Yardeni Research

June 18, 2024

Morning Briefing

TAMED Tales

Check out the accompanying chart collection.

Executive Summary: Indicators that often accurately signaled that a recession is on the horizon have missed the mark. Eric takes a look at why the economy has continued to thrive despite numerous Fed interest rate hikes and a plunging LEI. Thank the services and technology sectors as well as deflation imported from China. … We expect the yield curve will remain inverted for a while longer as the Fed cuts interest rates very slowly and the 10-year Treasury yield bounces between 4%-5%. … The Sahm Rule is close to warning that a recession is imminent or upon us. But after a closer look at why May's unemployment rate ticked up—blame college kids—we believe the labor market remains robust.

TAMED I: Technical Analysis Of Macro Economic Data. Over the past two years, the hard landers had innumerable theories and charts to explain why higher interest rates would undoubtedly plunge the economy into a recession. Now, the diehard hard landers are again insisting that their long-held recession call will be proven correct soon. Others among them say we're already in a recession.

So far, these forecasts have been wrong. The economy continues to grow, and the labor market remains robust. The S&P 500 and Nasdaq are both at all-time highs despite the Federal Open Market Committee (FOMC) informing market participants last week that they should expect no more than one cut in the federal funds rate (FFR) this year.

Markets started the year anticipating up to seven rate cuts (*Fig. 1*). The hard landers argued that the Fed would have to engineer a recession to bring down inflation by tightening monetary policy. When inflation turned out to be more transitory than they expected, the hard landers reversed course and argued that the Fed would have to ease aggressively to avoid a recession.

The common denominator underlying the gloomy forecasts of the hard landers has been a reliance on what we call Technical Analysis of Macroeconomic Data (TAMED). Causal effects and correlations that occurred during previous Federal Reserve tightening cycles were flashing red, and therefore, a recession was inevitable.

The hard landers correctly observed that previous Fed tightening cycles were followed by financial crises that turned into economy-wide credit crunches and recessions (*Fig. 2*). But the US and global economies are much different in the post-pandemic world than they were before, rendering many recession indicators with high success in the past, misleading now. Here's how the TAMED approach to forecasting missed the mark:

(1) *Leading vs. Coincident Economic Indicators*. The Conference Board's Index of Leading Economic Indicators (LEI) has plunged since it peaked during December 2021. It is down more than 14% since then through May of this year (*Fig. 3*). The Index of Coincident Economic indicators (CEI), meanwhile rose to another record high last month. It has risen steadily for several years after returning to its pre-pandemic trend relatively quickly. The CEI has been hitting new records since July 2021, despite the downbeat forecasts of the LEI.

The CEI probably rose to a new record in May, given its close correlation with S&P 500 forward earnings, which rose to a record of $260.02 per share in the week ended June 13. Earnings expectations are nearing our year-end target of $270 per share.

(2) *Industrial vs. digital economy*. The LEI, on the other hand, could easily continue to sink. One reason the index's recession forecast has failed is because five of its ten components are manufacturing and construction related. As a result, the LEI very highly correlated with the national manufacturing purchasing managers index (M-PMI) (*Fig. 4*). LEI was a much better predictor of economic downturns when the US economy was more industrial, and a greater share of workers produced goods. Employment in manufacturing, mining, and construction is now just 10% of total payrolls, down from a third in the early 1950s (*Fig. 5*). Today's US economy is more oriented toward services and technology-related industries.

(3) *China exporting deflation*. Most hard landers asserted a recession would be required to bring inflation back down. They missed that a property-led recession in China did the trick. In the US, the core goods CPI fell -1.7% y/y in May from a peak of 12.5% in February 2022. Contributing significantly to that decline was a -2.0% drop in import prices from China (*Fig. 6*).

TAMED II: Inverted Yield Curve. One component of the LEI gets more attention than the others for its predictive power in previous cycles: the inverted yield curve. It accurately predicted US recessions in the past, with only a couple of false positives. We think the LEI has become increasingly misleading as the economy has turned less industrial and more digital:

(1) *Buying bonds*. The two-year US Treasury yield has been above the 10-year yield since November 2022, and yet no recession has ensued (*Fig. 7*). In the past, the yield curve typically inverted as the Fed hiked short-term rates to combat inflation, while investors piled into long-term bonds. Investors anticipated something breaking in the financial system, which would spark a credit crunch and result in a full-blown recession. Thus, investors opted to lock-in higher long-term rates before the Fed had to cut the FFR swiftly to revive the economy out of a recession.

(2) *Crisis contained*. While the financial system did suffer a crisis during the current tightening cycle, the mini-banking crisis of March 2023 was quickly contained by the Fed. Many investors are still happy to clip more than 4.00% on 10-year US bond or more than

2.0% on inflation-adjusted Treasury Inflation-Protected Securities (TIPS). Though yields have come in slightly, they remain close to the highest rates offered on ultrasafe bonds in roughly two decades (*Fig. 8* and *Fig. 9*).

(3) *Rangebound rates*. We expect the 10-year Treasury yield will remain rangebound between 4.0% and 5.0% through the remainder of the year. Expecting the TIPS yield to remain around 2.0% to 2.5%, plus long-term inflation around 2.0% to 2.5%, gets us to this band. Furthermore, we expect the yield to remain below 4.5% more often than it is above, as inflation moderates towards the Fed's 2.0% target. Ten-year breakeven inflation—the difference between the 10-year nominal and TIPS yields—has largely remained between 2.0% and 2.5% for the past two years (*Fig. 10*). It closed last week at 2.16%.

(4) *Yield curve normalization?* So, with little reason for the yield curve to normalize without the Fed cutting the FFR significantly, the yield curve will continue to weigh on the overall LEI. Could the yield curve un-invert without the Fed cutting the FFR? It's possible, but long-term yields would have to surge. Last fall, we saw what happened when the 10-year yield reached 5.0%--Treasury Secretary Janet Yellen drastically shifted the government's debt issuance plans to mostly short-term Treasury bills, to avoid outstripping the relatively weaker demand for long-end notes and bonds.

TAMED III: The Sahm Rule. A relatively new recession model developed by former Fed economist Claudia Sahm is now widely followed. The eponymous Sahm rule suggests that a recession is either already here or on the way if the three-month average unemployment rate rises 0.5 percentage point above the low-water mark of the last 12 months. As of May, the Sahm rule is at 0.4 percentage point, just 0.1 point away from flashing red (*Fig. 11*). We have a few issues with the rule:

(1) *Timing matters*. We don't believe that simple moving averages are a good way to make economic forecasts—it's important to consider the idiosyncrasies of the macro environment in each cycle.

(2) *Momentum*. All the Sahm rule tells us is that when unemployment spiked in the past, it was preceded by an initial rise. In our opinion, that's fairly obvious. There are also several occasions where the Sahm rule came dangerously close to being triggered, or in fact was triggered—like in August 2003—but no recession materialized.

We believe it's important to consider the underlying cause of the uptick in unemployment. In May, much of the unemployment increase to 4.0% stemmed from younger Americans, many of whom are still in college and are off for the summer. Perhaps students aren't too worried about their financial situation considering all the student loan debt that's been forgiven. Meanwhile, the unemployment rate for workers aged 25-to-54 (3.3%) and aged 55 and over (2.7%) remains well below the headline rate (*Fig. 12*).

(3) *Jobs-a-plenty*. Lots of small businesses are struggling to fill jobs right now, and less than 14% of surveyed consumers say it's hard to get a job at the moment (*Fig. 13*). Immigration could put additional pressure on the unemployment rate even as employed workers continue to see real wage gains.

(4) *Mind the pandemic*. The Sahm rule, and other TAMED indicators are ignoring structural shifts in the economy from cycle to cycle. For instance, many hard landers missed the demographic change after the pandemic, when many Baby Boomers retired early and left a swath of job openings for younger workers to fill.

Thanks to record asset prices, Boomers have $78.6 trillion of the $160.8 trillion of US household net worth. The wealth effect has boosted consumption and Boomers are spending mightily on health care, leisure, and hospitality (*Fig. 14* and *Fig. 15*). Record consumption of these services has sent employment in these sectors to records as well (*Fig. 16* and *Fig. 17*).

(5) *Bottom line*. Economists are likely to continue searching for easy rules to forecast whether a recession is nigh considering the fame that comes with accurately predicting a recession that few foresee. We'll continue to look at the details behind the economic headlines and, so far, that leads us to believe inflation will continue to moderate, the economy will continue to grow, and the Roaring 2020s are alive and well.

TAMED IV: Other Tales. There are several other examples of TAMED reasoning which proliferated post-pandemic. To mention a few:

(1) *Retrenching consumers*. One theory was that after consumers ran out of their pandemic-era excess savings, they would be forced to retrench, sending the economy into a recession. But that hypothesis too missed the demographic shift, which we detailed in our May 21 *Morning Briefing*. Retired Boomers had no need to save their nonexistent labor income, but are spending their nonlabor income from money market funds and dividends.

Personal interest income has soared, up to $1.8 trillion in April from $1.5 in April 2021 (*Fig. 18*). That's boosted nonlabor income to a near record $6.6 trillion as of April, up from $5.7 trillion in April 2021 (*Fig. 19*). Rising incomes have helped keep the cost of servicing debt in check, at just 9.8% of disposable personal income as of Q4, especially since many homeowners locked-in low-rate mortgages (or paid down their mortgage) during the pandemic (*Fig.20*).

Consumers have been able to spend more thanks to increasing net worth, which has grown to 7.8 times disposable personal income as of the first quarter from 7 times three years prior. That's pushed the savings rate down to 4.2% in Q1 (four-quarter average), from a pandemic-era peak of 18% three years ago (*Fig.21*). Of course, lower-wage workers tend to have fewer assets and are more dependent on labor income. Fortunately, real average hourly earnings for the lower-wage cohort have risen since the pandemic began, up to $24.25 as of May from $22.60 in May 2021 (*Fig. 22*).

(2) *Long-and-variable lags*. The widely held assumption is that there are long and variable lags between when central bank tightening eventually spurs a recession. This assumes that rising interest rates depress demand, which inevitably sets off a recession. In our opinion, the real question is how long it takes before rates are high enough to break something in the financial system. The Fed did create a crisis less than a year after it began tightening policy, taking down three banks. That said, the Fed was able to avert a credit crunch by injecting up to $168 billion of liquidity through the Bank Term Funding Program, a rapidly

erected emergency lending facility. The Treasury also quickly soothed the venture capital and startup scene by fully backing deposits in toppled Silicon Valley Bank.

A key indicator the lags camp holds onto is the *Senior Loan Officer Opinion Survey* (SLOOS), which suggests banks have tightened their lending standards significantly since the Fed began to tighten. However, as we wrote in our May 29 *Morning Briefing*, SLOOS has become a less important indicator of credit conditions because banks have become a smaller part of the capital allocation engine in the economy. They now compete with nonbanks like private debt, private equity, and distressed asset funds to lend.

(3) *Consumer confidence*. Household confidence surveys have been weak since the pandemic. Some thought that depressed consumers would rein in their spending. As we noted in yesterday's *Morning Briefing*, June's preliminary Consumer Sentiment Index showed that consumer remain depressed.

But what if soft survey data don't have the same predictive value they did in the past? In a highly politicized environment, consumers are more likely to "vote" on the health of the economy based on their party alignment and whoever is in the White House.

Calendars

US: **Tues:** Headline & Core Retail Sales 0.3%/0.2%; Industrial Production 0.3%; Capacity Utilization 78.6%; Business Inventories 0.3%; Atlanta GDPNow 3.1%; API Weekly Crude Oil Inventories; Goolsbee; Collins. **Wed:** NAHB Housing Market Index 45. (FXStreet estimates)

Global: **Tues:** Eurozone Headline & Core CPI 0.2%m/m/2.6%y/y & 0.4%m/m/2.9%y/y; Eurozone ZEW Economic Sentiment 47.8; Germany ZEW Economic Sentiment 49.6; Eurogroup Meetings; RBA Interest Rate Decision 4.35%; De Guindos. **Wed:** UK Headline & Core CPI 2.0%/3.5% y/y ; UK PPI Input & Output Prices -0.3%/0.1%; Germany Buba Monthly Report; European Central Bank Non-monetary Policy Meeting. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week simultaneously for all three of these indexes, and has done so in eight of the past nine weeks. LargeCap's forward earnings rose 0.2% w/w to a new record high. It has achieved new record highs for 24 straight weeks and in 35 of the 40 weeks since mid-September; last week is now the lengthiest string of record-high forward earnings for LargeCap in six years (since the September 21 week of 2018, when it hit record highs for 26 straight weeks). MidCap's rose 0.7% w/w and improved to 2.3% below its record high in early June 2022. SmallCap's rose 0.2% w/w to 10.4% below its mid-June 2022 record. Through the week ending June 13, LargeCap's forward earnings has soared 15.3% from its 54-week low during the week of February 1, 2023; MidCap's is 6.4% above its 55-week low during the week of March 10, 2023; and SmallCap's is 3.7% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows ago a year, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.6%, 14.0%), MidCap (3.3, 16.8), and SmallCap (-4.2, 19.0).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower again during the June 14 week for these three indexes and remain slightly below their recent two-year highs. LargeCap's forward P/E rose 0.2pts w/w to 20.8. That's just 0.1pt below its 27-month high of 20.9 at the end of March and up from a seven-month low of 17.0 during the October 27 week. It's now up 5.7pts 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 0.2pts w/w to 14.8. That's down 1.2pts from a 27-month high of 16.0 at the end of March and up 2.5pts from a 12-month low of 12.3 at the end of October. It's now up 4.3pts from its 30-month low of 11.1 at the end of September 2022; these compare 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 was down 0.3pts w/w to 13.9, and is now 0.8pts below its 28-month high of 14.7 during the May 17 week. It's up 3.3pts 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 28% discount to LargeCap's P/E is now testing its 24-year-low 29% discount during the June 1, 2023 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 32% discount is also now testing its 23-year-low 34% discount during the October 19, 2023 week, which compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

US Economic Indicators

Regional M-PMIs (*link*): The New York Fed released its first glimpse of manufacturing activity for June, and showed manufacturing activity continued to contract, though at a slower pace. The *general activity* measure advanced 9.6 points (to -6.0 from -15.6), moving closer to expansionary territory. June's reading was not as steep as the -10.5 expected. The new orders (-1.0 from -16.5) gauge rebounded sharply, falling just short of zero—the breakeven point between expansion and contraction, while the shipments (3.3 from -1.2) measure moved back above zero; unfilled orders (1.0 from -8.1) held steady. Meanwhile, *inventories* (1.0 from 2.0) were level. *Delivery times* (-4.1 from -9.1) shortened somewhat in June, while supply availability (-1.0 from -1.1)—a new monthly indicator now included in the report—was little changed. Labor market indicators were weak, as both the *employment* (-8.7 from -6.4) and the *average workweek* (-9.9 from -5.8) components continued to decline, at a faster pace. Turning to prices, both the *prices-paid* (to 24.5 from 28.3) and *prices-received* (7.1 from 14.1) measures eased during the month, with latter increasing at half the pace of May. Looking ahead, the index for *future business conditions* (30.1 from 14.5) accelerated sharply, with 47.1% of respondents expecting conditions to improve in the next six months, while only 17.1% of respondents expect conditions to be worse. The *new orders* (to 30.0 from 17.7) and *shipments* (28.7 from 12.6) measures both expanded at roughly double the pace of last month. Meanwhile, the outlook for *employment* (9.4 from 6.3) remained weak, with only 22.8% expecting employment to be better in six months. Both the *future prices paid* (37.8 from 41.4) and *future prices received* (22.4 from 24.2) measures eased a bit this month.

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