MORNING BRIEFING
April 18, 2023

Pandemic Pandemonium

Check out the accompanying chart collection.

Executive Summary: The pandemic effectively accelerated the latest business cycle. Government interventions including lockdowns, rent moratoriums, stimulus payments, and ultra-easy monetary policy altered the behavior of economic actors including businesses, workers, consumers, landlords, tenants, home buyers, and home sellers. The result was a business cycle on warp speed. … Pandemic-altered consumer behavior escalated inflation, first for goods and then for services. … That disproves the theory that inflation is simply a monetary phenomenon, fully within the Fed's power to control.

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

Pandemic I: Reunion. I have one wife, five kids, two granddaughters, one mother-in-law, two sons-in-law, and three dogs. We had a family reunion this past weekend at our house on Long Island to celebrate the birthday of our nine-year-old granddaughter. Seven of us (not counting the dogs) spent March and April 2020 locked down in this house during the pandemic. And we all got along very nicely. So during our latest reunion, we reminisced about the experience. It certainly affected all our lives and still does in some ways.

Three years ago, we titled our April 27, 2020 *Morning Briefing* "The Twilight Zone: Where Is Everybody?" We explained: "The very first episode of *The Twilight Zone* aired on CBS on October 2, 1959. It was titled 'Where Is Everybody?.' The TV series was created by Rod Serling and broadcast from 1959 to 1964. Wikipedia observes: 'Each episode presents a stand-alone story in which characters find themselves dealing with often disturbing or unusual events, an experience described as entering "The Twilight Zone," often with a surprise ending and a moral.'" Later in that *Morning Briefing*, we observed: "[A] pandemic of fear continues to weigh on our economy. As a result of voluntary and enforced social distancing and lockdowns, the streets are empty, as are office buildings, shopping malls, restaurants, hotels, and airports."

In many ways, we're all still stuck in The Twilight Zone, still experiencing the shockwaves from the pandemic shock. Now as we approach the third anniversary of the lockdowns, which mostly ended by May 2020, we are struck by the thought that the economy and the

financial markets are trapped in that time warp too. Since the pandemic, consensus economic and financial forecasts have been mostly blindsided by surprise endings. Instead of “Where is everyone?” the main question seems to be “Where are we all going?”

Pandemic II: Economy on Warp Speed. The Trump administration formally introduced “Operation Warp Speed” on May 15, 2020. The goal was to speed up the development of a Covid vaccine with billions of dollars committed by the federal government to the project. The pandemic seems to have accelerated the latest business cycle at warp speed.

The lockdowns hurled the economy into a very severe recession, but it lasted only two months. The Index of Coincident Economic Indicators (CEI) plunged 13.1% from February through April 2020 (*Fig. 1*). Real GDP fell 9.6% from Q4-2019 through Q2-2020 (*Fig. 2*). It fully recovered by Q1-2021. It declined modestly during the first half of 2022; but by Q4-2022, it was at a record-high 5.0% above its previous business cycle peak just before the pandemic.

Weighing on the CEI has been payroll employment, which is one of its four components (*Fig. 3*). It didn’t fully recover from the pandemic until June 2022. There were plenty of job openings, which rose to a record high of 12.0 million during March 2022 (*Fig. 4*). The problem was that the labor force didn’t fully recover until August 2022.

The pandemic weighed on the recovery in the labor force. Many people couldn’t work because they were ill or had to take care of a family member who was sick. Some stayed home with their kids because schools offered only remote lessons or because government restrictions had closed daycare facilities. Many seniors decided to retire rather than be exposed to the virus at work. Sadly, more than a million Americans died from the virus (*Fig. 5*).

Nevertheless, consumer spending and saving were boosted by three rounds of pandemic relief checks provided by the government (*Fig. 6* and *Fig. 7*). To relieve their cabin fever, consumers went on a buying binge right after the lockdowns were lifted. Much of the binge focused on goods rather than services because the latter still faced social-distancing restrictions (*Fig. 8*).

During the second half of 2021, consumers pivoted toward buying more services as they became more available. Retailers experienced unintended inventory pileups as a result and had to cut back their orders and lower their prices, especially during 2022.

There was lots of talk about a recession in 2022 as the Fed was forced to raise the federal funds rate in the face of a surge in inflation, which was exacerbated by Russia's invasion of Ukraine. When a recession didn't happen, economists attributed the resilience of consumer spending mostly to the excess savings accumulated during the pandemic. Now there's lots of chatter about the possibility of a recession during the second half of this year if the Fed were to hike rates further notwithstanding the tightening of credit conditions caused by the banking crisis that started in early March.

Pandemic III: Transitory & Persistent Inflation. Contrary to renowned economist Milton Friedman's claim that inflation is essentially a monetary phenomenon—i.e., a product primarily of monetary policy—inflation remained remarkably subdued ever since the Great Financial Crisis notwithstanding the ultra-easy monetary policies of the major central banks, which would be expected to raise it if Friedman's thesis was correct. On December 9, 2020, we wrote: "We soon should find out if money matters to the inflation outlook given that the GVC [Great Virus Crisis] has resulted in ultra-easy monetary policies on steroids and speed combined!"

That was before we knew that the first round of pandemic relief checks would be followed by two more rounds. The third one in early 2021 was the charm: The combination of excessively stimulative fiscal policy and excessively easy monetary policy amounted to Friedman's "helicopter money." It fueled the consumer buying binge for goods. Goods producers and distributors raised prices and ordered more goods as their inventories were depleted.

However, as noted above, the buying binge for goods abated during the second half of 2022, forcing goods providers to slash prices to clear their inventories. As we noted in yesterday's *Morning Briefing*, the core CPI goods inflation rate soared from 1.3% y/y during February 2021 to peak at 12.3% during February 2022. It was back down to 1.5% during March of this year (*Fig. 9*). Goods inflation has turned out to be transitory.

On the other hand, the core CPI services inflation rate has increased from 1.3% to 7.1% over this same period. It has been more persistent largely because of the rent inflation component of the CPI. Rent inflation in the CPI hovered around 3.5% during the second half of the 2010s (*Fig. 10*). It dropped just below 2.0% following the lockdowns during the first half of 2021. It then soared to 8.8% last month.

The Centers for Disease Control and Prevention (CDC) took unprecedented action on September 1, 2020 by issuing a temporary national moratorium on most evictions for

nonpayment of rent to help prevent the spread of coronavirus. The CDC eviction moratorium took effect September 4 and was initially set to expire on December 31. Congress extended the moratorium through January 2021—and President Biden further extended it through March, June, and July 2021—and provided a total of $46.5 billion for emergency rental assistance (ERA). The eviction moratorium lapsed on July 31, but the CDC announced on August 3 a limited eviction moratorium through October 3, 2021 for renters living in communities experiencing a surge in Covid-19 cases, covering an estimated 80% of all US counties and 90% of all renters. Some states also passed legislation to protect tenants from eviction for failing to pay their rent if they suffered a financial hardship from Covid.

Guess what landlords did once the moratoriums were lifted? They raised rents aggressively. The ApartmentList index of rents soared from -1.2% y/y at the start of 2021 to peak at 18.1% by the end of 2021. The pace of rise was back down to 2.6% during March of this year (*Fig. 11*). The CPI primary residential rent inflation rate rose to 8.8% in March because it includes rents on all active leases, while the ApartmentList index includes just newly signed leases. We expect that the CPI rent inflation measure will peak by mid-year and then fall sharply during the second half of this year.

Pandemic IV: Fed Awakes From Being Woke. Based on the above, the Fed doesn't deserve all the blame for letting the inflation genie out of the bottle. Nevertheless, the Fed certainly exacerbated inflation. Most importantly, under Fed Chair Jerome Powell's leadership, the Fed turned woke and prioritized "inclusive" maximum employment over its stated 2.0% inflation target in its August 2020 statement on its long-run goals and strategy. Also in that statement, the Fed embraced flexible average inflation targeting, indicating that it now would tolerate inflation overshoots to compensate for prior inflation shortfalls.

By maintaining ultra-easy monetary policies through the start of 2022, the Fed succeeded in lowering the unemployment rate to 3.6%. In addition, the ratio of job openings to unemployed workers rose to a record 2.0 during March 2022. The result has been a significant increase in wage inflation, which has spiraled into price inflation, thus eroding the purchasing power of all workers. That has been the unintended consequence of the Fed's wokeness!

Recognizing that they were well behind the inflation curve, the members of the FOMC voted to raise the federal funds rate from 0.00%-0.25% to 0.25%-0.50% at the March 15-16, 2022 meeting of the committee. They continued to raise the rate at every meeting, all the way up to 4.75%-5.00% at the March 21-22 meeting this year.

Pandemic V: The Future Is Now. That has been the fastest and most dramatic tightening of monetary policy since former Fed Chair Paul Volcker let interest rates soar in late 1979.

As a result, the single-family housing market fell into a recession. However, construction remains strong for multi-family residential units and for infrastructure, funded by various government spending programs. In fact, construction employment rose to a record high during March (*Fig. 12*).

Consumer spending has held up very well during the pandemic thanks to the relief checks and now excess saving. In addition, employment gains have been very strong, and in recent months wages have been rising faster than prices, boosting the purchasing power of consumers. Nevertheless, consumers' pivot from goods to services depressed consumer goods manufacturing and retailing.

It has all added up to a rolling recession rather than an economy-wide one. The Atlanta Fed's *GDPNow* tracking model estimates as of April 14 that Q1-2023 real GDP rose 2.5% (saar). Real consumer spending is tracking at 4.2%.

Calendars

US: Tues: Housing Starts & Building Permits 1.40mu/1.45mu; Weekly Crude Oil Inventories. **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; Williams. (Bloomberg estimates)

Global: Tues: Eurozone Trade Balance; Germany ZEW Economic Sentiment 15.1; UK Average Earnings Index Including & Excluding Bonus 5.1%/6.2%; UK Employment Change 3m/3m 52k; UK Unemployment Rate 3.7%; UK Claimant Count Change 10.2k; UK Labor Productivity 0.3%; Canada Headline & Core CPI 4.3%/4.8% y/y; Macklem; Rogers. **Wed:** Eurozone Headline & Core CPI 0.9%m/m/6.9%y/y & 1.2%m/m/5.7%y/y; Eurozone Current Account; UK Headline & Core CPI 0.5%m/m/9.8%y/y& 0.6%m/m/6.0%y/y; UK PPI Input & Output 12.0%/8.7% y/y; Japan Industrial Production 4.5%; Japan Trade Balance -¥1.29t; China PBoC Loan Prime Rate; Australia NAB Quarterly Business Confidence; BOE Quarterly Bulletin; Schnabel; Mann; Lane. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for two of these three indexes, but all three remain above their lows during February and March. Through the week ending April 14, LargeCap's forward earnings rose 0.1% w/w to 0.6% above its 54-week low during the week of February 10. MidCap's fell 0.2% w/w to 0.8% above its 55-week low during the week of March 10. SmallCap's was also down 0.2% w/w, but to 1.9% above its 72-week low during the March 17 week. For a 42nd 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 7.4% below its record high in early June; and SmallCap's is 11.9% 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 an 11th straight week, but steady w/w at 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 -3.2% y/y is at a 29-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 -6.6% 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 and 2024 have been heading lower since last June. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (0.7% and 12.3%), MidCap (-10.1, 13.9), and SmallCap (-7.4, 15.2).

S&P 500/400/600 Valuation (*link*): Valuations mostly moved lower w/w through the April 14 week for these three indexes. LargeCap's forward P/E of 18.2 was up 0.1pt to match its nine-month high of 18.2 in early February. It's up 3.1pts 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 rose 0.2pt to 13.4, which is just 0.1pt below its four-week high of 13.5 during the March 31 week and 0.7pts below its recent 10-month high of 14.7 in early February. It's now 1.9pts 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 12.9 was up 0.2pt w/w to 0.1pt below its four-week high of 13.0 during the March 31 week and is 1.4pts 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 26% 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 29% 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 96th straight week; the current 4% discount was unchanged w/w but is down 1% during the March 31 week. 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 decelerate q/q for a seventh straight quarter in Q1-2023, to -7.9% y/y from -1.6% in Q4-2022 on a frozen actual basis and to -4.8% 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 (36.7% in Q1-2023 versus -15.6% in Q4-2022), Industrials (15.8, 41.4), Energy (12.5, 59.1), Financials (7.5, -8.9), Consumer Staples (-4.3, -2.5), S&P 500 (-4.8, -3.2), Real Estate (-8.4, -3.2), Utilities (-10.8, -4.6), Communication Services (-12.0, -28.2), Information Technology (-14.4, -10.0), Health Care (-19.0, -2.7), and Materials (-33.3, -20.4).

US Economic Indicators

Regional M-PMI (*link*): The New York Fed has provided the first glimpse of manufacturing activity for April, and the news is very encouraging. April's *composite index* showed activity expanded for the first time since November and at the fastest pace since last July, blowing past forecasts (-15.0) of a continued contraction, rebounding 35.4 points to 10.8 from -24.6 in March—which was the weakest since May 2020. Both orders (to 25.1 from -21.7) and shipments (23.9 from -13.4) rebounded sharply, from contraction to expansion, recording

their best performances since last April and July, respectively. Meanwhile, *delivery times* (0.0 from -7.6) held steady, and inventories (8.2 from -1.9) showed an accumulation. As for the labor market, *employment* (-8.0 from -10.1) contracted for the third month, though at a slightly slower pace than March, after adding jobs for 31 straight months, while *hours worked* (-6.4 from -18.5) shrank for the fifth month, though at a slower pace. Turning to *prices*, the prices-paid (33.0 from 41.9) measure eased back down to January's pace, which was the slowest since November 2020, while prices-received (23.7 from 22.9) continued to bounce in a volatile flat trend around recent lows. Both price measures are down sharply from their record highs of 86.4 and 56.1, respectively, during April and March of last year. Looking ahead, the *index of future business conditions* remained in expansionary territory, edging up to 6.6 from 2.9, suggesting that firms don't expect activity to improve much. Both new orders (6.6 from 6.3) and shipments (7.6 from 13.3) are expected to increase only modestly, while employment (13.4 from 4.1) is expected to pick up. Both the prices-paid (37.1 from 31.4) and prices-received (29.9 from 27.6) gauges continue to trend lower, though ticked up a slightly this month; they are down sharply from their record highs of 76.7 and 62.1, respectively, last January.

NAHB Housing Market Index (*link*): Homebuilders' confidence increased the first four months of this year after falling all 12 months of last year, a good sign for the housing sector. *Confidence* is up 14pts ytd, to a seven month high of 45, after sliding 53 points during the 12 months ending December 2022 to 31—which was the lowest since mid-2021 (excluding a drop to 30 at the height of the pandemic). "Builders note that additional declines in mortgage rates, to below 6%, will price-in further demand for housing," noted NAHB Chairman Alicia Huey, though she cautioned that a shortage of building materials remains a challenge. The *three components* of homebuilders' confidence show steady climbs over this year's first four months in both the current sales (to 51 from 36) and future sales (50 from 35) measures, each posting gains of 15 points, while traffic of prospective home buyers (31 from 20) advanced 11 points over the first three months of the year but was unchanged at 31 during April. They were at record highs of 96, 89, and 77, respectively, during November 2020.

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