MORNING BRIEFING
June 13, 2023

Long & Variable Lags?

Check out the accompanying chart collection.

Executive Summary: The economy has responded to monetary tightening quickly, our research finds, not with "long and variable lags" as monetarism theorizes. Today's economy and financial systems are exceptionally resilient. … Among some of the reasons: A deluge of post-pandemic fiscal spending has dulled the impacts of tightening. Certain typically interest-rate sensitive industries have been atypically resistant to tightening because of pandemic effects specific to them. Tighter credit conditions after the banking crisis have not triggered a widespread credit crunch. Consumers' excess savings are dropping fast, but the economic effects are offset by retiring Baby Boomers' massive net worth. AI and other tech advances have kindled the animal spirits of economic actors.

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

Monetary Policy I: Friedman's Rule. Fed officials have often stated that monetary policy operates with a "long and variable lag" on the economy. Economist Milton Friedman first promoted this concept. He was referring to the growth rate of the money supply rather than to interest rates. He was defending his monetarism theory—i.e., that monetary policy shouldn't try to manage the business cycle. Instead, policy should be aimed at maintaining a relatively constant growth rate in the money supply that would support real economic growth while keeping inflation subdued.

Theoretically, monetarism makes sense. Empirically, the theory has been challenged by the changing nature and definition of money. Financial deregulation since the 1980s has only reduced the feasibility of implementing monetarism.

In any event, our research over the years shows that tightening monetary policies—as defined by the troughs and peaks of the federal funds rate—tend to have relatively quick and abrupt impacts on subsequent economic activity, not delayed impacts after long and variable lags. In the past, the monetary tightening cycles ended when they resulted in financial crises (*Fig. 1*). The financial crises typically morphed into economy-wide credit crunches, which caused recessions and brought down inflation.

In the following sections, Debbie and I examine whether this time is different. In summary, we think so because the financial system and the economy have proven to be much more resilient in the face of tightening monetary policy than usual. The labor market has been particularly strong. As a result, the lags might indeed be longer but more muted this time. This conclusion is consistent with our soft-landing outlook for the economy.

The most common explanation for the resiliency of the economy is that consumers accumulated excess saving during the pandemic, allowing them to bolster their spending. The pessimistic view is that excess saving—after declining from around $2.0 trillion to $0.5 trillion—will fall to zero by the end of this year (*Fig. 2*). That would result in a recession, according to the naysayers. But we don't see it happening. We've previously observed that the Baby Boomers, who increasingly are retiring, have $73 trillion in net worth that they are just starting to spend. Their progeny undoubtedly expects to inherit some of that wealth and therefore can save less.

Monetary Policy II: Interest Rates. The Fed has raised the federal funds rate by 500bps since March 2022 from 0.00%-0.25% to 5.00%-5.25%. It has been the most aggressive tightening of monetary policy since then-Chair Paul Volcker allowed interest rates to soar in late 1979 and the early 1980s to halt the Great Inflation (*Fig. 3*).

The most interest-rate sensitive sector of the economy is housing, particularly single-family new and existing home sales (*Fig. 4*). They respond very quickly to changes in mortgage credit conditions. They plunged 29.5% from January 2022 through April 2023. Over this period, the 30-year mortgage rate soared by 383bps to 7.15% on June 9 (*Fig. 5*). That increase reflected the jump in the 10-year Treasury bond yield as well as the 171bps jump in the spread between the mortgage and bond yields (*Fig. 6*). The spread widened because Fed officials have indicated they want to get out of mortgage securities for good as part of their quantitative tightening program.

Keep in mind that while single-family housing activity responded quickly to tightening monetary conditions, multi-family construction and spending on home improvements both have remained strong (*Fig. 7*). Meanwhile, nonresidential construction spending is at a record high, showing no adverse impact yet from higher interest rates (*Fig. 8*). By the way, public construction is at a record high as well.

Consumer durable goods sales are also interest-rate sensitive, particularly auto sales (*Fig. 9*). They are even more sensitive to the unemployment rate. So far, the unemployment rate remains very low at 3.7% during May. If and when the jobless rate rises significantly in response to tightening credit conditions, then auto sales would likely weaken with a lag.

Monetary Policy III: Credit Tightening & Credit Crunches. In the past, rising interest rates relatively quickly depressed the most interest-rate sensitive sectors of the economy. As the Fed continued hiking the federal funds rate, the yield curve would flatten and then invert, signaling that bond investors expected additional Fed rate hikes to cause something to break in the financial system. The resulting financial crisis would morph into an economy-wide credit crunch and a recession. The Fed then would scramble to lower interest rates. In other words, the lag times between tightening monetary policy and a recession were shortened by credit crunches.

The banking crisis during March has caused credit conditions to tighten, but the impacts so far haven't added up to an economy-wide credit crunch. The Fed's aggressive hiking of the federal funds rate has caused a disintermediation problem for banks, especially small and regional ones. They've been losing deposits to money market funds (*Fig. 10*). They've had to raise their deposit rates to stem the outflows, which is squeezing their profitability.

In addition, small banks all together currently have $2.0 trillion in commercial real estate (CRE) loans on their books, as much as they have in all other loans combined (*Fig. 11*). Large banks have $0.9 trillion in CRE loans. The economy's rolling recession is just starting to hit the office segment of commercial real estate, which has been hammered by the jump in interest rates and the work-from-home trend. The S&P 500's Office REITs index is down 31.5% y/y through June 9 (*Fig. 12*).

The lag between tighter monetary policy and the negative impact on the CRE market is likely to take longer and last longer than usual. The same may apply to bank loans in general given the tightening of credit conditions reported in the latest Senior Loan Officers Opinion Survey (SLOOS). (See our *SLOOS chart book*.)

Monetary Policy IV: Excess Savings & Wealth Effects. Above, Melissa and I observed that consumers' excess savings of roughly $0.5 trillion currently are dwarfed by the net worth held by the Baby Boom generation that is retiring. The number of seniors (65 years old and older) rose to a record 58.0 million in May (*Fig. 13*). Of this total, a record 46.9 million are not in the labor force, leaving 11.1 million still in the labor force. The Baby Boomers are currently 59-77 years old. As we have previously noted, they had $73 trillion in net worth at the end of 2022 (*Fig. 14*).

Monetary Policy V: Fiscal Policy & the Roaring 2020s. Finally, let's not forget that tighter monetary policy has been offset by very stimulative fiscal policy since the pandemic. The Fed accommodated expansionary fiscal policy during 2020 and 2021. It stopped doing so and started to tighten in March 2021. The ongoing deluge of fiscal spending has dulled the impact of tightening Fed policy.

Also dulling the impact of the Fed's tightening may be the animal spirits unleashed by the exuberance for AI and other state-of-the-art technologies that could boost productivity and prosperity while keeping a lid on inflation. That's what we see happening in our Roaring 2020s scenario.

Calendars

US: Tues: Headline & Core CPI 0.3%/0.4%; Real Earnings 0.1%; NFIB Small Business Optimism; API Weekly Crude Oil Inventories; OPEC Monthly Report. **Wed:** Headline & Core PPI -0.1%m/m/1.5%y/y & 0.2%m/m/2.9%y/y; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 5.25%; FOMC Economic Projections; IEA Monthly Report. (Bloomberg estimates)

Global: Tues: Eurozone Core CPI; Germany CPI -0.2%/6.3%; Germany ZEW Economic Sentiment -13.0; Spain CPI 0.2%m/m/2.9%y/y; Italy Unemployment Rate; UK Average Earnings Including & Excluding Bonus; UK Claimant Change Count; UK Employment & Unemployment; Bailey; Dhingra. **Wed:** Eurozone Industrial Production 1.0%m/m/0.8%y/y; Germany WPI -1.0%m/m/-3.3%y/y; UK GDP 0.1%m/m/0.6%y/y; UK NIESR Monthly GDP Tracker; UK Industrial & Manufacturing Production -0.4%m/m/-1.7%y/y & -0.4%m/m/-0.9%y/y; China Retail Sales 13.7%y/y; China Industrial Production 3.8%y/y; China Unemployment Rate 5.2%; China NBS Press Conference; Japan Core Manufacturing Orders 3.0%m/m/-8.0%y/y; Australia Unemployment & Participation Rates 3.7%/66.7%; Australia Employment Change 15k. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for two of these three indexes; but for a 50th straight week, none were at a record high. During the May 4 week, all three had risen simultaneously for only the third time since they peaked at record highs last June. However, all three are up from their lows during February and March. Through the week ending June 9, LargeCap's forward earnings rose 0.2% w/w to 2.8% above its 54-week low during the week of February 10. MidCap's fell 0.2% w/w to

2.5% above its 55-week low during the week of March 10, and SmallCap's rose 0.1% w/w to 0.9% above its 72-week low during the March 17 week. The forward earnings downtrend since mid-2022 for these three indexes has been relatively modest this time around compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is now 3.2% below its record high at the end of June 2022; MidCap's is 5.9% below its record high in early June 2022; and SmallCap's is 12.8% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The -3.0% yearly rate of change in LargeCap's forward earnings was negative for a 19th straight week, but up from a 28-month low of -3.2% y/y during the May 18 week; 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 -5.9% y/y is at a 31-month low of -5.9%, 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 fell to a 32-month low of -12.2% y/y, 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 had been heading steadily lower since last June, but 2023's estimates briefly ticked higher during the Q1 reporting season as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.2% and 11.7%), MidCap (-10.0, 12.9), and SmallCap (-10.1,14.6).

S&P 500/400/600 Valuation (*link*): Valuations were mixed for these three indexes through the May 26 week. LargeCap's forward P/E rose less than 0.1pt w/w to a 15-month high of 18.5. It's up 3.4pts 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 a seven-week high of 13.5, and is 1.2pts 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 rose 0.2pt to a 14-week high of 13.4, which compares to a 19-week low of 12.5 during the May 12 week and is now 1.1pts below its recent 12-month high of 14.3 in early February. It's 2.8pts 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 lessened to a 27% discount to LargeCap's from a 24-year low 29% discount during the May 26 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 27% discount to LargeCap's P/E last week has improved from 30% during the May 12 week and 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 discount 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 104th straight week, but barely so; the current discount of less than 1% is 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 estimate declines accelerated considerably for the three quarters ending through Q4-2022 before easing for Q1-2023. Looking ahead to Q2-2023, analysts are forecasting that the S&P 500's y/y earnings growth rate will mark its cyclical bottom with an 8.1% decline, down from -2.9% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -5.4% in Q2, down from less than -0.1% in Q1-2023. S&P 500 ex-Energy earnings are forecasted to be up 0.1% y/y in Q2-2023, its first gain in five quarters and up from the 1.7% decline in Q1-2023 and the 7.4% drop in Q4-2022. Six sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors doing so in Q1-2023 and only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their nearly-final earnings growth rates for Q1-2023: Consumer Discretionary (24.9% in Q2-2023 versus 56.0% in Q1-2023), Financials (10.7, 7.8), Communication Services (9.3, -9.0), Industrials (6.2, 27.0), Consumer Staples (1.9, 0.3), Utilities (2.9, -21.8), S&P 500 ex-Energy (0.1, -1.7), Information Technology (-3.5, -8.5), Real Estate (-4.8, -6.2), S&P 500 (-5.4, 0.03), Health Care (-15.6, -14.8), Materials (-27.5, -22.2), and Energy (-43.6, 20.9).

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102