October 29, 2024

Morning Briefing

On Economic Data & Theories

Check out the accompanying chart collection.

Executive Summary: Survey-based economic data seem to have become less reliable in recent years, yet some prognosticators build their economic narratives around these soft data that often conflict with the relevant hard data. Today, Eric examines the reliability of five such data sources, which have led many hard-landers astray. … Likewise, ten macroeconomic theories are of dubious help in interpreting what's going on with the economy these days. Yet they are still followed by many, even when their signals fly in the face of evidence to the contrary.

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

US Economy I: Less Useful Soft Data. Soft data, or data from surveys, can give investors a heads-up about emerging economic shifts before hard data record them. They can also be useful for confirming or questioning the latest economic indicators before revisions arrive.

However, soft data seem to be getting less reliable. Whether due to longstanding pandemic distortions, political polarization, or declining (or online) response rates, we find surveys are less accurate today than in years past.

That's caused several head-fakes in this cycle and cemented many die-hard hard-landers to their narrative of impending doom and recession despite two years of a roaring bull market and above-trend economic growth.

Let's discuss a few of the key surveys that we believe some observers have been placing too much weight on:

(1) *Beige Book*. The Fed publishes its Beige Book roughly eight times per year and is often cited by officials on the Federal Open Market Committee (FOMC) as their grassroots perspective on the economy. The Beige Book collects anecdotes on current economic

conditions from the Fed's 12 District Banks on key sectors.

In the October 1 *Morning Briefing*, we cited anecdotes from the Fed's August 2024 Beige Book suggesting that the presidential election has weighed on economic activity across the country and myriad sectors. One of our competitors commented that the August Beige Book strongly supported a 50bps drop at the September FOMC meeting, which the bond market quickly assessed to be too much, too soon.

The *Beige Book* edition published last week held several bearish anecdotes, noting slowing bank lending volume (excluding credit cards) and a slowdown in hiring in several industries. The second point jibes with the slowdown in job openings and quits reported in the JOLTS survey (*Fig. 1*). But bank lending data show continued—and quicker—growth (*Fig. 2*).

Among the bullish comments, banks reported strong credit quality and low delinquency rates. That jibes with what Capital One's CEO said last week on the company's *Q3 earnings call*—i.e., that consumers generally are in good shape. But it flies in the face of some analysts' concerns about consumers and delinquencies.

Rather than being used to find new or contrarian ideas, soft data seem to be more often used to confirm biases and narratives. That can cause trouble, particularly when soft data become less reliable.

(2) *SLOOS*. The Fed's Senior Loan Officer Opinion Survey (SLOOS) is another survey that FOMC members like to cite. Credit conditions tightened rapidly as the Fed raised rates, per the SLOOS (*Fig. 3*). Yet bank lending continued to grow throughout the past two years. We expect the survey to start showing an outright loosening next quarter.

As Eric observed in the August 12 *Morning Briefing*, the SLOOS tends to tighten rapidly but ease slowly, because banks are hesitant to appear trigger happy with making loans to the Fed, knowing it may affect monetary policy. We believe the SLOOS reflected the same fears as the inverted yield curve—that monetary tightening would cause a credit crisis that morphed into a credit crunch and therefore recession, ultimately leading lenders to pull back from financing even for highly rated borrowers. What we call the "Credit Crisis Cycle" was put on pause by the Fed and Treasury's efforts to quickly stem the mini regional banking crisis in March 2023.

(3) *ISM M-PMI*. The Institute for Supply Management's (ISM) monthly manufacturing survey tends to lead the growth rate of real GDP goods. Indeed, new orders in the M-PMI is one of

the 10 series within the Index of Leading Economic Indicators (LEI). While the ISM M-PMI has been one of the few soft data series that is accurately aligned with the slowdown in actual production, real GDP goods has continued to grow at around a 2.0% y/y pace (*Fig. 4*). Survey data seem to be more pessimistic than the economic reality.

The monthly regional M-PMI surveys conducted by some Fed district banks come out before the national ISM report is released. For October, the average of the key districts we track remains negative, suggesting the October ISM M-PMI will as well (*Fig. 5*).

(4) *NFIB*. The NFIB Small Businesses survey has similarly been depressed since the Fed began tightening monetary policy in 2022 (*Fig. 6*). The survey suggests that few small business owners believe it's a good time to expand (*Fig. 7*). However, it's unclear whether that's because business is bad or because they cannot find enough qualified workers (*Fig. 8*). Inflation remains small business owners' biggest issue, while poor sales and higher interest rates are the least cited "most important problem" (*Fig. 9*).

(5) *Consumer sentiment*. Consumer expectations for business conditions in the Consumer Sentiment Index (CSI) and the Consumer Confidence Index (CCI) are also in the LEI (*Fig. 10*). Yet the University of Michigan's CSI has been extremely downbeat, most recently below 69. We believe that has to do with the survey's focus on inflated prices compared to when the pandemic started, which remains top of mind for consumers.

Meanwhile, a *recent study* by former Council of Economic Advisers chief economist Ernie Tedeschi and Ryan Cummings found that the University of Michigan's switch to online interviews has artificially depressed the data by 9 points. Participants also increasingly rate the economy as better when their party is in the White House.

The CCI has also recorded much lower readings for income cohorts below $50,000 per year (*Fig. 11*). Many of these respondents are either part-time or much younger, which isn't a surprise. Earning $30,000 per year after the cost of essentials rose roughly 40% in a few years would certainly make anyone pessimistic (*Fig. 12*). However, a significant portion of young adults are receiving financial help from their parents, as Ed knows all too well.

Such misleading soft surveys are the reason we believe the LEI has inaccurately predicted a recession for the past two years despite brisk economic growth and new record highs in the Index of Coincident Economic Indicators (*Fig. 13*). Those who over-rely on soft data are likely to continue to be misled.

US Economy II: Ten Useless Macro Theories. It's difficult to count the number of mainstream macro theories that we've debunked over the past few years. Many long-used relationships and correlations have been upended by record monetary and fiscal stimulus during the pandemic, a wave of early retirements by Baby Boomers, and interest-rate hikes off ultralow levels. We've been busy shooting them down since early 2022. Taking great pains to keep it short, below is a review of the 10 widely held macro theories that haven't held water and the reasons that they've led many astray:

(1) *Modern Monetary Theory.* Melissa and I have said before that Modern Monetary Theory (MMT) isn't modern, isn't monetary, and isn't a theory. MMT's proposition that a government that borrows in its own currency can finance its spending at will with more debt lost credibility as inflation soared in 2022 and 2023. However, MMT seems to be working now that inflation has subsided. Even as the federal deficit remains very wide—and the consensus is that after the November elections, it will continue to widen—inflation has moderated to near 2.0% (*Fig. 14* and *Fig. 15*).

MMT's zealots within the current administration have been essentially using a blank check to load up on fiscal stimulus even though the economy is already growing faster than 3.0% y/y. The interest cost on the federal debt is increasing rapidly due to the record debt issuance and higher rates (*Fig. 16*).

It's not the Fed's job to lower rates to accommodate the government, as some have suggested, because that would lead to more inflation. The government instead needs to slow its pace of debt financing (*Fig. 17*). Without doing so, future generations will be saddled with a huge pile of debt that will hamper any stimulus efforts if and when there is a recession (*Fig. 18*).

(2) *Inverted yield curve.* According to our Credit Crisis Cycle theory, the inverted Treasury yield curve signals that bond investors are worried that higher short-term interest rates will cause a credit crisis and therefore a recession. Because the Fed and Treasury prevented a credit crunch from emerging as regional banks collapsed last March, the expansion was able to continue (*Fig. 19*).

(3) *Disinverting yield curve*. The Treasury yield curve has flipped positive in September, with the 10-year yield now roughly 15bps above the 2-year yield (*Fig. 20*). Historically, a recession has followed soon after such a disinversion—but only because the Fed was cutting interest rates rapidly to stem a crisis, which then morphed into a recession. This time around, the Fed is cutting rates as a preventative measure.

(4) *Falling LEI*. The 10 components of the LEI are heavily weighted toward the manufacturing sector and include things like the inverted yield curve. That's led the LEI to inaccurately predict a recession for the past two years. Goods consumption has stagnated at record highs since the Fed raised financing costs and demand for goods decreased after surging during the pandemic (*Fig. 21*). The US economy depends on services versus goods at a roughly 2:1 ratio, rendering the LEI less effective at predicting the economy's performance (*Fig. 22*).

(5) *Phillips Curve*. The Phillips Curve model is based on the inverse correlation between wage and price inflation versus the unemployment rate (*Fig. 23*). However, it ignores the inverse relationship between the unemployment rate and productivity growth. So inflation was able to fall in this cycle without a recession, in part because the tight labor market promoted investments that improved productivity (*Fig. 24*).

(6) *Neutral interest rate*. Doves on the FOMC advocate for cutting the federal funds rate (FFR) in order to maintain a neutral real FFR. Their worry is that as inflation falls, the real FFR gets tighter and exerts unnecessary pressure on the economy (*Fig. 25*). We think that adjusting an overnight borrowing rate (which few consumers or businesses actually use) by the y/y change in inflation makes no sense. Empirically, the US economy has also done well despite a rising real rate.

We believe that productivity growth may be one of the most important factors in determining the neutral interest rate. Fiscal policy certainly matters as well. But the Fed commentators who oft-cite the neutral rate don't seem to account for those two factors.

(7) *Taylor Rule*. The Taylor Rule is a mechanical formula for setting the FFR based on the unemployment rate (or economic growth) and inflation. As inflation has fallen, proponents of the rule suggest rates should, too. However, the rule depends on knowing how high the economy's potential growth is, and what the neutral unemployment rate is (the rate that neither raises nor weighs on inflation). Of course, neither of these is measurable. If anything, we believe that higher productivity growth and immigration have raised the US economy's potential, suggesting the model would advise a higher FFR.

Of course, anyone using the Taylor rule to set monetary policy would have ended easing and started raising rates much sooner than this Fed did (*Fig. 26*).

(8) *Sahm Rule*. The so-called Sahm Rule, a recession indicator based on the moving

average of the headline unemployment rate, was triggered in July when the unemployment rate rose to 4.3% (*Fig. 27*). We dismissed this at the time as yet another false recession signal. That proved to be the right call, as the unemployment rate ticked down from 4.2% in August to 4.051% last month. Besides, soaring unemployment is associated with credit crunches and recessions, not with real GDP growing 3.0%!

(9) *Excess saving*. JP Morgan Chase CEO Jamie Dimon warned in December 2022 that the exhaustion of excess savings and inflation would "derail the economy and cause a mild or hard recession." We said that rising real wages, increased income from higher rates, and a very positive wealth effect would allow consumers to keep spending. Baby Boomers in particular would "dissave" as they retired during the pandemic, and soaring home and stock values would embolden them to spend.

The latest revision from the Bureau of Economic Analysis found that nonlabor incomes were much higher in 2022 and 2023 than it had believed, which raised the personal saving rate from 3.3% to 5.2% as of Q2 (*Fig. 28*). It seems consumers haven't exhausted their savings after all.

(10) *Money matters.* M2 money supply contracted from November 2022 through March 2024 (*Fig. 29*). Yet the stock market enjoyed a huge bull run and inflation moderated. That should have quieted the monetarist view that inflation is everywhere and always a monetary phenomenon.

Perhaps monetary policy is not the most important factor for economic growth. Productivity attributable to the efforts of the private sector may be more important, in our opinion. Furthermore, fiscal policy may quicken money velocity and encourage more consumer spending and business investment.

Calendars

US: Tues: JOLTS Job Openings 7.92m; Consumer Confidence 99.2; Goods Trade Balance -$96.1b; Atlanta Fed GDPNow 3.3%; Wholesale Inventories 0.2%; S&P/CS HPI Composite 0.2%m/m/4.6%y/y; Weekly Crude Oil Inventories. **Wed:** Real GDP & Price Index 3.0%2.0%; ADP Employment Change 101k; Pending Home Sales 0.9%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Tues: Australia CPI 0.3%q/q/2.3%y/y; Macklem; Rogers. **Wed:** Eurozone GDP

0.2%q/q/0.8%y/y; Eurozone Business & Consumer Survey 96.4; Eurozone Consumer Confidence -12.5; Eurozone Industrial Sentiment -10.5; Germany GDP -0.1%q/q/-0..3%y/y; Germany CPI 0.2%m/m/1.8%y/y; Germany Unemployment Rate 6.1%; France GDP 0.3%q/q; Italy GDP 0.2%q/q/0.7%y/y; Spain GDP 0.6%q/q/3.0%y/y; Spain CPI 1.7%y/y; BOJ Interest Rate Decision 0.25%; Japan Industrial Production 0.9%; Japan Retail Sales 2.1%yy; Japan Household Confidence 36.7; China M-PMI & NM-PMI 50.0/50.5; Schlegel; Schnabel; Nagel; Rogers; Macklem. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings move higher during the October 25 week. LargeCap's forward earnings rose for a fourth week to a record high after falling for two straight weeks for the first time since December, when it fell for three straight weeks. LargeCap snapped its 37-week streak of record-high forward earnings during the September 13 week, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's rose less than 0.1% w/w to 2.0% below its record high in early June 2022. SmallCap's dropped 0.2% w/w to 11.4% below its mid-June 2022 record. Through the week ending October 25, LargeCap's forward earnings has soared 19.4% from its 54-week low during the week of February 1, 2023; MidCap's is 6.7% above its 55-week low during the week of March 10, 2023; and SmallCap's is 2.5% 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 has improved faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.5%, 13.7%), MidCap (-1.2, 15.8), and SmallCap (-10.0, 17.6).

S&P 500/400/600 Valuation (*link*): Valuations fell during the October 25 week from multi-year highs a week earlier for these three indexes. LargeCap's forward P/E dropped 0.3pt w/w to 21.5 from a 42-month high of 21.8 and is 1.4pts above its 14-week low of 20.1 during the August 9 week. It's also up 4.5pts from a seven-month low of 17.0 during the October 27, 2023 week and 6.2pts 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 0.4pt w/w to 15.9 from a 35-month high of 16.3 and is up 3.6pts from a 12-month low of

12.3 at the end of October last year. 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 fell 0.5pt w/w to 15.3 from a 35-month high of 15.8. It's up 4.8pts 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 26% 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.

US Economic Indicators

Regional M-PMIs (*link*): The *Dallas Fed*, the fifth regional Fed bank to report on manufacturing activity for October, revealed a notable increase. *Production*, a key measure of state manufacturing conditions, soared 17.8 points (to 14.6 from -3.2) to its highest level in more than two years. Other measures were mixed. Both the *shipments* (1.5 from -7.0) and *capacity utilization* (4.3 from -7.0) gauges moved from contraction to expansion, while the *new orders* (-3.7 from -5.2) gauge continued to contract, though at a slower pace. Perceptions of broader business conditions show the *business activity* (-3.0 from -9.0) continued to contract, though moved closer to the breakeven point of zero, with *company outlook* (-3.3 from -6.4) showing a similar pattern. Labor market measures show *employment* (-5.1 from 2.9) in the manufacturing sector declined, with 66.3% of firms reporting no change in employment, while 19.4% reported a decline and 14.3% reported an increase; the *average workweek* (-5.5 from -2.5) was shorter. Turing to prices, there was a slight easing in price pressures, with both *prices paid for raw materials* (16.3 from 18.2) and *prices received for finished goods* (7.4 from 8.4) measures ticking down slightly. *Expectations for manufacturing six months from now* are upbeat, with the *future business production* (42.4 from 35.2) measure posting its highest reading in nearly three years, while the future *general activity* (29.6 from 11.4) index shot up 18.2 points to a three-year high. Previously, the *New York Fed* (the first to report on October manufacturing activity in its region) revealed that the sector fell back into contractionary territory after a brief move above in September. The *Philadelphia Fed* (second to report) showed improved activity, posting its second successive gain, while manufacturing in the *Richmond Fed* (third to report) remained depressed—with its composite index remaining in contractionary territory—though there were signs of life in the three main future indexes, which moved further into expansionary territory. The *Kansas City Fed* (the fourth to report) showed the region's manufacturing activity declined modestly, while expectations for future activity remained positive.

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