Yardeni Research

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Morning Briefing

The Recession Is Over, Again!

Check out the accompanying chart collection.

Executive Summary: The financial markets have been recalibrating their expectations for monetary policy since the FOMC's December meeting and their expectations for economic changes under the incoming Trump 2.0 administration since Election Day. In this context, Friday's strong employment report only served to cement investors' sense that the Fed should pause its easing. Both bond and stock markets reacted like the sky was falling. We're not surprised by this January correction, and we view it as healthy: The markets are gaining a more realistic sense of the current situation, recognizing that interest rates will stay higher (i.e., normal) for longer, while the economy remains resilient. A strong Q4 earnings season should help to restore shaken investors' confidence. ... Also: Dr. Ed pans "The Substance" (- - -).

YRI Weekly Webcast. Join our live webcast with Q&A on Mondays at 11 a.m., EST, with Ed and Eric. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

Strategy: Recalibrating the Fed. From March 2022 through August 2024, there was widespread concern that the tightening of monetary policy by the Fed over that period would cause a recession. It was the most widely anticipated recession that didn't happen on record. Once the Fed started easing monetary policy on September 18, 2024, it was widely expected that the Fed would have to lower interest rates significantly to avert a recession. Now that scenario has lost its credibility, especially following Friday's strong employment report for December.

The bond and stock markets have been recalibrating the outlook for the Federal Reserve's monetary policy. The Fed cut the federal funds rate (FFR) by 100bps from September 18 through December 18 and signaled that more cuts are ahead in 2025. Bond market action suggests that investors have come around to our view that the Fed was stimulating an economy that didn't need to be stimulated and that inflation was getting sticky north of the Fed's 2.0% target. We argued that the economic and inflation data were signaling that the so-called neutral FFR was closer to 4.0%-5.0% than to 3.0%. We disagreed with the Fed's view that the FFR was too restrictive when it was around 5.0%.

Our view has rapidly become the consensus view in recent weeks, especially after Friday's strong employment report. That view can be described as a "higher-for-longer" interest-rate outlook, but "normal-for-longer" is the way we prefer to look at it. One of the reasons that we dissented over the past three years from the consensus forecast that a recession was coming is that we believed that the Fed's monetary tightening simply brought interest rates back up to their normal levels in the years prior to the Great Financial Crisis and wouldn't unduly stress the financial system, culminating in a recession (*Fig. 1*).

In his September 18, 2024 *press conference*, Fed Chair Jerome Powell said that the 50bps cut in the FFR announced that day by the Federal Open Market Committee (FOMC) was simply a recalibration of monetary policy: "So we know that it is time to recalibrate our policy to something that is more appropriate given the progress on inflation and on employment moving to a more sustainable level. So the balance of risks are now even. And this is the beginning of that process I mentioned, the direction of which is toward a sense of neutral, and we'll move as fast or as slow as we think is appropriate in real time."

We and our friends the Bond Vigilantes disagreed with the Fed's recalibration. Our August 19 *Morning Briefing* was titled "Get Ready To Short Bonds?" We argued that the economy was in a soft patch that wouldn't last too long. We predicted: "Bond investors may be expecting too many interest-rate cuts too soon if in fact August's economic indicators rebound from July levels and the Fed pushes back against the markets' current expectations for monetary policy. So we are expecting to see the 10-year Treasury bond yield back in a range between 4.00% and 4.50% next month."

Much to our consternation, instead of pushing back against the markets' expectations, the Fed cut the FFR by 50bps on September 18 and Powell signaled that more rate cuts were coming. We pushed back against the Fed. Our October 15 *Morning Briefing* was titled "Will Fed Get Stuck With Sticky Inflation?" We wrote: "By cutting interest rates despite strong economic growth, the Fed now risks overstimulating demand and reviving inflation. Services and wage inflation remain sticky, raising the risk that headline inflation gets stuck above 2.0%. The bond market agrees with our assessment that the Fed turned abruptly too dovish recently, boosting market expectations for long-term inflation higher."

So now that the Fed has cut the FFR by 100bps since September 18, 2024, the 10-year bond yield is up 114bps since September 16, 2024 (*Fig. 2*). Even the 2-year Treasury note yield is up 91bps since September 24, 2024. Since the last FFR cut, on December 18, the number of additional 25bps rate cuts expected by the FFR futures market has declined from two to one over the next 12 months and none over the next six months (*Fig. 3*).

In early December, the stock market started to recalibrate the outlook for interest rates to higher-for-longer. Consider the following:

(1) The S&P 500 market-cap-weighted stock price index peaked at a record 6090.27 on December 6 and fell 4.3% through Friday's close to 5827.04 (*Fig. 4*). It is 2.4% below its 50-day moving average. If it drops to its current 200-day moving average, that would be an 8.1% pullback from the peak.

The S&P 500 equal-weighted stock price index is down 7.5% from its November 29 peak and only slightly above its 200-day moving average (*Fig. 5*).

(2) The Nasdaq peaked at a record high of 20,173.89 on December 16 (*Fig. 6*). It is down 5.0% since then, to below its 50-day moving average. Its 200-day moving average is currently 17,881.5.

(3) The Russell 2000 peaked at 2442.03 on November 25, matching its high at the end of 2021 (*Fig. 7*). It is down 10.4% since then. So it is officially in a correction. We have not been keen on SMidCaps in general, and particularly not on the Russell 2000, because their earnings have been flatlining since 2022.

(4) Since Election Day, the following stock price indexes are down: the Dow Jones Industrials Average (-0.7%), the S&P 500 Equal-Weighted (-3.0), and the Russell 2000 (-3.2) (*Fig. 8*). Still up since then are the Magnifient-7 stocks (12.2) as well as the Nasdaq (3.9), Nasdaq 100 (3.1), and S&P 500 (0.8).

(5) We anticipated this stock market correction at the end of last year. In the December 17 *Morning Briefing*, we wrote: "With bullishness abounding, contrarian indicators are flashing red, and we see the potential for a market correction early next year." Our major concern was that the stock market was discounting too many FFR rate cuts, while the bond market was signaling that the Fed had already cut the rate by too much. Friday's stock market rout suggests that stock investors have recalibrated their interest-rate outlook to higher-for-longer, a.k.a. normal-for-longer.

The animal spirits unleashed when President Donald Trump won a second term in office on November 5 have been subdued by more realistic outlooks for both Fed policy and the policy stew cooked up by Trump 2.0.

(6) Another important development: Stock market sentiment is turning less bullish, which is

a positive from a contrarian perspective. The Investor Intelligence and AAII bull/bear ratios have dropped sharply over the past couple of weeks and undoubtedly did so again this past week (*Fig. 9*).

(7) More downside for stock prices is likely this week if December's CPI, which will be released on Tuesday, is as hot as the Cleveland Fed's *Inflation Nowcasting* tracking model shows—i.e., a 0.38% increase in the headline rate. The core rate indicated is less than that, however, at 0.27%. These m/m increases would put December's y/y readings at 2.9% and 3.3%.

However, the downside may be short-lived. We are still expecting that the Q4-2024 earnings reporting season, which starts this week, will show at least a 10% y/y increase in S&P 500 companies' aggregate operating earnings per share. The analysts' consensus is 8.2% currently (*Fig. 10*). The big banks will start the reporting off at the end of this week. Their results should be strong. In addition, their managements might discuss how deregulation under Trump 2.0 might boost their earnings.

US Economy: A Solid Labor Market. "The sky is falling! Get out of the way!" That was the reaction of the stock and bond markets on Friday to the stronger-than-expected employment report as investors rushed to sell both stocks and bonds. Is such good news for the economy really bad news for investors? Not in our opinion. Consider the following:

(1) December's payroll employment increased 256,000, beating expectations after November's increase of 212,000 was less than expected. Those surprises were mostly attributable to retail sales payrolls, which fell 29,200 in November and increased 43,400 last month. That was attributable to a late Thanksgiving holiday.

The three-month moving average of the monthly changes in total and private payrolls were 170,000 and 138,000 through December (*Fig. 11*). Those are in line with the paces of 2018 and 2019 and consistent with our view that the labor has normalized following the tight conditions during the pandemic years.

(2) Aggregate weekly hours rose 0.2% m/m to another record high last month, while average hourly earnings (AHE) increased 0.3% m/m (*Fig. 12*). As a result, our Earned Income Proxy for private-industry wages and salaries in personal income rose 0.5% to another record high. This augurs well for other measures of consumer income and consumer spending during December, which will be reported over the rest of this month (*Fig. 13*).

(3) AHE for all workers has been rising faster than consumer prices since early last year, suggesting that productivity growth has rebounded from the pandemic levels (*Fig. 14*).

(4) December's unemployment rate edged down to 4.1% from 4.2% the month before. Layoffs and initial unemployment claims remain low. There are plenty of job openings. The only issue we see in the labor market is that the average weekly duration of unemployment has risen from 20.6 weeks during July to 23.7 weeks last month (*Fig. 15*). It may be taking longer to find a job because of skills mismatches.

Commodities: An Oily Policy Change. The price of a barrel of a barrel of Brent crude oil rose by $5.12 to $79.76 since the start of the new year through Friday's close (*Fig. 16*). Initially, the rally was driven by cold weather in the US and Europe. In addition, the Chinese government announced plans for more fiscal stimulus to revive China's economy.

Last week on Friday, the Biden administration imposed new sanctions on Russia. They target more than 180 vessels from Russia's fleet of shadow tankers that Moscow has used to evade existing oil sanctions. They also blacklist two leading Russian oil producers, Gazprom Neft and Surgutneftegas, and their subsidiaries.

According to *The New York Times* report, Daleep Singh, the deputy national security adviser for international economics, said it was a "fair question" to ask why Mr. Biden waited until the end of the administration to impose such sanctions.

It might give the Trump administration more bargaining power over Russia in negotiating an end to that country's war with Ukraine. It might also leave the new administration with an inflation problem that will further unsettle the bond and stock markets. Then again, Trump will probably counter by announcing lots of oil leases on federal land.

Movie. "The Substance" (- - -) (*link*) is a horrible movie starring Demi Moore as an aging TV celebrity with her own very popular exercise show. She learns that the network's president intends to replace her with a younger and curvier performer. She takes a black-market drug that replicates her genes and produces a younger and fitter version of herself and gets her job back. It turns out she has made a deal with the devil that ends with the spilling of lots of blood. So the movie is a bit like mixing "The Picture of Dorian Grey" and "Carrie." If you like horror films, you might enjoy this horrible one.

Calendars

US: Mon: Budget Deficit -$67.6b; Consumer Inflation Expectations. **Tues:** NFIB Business Optimism Index 100.8; Headline & Core PPI 0.3%m/m/3.0%y/y & 0.2%m/m/3.2%y/y; Williams; Lane. (FXStreet estimates)

Global: Mon: China Trade Balance $99.8b; Lane. **Tues:** Italy Industrial Production 0.3%; Breeden. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index fell 2.0% w/w to 4.5% below its December 6 record high. The AC World ex-US index outperformed, albeit with a 0.8% decline to a 10.3% correction from its June 15, 2021 record high. It had been just 0.7% below its record high at the end of September. EMU was the best performing region last week, with a gain of 1.3%, followed by EM Latin America (1.0%), Europe (0.4), EMEA (-0.4), EAFE (-0.4), and the AC World ex-US. EM Asia and EM were the worst regional performers, with declines of 1.9% and 1.5%, respectively. The Korea MSCI index performed the best last week, with a gain of 3.5%, followed by France (1.5), Mexico (1.4), Germany (1.3), and Taiwan (0.9). China was the worst performer, falling 4.4%, followed by India (-3.8), South Africa (-3.2), Hong Kong (-3.2), and Japan (-2.6). The US MSCI's 0.8% ytd decline remains relatively close to the AC World ex-US (-1.0). EM Latin America is ahead of the pack as the leading region ytd with a gain of 0.5%, followed by EMEA (0.4), EMU (0.2), Europe (-0.1), EAFE (-0.7), and the AC World ex-US. The worst performing regions so far in 2024: EM Asia (-2.2) and EM (-1.7). Looking at the major selected country markets that we follow, Korea is the best ytd performer with a gain of 5.9%, followed by Australia (1.1), Mexico (0.7), and Switzerland (0.5). The worst performing countries ytd: China (-6.4), Hong Kong (-4.6), Japan (-2.8), and India (-2.3).

US Stock Indexes (*link*): Just one of the 48 major US stock indexes that we follow rose w/w. The S&P 500 Transportation index was the best performer, with a gain of 0.5%, ahead of Dow Jones 20 Transports (-0.5), S&P 400 MidCap Pure Value (-0.6), S&P 500 LargeCap Pure Growth (-1.0), and S&P 400 MidCap Pure Growth (-1.1). The Russell 2000 Value index, with a decline of 3.7%, was the worst performer, followed by Russell 2000 (-3.5), Russell 2000 Growth (-3.3), and S&P 600 SmallCap Value (3.1). Looking at their ytd performances, just four of the 48 indexes are now positive so far in 2025, compared to 46 rising in 2024. The S&P 500 Transportation index is in the top spot as the best performer so far in 2025, with a gain of 1.6%, ahead of S&P 500 LargeCap Pure Growth (0.9), S&P 400 MidCap Pure Growth (0.6), and Dow Jones 20 Transports (0.2). The worst performing major US stock indexes ytd: Russell 2000 Value (-2.4), S&P 600 SmallCap Pure Value (-2.4), S&P 600 SmallCap Value (-2.3), S&P 600 SmallCap Equal Weighted (-2.2), and S&P 600 SmallCap (-1.9).

S&P 500 Sectors Performance (*link*): Three of the 11 S&P 500 sectors rose last week, and six were ahead of the S&P 500's 1.9% decline. The outperformers last week: Energy (0.9%), Health Care (0.5), Materials (0.1), Communication Services (-0.7), Industrials (-1.0), and Consumer Staples (-1.9). The underperformers last week: Real Estate (-4.1%), Information Technology (-3.1), Financials (-2.7), Consumer Discretionary (-2.3), and Utilities (-2.0). The S&P 500 is down 0.9% ytd, with three sectors in positive territory and five sectors ahead of the index. Energy wears the crown as the best ytd performer, with a gain of 2.9%, ahead of Health Care (1.5), Communication Services (0.7), Utilities (-0.2), and Industrials (-0.3). These sectors are lagging the S&P 500 so far in 2025: Real Estate (-3.8), Consumer Staples (-2.2), Financials (-2.1), Information Technology (-1.7), Consumer Discretionary (-1.2), and Materials (-1.0).

US Economic Indicators

Employment (*link*): Employment was considerably above expectations in December, while there were minor revisions to the prior two months. *Payroll employment* advanced 256,000 in December (vs 153,000 expected), with November (to 212,000 from 227,000) payrolls showing a downward revision of 15,000 and October (43,000 from 36,000) payrolls an upward revision of 7,000 for a net loss of 8,000. *Private payroll* employment climbed 223,000, after increasing 182,000 in November, with *service providing* jobs adding 231,000 to payrolls last month, a pick-up from November's 148,000 tally, while *goods-producing* jobs fell 8,000 after a 34,000 gain in November. *Manufacturing* jobs fell 13,000, with durable manufacturing shedding 16,000, while nondurable goods manufacturing added 3,000 to payrolls. Construction jobs rose 8,000 during the month, while mining jobs slipped 3,000. Within *service-providing* industries, *health care* added 46,000 jobs in December and an average of 57,000 jobs per month in 2024, matching 2023's average monthly gain. *Leisure & hospitality* jobs rose 43,000 last month, averaging monthly gains of 24,000 per month during 2024—roughly half of 2023's monthly increase of 47,000. *Retail trade* also advanced 43,000 last month, rebounding from November's 29,000 loss, with overall employment showing little change for all of 2024; it averaged monthly gains of only 10,000 during 2023.

Government payrolls remain on an uptrend, adding 33,000 in December—close to 2024's average monthly gain of 37,000. *Social assistance* jobs added 23,000 to payrolls last month—slightly above the average monthly 18,000 for all of 2024.

Wages (*link*): Average hourly earnings (AHE) for *all workers on private payrolls* increased 0.3% in December, while the three-month rate increased 4.1% (saar), exceeding the yearly rate of 3.9%. The yearly rate is up from 3.6% in July, which was the lowest since May 2021; the yearly rate peaked at 5.9% in March 2022. *Service-providing industries showing three-month rates above their yearly rates*: information services (7.1% & 4.5% y/y), professional & business services (6.0 & 5.2), retail trade (4.9 & 2.8), utilities (4.6 & 3.6), financial services (4.4 & 4.1), education & health services (4.2 & 3.7), other services (3.4 & 2.9), and wholesale trade (2.6 & 2.3). *Service-providing industries showing three-month rates below their yearly rates:* transportation & warehousing (1.0 & 2.2). The three-month and yearly rates for leisure & hospitality (3.8 & 3.9) were nearly identical. Within *goods-producing* industries, the annualized three-month rates were above the yearly rate for *durable goods* manufacturing (4.0 & 5.0) and nearly identical for *nondurable goods* manufacturing (2.6 & 2.7) industries.

Earned Income Proxy (*link*): Our Earned Income Proxy (EIP), which tracks consumer incomes and spending closely, climbed to yet another a new record high in December, increasing 0.5%. *Average hourly earnings* in December advanced 0.3%, while *aggregate weekly hours* *also* rose 0.2%—with private payroll employment ticking up 0.2% and the average workweek flat. Over the past 12 months, our EIP advanced 5.0%—with aggregate weekly hours up 1.1% and average hourly earnings up 3.9%.

Unemployment (*link*): The *number of unemployed* fell 235,000 in December to 6.9 million, down from a recent peak of 7.2 million in July. The *unemployment rate* edged down to 4.1 from 4.2% in November, hovering between 4.1% and 4.2% the past seven months. The rate was below 4.0% from February 2022 through April 2024 before reaching 4.0% this May. *Household employment* rose 478,000 in December, while the *labor force* was 243,000,000 higher than in November. The *participation rate* was at 62.5% for the third month, after being at 62.7% the prior three months, and has been in a volatile flat trend over the past year. *By race*, unemployment rates in December fell across the board: African Americans (to 6.1% from 6.4%) and Hispanics (5.1 from 5.3), Asians (3.5 from 3.8) and Whites (3.6 from 3.8). *By education*, unemployment rates also fell across the board: less than a high school diploma (5.6% from 6.0%), with a high school degree (4.3 from 4.6), some college or associate's degree (3.5 from 3.6), and those with a bachelor's degree or higher (2.4 from 2.5).

Consumer Sentiment Index (*link*): Consumer sentiment edged lower in mid-January, on a slump in the expectations component. *Consumer sentiment* slipped to 73.2 (below consensus estimates of 74.0) this month, after climbing from 66.4 in July to an eight-month high of 74.0 in December. *Current conditions* jumped from a recent low of 61.3 in August to a nine-month high of 77.9 this month, while expectations measure slumped for the second month, from 76.9 in November to a six-month low of 70.2 in mid-January. According to the report, "January's divergence in views of the present and future reflects easing concerns over the cost of living this month, but surging worries over the future path of inflation." Inflation expectations for the year ahead jumped from 2.8% in December to an eight-month high of 3.3% in January. Long-run expectations rose from 3.0% to 3.3% over the same period.

Global Economic Indicators

Eurozone Retail Sales (*link*): Eurozone retail sales barely budged in November, though climbed for the fourth time in five months. *Headline retail sales* edged up 0.1% in November and posted a 1.8% gain during the five months through November. The *components of retail sales* show spending on *automotive fuels* rebounded 0.8% after sinking 1.0% the prior two months, while *non-food products ex auto fuels* slumped 1.2% during the two months through November. Meanwhile, *food, drinks, and tobacco* climbed for the third time in four months, by 0.1% m/m and 0.6% over the period. November data are available for *three of the Eurozone's four largest economies*, with France (0.3% m/m & 1.5 y/y) posting gains on both a monthly and yearly basis, while Germany (-0.6% & 2.4%) and Spain (-0.6% & 1.0) fell during November, though were above year-ago levels.

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