Orwell was inspired by Jones to write *Animal Farm*.

Calendars

US: Mon: Consumer Inflation Expectations; Bowman. **Tues:** Headline & Core CPI 0.4%m/m/6.2%y/y & 0.4%m/m/5.5%y/y; NFIB Small Business Optimism 90.9; API Weekly Crude Oil Inventories; OPEC Monthly Report; Williams; Harker; Logan. (Bloomberg estimates)

Global: Mon: Germany Current Account; Australia Westpac Consumer Sentiment; Australia NAB Business Confidence; Japan GDP 0.5%q/q/2.0%y/y; Japan Industrial Production -0.1%; Eurogroup Meetings. **Tues:** Eurozone GDP 0.1%q/q/1.9%y/y; Eurozone

Employment Change; Germany WPI 1.2%; France Unemployment Rate 7.3%; UK Average Earnings Index Including & Excluding Bonus 6.2% & 6.5% y/y; UK Claimant Change 17.9k UK Employment Change 3m/3m 40k; UK Unemployment Rate 3.7%; UK Labor Productivity; Lowe. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index fell 1.2% w/w for its first decline in five weeks, but remained out of a bear market at 15.9% below its record high on December 27, 2021. The US MSCI ranked 20th of the 48 global stock markets that we follow in a week when 11 of the 48 countries rose in US dollar terms. The AC World ex-US index fell 1.7%, but remained out of a bear market at 16.4% below its June 15, 2021 record high. EAFE was the best regional performer, albeit with a decline of 1.6%, and was the only region ahead of the AC World ex-US. EM Eastern Europe was the worst performing region last week with a decline of 3.4%, followed by EMU (-3.2%), EMEA (-2.4), EM Latin America (-2.4), BIC (-2.3), and EM Asia (-2.3). Egypt was the best-performing country last week, with a gain of 13.2%, followed by Pakistan (11.3), Morocco (3.3), Greece (3.0), and Norway (2.9). Among the 64 countries that underperformed the AC World ex-US MSCI last week, Turkey's 9.9% decline was the biggest, followed by those of Poland (-5.8), Ireland (-5.6), South Africa (-5.1), and the Netherlands (-4.9). Looking at 2023's performance so far, the US MSCI is up 6.8% and ranks 24/48 as just eight of the 48 countries are down ytd. The AC World ex-US has risen 7.0% ytd, with nearly all regions in positive territory. EMU is the best performer ytd, with a gain of 10.4%, followed by EM Asia (7.3) and EAFE (7.3). The regional laggards so far in 2023: EMEA (-0.8), EM Latin America (3.5), BIC (3.9), and EM Eastern Europe (5.3). This year's best ytd country performers: the Czech Republic (23.8), Greece (18.1), Taiwan (15.2), Italy (13.4), and the Netherlands (13.2). Here are the worst-performing countries of the year so far: Turkey (-15.3), Pakistan (-8.6), India (-3.9), Colombia (-3.1), and Portugal (-2.2).

S&P 500/400/600 Performance (*link*): All three of these indexes fell for just the second time in six weeks as MidCap stayed out of correction territory for a second straight week. LargeCap fell 1.1% w/w, less than the 2.5% and 3.0% declines recorded for MidCap and SmallCap. At the week's end, LargeCap finished at 14.7% below its record high on January 3, 2022, MidCap at 9.3% below its record high on November 16, 2021, and SmallCap at 13.7% below its November 8, 2021 record high. Just three of the 33 LargeCap and SMidCap sectors moved higher for the week, down from 28 rising a week earlier. LargeCap Energy was the best performer, with an increase of 5.0%, followed by MidCap Energy

(3.7%), SmallCap Energy (1.8), LargeCap Health Care (-0.2), LargeCap Utilities (-0.4), and LargeCap Financials (-0.4). Among the worst performers for the week were LargeCap Communication Services (-6.6), followed by MidCap Consumer Discretionary (-6.1), SmallCap Materials (-5.4), SmallCap Communication Services (-5.0), and SmallCap Consumer Discretionary (-4.8). Looking at performances so far in 2023, LargeCap's 6.5% gain is trailing the advances of SmallCap (9.3) and MidCap (8.6), and 28 of the 33 sectors are higher ytd. The top sector performers in 2023: SmallCap Communication Services (17.3), SmallCap Consumer Discretionary (16.9), MidCap Tech (14.6), LargeCap Consumer Discretionary (14.4), and MidCap Communication Services (13.3). Here are 2023's biggest laggards: LargeCap Utilities (-4.1), LargeCap Health Care (-2.7), LargeCap Consumer Staples (-2.1), SmallCap Utilities (-1.1), and MidCap Utilities (-0.6).

S&P 500 Sectors and Industries Performance (*link*): Just one of the 11 S&P 500 sectors rose last week, but seven outperformed the composite index's 1.1% decline. That compares to a 1.6% gain for the S&P 500 a week earlier, when seven sectors rose and four outperformed the index. Energy was the best performer, with a gain of 5.0%, followed by Health Care (-0.2%), Utilities (-0.4), Financials (-0.4), Consumer Staples (-0.5), Industrials (-0.7), and Tech (-1.1). Communication Services was the worst performer, with a decline of 6.6%, followed by Consumer Discretionary (-2.2), Real Estate (-2.0), and Materials (-1.7). Looking at 2023's performance so far, the S&P 500 is up 6.5% ytd with four sectors outperforming the index and eight higher for the year. The best ytd performers: Consumer Discretionary (14.4), Communication Services (12.9), Tech (12.7), and Real Estate (8.6). These are 2023's worst performers: Utilities (-4.1), Health Care (-2.7), Consumer Staples (-2.1), Energy (2.9), Industrials (3.9), Materials (5.6), and Financials (6.4).

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), though stayed above them for a fifth week. That's the index's longest positive 200-dma streak since the 81-week-long one that ended February 2021. The S&P 500's 50-dma dropped to 3.3% above its rising 50-dma from an eight-week high of 4.7% above its rising 50-dma a week earlier. That compares to a four-month 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 4.0% above its now-falling 200-dma, down from a 13-month high of 5.1% above its rising 200-dma a week earlier. The 200-dma had risen w/w a week earlier for the first time in 39 weeks. Still, the S&P 500 is well above its 26-month low of 17.1% below its falling 200-dma in mid-June and compares to 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.

S&P 500 Sectors Technical Indicators (*link*): Eight of the 11 S&P 500 sectors are trading above their 50-dmas, up from seven above a week earlier. Energy moved back above in the latest week, leaving these three sectors still trading below their 50-dma: Consumer Staples, Health Care, and Utilities. Seven sectors have a rising 50-dma now, unchanged from a week earlier. Energy's 50-dma turned up w/w, and Materials turned down and joined Consumer Staples, Health Care, and Utilities in the falling-50-dma club. Looking at the more stable longer-term 200-dmas, ten sectors remained above in the latest week—the lowest count in nine months. Only Utilities is still below that measure. The rising 200-dma club has four members now, unchanged from a week earlier and contains Energy, Financials, Health Care, and Industrials.

US Economic Indicators

Consumer Sentiment Index (*link*): Consumer sentiment continued to improve in mid-February, climbing for the seventh time in eight months, with sentiment 6% above a year ago though still 14% below two years ago. Latest data show *overall consumer sentiment* advanced from 50.0 last June to 66.4 this month—the highest since the start of last year. The *present situation component* increased 4.2 points this month and 18.8 points over the eight months through mid-February to 72.6, while the *expectations component* dipped 0.4 point this month to 62.3 after climbing the prior two months, by 7.1 points, to 62.6. Joanne Hsu, director of the survey, warned: "Overall high prices continue to weigh on consumers despite the recent moderation in inflation, and sentiment remains more than 22% below its historical average since 1978." The *one-year expected inflation rate* climbed to 4.2% in mid-February after falling from 5.0% in October to 3.9% by January. Meanwhile, the *five-year expected inflation rate* was unchanged at 2.9% for the third successive month—remaining within the narrow 2.9% to 3.1% range during 18 of the last 19 months—above its 2.2%-2.6% range seen in the two years pre-pandemic.

Global Economic Indicators

UK GDP (*link*): Real GDP in December contracted 0.5% after gains of 0.1% and 0.5% the previous two months, with growth flat during the three months through December. The *service sector* led December's decline, contracting 0.8%, erasing the 0.8% gain the prior two months, while production rose 0.3% and construction output was unchanged during the month. *Within services*, the largest declines occurred in arts, entertainment & recreation (-7.8%), transport & storage (-3.1), human health activities (-2.8), and education (-2.6). The report notes than output in consumer-facing services fell 1.2% during the final month of 2022 after expanding an upwardly revised 0.4% during November. *Industrial* output climbed the final three months of 2022, after not posing a gain the first nine months of the year, rising 0.3% in December and 0.6% over the period. *Manufacturing* production was flat in December, following a 0.6% loss and a 0.9% gain the prior two months, falling 5.7% y/y . As for the *main industrial sectors* on a y/y basis, consumer durable (-8.6%) goods posted the largest decline, followed by consumer nondurable (-6.9) goods, intermediate (-6.7) goods, and capital (-3.5) goods—with the latter increasing the final three months of last year.

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