MORNING BRIEFING
April 25, 2023

The Economy Is Beige

Check out the accompanying chart collection.

Executive Summary: The stock market's resilience since October 12 in the face of Fed rate hiking reflects the economy's resilience. Measures of breadth for industry analysts' estimates of S&P 500 revenues and earnings have been improving since early this year, and their optimism is supported by surveys of corporate purchasing managers. … The Fed's latest *Beige Book* confirms that the banking crisis hasn't knocked the economy off its rolling-recession path. … Also: We've known that QT and the banking crisis exert tightening forces equivalent to some amount of federal funds rate hiking. Now the SF Fed has quantified it, finding that the "effective" federal funds rate is currently over 6%.

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

Strategy: Forward Earnings Breadth Improving! Why is the stock market holding up so well, frustrating the bears who see a recession coming that will clobber both earnings and valuations? Their most optimistic scenario seems to be that the S&P 500 will retest last year's October 21 closing low of 3577.03. Their pessimistic scenarios send the index down to 3000 or even lower.

The answer is that the economy has been remarkably resilient to the 500bps hike in the federal fund rate since early last year. It did trigger a financial crisis in mid-March, but that crisis seems to have been contained by the Fed. It hasn't turned into an economy-wide credit crunch and recession, so far. In addition, investors seem to believe that the Fed is almost done tightening. Even if the central bank raises the federal funds rate by 25bps to 5.00%-5.25% at the FOMC's May 2-3 meeting and keeps it there for a while, the economy will continue to grow, albeit slowly, while inflation continues to moderate, albeit slowly, but surely.

In this scenario, investors have nothing to fear but the "X-Day" for the federal debt ceiling impasse. If there is no deal in Washington by that day, the US will be in technical default. In this scenario, stock prices might plunge, causing our leaders to scramble to work out a deal quickly.

There may be more compelling fundamental support for the stock market. Joe has been

tracking the percent of S&P 500 companies with positive three-month percent changes in forward revenues and forward earnings (*Fig. 1* and *Fig. 2*). (FYI: "Forward" revenues and earnings are the time-weighted average of analysts' consensus estimates for the current and following years.)

Both data series are weekly and start in 1998. Both tend to fluctuate around 80% during economic expansions. Both dive toward 50% and lower during recessions. So far, both seem to have bottomed around 50% at the end of last year without an actual recession transpiring. As of the April 21 week, the forward revenues series was back up to 72.5%, and the forward earnings series was at 61.6%.

These numbers suggest that industry analysts have turned more upbeat about the prospects for both earnings and revenues since the start of the year, notwithstanding the cacophony of the nattering nabobs of negativism. Confirming the positivism of the analysts are April's flash PMIs compiled by S&P Global for manufacturing and nonmanufacturing industries in the US. Both have been rising in recent months, with the former up to 50.4 (the highest since October) and the latter up to 53.7 (the highest since last April) (*Fig. 3* and *Fig. 4*).

US Economy I: Proceed With Caution. The cover of the economy's playbook is neither green nor red. Economic growth is neither accelerating nor decelerating. It is just rolling along in a way consistent with our rolling recession scenario. So color the economy beige.

The Fed's latest *Beige Book* was released last Wednesday, April 19. It represents an attempt to get a grassroots perspective on the economy, as described on the Fed's website: "Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its District through reports from Bank and Branch directors and interviews with key business contacts, economists, market experts, and other sources. The *Beige Book* summarizes this information by District and sector. An overall summary of the twelve district reports is prepared by a designated Federal Reserve Bank on a rotating basis."

According to the latest report, "Expectations for future growth were mostly unchanged as well; however, two districts saw outlooks deteriorate." In addition, "[c]ontacts expected further relief from input cost pressures but anticipated changing their prices more frequently compared to previous years."

The Fed's latest read on the state of the economy provides a snapshot of the economy and financial system in the aftermath of the mid-March failure of two large regional banks that

shook confidence in the US banking sector and prompted an emergency response from the Fed, the FDIC, and the US Treasury to contain the fallout.

Overall, the economy seems to remain on the same muddling-along trajectory as before the crisis. Credit conditions were mixed. In the San Francisco Fed district, where failed Silicon Valley Bank was located, “lending activity fell significantly in recent weeks amid higher interest rates and elevated uncertainty in the banking sector,” the report said. On the other hand, the Chicago Fed reported “little change in credit availability.” The Cleveland Fed noted that the banking situation “had limited impact on recent business activity.”

Similarly, the latest *Beige Book* painted a mixed picture of inflation: “Overall price levels rose moderately during this reporting period, though the rate of price increases appeared to be slowing. Contacts noted modest-to-sharp declines in the prices of nonlabor inputs and significantly lower freight costs in recent weeks.” However, “[c]onsumer prices generally increased due to still-elevated demand as well as higher inventory and labor costs.”

Overall, “[w]ages have shown some moderation but remain elevated. Several Districts reported declining needs for off-cycle wage increases compared to last year.”

The Richmond Fed reported, “Trucking firms stated that in response to lower freight volumes, they were still adding drivers, but they had scaled-back recruiting and were being very selective in hiring.” Several other districts reported similar developments in the trucking industry.

The report’s mixed messages add up to a beige light, rather than either a red or green light, for the economy. The primary message that we think the Fed should take away from this report is to proceed with caution. The Fed should ease up on the monetary brakes.

Let’s not forget that the *minutes* of the March 21-22 FOMC meeting observed: “For some time, the forecast for the U.S. economy prepared by the staff had featured subdued real GDP growth for this year and some softening in the labor market. Given their assessment of the potential economic effects of the recent banking-sector developments, the staff’s projection at the time of the March meeting included a mild recession starting later this year, with a recovery over the subsequent two years.”

On inflation, the Fed staff’s inflation forecast was 2.8% this year, with core inflation at 3.5%. Furthermore, “[c]ore goods inflation was projected to move down further this year and then remain subdued; housing services inflation was expected to peak later this year and then

move down, while core nonhousing services inflation was forecast to slow gradually as nominal wage growth eased further."

We agree with the staff's outlook. The question is whether the FOMC's members are on the same page. They weren't at their last meeting because they proceeded without caution, making a 25bps hike in the federal funds rate. That was barely two weeks after the banking crisis hit on March 10.

US Economy II: Meet the Real Nominal Federal Funds Rate. Last summer, the Fed started its second quantitative tightening (QT2) program, which allowed maturing securities simply to roll off its balance sheet with no reinvestment of the proceeds. The Fed's holdings of securities peaked at a record $8.5 trillion during the week of May 18, 2022 (*Fig. 5*). At the time, Melissa and I argued that QT was equivalent to a hike in the federal funds rate. We just didn't know if it amounted to a 25, 50, 75, or 100bps hike in the federal funds rate.

Now we are arguing that the banking crisis, or more specifically the tightening of lending standards it caused, equates to a similarly unknown hike in the federal funds rate. Fed officials were readily able to justify QE2 as an effective cut in the federal funds rate in 2010. That's when the Fed's econometric model indicated that the federal funds rate should be lowered from zero to minus 75bps. The model showed that Fed purchases of $600 billion in US Treasuries effectively would equate to this negative level of the federal funds rate.

We haven't heard anything from Fed officials about their econometric model since then. Why aren't they running it to assess the impact of QT2 and the banking crisis on the effective federal funds rate?

Four staff economists at the San Francisco Fed have done so. They published an *article* titled "Monetary Policy Stance Is Tighter than Federal Funds Rate" in the November 7, 2022 issue of the *FRBSF Economic Letter*. Their model calculates an effective federal funds rate (EFFR) using a set of 12 financial variables, including Treasury rates, mortgage rates, and borrowing spreads, to assess the broader stance of monetary policy. Here is their conclusion:

"The FOMC's use of forward guidance provides more information about future policy than what is reflected in the federal funds rate alone. Similarly, the use of the balance sheet has a monetary policy impact that is not captured in the federal funds rate. A proxy funds rate based on financial conditions measures the broader stance of policy and suggests that these combined policy tools have a more complex effect on the economy than the federal

funds rate indicates. The stance of monetary policy in September 2022 was conducted as if the policy rate was above 5¼%, as opposed to the actual rate of 3-3¼%. As the FOMC increasingly used forward guidance and the balance sheet, the proxy rate has tended to lead the actual funds rate, reflecting the fact that financial markets are forward looking."

The monthly EFFR was almost identical to the actual federal funds rate (FFR) prior to December 2008 when the rate first fell to zero (*Fig. 6*). During the period from 2009-15—which included QE1, QE2, and QE3—the EFFR was negative most of the time (*Fig. 7*). The EFFR has consistently exceeded the FFR since October 2021 (*Fig. 8*).

Where are we now? As of March, the EFFR was 6.27%, well above the FFR's reading of 4.65%. (The data are updated *here*.)

Calendars

US: Tues: Consumer Confidence 104.0; Richmond Fed Manufacturing Index; New Home Sales 634k; S&P/CS Composite 20 House Price Index -0.4%; API Weekly Crude Oil Inventories. **Wed:** Durable Goods Orders Total, Ex Defense, and Core 0.8%/0.3%/-0.2%; Goods Trade Balance -$89.0b; Wholesale & Retail Inventories; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: Tues: Spain PPI; UK CBI Industrial Trends; Japan CPI; Enria; Broadbent; Australia CPI. **Wed:** Germany Gfk Consumer Climate -27.5; France Consumer Confidence 82; UK Labor Productivity 0.3%; Canada Manufacturing Sales -0.3%; China Industrial Production -12.0%ytd; De Guindos; Tuominen; Jochnick; Enria. (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 21, LargeCap's forward earnings rose 0.2% w/w to 0.8% above its 54-week low during the week of February 10. MidCap's fell 0.4% w/w to 0.4% above its 55-week low during the week of March 10. SmallCap's was down 0.3% w/w to 1.6% above its 72-week low during the March 17 week. For a 43rd 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 5.1% below its record high at the end of June; MidCap's is 7.7% below its record high in early June; and SmallCap's is 12.2% 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 12th straight week, and dropped to a 27-month low of -3.0% 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 -3.9% 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 -7.1% 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 12.1%), MidCap (-10.6, 13.6), and SmallCap (-8.0,15.3).

S&P 500/400/600 Valuation (*link*): Valuations were mostly steady w/w through the April 21 week for these three indexes. LargeCap's forward P/E was unchanged at 18.2, which matches 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 0.1pt to 13.5, which is 0.6pts below its recent 10-month high of 14.7 in early February. It's now 2.4pts 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 remains 1.4pts below its recent 12-month high of 14.3 in early February. It's 2.3pts 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 25% 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 97th straight week; the current 5% discount has weakened from 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 -7.2% y/y from -1.6% in Q4-2022 on a frozen actual basis and to -4.7% 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 (37.6% in Q1-2023 versus -15.6% in Q4-2022), Industrials (16.9, 41.4), Energy (12.2, 59.1), Financials (6.8, -8.9), Consumer Staples (-3.7, -2.5), S&P 500 (-4.7, -3.2), Real Estate (-8.1, -3.2), Communication Services (-11.9, -28.2), Utilities (-13.8, -4.6), Information Technology (-14.3, -10.0), Health Care (-18.5, -2.7), and Materials (-31.9, -20.4).

S&P 500 Q1 Earnings Season Monitor (*link*): With the Q1-2023 earnings season now 18% complete, the early indications are that this season is an improvement from Q4-2022's relatively weak showing. Then, the earnings surprise was the lowest since Q4-2008 and the revenue surprise the smallest since Q1-2020. Furthermore, the earnings surprise failed to outpace the revenue surprise in Q4-2022 for the first time since we began tracking that data in Q1-2009. With 90 of the S&P 500 companies finished reporting for Q1-2023, revenues are ahead of the consensus forecast by 2.0%, and earnings have exceeded estimates by 7.8%. At the same point during the Q4 season, revenues were 0.5% above forecast and earnings had beaten estimates by 1.7%. Just 64% of the 90 Q1 reporters that have reported so far through mid-day Monday has reported a positive revenues surprise, while 77% has reported an earnings beat. That's the weakest reading for revenues since the Great Virus Crisis, but the percentage with positive earnings surprises may have bottomed in Q4-2022. Their aggregate y/y revenue and earnings growth rates have ticked up from their Q4-2022 readings. The collective y/y revenue gain for the 90 reporters so far has edged up to 7.1% from 5.7%, and earnings are up 1.3% y/y from a 1.9% decline. During the past 56 quarterly reporting seasons over the last 14 years, y/y earnings growth has trailed revenue growth in only 14 of the quarters, and it's likely to do so again in Q1-2023. Significantly fewer companies are reporting positive y/y earnings growth in Q1 (58%) than positive y/y revenue growth (78%). These figures will continue to change as more Q1-2023 results are reported in the coming weeks. While we expect y/y revenue growth rates to remain positive in Q1, earnings are likely to decline for a second straight quarter.

US Economic Indicators

Regional M-PMIs (*link*): Three Fed districts (New York, Philadelphia, and Dallas) have reported on *manufacturing activity* for April, and they show growth declined for the 12th successive month though more slowly, as the New York region showed a big swing in growth from negative to positive. Overall manufacturing activity declined at a slightly slower pace in April, climbing to -14.6 this month after deteriorating from -14.5 in February to -21.2 in March, fluctuating between -14.5 and -21.2 the past five months. New York's (to +10.8 from -24.6) measure expanded for the first time since last November and at the fastest pace since last July (recording a 35.4-point swing), while both the Philadelphia (-31.3 from -23.2) and Dallas (-23.4 from -15.7) regions showed steeper declines. *New orders* (-2.4 from -21.4) moved back toward expansionary territory, as billings in the New York (+25.1 from -21.7) region rebounded sharply, while Dallas' (-9.6 from -14.3) contracted at the slowest pace in three months, and Philadelphia (-22.7 from -28.2) billings continued to contract at a fast pace. *Employment* (-0.1 from -3.3) was basically flat this month, as hirings in the Philadelphia (-0.2 from -10.3) area moved back up to the break-even point of zero. Factories in the Dallas (+8.0 from +10.4) region hired at a slower pace, while New York's (-8.0 from -10.1) declined at a slower pace. Looking at *prices-paid* indexes, the Philadelphia (8.2 from 23.5) measure slowed dramatically to its lowest percentage since mid-2020, while Dallas' (19.5 from 20.3) eased to a 33-month low, and New York's (33.0 from 41.9) saw price pressures ease back to January's 26-month low of 33.0 after a slight tightening in February. They were at record highs of 83.6 (November 2021), 84.1 (November 2021), and 86.4 (April 2022), respectively. *Prices-received* indexes were mixed: New York's ticked up to 23.7 after easing to 22.9 in March, remaining above January's two-year low of 18.8, while Dallas' inched up to 8.4 this month after easing to a 28-month low of 7.0 in March. The Philadelphia measure moved down for the third month to -3.3 this month from 29.9 at the start of the year. They were at record highs of 56.1 (March 2022), 51.3 (October 2021), and 65.8 (November 2021) respectively.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "German business' worries are abating, but the economy is still lacking dynamism," noted Clemens Fuest, Ifo's president. "It's a stagnating economy and the question is what could take the economy out of stagnation. Something that could achieve that would be further improvement in supply chains, and maybe a perspective for a settlement in the Ukraine war." German business *confidence*

extended its winning streak to six months in April, climbing to its highest level since February 2022, up 8.6 points over the period, from 85.0 to 93.6. The *expectations* component accounts for the upswing, rising by a total of 15.6 points over the six-month period to a 14-month high of 92.2. It had plunged 21.6 points—from 98.3 last February to 76.7—by September, which was the lowest since April 2020. Meanwhile, *current conditions* has remained around recent lows, slipping 0.4 point this month to 95.0, averaging 94.4 the past six months. The *manufacturing* sector saw its business climate index continue to improve, moving further into positive territory, jumping 21.2 points the past six months, from a 28-month low of -14.5 last October to +6.7 this month, as companies were less pessimistic about the future (to -1.4 from -38.5 in October) over the period—nearing positive territory. The current assessment component was up from November's recent low of 10.3 to 15.2 this month, though did take a step back from March's 19.1. The *service sector* saw its business climate index deteriorate for the first time in six months, easing to 6.8 this month after climbing the prior five months, from -8.9 last October to +8.8 in March, as its expectations fell to -7.2 this month after improving from -35.2 last September to -4.0 by March. Businesses' current conditions were little changed this month at 21.7 after improving from 16.8 at the start of this year to 22.6 in March. Sentiment in the *trade sector* has shown little change, averaging -10.5 the past three months, moving up from -32.1 last September to -10.6 in February. *Expectations* (-24.6 from -57.2) continued its rebound from historical lows, while current conditions posted its fifth successive reading above zero, though did slow a bit this month, to 4.3, after climbing from -2.5 last September to 8.2 in March. Retailers are getting over last year's collapse in sentiment, with expectations on an accelerating trend, while wholesalers are stalled around recent highs. Both are still showing readings in contractionary territory. The *construction sector* remained entrenched in negative territory, though improved the first four months of this year, to -16.7 from -22.0 at the end of last year. Its expectations component is up from its recent low of -47.3 last October to -32.7 hits month, while its current conditions measure is heading south, dropping to 0.90 this month, and is about to fall below zero for the first time since the end of 2015.

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