MORNING BRIEFING
September 25, 2023

Money & Credit: Debatable Points

Check out the accompanying chart collection.

Executive Summary: Some economic prognosticators still believe that a credit crunch and recession are just around the bend. Today, we question two of their main arguments: We don't believe that falling M2 presages anemic GDP growth; contrary to conventional wisdom, there is no reliable correlation between the two. And we can't see consumers slamming the brakes on their spending and hobbling the economy; they don't need to with their net worth at a record high and real disposable income growing. … Also: The inverted yield curve correctly predicted the banking crisis earlier this year, but there has been no credit crunch so far; we are monitoring commercial bank lending stats closely. ... And: Dr. Ed reviews "Golda (+ + +).

YRI Weekly Webcast. This week, join Dr. Ed's live webcast with Q&A on Tuesday, September 26, at 11 a.m. EST. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

Money I: The Velocity Myth. Among the debating points proffered by the proponents of the hard-landing economic outlook since last year is that the M2 monetary aggregate has been falling since it peaked at a record high of $21.7 trillion in July 2022 (*Fig. 1*). It is down $801 billion since then through July of this year. They've observed that on a yearly percent change basis, it turned negative for the first time ever in December 2022; the data series is available since 1959 (*Fig. 2*). In July, it was down 3.7%.

On an inflation-adjusted basis, using the CPI as the deflator, real M2 peaked in December 2021 and fell 11.5% through July (*Fig. 3*). On a yearly percent change basis, it turned negative in April 2022 and was down 6.7% in July (*Fig. 4*).

The flaw in this hard-landing argument is the assumption that M2 and GDP are correlated. We point out that nominal and real GDP were up 6.1% y/y and 2.5%, respectively, during Q2-2023 (*Fig. 5* and *Fig. 6*). This suggests that any correlation between M2 and GDP is debatable. Consider the following:

(1) *Velocity is a fudge factor*. It is widely believed that the growth rate of nominal (real) GDP is determined by the growth rate of nominal (real M2) multiplied by the velocity of money. That's a myth because velocity is a meaningless residual variable that is calculated as the

ratio of nominal GDP divided by M2 (*Fig. 7*).

There is no predictable relationship between M2 and GDP, in either nominal or real terms—because V is unpredictable. V was relatively stable and predictable from the 1960s through the late 1980s. Then it rose through the mid-1990s and mostly fell since then through the pandemic. It has been rising over the past seven quarters through Q2.

The quantity theory of money posits that M2 x V = GDP, in current dollars. From our perspective, this isn't a theory at all; it is a meaningless tautology!

(2) *Before M2 fell, it soared.* The recent decline in M2 seems much less alarming when we recall that it soared during the pandemic because it was boosted by three rounds of pandemic relief checks dropped by the US Treasury into the deposit accounts of millions of Americans. In addition, many Americans saved more in the liquid assets included in M2 because they couldn't spend much of their incomes during the pandemic lockdowns; they continued to save more for a while after that point for precautionary reasons. Indeed, the 12-month change in M2 has tracked the 12-month sum of personal saving very closely since the start of the pandemic (*Fig. 8*).

M2 soared by $6.3 trillion from January 2020 (just before the pandemic) to its record high on July 2022. It then fell $801 billion, as noted above. Our opinion is that it is simply falling back to its pre-pandemic upward trendline. In July, we reckon it was still about $3 trillion above that trendline. Meanwhile, M2 has been flat since May. The weekly commercial bank deposits series, which closely tracks M2, has been relatively flat for the past 24 weeks through the September 13 week (*Fig. 9*).

Money II: The Excess Saving Myth. The hard-landers have also been claiming that the reason that they have been wrong since early last year is that consumers have been holding the economy aloft by spending their excess saving accrued during the pandemic, which will soon be depleted. So a consumer-led recession is imminent, they figure.

They observe that personal saving soared during the pandemic years well above the pre-pandemic pace. It then fell below that pace. They claim that the excess saving with which consumers were left after the pandemic now mostly has been spent, as saving has fallen below the pre-pandemic pace since mid-2021. Presumably, consumers' spending on goods and services will take a dive, probably soon when the excess saving is gone and the pace of saving returns to its pre-pandemic trend.

The hard-lander's narrative seems to make sense, but it might be nonsense. There are good reasons to believe that consumer spending is not about to retrench. Consider the following:

(1) The sum of total deposits at all commercial banks plus money market mutual funds (MMMFs) jumped $2.8 trillion during the lockdowns from the last week of February 2020 through the last week of April 2020 (*Fig. 10*). This series has continued to climb to a record $22.9 trillion through the September 13 week. It is well above its pre-pandemic uptrend. Of course, consumers aren't the only holders of these assets, but the sum of deposits plus MMMFs suggests that there is still plenty of excess saving that hasn't been spent by consumers and may remain in liquid assets, especially now that the yields on deposits and money market securities are so high!

(2) The net worth of the household sector rose to a record $154.3 trillion at the end of Q2-2023 (*Fig. 11*). It is up a whopping $37.6 trillion since Q4-2019, just before the pandemic. There's no pressing need for consumers to save more than they've been saving recently, in our opinion. There tends to be an inverse relationship between the personal saving rate and household net worth as a percentage of disposable personal income (DPI) (*Fig. 12*).

(3) Prior to the pandemic, the main driver of real personal consumption expenditures was real DPI (*Fig. 13*). During the pandemic years (2020 and early 2021), pandemic relief checks boosted real DPI, while consumption didn't recover back to its pre-pandemic trend until mid-2021. Real DPI fell during most of 2021 and early 2022, but real consumer spending resumed its pre-pandemic upward trend because households saved less. Meanwhile, real DPI has been rising again since early 2022.

So in reality, consumers saved less of their real DPI to bolster their spending on goods and services when real DPI was falling. They could afford to do so because they enjoyed a huge windfall from the "helicopter money" dropped by the government in their accounts, much of which still seems to be sitting in liquid assets. They also enjoyed gains again in their stock portfolios since October of last year, while their home values remained elevated despite rising mortgage rates. So now there is no pressing need for consumers to boost their saving rate back to where it was just before the pandemic (i.e., at 9.1% during January 2020 from 3.5% during July 2023).

(4) The bottom line is that a significant portion of the pandemic relief checks might remain in consumers' net worth. They saved rather than spent quite a bit of their so-called excess saving. Then when their DPI fell, they saved less of it, so their spending actually rose. Now

growing DPI is supporting consumption without any compelling reason for consumers to save more of it.

Credit I: No-Show Credit Crunch Despite Inverted Yield Curve. The inverted yield curve has also been a favorite debating point of the hard-landers. The yield-curve spread between the 10-year US Treasury bond yield and the federal funds rate is one of the 10 components of the Index of Leading Economic Indicators (LEI) (*Fig. 14*). It has contributed to the decline in the LEI, which peaked at a record high in December 2021 and has been falling since then through July. The yield curve has been inverted since December 2022.

Yet so far, the inverted yield curve hasn't correctly predicted a credit crunch, which is what caused previous recessions. So far, the credit crunch has been a no-show, just like the *Godot* recession. The inverted yield curve did correctly predict a financial crisis, which occurred in the banking system during March. But the Fed whacked that mole by quickly providing an emergency lending facility for the banking system.

So while the hard-landers still argue that Godot soon will make a belated entrance on stage, the Index of Coincident Economic Indicators (CEI) suggests not: It rose 0.2% m/m in August to yet another record high (*Fig. 15*). It tracks the y/y growth rate of real GDP closely. The former was up 1.4% y/y in July, while real GDP was up 2.5% y/y through Q2 (*Fig. 16*).

Meanwhile, the yield curve has been disinverting. From a daily perspective, the yield-curve spread between the 10-year and 2-year Treasuries narrowed to -66bps on Friday from a low of -108bps on July 3 (*Fig. 17*). That's because the economic outlook currently appears to be "stronger for longer," which is why Fed officials have been promoting a higher-for-longer outlook for the federal funds rate.

By the way, Melissa and I literally "wrote the book" on the yield curve in 2019; it's titled *The Yield Curve: What Is It Really Predicting?* You can download a pdf of it at the provided link.

Credit II: Banks Lending As Usual. Notwithstanding the above, Melissa and I are on full alert watching for a credit crunch in the weekly balance-sheet data on the commercial banking system provided by the Fed. So far, so good. Keep in mind that commercial and industrial (C&I) loans at the banks is a component of the Index of Lagging Economic Indicators. In any event, here are our observations on the latest data, through September 13:

(1) All loans and leases rose 4.4% y/y through the September 13 week, down from a recent

peak of 12.2% during the October 26, 2022 week (*Fig. 18*). The slowdown is widespread among the four major loan categories, and especially noticeable for C&I loans, which are up just 0.1% y/y (*Fig. 19*). Might this weakness signal a credit crunch? More likely is that it is coinciding with the business inventory cycle, especially for retailers that had to discount unsold merchandise late last year to clear it out of their stores (*Fig. 20*).

(2) Interestingly, commercial real estate loans were still up 7.3% y/y during the September 13 week to a record high of $2.9 trillion (*Fig. 21*). Nevertheless, we still believe that the commercial real estate (CRE) market is getting hit with a rolling recession. It is likely to be quite severe and spread beyond old urban office buildings as CRE borrowers are forced to refinance their properties at much higher interest rates. A glut of new multi-family residential housing is depressing rents and could cause distress in this sector of the CRE market. We note that multi-family housing starts dropped sharply in August.

(3) The only bit of bank loan data that, taken alone, could be construed as a sign of a credit crunch so far is that auto loans are down 2.2% y/y (*Fig. 22*). But credit card and other revolving plans are up by a much greater 10.8% y/y.

Movie. “Golda” (+ + +) (*link*) is a docudrama about Golda Meir, when she led Israel as prime minister during the Yom Kippur War in 1973. Helen Mirren does an incredibly good job in the lead role. The movie depicts Israel’s existential crisis attributable to the war and Golda’s adroit management of the near calamity. Israel succeeded in winning the war, which started with a surprise attack by a coalition of Arab states led by Egypt and Syria. Golda agreed to a ceasefire with Egyptian President Anwar Sadat. She lived to see the signing of the Camp David Accords in 1978. It was the first formal peace agreement between Israel and its Arab neighbors.

Calendars

US: Mon: Dallas Fed Manufacturing Index; Chicago Fed National Activity Index; Kashkari. **Tues:** Consumer Confidence 105.9; New Home Sales 700k; Richmond Fed Manufacturing; API Weekly Crude Oil Inventories; Bowman. (FXStreet estimates)

Global: Mon: Germany Ifo Business Climate Index, Current Assessment, and Expectations 85.1/.87.9/82.8; Lagarde; Schabel; Jones. **Tues:** BoJ Monetary Policy Meeting Minutes; Lane; Wuermeling. (FXStreet estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index tumbled 3.0% last week for its third straight decline and its biggest in 28 weeks. The index is now back in a correction at 11.1% below its record high on December 27, 2021. The US MSCI ranked 37th of the 48 global stock markets that we follow in a week when 12 of the 48 countries rose in US dollar terms. The AC World ex-US index outperformed, but dropped 2.2% to end the week at a deep 18.3% correction from its June 15, 2021 record high. All regions fell for the week, but most outperformed or matched the AC World ex-US: EMEA (-1.2%), BIC (-1.4), EAFE (-2.1), EMU (-2.1), and EM Latin America (-2.2) . EM Eastern Europe and EM Asia were the worst performing regions last week with 2.3% declines. Pakistan was the best-performing country last week, with a gain of 3.1%, followed by Egypt (1.6), New Zealand (1.6), and South Africa (0.8). Among the 18 countries that underperformed the AC World ex-US MSCI last week, the 8.6% decline for Hungary was the biggest, followed by those of Taiwan (-4.8), Korea (-4.5), Peru (-4.2), and Ireland (-3.8). Looking at 2023's performance so far, the US MSCI is up 12.9%, as its ytd ranking remained dropped one place w/w to 12/48. The AC World ex-US's ytd gain of 4.5% is trailing the US's, with 31/48 countries in positive territory. EM Eastern Europe is the best regional performer ytd with a gain of 12.3%, followed by EM Latin America (9.9), EMU (8.8), and EAFE (6.2). The regional laggards so far in 2023: BIC (-2.2), EMEA (-0.1), and EM Asia (0.4). This year's best ytd country performers: Sri Lanka (32.5), Greece (32.4), Argentina (26.2), Hungary (23.5), and Italy (19.9). Here are the worst-performing countries of the year so far: Pakistan (-28.7), Hong Kong (-18.9), Finland (-13.5), Thailand (-12.1), New Zealand (-9.7), and South Africa (-9.7).

S&P 500/400/600 Performance (*link*): All three of these indexes fell w/w, but LargeCap's decline was its worst in 28 weeks. MidCap dropped 2.8%, less than the 2.9% and 3.4% declines for LargeCap and SmallCap. At Friday's close, LargeCap finished the week nearly back in a correction at 9.9% below its record high on January 3, 2022, MidCap remained in a correction to end at 14.3% below its record high on November 16, 2021, and SmallCap dropped back into bear market territory at 21.8% from its November 8, 2021 record high. All 33 LargeCap and SMidCap sectors moved lower for the week, compared to 19 rising a week earlier. LargeCap Health Care was the best performer, albeit with a decline of 1.2%, followed by SmallCap Communication Services (-1.4), LargeCap Utilities (-1.7), LargeCap Consumer Staples (-1.8), and MidCap Consumer Staples (-1.8). Among the biggest underperformers for the week were LargeCap Consumer Discretionary (-6.3), SmallCap Real Estate (-6.0), LargeCap Real Estate (-5.4), MidCap Real Estate (-4.7), and SmallCap Materials (-4.3). Looking at performances so far in 2023, LargeCap, with a gain of 12.5%,

remains well ahead of MidCap (2.7) and SmallCap (-1.0); 18 of the 33 sectors are higher ytd. The top sector performers in 2023: LargeCap Communication Services (39.4), LargeCap Tech (33.9), LargeCap Consumer Discretionary (26.0), MidCap Industrials (15.3), and MidCap Tech (13.5). Here are 2023's biggest laggards: MidCap Utilities (-18.8), MidCap Communication Services (-16.0), SmallCap Financials (-15.3), SmallCap Utilities (-14.1), and SmallCap Health Care (-13.9).

S&P 500 Sectors and Industries Performance (*link*): All 11 S&P 500 sectors fell last week, but seven outperformed the composite index's 2.9% decline. That compares to a 0.2% decline for the S&P 500 a week earlier, when seven sectors rose and nine outperformed the index. Health Care was the best performer, albeit with a decline of 1.2%, followed by Utilities (-1.7), Consumer Staples (-1.8), Energy (-2.3), Tech (-2.6), Industrials (-2.7), and Financials (-2.8). Consumer Discretionary was the worst performer, with a drop of 6.3%, followed by Real Estate (-5.4), Materials (-3.7), and Communication Services (-3.2). Looking at 2023's performance so far, the S&P 500 is up 12.5% ytd, with just three sectors still outperforming the index and six higher for the year. The best ytd performers: Communication Services (39.4), Tech (33.9), and Consumer Discretionary (26.0). These are 2023's worst performers: Utilities (-10.3), Real Estate (-6.5), Consumer Staples (-4.7), Health Care (-4.3), Financials (-1.5), Materials (0.9), Energy (2.0), and Industrials (3.6).

S&P 500 Technical Indicators (*link*): The S&P 500 fell 2.9% last week and weakened relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index remained below its 50-dma for a third week, but has been above in 21 of the past 26 weeks. It remained above its 200-dma for a 27th week. As for what the dmas themselves have been doing, the 50-dma turned down w/w for just the second time in 26 weeks, and the 200-dma rose for a 17th week in its longest positive streak since March 2022. The S&P 500 tumbled to a six-month low of 3.5% below its now-falling 50-dma from 0.8% below its rising 50-dma a week earlier. For perspective, the latest reading is also down from a 20-week high of 5.4% above its (rising) 50-dma in mid-June and up from a 20-week low of 3.6% below its (falling) 50-dma at the beginning of March. Other comparison points include: a four-month low of 10.6% below its (falling) 50-dma at the end of September 2022, a 23-month high of 8.7% above its (rising) 50-dma in August 2022, and a 27-month low of 11.1% below its (falling) 50-dma in June 2022. The index had been trading above its 50-dma from most of late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. Turning to the 200-dma, the price index weakened to a five-month low of 2.8% above its (rising) 200-dma from 6.1% above a week earlier. That compares to a 24-month

high of 12.4% above its (rising) 200-dma in mid-July. The S&P 500 is well above its 26-month low of 17.1% below its (falling) 200-dma in June 2022 and compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst level of the Great Financial Crisis following the failure of Lehman Brothers, the S&P 500 index was 39.6% below its 200-dma on November 11, 2008.

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US Economic Indicators

Leading Indicators (*link*): Leading indicators continued to plunge in August, while coincident indicators set yet another record high. The Leading Economic Indicators (LEI) fell in August for the 17th straight month, sinking 0.4% m/m and 10.4% over the period—the

longest losing streak since 2007-08—to the lowest level since mid-2020. Over the six months through August, the LEI dropped 3.8%, little changed from the 3.9% drop over the previous six-month period through February. Leading indicators is biased toward the goods economy. In August, six of the 10 components contributed negatively, three positively, and the average workweek was unchanged. The biggest negative contributors to August's LEI once again were the new orders diffusion index (-0.19ppts), consumer expectations (-0.17), and the interest rate spread (-0.15), followed by stock prices (-0.05), leading credit index (-0.04), and initial claims (-0.01). Positive contributions were recorded by building permits (+0.20), real capital goods orders (+0.02), and real consumer goods orders (+0.01).

Coincident Indicators (*link*): The Coincident economic Indicators (CEI) index hasn't posted a decline this year, though there have been a few flat readings. The CEI rose for the fourth time in five months in August, up 0.2% m/m and 0.8% over the period to yet another new record high; it's up 1.2% ytd and 1.4% y/y. It exceeds its previous record high, just before the pandemic, by 3.1%. All four CEI components rose in July: 1) *Industrial production (+0.07ppts)* was a surprise on the upside, led by mining output and defense production. Headline production rose 0.4% in August, double the expected 0.2% gain though only roughly half of July's 0.7% increase. A 1.4% increasing in mining output and a 3.5% jump in production of defense and space equipment led to the upside surprise. Meanwhile, manufacturing production edged up only 0.1% during the month, held back by a 5.0% drop in the production of motor vehicles and parts. 2) *Real personal income less transfer payments (+0.07ppt)* hasn't posted a decline this year, climbing 0.2% in August and 1.4% ytd to a new record high and is up 11.7% from its April 2020 bottom. 3) *Payroll employment (+0.04)* in August was stronger than expected, climbing 187,000 (vs 168,000 expected), though there were downward revisions to July and June payrolls for a net loss of 110,000. Nonfarm payrolls averaged monthly gains of 287,000 the first five months of the year, slowing to an average gain of 149,700 during the three months through August. 4) *Real manufacturing & trade sales (+0.04)* rose for the third month time in four months, by 0.2% in August and 1.5% over the period, slowing from May's 1.0% increase. It remains in a volatile flat trend and is within 0.5% of its record high posted during January 2022.

Regional M-PMIs (*link*): Two Fed districts have reported on manufacturing activity for September—New York and Philadelphia—and show it's a tale of two regions. Manufacturing activity (to -5.8 from -3.5) continued to contract, though at a slower pace from March's -23.9, as the New York (to 1.9 from -19.0) region's measure swung from contraction to expansion, while Philadelphia's (-13.5 from 12.0) swung from expansion to contraction. New orders (-2.6 from –2.0) held around the breakeven point between expansion and contraction this month, as billings in the Philadelphia (-10.2 from 16.0) area

experienced a wide 26.2-point swing back into contractionary territory, while New York's (5.1 from -19.9) recorded a positive 25.0-point swing back into expansionary territory. Employment (-3.7 from 1.9) showed factories are slow to hire, bouncing around zero the past few months, with both the New York (-1.4 from 4.7) and Philadelphia (-6.0 from -1.0) regions showing slight contractions. Looking at prices-paid indexes, the Philadelphia (25.7 from 20.8) measure showed an acceleration from April's 8.2 reading—which was its lowest since mid-2020—while New York's (25.8 from 25.2) held steady. Prices-received indexes were mixed: New York's (19.6 from 12.8) picked up a bit from July's three-year low; it was at a record high of 56.1 in March 2022. Philadelphia's (14.8 from 14.1) barely budged, in September, though did ease from May's 23.0. It was at a record high of 65.8 in November 2021.

Existing Home Sales (*link*): "Home sales have been stable for several months, neither rising nor falling in any meaningful way," noted Lawrence Yun, NAR's chief economist. He went on to say, "Mortgage rate changes will have a big impact over the short run, while job gains will have a steady, positive impact over the long run. The South had a lighter decline in sales from a year ago due to greater regional job growth since coming out of the pandemic lockdown." *Existing home* sales declined 0.7% in August to 4.04mu (saar) and are down 0.2% ytd; sales are down 15.3% y/y. Single-family sales dropped for the sixth successive month in August, by 12.2% over the period to 3.60mu (saar), after a 14.2% jump in February. These sales were also 15.3% below a year ago. *Multi-family* sales rose 4.8% to 440,000 units (saar) during August, but were down 15.4% from a year ago. Existing home sales were a mixed bag in August, rising in one region, falling in two, and unchanged in another; they continue to post double-digit declines on a year-over-year basis: Midwest (+1.0% m/m & -16.4 y/y), Northeast (0.0 & -22.6), South (-1.1 & -12.4), and West (-2.6 & -15.7). Total *housing inventory* at the end of August was 1.1 million units, down 0.9% from July and 14.1% from a year ago, with unsold inventory sitting at a 3.3 months' supply at the current sales pace. Yun noted, "Home prices continue to march higher despite lower home sales. Supply needs to essentially double to moderate home price gains."

Global Economic Indicators

US PMI Flash Estimates (*link*): "Further loss of service sector momentum weighs on overall US economic performance," according to September's flash estimate report. The US private sector in September slowed for the fourth successive month, as the manufacturing sector continued to contract while the service sector's reading hovered around the breakeven point between expansion and contraction. The *C-PMI* eased to 50.1 in August,

down from May's 13-month high of 54.3. The *NM-PMI* also slowed for the fourth successive month, to 50.2, after advancing the prior five months, from 44.7 at the end of last year to a 13-month high of 54.9 in May, while the *M-PMI* remained below the breakeven point of 50.0 for the 10th time in 11 months. According to the report, there were added concerns regarding the trajectory of demand conditions in the US economy following interest-rate hikes and elevated inflation. The overall Output index held above the 50.0 demarcation mark, though only fractionally. On the *price front*, the overall rate of input inflation was the sharpest since June, led by manufacturing, which showed the biggest gains since April as higher oil prices pushed up chemicals, plastics, and transportation costs. Meanwhile, firms found it challenging to pass through the full extent of higher cost burden to clients.

Japan PMI Flash Estimates (*link*): The private sector in September showed its slowest rise in growth since February, according to flash estimates. The service sector continued to grow, with a sustained increase in business activity, though the rate of growth was the slowest in eight months. Meanwhile, the manufacturing sector recorded a fourth successive deterioration in operating conditions—which was the steepest in seven months. Japan's *C-PMI* has dropped from a recent high of 54.3 in May to a seven-month low of 51.8 in September. The *NM-PMI* dipped for third time in four months to 54.3 in September from 55.9 in May, while the *M-PMI* hasn't increased since May, easing to 48.6 in September from 50.6 in May. According to the report, "forward looking indicators from the survey suggest the potential for softening demand and activity over the coming months." Price pressures remain elevated for manufacturer as the rate of *input inflation* accelerated at this fastest pace in four months. Meanwhile, the report noted that *output charges* were "increased at an unchanged, albeit solid pace in the latest survey period."

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