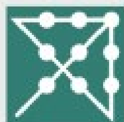
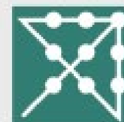
 Yardeni Research 

MORNING BRIEFING
February 14, 2023

Guides to Inflation & the Economy

Check out the accompanying chart collection.

Executive Summary: How investors interpret this morning's CPI release for January could move the markets; but assessing what the data say about inflation's stickiness may be tricky given BLS's new CPI calculation methodology. All eyes will be on services inflation in particular since it hasn't yet peaked, buoyed by wage inflation. … The long-running hard-vs-soft-landing economic debate now includes a no-landing prospect, which itself has two scenarios—an inflationary version (possibly the long route to a hard landing?) and a disinflationary one. The latter would be ideal, and we think it's possible. … Also: The economies of Europe and China both dodged bullets this winter, to widespread surprise.

Inflation Guide: Valentine's Day Massacre? Have you heard? January's CPI will be released this morning at 8:30 a.m. A bad number could result in a Valentine's Day Massacre in the bond and stock markets. A good number would allow investors who own bonds and stocks to share their joy (along with a bouquet of flowers and a box of chocolates) with their significant others.

Everyone in our business will be holding their breath. Will the number confirm that disinflation is spreading, or will it show that inflation is sticky? Debbie and I are in the disinflation camp. We're holding our breath simply because month-to-month changes in the CPI tend to be volatile and less predictable than usual. Today's number is especially tricky to forecast—and will be tricky to assess once it comes out—because the Bureau of Labor Statistics (BLS) started out the new year with new seasonal adjustment factors and new weights for the components of the CPI. Here are some things to watch out for:

(1) *Good vs bad numbers.* What numbers have been discounted by the financial markets for January's CPI? The Bloomberg consensus is that the headline and core CPI inflation rates will be 0.5% and 0.4%, respectively. Those prints will be compared to December's 0.1% and 0.4%.

More important will be the y/y comparisons since they will more clearly show whether inflation is continuing to moderate or not. The y/y consensus forecasts for January's headline and core CPI inflation rates are 6.2% and 5.5% versus 6.5% and 5.7% in December (*Fig. 1*). If those estimates are on target, the markets should remain calm and

move on to the next BIG number, i.e., February's payroll employment, which will be released on March 3.

(2) *Seasonal adjustments.* December's CPI inflation readings of 0.1% and 0.4% were upwardly revised from -0.1% and 0.3% by the BLS on Friday. October and November were also revised higher. These revisions were attributable to new seasonal adjustment factors. So the y/y comparisons remained the same. Nevertheless, there was some Internet buzz that the revisions were a major setback for the disinflation story. That's not correct given that the y/y comparisons didn't change, as noted above.

(3) *New weights.* Starting with the January 2023 data, the BLS plans to update the weights of the CPI's components annually based on a single calendar year's worth of data, using consumer expenditure data from 2021. This reflects a change from its prior practice of updating weights biennially using two years' worth of expenditure data. Debbie and I will have a look and let you know if we find anything worth mentioning.

(4) *Goods vs services.* We noted in the February 6 *Morning Briefing* that the word "disinflation" was uttered 11 times at Fed Chair Jerome Powell's *press conference* on February 1. He was the only one who mentioned the word at his presser. He repeatedly acknowledged that inflation was moderating but still had a ways to go before reaching the Fed's 2.0% target. Nevertheless, Powell sounded much less hawkish than during his previous presser on December 14, 2022, when the word was mentioned only twice, both times by reporters.

Powell explained that while goods prices clearly have disinflated, inflationary pressures have remained too high in services. Indeed, the headline and core CPI goods inflation rates peaked at 14.2% y/y and 12.3%, respectively, during March and February 2022 (*Fig. 2*). They were down to 4.8% and 2.1% during December.

The headline and core CPI services inflation rates have yet to peak. They were 7.5% and 7.0% during December (*Fig. 3*). Fed officials have acknowledged that the rent components of the services CPI are lagging indicators because they reflect rents of all current leases. Rents for tenant and owners' occupied residences in the CPI rose 8.3% y/y and 7.5% during December (*Fig. 4*). Meanwhile, newly signed leases have been showing significant disinflation since the start of last year (*Fig. 5*).

As a result, all eyes will be on the core CPI services excluding shelter inflation rate coming out tomorrow (*Fig. 6*). It might give us a clue about the core PCED services excluding

housing inflation rate, which has become the new obsession for Fed officials. It has been stalled around 4.0%-5.0% y/y for the past year. However, the CPI version clearly peaked last February at 7.6% y/y and has been falling since, to 4.4% during December.

(5) *Wage inflation.* Powell recently observed that core services-providing industries excluding housing are more labor intensive than are goods-producing industries. He concluded that it might be harder and take longer to bring inflation down in the former than in the latter because wage inflation tends to be sticker than inflation in most prices. He might be right. However, the data show that average hourly earnings (AHE) of all workers in private services-providing industries peaked at 6.1% y/y during March 2022 and fell to 4.5% by January. So far, this wage disinflation seems to have brought down the core CPI excluding shelter inflation rate more than it has the comparable PCED inflation rate (*Fig. 7* and *Fig. 8*).

Interestingly, the AHE data for production and nonsupervisory workers actually show that wage inflation has moderated significantly in services-providing industries—from last year's June peak of 7.3% to 5.0% by January 2023—while wage inflation has been stuck just south of 6.0% for goods-producing industries over the same period. For all workers, wage inflation has disinflated in both goods-producing and services-providing industries (*Fig. 9* and *Fig. 10*).

(6) *Real interest rates.* Real interest rates have increased significantly in recent months as a result of the surge in the federal funds rate and in the 10-year US Treasury bond yield along with the disinflation in the CPI since last summer (*Fig. 11*, *Fig. 12*, *Fig. 13*, and *Fig. 14*). The real federal funds rate is up from a record low of -8.3% during March 2022 of last year to -2.4% during December. The real 10-year US Treasury bond yield is up from -6.4% during March 2022 to -2.8% during December.

(7) *Inflationary expectations.* Real rates actually are positive now if we use the three-years-ahead inflation expectations data collected by the Federal Reserve Bank of New York (*Fig. 15*). It was down to 2.7% during January, the lowest since October 2020. That's well below December's 6.5% headline CPI inflation rate. It is also below the current readings of the federal funds rate (4.75%), the 2-year Treasury (4.52%), and the 10-year Treasury (3.72%).

US Economy Guide: Landings or No Landing? The debate over a soft versus hard landing of the US economy landed in a *WSJ* *article* fittingly titled "Hard or Soft Landing? Some Economists See Neither if Growth Accelerates" and dated February 12, 2023. Debbie and I have discussed this issue in recent weeks, observing that while the debate has been

raging about soft or hard landings, the economy remains airborne and shows few signs of actually landing. Here is what we wrote in the January 3 *Morning Briefing*:

"In recent months, the economic indicators have supported the 'no-landing' scenario rather than either the hard-landing or soft-landing alternatives. Surprisingly resilient economic growth might cause inflation to persist at high levels rather than to moderate. If so, the Fed will have no choice but to hike the federal funds rate higher for longer. The narrowing path to a soft landing would no longer be an option for the Fed. Instead, Fed officials likely would conclude that the only way to bring inflation down is by causing a recession. In this scenario, they might have to raise the federal funds rate much closer to the inflation rate (or even above it) until that does the job."

In other words, the inflationary no-landing scenario may turn out to be the long way to a hard landing. That leaves the question of whether a disinflationary no-landing scenario is possible. We think it is. We think that the economy has been in a "rolling recession" since the start of 2022. We first started to write about this scenario in the August 16, 2022 *Morning Briefing*: "It's possible that we might all collectively talk ourselves into a recession. It's also possible that we are all hunkering down just enough that any recession will be mild since there won't be too many excesses to worsen it. The downturn could be what we've called a 'rolling recession' during the mid-1980s for the US."

Housing fell into a recession in early 2022 as the 30-year mortgage rate soared from 3.32% at the start of the year to peak at 7.41% on November 3 of that year. It is now showing signs of bottoming, as lower home prices and a slight easing of mortgage rates have boosted affordability.

Consumer spending on goods has been flat since mid-2021 following the post-lockdown buying binge. As a result, goods-providers were stuck with inventories that had to be discounted to be sold. Meanwhile, consumers have been increasing their spending on services.

Technology industries went on a hiring spree during the pandemic, expecting to be among the few beneficiaries of the calamity. They are now paring their bloated payrolls. So far, these cuts have been too small to boost overall initial unemployment claims, which remain historically low.

Global Economy Guide: A World of Less Trouble? While the US economic outlook has been a source of dissention since early last year, few disagreed last summer that both

Europe and China would be in recessions by now. Europe was expected to go dark and freeze during the winter months because of a shortage of natural gas resulting from Russia's attack on Ukraine. China's recession was expected to result from the government's zero-Covid lockdowns. Instead, Europe succeeded in finding other sources of natural gas and Beijing simply ended its Covid restrictions.

Here are some recent relevant developments in Europe and China:

(1) *Europe.* The Economic Sentiment Indicator for the Eurozone fell below 100 last year during July and fell to a low of 93.7 during October (*Fig. 16*). That suggested that real GDP could be headed for a hard landing. However, the index has recovered since then back to 99.9 in January, consistent with a soft landing.

(2) *China.* The Chinese government not only reversed course on its zero-Covid policy but also refocused on stimulating the economy. That's evident in January's bank loans, which increased by a record $725.3 billion during the month (*Fig. 17*). That isn't an annualized number: It's what was lent in one month!

Calendars

US: **Tues:** Headline & Core CPI 0.5%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. **Wed:** Retail Sales Headline, Core, and Control Group 1.8%/0.8%/0.8%; Business Inventories 0.3%; Empire State Manufacturing Index -17.75; Headline & Manufacturing Industrial Production 0.5%/0.8%; Capacity Utilization Rate 79.0%; NAHB Housing Market Index 37; TIC Net Long-Term Transactions; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: **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. **Wed:** Eurozone Industrial Production -0.8%m/m/-0.7%y/y; Eurozone Trade Balance –€12.5b; Spain CPI -0.3%m/m/5.8%y/y; UK Headline & Core CPI 0.4%m/m/10.3%y/y & -0.5%m/m/6.2%y/y; ; UK PPI Input & Output 0.2%m/m/14.7%y/y & 0.1%m/m/13.3%y/y; Japan Core Machinery Orders 3.0%m/m/-6.0%y/y; Japan Adjusted Trade Balance; Japan Exports & Imports 0.8%/18.4% y/y; Australia Employment Change 20k; Australia Unemployment &

Participation Rates 3.5%/66.6%; Lagarde. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell for a fifth straight week for two of these indexes as analysts' revision activity remains elevated following the release of Q4 results. Through the week ending February 9, LargeCap's forward earnings dropped to a 54-week low and is down in 14 of the past 19 weeks. MidCap's fell to a 51-week low and has dropped in 19 of the past 21 weeks. SmallCap's rose for the first time in five weeks from a 65-week low, but is down in 16 of the past 19 weeks. For a 33rd 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 5.8% below its record high at the end of June; MidCap's is 8.0% below its record high in early June; and SmallCap's is 9.5% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings turned negative w/w, falling to a 23-month low of -0.6% 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 1.7% y/y is at a 24-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 -2.2% y/y is up from a 26-month low of -2.7% a week earlier, but that's 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, 2023, and 2024: LargeCap (5.5%, 1.5%, and 11.9%), MidCap (15.7, -7.0, 12.7), and SmallCap (6.3, 0.8, 15.7).

S&P 500/400/600 Valuation (*link*): Valuations fell w/w for these three indexes through the February 10 week from multi-month highs a week earlier. LargeCap's forward P/E edged down 0.1pt to 18.1 from a nine-month high of 18.2. It's up 3.0pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.4pt to 14.3 from a 10-month high of 14.7. 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 fell 0.6pt w/w to 13.7 from a 12-month high of 14.3. That's 3.1pts 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 P/E relative to LargeCap's has improved from a 23-year-low 28% discount last July to a 21% discount, which is near its best reading in 15 months. SmallCap's discount has improved from a 21-year low of 32% last April to 25% last week; that's near its lowest discount in 18 months. 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 87th straight week; the current 5% discount is near its lowest in five months and an improvement from its 20-year low 9% discount in December 2021.

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. Analysts expect the S&P 500's earnings growth rate to weaken q/q in Q4 to -1.1% y/y from 4.0% in Q3 on a frozen actual basis and to -2.8% from 4.4% on a pro forma basis. Just four sectors are expected to record positive y/y percentage earnings growth in Q1-2023 and Q4-2022, down from five sectors doing so in Q3. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2023 versus their blended Q4-2022 growth rates: Consumer Discretionary (32.7% in Q1-2023 versus -17.0% in Q4-2022), Energy (18.8, 59.6), Industrials (18.5, 40.5), Financials (5.4, -10.8), Consumer Staples (-2.6, -2.2), Real Estate (-5.8, 7.8), Utilities (-8.6, 5.0), Communication Services (-11.9, -25.4), Information Technology (-11.9, -9.2), Health Care (-16.9, -2.5), and Materials (-27.9, -18.8).

S&P 500 Q4 Earnings Season Monitor (*link*): With the Q4-2022 earnings season now past the two-thirds mark, it's becoming clearer that this is a relatively poor one 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 nearly 60% of S&P 500 companies finished reporting for Q4, revenues are ahead of the consensus forecast by just 1.2%, and earnings have exceeded estimates by only 1.7%. 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 1.6% above forecast and earnings had beaten estimates by 4.8%. For the 345 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 345 reporters so far has slowed from double-digit percentage gains in the prior seven quarters to 5.4%, and earnings are down 1.1% y/y as higher costs and increased loan-loss provisions continue to pressure profit margins. Just 67% of the Q4 reporters so far has reported a positive revenue surprise,

and 70% 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 less 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.

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