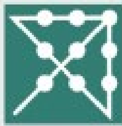

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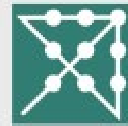

MORNING BRIEFING
October 17, 2023

It's Different This Time

Check out the accompanying chart collection.

Executive Summary: Today, we compare the current economic and financial environment with those of three past periods—the late 1970s, early 2000s, and mid-2000s. Today's environment resembles the other three in that easy credit conditions fueled price and/or asset inflation, which led to tightening of credit conditions. In the past periods, that set off economywide credit crunches and recessions that moderated inflation. This time is different: No economywide recession is forthcoming, yet inflation is moderating anyway. The most important difference about this period, however, is that productivity growth is unlikely to collapse but to boom throughout the rest of this decade.

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

History I: Then & Now. Mark Twain said, "History doesn't repeat itself, but it often rhymes." In other words, details change, circumstances change, settings change, names change, but similar events will essentially recycle. That's because human nature doesn't change. Several years after Twain's comment on history, Yogi Berra observed, "It's like déjà vu all over again."

Debbie and I were recently asked by one of our accounts in Manhattan to compare the current economic and financial environment to those of the late 1970s, the early 2000s, and the mid-2000s. The first period was associated with the Great Inflation. The second period included the Tech Wreck and the 9/11 terrorist attacks. The third period was marked by the bursting of the housing bubble.

We were tasked with the job of assessing the similarities and the differences between what happened back then and what is happening now. We were asked to focus on GDP, inflation, money and credit, speculative bubbles, and geopolitics. We've previously compared what happened then and now. Indeed, in 2018, I wrote a book on the subject titled "*Predicting the Markets: A Professional Autobiography*." In effect, it is a history of the first 40 years of my career on Wall Street, which started in 1979. Over that period, history often rhymed, though not always.

The four historical cycles under review, including the current one, all started with easy credit

conditions that fueled economic booms and inflated consumer prices and/or assets prices. Price inflation and/or speculative asset bubbles forced the Fed to tighten credit conditions. The result during the first three cycles were financial crises that morphed into economy-wide credit crunches and recessions. Price inflation moderated and the speculative bubbles burst, which exacerbated the economic downturn.

So far, this time has been different, but it still rhymes with recent history. Easy money boosted economic growth following the pandemic lockdown. Fiscal policy also was very stimulative, much more so than in the past. Price inflation soared, as it did during the 1970s. Wage inflation did so too. Assorted speculative mini-bubbles in the stock market burst, causing a relatively short bear market. But the biggest bubble turned out to be the one in the bond market, which has suffered the worst bear market of all times over the past three years as the Fed slammed on the monetary brakes to break the back of inflation.

This time, there was a financial crisis that caused a couple of banks in California to collapse. But the Fed contained the problem by quickly providing an emergency liquidity facility for the banks. Credit conditions certainly have tightened, but there hasn't been an economy-wide credit crunch like the ones during the previous three periods. So far, the most widely anticipated recession of all times has been a no-show, even though the tightening of monetary policy is reminiscent of that of the late 1970s, when the Fed, under then-chairman Paul Volcker, likewise slammed on the brakes.

History II: GDP. There were four recessions during the Great Inflation from 1965 through 1982 (*Fig. 1* and *Fig. 2*). The second and the fourth were among the longest and deepest ones since the end World War II. Leading the way down were the quarterly housing and auto components of real GDP (*Fig. 3* and *Fig. 4*). They fell along with the monthly series on housing starts and auto sales (*Fig. 5* and *Fig. 6*).

The recession at the start of the 2000s was largely attributable to the bursting of the tech bubble. There was a big boom in spending on communications equipment prior to that recession. The industrial production index for communication equipment plunged 40.7% from January 2001 through October 2002 (*Fig. 7*). During the recession of the Great Financial Crisis (GFC), computer & peripheral equipment output dropped 41.9% from May 2008 through March 2011.

The biggest contributor to the recession of the GFC was the bursting of the real estate bubble and all the credit derivatives that had inflated the bubble. The resulting credit crunch was significant.

History III: Inflation. The most intense and prolonged bout of inflation occurred during the Great Inflation period (*Fig. 8*). The Great Inflation of the 1970s actually started during the second half of the 1960s. It was triggered by President Lyndon Johnson's decision to deficit-finance the Vietnam War rather than to increase taxes to fund the war. The same can be said about his Great Society initiative. A result of this guns-and-butter approach to fiscal policy was higher inflation.

President Richard Nixon continued that approach during the early 1970s and exacerbated inflation by closing the gold window on August 15, 1971, which caused the dollar to depreciate significantly. The weaker dollar boosted commodity prices and caused OPEC to drive oil prices higher during the 1970s. A wage-price-rent spiral ensued during the Great Inflation.

Then-Fed Chair Paul Volcker allowed interest rates to soar in late 1979 and the early 1980s to halt the Great Inflation by triggering a credit crunch and a recession. Inflation did decline and remained low during the Great Moderation from the mid-1980s until the start of the GFC. From the GFC through the GVC (Great Virus Crisis), central bankers obsessed about deflation and provided ultra-easy monetary policy, hoping to boost inflation to their 2.0% inflation targets.

This time, several rounds of fiscal stimulus programs combined with ultra-accommodative monetary policies caused a demand shock that overwhelmed supplies, unleashing the current bout of inflation. The programs presumably were aimed at offsetting the negative impact of the pandemic on workers. 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 Volcker headed the Fed.

What's different this time is that the US dollar is strong. The Fed has been more aggressive in tightening monetary policy in response to inflation than the other major central banks. Also, the US economy is performing much better than the other major economies, which likewise supports the dollar. In addition, the current inflationary spike is turning out to be relatively transitory, as we discussed in yesterday's *Morning Briefing*.

History IV: Money & Credit. The most intense credit crunch occurred during the GFC. Home mortgage borrowing collapsed from a record high of $1.26 trillion over the four quarters through Q2-2006 to a record low of -$136 billion through Q4-2010 (*Fig. 9*). Commercial mortgage borrowing peaked at a record $289 billion over the four quarters through Q4-2006 and plunged to -$143 billion during Q3-2010 (*Fig. 10*).

The credit crunch triggered by Volcker hit consumer spending on durable goods and housing the most. During the Tech Wreck of the early 2000s, the credit market for telecommunication loans and bonds was hit the hardest. Several significant failures ensued, including WorldCom (2002). It was brought down by an accounting scandal. So too was Enron in 2021.

This time, credit conditions have tightened in response to the Fed's aggressive tightening of monetary policy. However, there remains plenty of liquidity in the financial system. In any event, the economy has proven to be remarkably resilient.

History V: Bubbles. During the 1970s, the biggest bubble was inflated in the global energy industry as oil prices soared. When it burst in the first half of the 1980s, the US energy sector fell into a rolling recession. The overall economy continued to grow because the Fed lowered interest rates. Commercial real estate turned out to be a bubble in the oil patch back then.

The tech bubble burst in the early 2000s. It had less to do with the Fed than with the cash burn rate of unprofitable dotcom startups. Many were able to raise money for a while during the late 1990s. They used the funds to buy lots of IT hardware and software. In addition, such spending was boosted by a scramble to avert a Y2K calamity by upgrading. At the turn of the millennium, Y2K spending dried up, and most dotcoms failed to attract more funding for their questionable business plans.

The housing bubble during the GFC was an accident waiting to happen. A series of blowups in the credit derivatives market led to a credit crunch that spread well beyond the US housing market after Lehman Brothers failed in September 2008.

This time, as noted above, the biggest bubble to burst has been the bond market's, as the yield on the 10-year US Treasury bond soared from a record low of 0.52% on August 4, 2020 to 4.80% recently (*Fig. 11*). Yet so far, there has been no significant adverse effect on the overall economy and labor market. That's partly because bond investors aren't forced to take losses if they can hold their bonds to maturity. In addition, as we've previously observed, there is still lots of liquidity in the financial system. Many corporations refinanced their debts at record-low interest rates. Corporate cash flow is at a record high (*Fig. 12*). Household net worth is also at a record high (*Fig. 13*).

History VI: Geopolitics. Fifty years ago, on October 6, 1973, Israel was hit by a surprise

attack by Arab armies from Egypt, Jordan, and Syria. That was the Yom Kippur War. A week ago, on Saturday, October 7, Israel was hit by a surprise attack by Hamas terrorists.

In recent years, previous geopolitical crises in the Middle East have tended to be short-lived. Selloffs in the US stock market turned out to be buying opportunities. So far, the stock market hasn't reacted adversely to the latest crisis. That's partly because the price of oil hasn't spiked on this development. The widespread assumption is that this crisis will also be short-lived and won't turn into a regional war with Iran joining forces with Hamas and Hezbollah.

History VII: Now & Then. There are many similarities and many differences between now and our very brief review of the 1970s and the 2000s. Books have been written about the financial and economic history of the past 40+ years, including my own book.

In our opinion as prognosticators, the most important difference between now and then is that we are expecting a productivity growth boom over the rest of this decade. Conversely, productivity growth collapsed during the previous three periods we spotlighted above (*Fig. 14*).

The biggest risk to our optimistic outlook is that the Bond Vigilantes respond to Washington's fiscal excesses and follies by pushing the bond yield up to levels that cause a credit crunch and a recession. We reckon that would put the 10-year Treasury bond yield well north of 5.00%.

Calendars

US: Tues: Headline & Core Retail Sales 0.2%/0.1%; Industrial Production 0.1%; Capacity Utilization Rate 79.6%; Business Inventories 0.1%; NAHB Housing Market Index 44; API Weekly Crude Oil Inventories Williams; Bowman. **Wed:** Housing Starts & Building Permits 1.380mu/1.455m; /MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; Williams; Waller; Bowman; Harker; Cook. (FXStreet estimates)

Global: Tues: Germany ZEW Economic Sentiment -10.8; UK Earnings Index Including & Excluding Bonus 8.3%/7.8%; UK Employment Change 3m/3m -195k; UK Unemployment Rate 4.3%; China GDP 1.0%q/q/4.4%y/y; China Industrial Production 4.3% y/y; China Retail Sales 4.5% y/y; Canada CPI 0.1%m/m/4.0%y/y; NBS Press Conference; Nagel; De Guindos; Jochnick; Bullock. **Wed:** Eurozone Headline & Core CPI 0.3%/m/4.3%y/y &

0.2%m/m/4.5%y/y; UK 0.4%m/m/6.5%y/y; UK PPI Input & Output 0.6%/0.3&; UK RPI 0.6%m/m/8.9%y/y; UK House Price Index 0.3%; Australia Employment Change 18k; Australia Unemployment & Participation Rates 3.7%/67.0%; Lagarde; Wuermeling; Elderson. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for all three of these indexes during the October 13 week. LargeCap's forward earnings was at a record high 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 3.9% below its record high in early June 2022, and SmallCap's rose to 8.6% below its mid-June 2022 record. Through the week ending October 13, LargeCap's forward earnings has risen 6.8% from its 54-week low during the week of February 10; MidCap's is 4.6% above its 55-week low during the week of March 10; and SmallCap's is 5.8% 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 2.2% 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 -1.0% 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 -6.4% 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 (1.1% and 12.0%), MidCap (-12.3, 13.6), and SmallCap (-8.5, 12.2).

S&P 500/400/600 Valuation (*link*): Valuations mostly ticked lower for these three indexes during the October 13 week. LargeCap's forward P/E was unchanged w/w at 17.9. That's up from a 27-week low of 17.8 during the September 29 week, 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 0.1pt w/w to an 11-month low of 12.7, and is down from its 21-week high of 14.4 during the July 28 week. It's now 2.0pt below its recent 10-month high of 14.7 in early February and up 1.6pts 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 0.1pt w/w to an 11-month low of 11.9, which compares to a 21-week high of 14.1 during the July 28 week and is now 2.4pt below its recent 12-month high of 14.3 in early February. It's up 1.3pts 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 29% 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 34%, 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 122nd straight week; the current 7% 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 2.2% in Q3, up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 7.2% 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 (33.6% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (23.0, 57.0), Financials (16.8, 9.3), Utilities (12.4, 0.6), S&P 500 ex-Energy (7.2, 3.6), Information Technology (6.0, 5.0), Industrials (5.3, 15.7),

S&P 500 (2.2, -2.8), Consumer Staples (1.5, 8.5), Real Estate (-7.3, -2.1), Health Care (-9.9, -26.7), Materials (-21.1, -26.4), and Energy (-34.5, -47.5).

US Economic Indicators

Regional M-PMI (***link***): The New York Fed has provided the first glimpse of manufacturing activity for October and showed a minor decline, after a big move up in September—continuing the up-and-down pattern prevalent in recent months. October's composite index slipped 6.5 points this month to -4.6, after rebounding 20.9 points in September, from -19.0 to 1.9. Orders (to -4.2 from 5.1) this month moved from expansion to contraction, while shipments (1.4 from 12.4) showed little growth. Meanwhile, delivery times (-6.4 from 2.1) shortened, while inventories (-2.1 from -6.2) continued to contract, though at a slower pace. Labor market measures recorded slight increases in both employment (3.1 from -2.7) and the average workweek (2.2 from -5.0). Turning to prices, the prices-paid (25.5 from 25.8) measure was little changed again this month, while the prices-received (11.7 from 19.6) gauge decelerated after accelerating the prior two months—from 3.9 in July (to lowest reading since summer 2020) to 19.6 in September. 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 remains on an upward trend, in expansionary territory, though slowed scantly, to 23.1 this month from September's 18-month high of 26.3; its recent bottom was -6.1 last November. Both new orders (19.4 from 34.8) and shipments (15.2 from 33.7) are expected to increase again, though at roughly half the pace of September. Employment (21.0 from 15.9) gains are expected to accelerate a bit

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