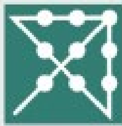

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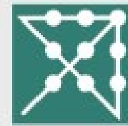

MORNING BRIEFING
April 11, 2023

The Big Lebowski

Check out the accompanying chart collection.

Executive Summary: The Fed's rate hiking may have busted something in the credit system. Specifically, the disintermediation that tightening has caused may require small banks to cut costs so deeply that merging is their only recourse. … Given this, how can the Fed fail to conclude that the federal funds rate is restrictive enough now? Pausing the tightening for a while should land the economy softly, with moderating inflation. But continued tightening would cause a hard landing and possibly even deflation. … And: You wouldn't know there's any landing debate going on looking just at the labor market; payroll employment is at a record high.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

US Economy I: Disintermediation vs Disinflation. "The Big Lebowski" is a 1998 crime comedy film written, produced, and directed by Joel and Ethan Coen. It stars Jeff Bridges. It is a comedy masterpiece. There are two Lebowskis, who appear to represent the opposing values of two different eras: the "Dude" embodies the free-spirited liberalism of the 1960s and 1970s and the "Big Lebowski" personifies the capitalism of the 1980s and 1990s. The plot is extremely convoluted and nearly impossible to comprehend with only one viewing.

Today, we are all struggling to figure out the economy's complex plot line. Getting it right is deadly serious; there's nothing funny about it. We aren't even sure who is today's Big Lebowski. The obvious choice is Fed Chair Jerome Powell. Since early last year, he and his colleagues on the Federal Open Market Committee (FOMC) have been scrambling to tighten monetary policy to subdue soaring inflation. At first, when prices started rising at a faster pace in 2021, they thought it was transitory.

Powell first used the term "transitory" to describe inflation in a *press conference* following the FOMC meeting on April 28, 2021. He said then that the recent increase in inflation was due to temporary factors related to the reopening of the economy following the Covid lockdowns and that he expected inflation to return to the Fed's 2% target over time.

Powell and other Fed officials continued to use the term "transitory" to describe inflationary pressures until November 30, 2021. That day, in congressional testimony, Powell said: "The word transitory has different meanings for different people. To many it carries a sense of

short-lived. We tend to use it to mean that it won't leave a permanent mark in the form of higher inflation." He added: "I think it's probably a good time to retire that word and try to explain more clearly what we mean."

Once Powell & Company realized how far behind the inflation curve they were, they moved quickly and forcefully to tighten monetary policy. The federal funds rate range was raised from 0.00%-0.25% to 0.25%-0.50% during the March 15-16, 2022 FOMC meeting and raised further at every meeting since, to 4.75%-5.00% at the March 21-22, 2023 FOMC meeting (*Fig. 1*). It was the most aggressive tightening of monetary policy since former Fed Chair Paul Volcker let interest rates soar in late 1979 (*Fig. 2*).

As the FOMC tightened, Powell and his colleagues said they were mindful that monetary policy operated with a "long and variable lag" on the economy. They said that they aimed to follow a narrow path that would permit the economy to grow even as their tightening brought inflation down. So far so good: Real GDP rose 2.1% last year and is on track to grow during Q1-2023 (*Fig. 3*). Meanwhile, the headline PCED inflation rate peaked at 7.0% in June of last year and fell to 5.0% in February (*Fig. 4*). We think it is on track to fall to 3.0%-4.0% by the end of this year.

While prices have been disinflating on balance since last summer, there is mounting concern that the Fed's rapid rate hiking has broken something in the credit system, namely small community and regional banks. Rapidly rising bond yields and mortgage rates have slashed the value of their securities portfolios. That's not a problem to the extent that the banks are able to categorize the securities as "held-to-maturity" (HTM). They have a worse problem, shared by bigger banks as well: The Fed's efforts to disinflate prices have caused a disintermediation crisis. In other words, rising interest rates in the money markets are attracting funds out of deposit accounts:

(1) *Deposits at all commercial banks* have declined by $878 billion y/y through the March 29 week (*Fig. 5*). Over this period, deposits are down $648 billion and $206 billion at the large and small banks (*Fig. 6*).

(2) *Assets of money market mutual funds* (MMMF) are up $687 billion y/y through the April 5 week to a record high $5.2 trillion (*Fig. 7*). Over this period, retail and institutional MMMFs are up $462 billion and $225 billion (*Fig. 8*).

(3) *Bottom line.* To stop disintermediation, the banks must raise their deposit rates. But that's bad for their profits. Higher rates might pose an existential threat for some banks that

have lots of loans on their books made in recent years when the federal funds rate was around zero. Banks that face losses rather than gains on their income statements might scare depositors away, especially since the same banks are also likely to have big losses on their balance sheets on a mark-to-market basis, even if they have assets categorized as HTM.

We expect that rising costs of deposits and shrinking profits will force banks to cut costs, prompting lots of M&A activity among them. Politicians and regulators are bound to respond to the current banking crisis by increasing regulations and supervision of the smaller banks, i.e., those that haven't been as tightly regulated as the bigger ones. The rising costs of complying with more regulations also will force many banks to lower costs by merging with each other.

US Economy II: Fed Would Be Nuts To Raise Rates Again. Under the circumstances, Powell & Company should declare that they've accomplished what they set out to do a year ago. They said that they were going to raise the federal funds rate until it was restrictive enough to slow the economy and bring inflation down. They said that once the rate got there, they'd leave it alone for a while until inflation falls closer to their 2.0% target.

The recent banking crisis strongly suggests that the federal funds rate is restrictive enough at 4.75%-5.00%. If so, then the long and variable lag between when the Fed started to raise interest rates and when they became sufficiently restrictive might be one year this time.

The Fed would have to be nuts to keep raising interest rates now that something has broken in the financial system. The yield curve has been predicting this outcome since last summer, when the 10-year Treasury bond yield first fell below the 2-year Treasury yield (*Fig. 9*). Financial crises tend to occur a few months after yield-curve inversions (*Fig. 10*).

If the Fed pauses for a while, the result is likely to be a soft landing with moderating inflation. If the Fed continues to tighten, then a hard landing and even deflation could result.

US Economy III: Leading Employment Indicators. Meanwhile, as reported on Friday by the Bureau of Labor Statistics, payroll employment rose to a new record high during March, and so did the household measure of employment (*Fig. 11*). They are up 1.0 million and 1.6 million during the first three months of the year. There's no hard landing in those numbers!

Let's drill down into the March payroll numbers to see whether there might be some signs of trouble:

(1) *Goods and construction.* Goods-producing employment in March held around its highest level since May 2008 (*Fig. 12*). Leading the way was construction employment, which barely budged from February's record high (*Fig. 13*)! That's impressive given the recession in the single-family housing market. The strength in nonresidential construction is corroborated by the record high in heavy and civil engineering construction payrolls (*Fig. 14*).

(2) *Consumer services.* Employment in service-producing industries rose to a record high in March (*Fig. 15*). Leading the way higher are consumer-related services, especially those catering to the health care needs of the many senior Baby Boomers, including ambulatory health care services, hospitals, and social assistance. All three are at record highs (*Fig. 16*).

Also in high demand, especially by Baby Boomers, are food services (including drinking places) & accommodations (including hotels and motels). Both remain in V-shaped recoveries, remaining below their pre-pandemic highs mostly because of a shortage of workers (*Fig. 17*).

Also in record-high territory are payrolls in educational services. Retail trade employment is still below its pre-pandemic record high and has stalled at around 15.5 million over the past eight months.

(3) *Other services.* Also still going strong and at record highs are payrolls in professional, scientific & technical services as well as administrative & support services (*Fig. 18*). That's impressive given that tech companies have been announcing layoffs in recent months.

Employment in transportation & warehousing has stalled at a record high in recent months following big gains as the pandemic lockdown restrictions were lifted (*Fig. 19*). Wholesale trade payrolls rose to another record high last month.

(4) *Bottom line.* The labor market remains hot. That's impressive given that Fed officials have been aiming to cool it off by tightening monetary policy.

Calendars

US: Tues: NFIB Small Business Optimism; API Weekly Crude Oil Inventories; WASDE Reports; IMF Meetings; Harker; Kashkari. **Wed:** Headline & Core CPI 0.3%m/n/5.2%y/y &

0.4%m/m/5.6%y/y; Real Earnings -0.2%; MBA Mortgage Applications; Federal Budget Balance -$257.0b; Crude Oil Inventories & Gasoline Production; FOMC Minutes; IMF Meetings. (Bloomberg estimates)

Global: **Tues:** Eurozone Retail Sales -0.8%m/m/-3.5%y/y; Eurozone Sentix Investor Confidence -9.8; Japan Machine Tools; Japan Core Machinery Orders -7.8%m/m/2.9%y/y; Japan PPI -0.3%m/m/-13.8%y/y; China Total Social Financing. **Wed:** UK RICS House Price Balance -48%; Australia Employment Change 20k; Australia Unemployment & Participation Rates 3.6%/66.5%; China Trade Balance ¥82.0b; BOC Rate Decision 4.50%; De Guindos; Baily; Bullock. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for these three indexes in their first broad decline in five weeks. Through the week ending April 7, LargeCap's forward earnings fell 0.1% w/w to 0.5% above its 54-week low during the week of February 10. MidCap's fell 0.2% w/w to 1.0% above its 55-week low during the week of March 10. SmallCap's was down 0.3% w/w to 2.1% above its 72-week low during the March 17 week. For a 41st 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 5.3% below its record high at the end of June; MidCap's is 7.2% below its record high in early June; and SmallCap's is 11.8% below its mid-June record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a fifth straight week, edging down to a 26-month low of -2.8% 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 -2.6% y/y is at a 27-month low, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's rate of -7.0% y/y is up from a 29-month low of -7.4% y/y during the March 17 week, but down from a record high of 124.2% in June 2021; it compares to 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 2023 and 2024: LargeCap (0.8% and 12.3%), MidCap (-9.6, 13.5), and SmallCap (-7.0, 15.2).

S&P 500/400/600 Valuation (*link*): Valuations mostly moved lower w/w through the April 7 week for these three indexes. LargeCap's forward P/E of 18.1 was unchanged w/w, but is

down a hair from a nine-month high of 18.2 in early February. 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 0.3pt to 13.2 from a four-week high of 13.5 and is 0.9pts below its recent 10-month high of 14.7 in early February. It's now 2.1pts above its 30-month low of 11.1 at the end of September, which 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 of 12.7 was down 0.3pt w/w from a four-week high of 13.0 and is now 1.6pts below its recent 12-month high of 14.3 in early February. It's 2.1pts 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 is at a 27% discount relative to LargeCap's, not much improved from a 23-year-low 28% discount last July. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 30% discount to LargeCap's P/E last week is also not much improved from a 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest since August 2021. 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 a 95th straight week; the current 4% discount was unchanged w/w but down from 1% the week before that. That 1% discount had been its lowest since July 2021 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 Q1-2023 to -7.7% y/y from -1.6% in Q4-2022 on a frozen actual basis and to -5.2% from -3.2% on a pro forma basis. Four sectors are expected to record positive y/y percentage earnings growth in Q1-2023, up from only two sectors doing so in Q4-2022. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2023 versus their final Q4-2022 growth rates: Consumer Discretionary (36.5% in Q1-2023 versus -15.6% in Q4-2022), Industrials (17.1, 41.4), Energy (13.7, 59.1), Financials (4.3, -8.9), Consumer Staples (-4.3, -2.5), S&P 500 (-5.2, -3.2), Real Estate (-8.4, -3.2), Utilities (-10.1, -4.6), Communication Services (-12.3, -28.2), Information Technology (-14.4, -10.0), Health Care (-18.9, -2.7), and Materials (-32.9, -20.4).

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