MORNING BRIEFING
October 10, 2023

Reassessing Recession Risk

Check out the accompanying chart collection.

Executive Summary: The prospects of a prolonged war in the Middle East heighten the chance of a recession in the US. That's not our base-case outlook, but we are raising the odds we see of a recession before year-end 2024 to 30% from 25%. The other 70% represents the rolling recessions/recoveries scenario we expect to continue; it's tough to envision a recession when consumers have the support of such a robust labor market. … But our worry list has expanded with the recent addition of a potential debt crisis and now the escalation of Middle East hostilities. Additionally, we're monitoring the banking industry for any sign of an emergent credit crunch.

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

Worry List I: New Worries & Unchanged Hopes. We are raising our odds of a recession before year-end 2024, though that's still not our base-case outlook. Our subjective probability of a recession is now 30%, up from 25%. We raised it from 15% to 25% on September 18.

The September increase reflected our new concern about a US debt crisis attributable to the widespread recognition that US federal government deficits are too d@mn wide. Today's increase reflects a new concern: the start of the latest war in the Middle East on Saturday. This one isn't likely to lead to a quick ceasefire between Israel and Hamas, as occurred in the past, because it is in fact a war between Israel and Iran. For Israel, it is existential. This time, Israel's goal is to wipe out Hamas, which is Iran's surrogate in Gaza. The war is also existential for Iran's mullahs, who need it to distract the population from discontent over their authoritarian regime by moving forward on their machinations to wipe out Israel.

Our base case remains a rolling recession with rolling recoveries, now with a 70% subjective probability. The economy-wide recession scenario has been based on the widely held view that the Fed's aggressive rate hiking combined with quantitative tightening since early last year would trigger a credit crunch and a recession. Lending credence to that forecast have been the inversion of the yield curve and falling leading indicators. However, the *Godot* recession has been a no-show so far because the economy has proven

remarkably resilient in the face of rolling recessions that have rolled through the single-family housing and retailing industries. There was a banking crisis in March, but the Fed contained it quickly.

Meanwhile, the labor market remains strong, as evidenced by the latest payroll employment and job openings reports (*Fig. 1*). Consumer spending has held up very well thanks to record-high employment (*Fig. 2*). The Atlanta Fed's *GDPNow* tracking model is currently forecasting that real GDP rose 4.9% (saar) during Q3 led by a 3.7% increase in consumer spending.

While the Index of Leading Economic Indicators is down 10.5% since it peaked on December 2021 through August this year, the Index of Coincident Economic Indicators (CEI) rose to new record highs during that period (*Fig. 3*). Payroll employment is one of the four components of the CEI (*Fig. 4*). It is the first one of them that is reported at the beginning of every month and tends to predict the other three. We've said it before: It's hard to have a consumer-led recession when payroll employment is rising to record highs month after month.

Nevertheless, let's discuss the latest risks to this happy outlook to explain why we've ratcheted up our odds of a recession.

Worry List II: Debt Crisis. The potential for a debt crisis became apparent after Fitch Ratings downgraded US Treasury debt from AAA to AA+ on August 1. Fitch's reasons for doing so were well known; however, the downgrade suddenly brought the deficit issue to the fore.

I've often said that I will care about the deficit issue when the financial markets care about the issue. They clearly care now. So does the financial press, which has been running lots of stories about the unmanageable size of the deficit now and in the future. And most importantly, the Bond Vigilantes seem to have saddled up and formed a posse of rough riders aiming to bring law and order back to fiscal policy. Consider the following:

(1) *Bond yield soaring too much.* The 10-year Treasury bond yield was 3.97% on July 31. Following the Fitch downgrade, it soared to 4.78% on Friday (*Fig. 5*). The 30-year Treasury yield rose from 4.02% to 4.95% during this same period. Both are back to their Old Normal levels, i.e., where they were from 2003 to 2007, which preceded the "New Abnormal" period from 2008 to early 2022, i.e., from the Great Financial Crisis through the Great Virus Crisis.

We still expect that the 10-year Treasury bond yield will settle around the Old Normal range of 4.50%-5.00%. That will happen only if inflation continues to moderate, as we've been predicting. Inflation is turning out to be relatively transitory after all, in our opinion. As we've noted previously, the headline and core CPI inflation rates excluding shelter rose just 1.9% and 2.2% y/y through August (*Fig. 6*). We know that rent inflation is heading lower in coming months (*Fig. 7*).

(2) *Yield curve disinverting the wrong way.* Meanwhile, the yield-curve spread between the 10-year and 2-year Treasury notes has narrowed significantly from a recent low of -108bps to -30bps on Friday (*Fig. 8*). Does a disinverting yield curve signal that a recession is now less likely?

In the past, yield-curve inversions disinverted during recessions when the Fed cut interest rates to revive economic growth. Short-term rates fell faster than long-term rates. This time, the 10-year Treasury bond yield is rising faster than the 2-year yield. If that continues, the chances of something breaking in the credit markets will increase. If something breaks, it could precipitate a credit crunch and a recession.

(3) *Dalio's debt crisis.* Our baseline scenario requires that the bond yield is now high enough to equilibrate the supply and demand for Treasury securities without causing a recession. The "immaculate disinflation" (i.e., without a recession) that we expect should facilitate such an equilibrium. We will be watching the Treasury's bond auctions in coming months, along with everyone else, to see whether the bond yield is stabilizing or needs to go higher to clear the Treasury market's supply.

If the auctions are sloppy, yields will continue to rise above 5.00%. That would increase the odds of *Ray Dalio's debt crisis* scenario in which the yield rises to levels that crowd out demand for the private sector's debt, triggering a financial crisis, credit crunch, and a recession (see our October 4 *Morning Briefing*).

Worry List III: Geopolitical Crisis. The debt crisis scenario is a relatively new worry for the markets and for us. We all started to worry about it this summer, as noted above, especially after the 10-year Treasury bond yield jumped above last year's high of 4.25% on August 16.

The new worry is that the war that broke out on Saturday between Hamas, Iran's proxy in Gaza, and Israel will widen and be prolonged. That would be the case if Hezbollah, Iran's proxy in Lebanon, enters the war.

It's unlikely that the result will be a direct confrontation between Iran and Israel, but that scenario isn't out of the question. More likely is that the Biden administration will tighten sanctions on Iran's oil exports, which plunged 1.6 million barrels per day during the Trump administration and rose 0.6 mbd during the first three years of the Biden administration (*Fig. 9*).

The tightening of sanctions on Iran oil could cause oil prices to spike above $100 a barrel, which could trigger a worldwide recession. More likely is that Saudi Arabia would increase its production and exports to keep the price of oil below $100 a barrel. Producers just recently learned that the 23% increase in the price of a barrel of crude oil during Q3-2023 immediately depressed oil demand, especially gasoline usage in the US (*Fig. 10*).

Worry List IV: US Credit Risks. Of course, we continue to monitor the weekly commercial bank data compiled by the Fed for signs of a bank-led credit crunch. The latest data show slowing growth in loans but not a sudden credit contraction:

(1) Here are the y/y growth rates of the major bank loan categories through the September 27 week and their recent peaks either last year or earlier this year: commercial & industrial (C&I) loans (0.4%, 15.0%), residential real estate (5.2, 10.2), commercial real estate (6.8, 13.5), and consumer loans (5.2, 12.8) (*Fig. 11*).

The most notable slowdown is in C&I loans. Last week, we attributed this development to a lack of demand to finance inventories as a result of the rolling recession in the goods sector. So the weakness reflects a weakening of credit demand rather than a tightening of credit supply.

(2) We are on high alert for a credit problem in commercial real estate. Here, too, we are seeing a slowdown; but we are certain it is heading for a credit crunch as long as bond yields remain high or go higher (*Fig. 12*). Interestingly, commercial real estate loans secured by multi-family properties are up 14.4% y/y through August, but that's down from a red-hot peak of 27.7% during December 2022.

(3) We are also monitoring provisions for loan losses at the large and small banks (*Fig. 13*). They have been rising for both, but not in an alarming fashion.

Calendars

US: Tues: NFIB Small Business Optimism Index; Wholesale Inventories -0.1%; Consumer Inflation Expectations; IMF Meetings; Waller; Kashkari; Daly; Bostic. **Wed:** Headline & Core PPI 0.3%m/m/1.6%y/y & 0.2%m/m/2.3%y/y; MBA Mortgage Applications; FOMC Meeting Minutes; EIA Short-Term Energy Outlook; IMF Meetings; Bowman; Waller; Bostic. (FXStreet estimates)

Global: Tues: UK Labor Productivity 0.7%; BoE FPC Meeting Minutes; Lagarde; Balz; Kent. **Wed:** Germany CPI 0.2%m/m/4.3%y/y; Italy Industrial Production; Japan PPI 0.1%m/23%y/y; Japan Core Machinery Orders 0.4%m/m/-7.3%yy; China New Loans & Total Social Financing ¥2.5t & ¥3.8t; Mauderer; Noguchi. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for two of these three indexes during the October 6 week. LargeCap's forward earnings was at a record again after first hitting that mark during the September 15 week for the first time in 15 months, dating back to the June 24 week of 2022. MidCap's improved to 4.1% below its record high in early June 2022; and SmallCap's weakened to 8.7% below its mid-June 2022 record. Through the week ending October 6, LargeCap's forward earnings has risen 6.7% from its 54-week low during the week of February 10; MidCap's is 4.4% above its 55-week low during the week of March 10; and SmallCap's is 5.7% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrend since mid-2022 has been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Forward earnings momentum remains near two-year lows but is steadily ticking higher now. The yearly rate of change in LargeCap's forward earnings has improved to 1.8% y/y from a 29-month low of -3.2% y/y during the June 23 week. Those levels compare to a record-high 42.2% at the end of July 2021 and, on the downside, to -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -1.8% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -6.8% y/y rate is up from a 32-month low of -12.9% in mid-June and 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 June of last year, but the 2023 estimate for the S&P 500 ticked higher during the Q1

and Q2 reporting seasons 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 12.0%), MidCap (-12.3, 13.6), and SmallCap (-8.2, 12.0).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower for these three indexes during the October 6 week. LargeCap's forward P/E rose 0.1pt w/w to 17.9 from a 27-week low of 17.8, but remains below its 18-month high of 19.6 during the July 28 week. It's up 2.8pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.3pt w/w to an 11-month low of 12.8, and is down from its 21-week high of 14.4 during the July 28 week. It's now 1.9pt below its recent 10-month high of 14.7 in early February and up 1.7pts from its 30-month low of 11.1 at the end of September 2022, 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 fell 0.2pt w/w to an 11-month low of 12.0, which compares to a 21-week high of 14.1 during the July 28 week and is now 2.3pt below its recent 12-month high of 14.3 in early February. It's up 1.4pts from its 14-year low of 10.6 in September 2022 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 28% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's fell to a 23-year low discount of 33%, which 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 121st straight week; the current 6% discount is 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 through Q1-2023 before easing for Q2-2023. Looking at Q3-2023, the revisions pendulum turned slightly negative w/w in the usual performance right before the start of the earnings season. They're forecasting that the S&P 500's earnings will drop 0.4% y/y in Q3-2023. That's up from a 5.8% decline in Q2-2023, which likely marked the cyclical bottom for earnings growth. On a pro forma basis, they expect a y/y earnings gain of 1.3% in Q3, up from a

2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 6.2% y/y in Q3-2023, an improvement from the 3.6% gain in Q2-2023, the 1.6% decline in Q1-2023, and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q3-2023, unchanged from Q2-2023's count. However, that's up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q3-2023 versus their final earnings growth rates for Q2-2023: Communication Services (33.8% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (23.1, 57.0), Utilities (12.5, 0.6), Financials (11.3, 9.3), S&P 500 ex-Energy (6.2, 3.6), Information Technology (6.0, 5.0), Industrials (5.3, 15.7), S&P 500 (1.3, -2.8), Consumer Staples (1.2, 8.5), Real Estate (-7.3, -2.1), Health Care (-10.0, -26.7), Materials (-20.5, -26.4), and Energy (-34.7, -47.5).

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