Yardeni Research

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Morning Briefing

On Geopolitical & Credit Crises

Check out the accompanying chart collection.

Executive Summary: As geopolitical tensions in the Middle East mount and Ukraine's war with Russia intensifies oil prices may be starting to spike. So we reiterate our commodity- and equity-based hedges for these risks. On a happier note, Ed reviews our Credit Crisis Cycle theory for how monetary policy induces a recession... and why we don't see one currently. Eric also reviews the latest consumer credit data, explaining why household balance sheets look better than before the pandemic despite alarms sounding on credit card delinquencies.

YRI Weekly Webcast. Join Dr. Ed's live webcast with Q&A on Mondays 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*.

Geopolitical Crises I: Clear & Present Danger. As you know I don't like to be an alarmist. However, the geopolitical situation is getting even more unsettled and unsettling. On Saturday, Ukraine's president confirmed that his troops are fighting in the southern region of Kursk in Russia. It was an unprecedented Ukrainian incursion into Russia. Vladimir Putin declared that it was "another major provocation" by Kyiv. The region's acting governor declared a state of emergency, describing the situation as "very difficult." Above all, it was humiliating for a Russian state that prides itself on protecting the motherland. The war could get uglier depending on Russia's response.

At the same time, Israelis are bracing for a missile attack from Iran and its proxies in the Middle East. Here are my brief summaries of two articles in Sunday's *The Jerusalem Post*:

(1) "*Israeli intel believes Iran will attack directly within days*." According to this story, Iran may not be restrained by international pressure from launching an attack on Israel in coming days. The Israeli intelligence community believes that Iran has decided to directly target Israel in retaliation for the assassination of Hamas Political Bureau Chief Ismail

Haniyeh. That decision was made after an internal debate between the Iranian Revolutionary Guards (IRG) and the new Iranian president and his advisors. The IRG has been pushing for a more severe and widespread response than the April 13 attack on Israel. The president and his advisors advocated for a more limited attack.

(2) "*US sends submarine, ships to Israel in preparation for Iranian attack*." In a call on Sunday night, the defense minister of Israel informed US Defense Secretary Lloyd Austin that Iran is preparing a significant attack against Israel. "Austin ordered that the *USS Abraham Lincoln* Carrier Strike Group, along with F-35C fighters, accelerate its transit to the Central Command area, bolstering the military presence already provided by the *USS Theodore Roosevelt* Carrier Strike Group. Additionally, the *USS Georgia*, a guided missile submarine, has been deployed to the region."

Geopolitical Crisis II: Hedging Turmoil. We've been recommending overweighting oil and gold in portfolios as shock absorbers against geopolitical shocks like the ones above (*Fig. 1* and *Fig. 2*). Both geopolitical crises mentioned above have the potential to cause the prices of these commodities to soar. Consider the following:

(1) Two days ago, Ukraine dealt Vladimir Putin another huge blow after blasting a Russian gas rig in the Black Sea, killing 40 soldiers. The decimated rig was packed with "reconnaissance equipment" to help with Russia's war effort, according to Ukrainian media. Two weeks ago, suspected Ukrainian military drones struck an oil storage depot in Russia's Kursk region, a regional Russian official said Sunday. Since then, Ukrainian forces have invaded the region.

(2) It's unclear how Israel might respond to an Iranian attack. If it happens and causes significant casualties and damage, the result might be an outright war between Israel and Iran with Israel targeting Iran's oil and nuclear facilities. They would also target key officials of the Iranian regime.

(3) Oil prices jumped by more than 3% on Monday suggesting an imminent widening of the war in the Middle East. Our Energy sector overweight hasn't played out as well as our overweights in S&P 500 Tech (Information Technology & Communication Services), Industrials, and Financials. Fortunately, at just 3.7% of the S&P 500 market capitalization, Energy is an easy sector to overweight in a portfolio these days (*Fig. 3*).

We're reiterating that call, and if anything, investors should buy protection when it's cheap. The S&P 500 energy sector is trading at 11.7 times forward earnings, a historically low P/E as the sector hasn't yet re-rated to reflect generally higher forward earnings expectations or to price in a rising geopolitical risk premium (*Fig.4*). With the US as a net energy exporter, US-listed energy companies are likely to benefit further from a global supply squeeze if Iranian exports are hindered (*Fig.5*).

Credit Crisis I: The Missing Link. Now let's turn to a happier story about our Credit Crisis Cycle (YRI-CCC) theory. We've been promoting it as an explanation for why the tightening of monetary policy didn't cause a recession during 2022 and 2023, and likely still won't in 2024 and 2025. Eric and I have been asked a few times recently to provide a crib sheet on our theory.

The basic premise is that monetary theories of the business cycle typically ignore the credit cycle, especially when it is associated with a financial crisis that triggers a credit crunch. Monetary cycle models mostly ignore these recurring events or chalk them up to one-off aberrations. The monetary cycle, meanwhile, has been widely studied by monetary economists, who are considered the rock stars of the economics world. The credit cycle, on the other hand, gets treated like Rodney Dangerfield; it "don't get no respect."

However, we believe that the credit cycle can explain more about the relationship between the Fed and the business cycle than can monetary theories. Consider the following:

(1) *Recessions are caused by credit crunches*. We apologize for repeating ourselves, but: Monetary tightening cycles usually cause something to break in the financial system. This triggers a financial crisis that rapidly morphs into a credit crunch, in which even good credits can't borrow. The result is a recession.

In the past, the Fed raised the federal funds rate (FFR) during monetary tightening cycles until a financial crisis was triggered. That forced the Fed to reverse course and lower the FFR rapidly to stabilize the credit system. However, by then, it was too late to avert a credit crunch and a recession (*Fig. 6*).

(2) *Inverted yield curves don't cause recessions.* In 2019, Melissa and I wrote a study titled, *The Yield Curve: What Is It Really Predicting?* We concluded: "In our opinion, the yield curve, first and foremost, predicts the Fed policy cycle rather than the business cycle. Our research confirms this conclusion, as does a recent Fed study. More specifically, inverted yield curves don't cause recessions. Instead, they provide a useful market signal that

monetary policy is too tight and risks triggering a financial crisis, which can quickly turn into a credit crunch causing a recession." That's the central proposition of our Credit Crisis Cycle theory.

The yield curve inverts anticipating a falling dominoes process. Tightening monetary policy will cause a financial crisis, which will trigger a credit crunch, and cause a recession. That's when the Fed reverses course and starts slashing the FFR. The inverted yield curve then bottoms, starts to disinvert, and then reverts back to an upward sloping curve with the 10-year Treasury yield back above the federal funds rate and 2-year yield (*Fig. 7*).

(3) *Unemployment soars when credit crunches cause recessions.* The unemployment rate tends to bottom when the monetary tightening cycle triggers a financial crisis (*Fig. 8*). It soars when the crisis turns into a credit crunch and a recession.

From the perspective of our CCC, the Sahm Rule is a "statistical regularity" as Fed Chair Jerome Powell said at his *press conference* on July 31. It is triggered when financial crises start to weaken the labor market. If so, then the rule is likely to give a false positive if there is no financial crisis because of monetary tightening. It would also give a false positive if a financial crisis doesn't cause a credit crunch and a recession. So far that describes the current situation since last year's mini banking crisis hasn't caused a recession.

(4) *The Fed slashes rates in response to credit crises.* The widespread expectations (at the start of the year and again now after July's weaker-than-expected employment report) that the Fed will slash interest rates only makes sense based on previous monetary easing cycles if a credit crunch occurs. So far, the Fed managed to stop last year's financial crisis from turning into a credit crunch by providing an emergency lending facility to the banks with the FDIC guaranteeing all deposits.

(5) *The long-and-variable lags of monetary policy are a myth.* In our CCC framework, there is no long-and-variable lag between the tightening of monetary policy and recessions. That monetary theory implies that the rise in interest rates takes a while to depress interest-sensitive demand, especially in housing and autos. From our perspective, it may take a while for higher rates to cause a financial crisis, but once it happens there almost no lag before a recession occurs, unless the Fed succeeds in averting a credit crunch as it has so far this time (*Fig. 9*).

(6) *The economy is less interest rate sensitive.* We have previously observed that the economy is less interest-rate sensitive for several reasons. So if rising interest rates don't cause a credit crisis and credit crunch, the economy is likely to remain surprisingly resilient.

Credit Crisis II: Mixed Signals On Consumer Credit Cards. The latest household debt & credit from the New York Fed reignited worries that the consumer is overextending themselves with credit card debt, and rising delinquencies mean a retrenchment on spending is looming that will plunge the economy into a recession.

New York Fed data show that 7.2% of credit card balances transitioned into serious (90+ days) delinquencies in Q2, the highest share since 2011 (*Fig.10*). Transitions for auto loans also rose to 2.9%, the highest since 2010. However, as our friend Wolf Richter at Wolf Street notes, "transitions" accounts for flows into delinquency over the past year, but not those transitioning back out of delinquency by paying off their debt. When you look at the broader picture—as we did in our roundup of the Q1 data back in our *May 21 Morning Briefing*—consumer credit looks even healthier than it did before the pandemic. Here's more:

(1) *Credit cards in context*. 10.9% of credit card balances were delinquent during Q2, slightly up from 10.7% in Q1 and the highest share since 2012 (*Fig.11*). However, delinquencies on the biggest source of borrowing—mortgages—have plummeted. So just 3.2% of total household debt is delinquent, down from 4.7% in Q4-2019 (*Fig.12*). That makes sense as credit card debt makes up just 6.4% of total household debt, whereas mortgages comprise 70.3% (*Fig. 13*).

(2) *Higher rates, higher pressure*. We wrote on May 21 that delinquencies were disproportionately among "maxed-out" borrowers using 90%-100% of their credit limits. It's only natural for delinquencies to rise when credit card rates surge to more than 20% monthly annualized rates (*Fig. 14*).

(3) *Rising incomes boost household balance sheets*. Income growth is supporting spending. Our preferred measure for the health of the consumer is personal consumption expenditures per household, which rose to a record high of $147,800 per household (saar) in June (*Fig. 15*). That spending is funded by rising personal disposable income, which climbed to $159,100 per household (saar) (*Fig. 16*). That's an all-time high excluding the pandemic spike.

Income growth is beating inflation as well. Real disposable personal income climbed to $17 trillion in June, another record excluding the pandemic (*Fig. 17*). That's helped keep consumer debt loads in check—revolving consumer credit outstanding remains around its pre-pandemic norm of 6.4% of DPI (*Fig. 18*). Near-record asset prices (e.g., stocks, homes, etc.) also suppress the need to save and boost consumption via the very positive wealth effect.

Some lower-income and low-FICO score consumers are struggling amid higher rates, unsurprisingly. But by and large, the US consumer continues to spend supported by income growth rather than levering up.

Calendars

US: Tues: Headline & Core PPI 0.2%/0.2%; NFIB Small Business Optimism 91.5; IEA Monthly Report; API Weekly Crude Oil Inventories; IEA Monthly Report; Bostic. **Wed:** Headline & Core CPI 0.2%m/m3.0%y/y & 0.2%m/m/3.2%y/y; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Tues: Eurozone ZEW Economic Sentiment 35.4; UK Unemployment Rate 4.5% UK Claimant Count Change 14.5k; UK Average Earnings Ex Bonus 4.6%; Japan Machine Tool Orders; Spain CPI -0.7%m/m/2.9%y/y. **Wed:** Eurozone GDP 0.3%q/q/0.6%y/y; Eurozone Industrial Production 0.4%; UK Headline & Core CPI 2.3%/3,4%y/y; UK PPI Input & Output -0.3%/0.1%; Japan GDP 0.6%q/q/2.1%y/y; Japan GDP Price Index 2.6%y/y; China Industrial Production 5.3%y/y; China Retail Sales 2.6%y/y; China Unemployment Rate 5.1%; NBS Press Conference. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose 0.2% w/w to a new record high. It has achieved new record highs for 32 straight weeks and in 43 of the 48 weeks since mid-September; last week now matches the lengthiest string of record-high forward earnings for LargeCap in six years (since the March 16 week of 2018, when it hit record highs for 34 straight weeks). MidCap's fell 0.1% w/w to 2.2% below its record high in early June 2022, but has risen in 17 of the past 21 weeks. SmallCap's fell 0.3% w/w to 9.8% below its mid-June 2022 record, but has posted gains in 16 of the past 22 weeks. Through the week ending August 2, LargeCap's forward earnings has soared 17.4% from its 54-

week low during the week of February 1, 2023; MidCap's is 6.5% above its 55-week low during the week of March 10, 2023; and SmallCap's is 4.6% 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 just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.0%, 14.8%), MidCap (0.6, 17.4), and SmallCap (-6.4, 19.6).

S&P 500/400/600 Valuation (*link*): Valuations were lower during the August 9 week for these three indexes, but remain at near recent multi-year highs. LargeCap's forward P/E fell 0.1pt w/w to a 14-week low of 20.1. That's down 1.3pts from a 30-month high of 21.4 during the July 12 week, but is up 3.1pts from a seven-month low of 17.0 during the October 27 week. It's now up 5.0pts 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 a five-week low of 15.0 and is down from a 17-week high of 15.7 during the July 26 week. It's down 1.0pt from a 27-month high of 16.0 at the end of March and up 2.7pts from a 12-month low of 12.3 at the end of October. 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 dropped 0.1pt w/w to 14.5 and is down from a 32-month high of 14.9 during the July 26 week. It's up 3.9pts 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 25% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 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 28% discount is up from a 24-year low 34% discount during the July 5 week. That 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.

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