

July 4, 2022

## U.S. Recession – When, Not If.

Just as we rolled out our U.S. recession call, forecasting it would start in 4Q of 2022, last week's data pointed to it starting here in 3Q. Yes, I know 2Q could be negative, which would put 1Q/2Q both negative. But the hit in 1Q was due to imports, not domestic demand. Maybe the recession started in 2Q, but with its strong employment gains, that also seems unlikely. No matter, we are moving into a recession. Why the pull-forward? ... If there's one answer, it's the fallout from the popping of the stay-at-home bubble, smashing corporate profits (from retailers to sneakers to streamers to computers to chips), crushing business confidence, also now hitting mfg, leading to layoffs, hitting consumer confidence hard, all intensifying/spreading financial strains. And to be sure the declines in Drs. Copper, KOSPI, and Junk also point to a recession, as does the sharp decline in trucking activity.

We're watching most closely the 6Cs, which are all deteriorating: Confidence (plunging), Credit (deteriorating), Claims (rising), Contagion (spreading), Crude (gut-wrenching), and China (Covid shutdowns back?). The good news is, inflation will slow sharply, with some areas of deflation. But getting there will not be pretty, i.e., higher unemployment will push down wage inflation.

That all said, the structural backbone of the U.S. economy is solid ... if Washington would just further support that and pass the Chips Act. And remember August 1982, when inflation was squeezed out, with a recovery in the offing ... unfortunately, it'll be some time before we can celebrate like it's August 1982!

But it is a great day to celebrate the 4<sup>th</sup> of July. Enjoy. We're in Aspen, and looking forward to the parade (which is back to normal this year!), and a lovely picnic lunch (thanks D&M).

Please let us know if you have any suggestions, questions, or criticisms.

### *7 Takeaways From Nancy's Narrative:*

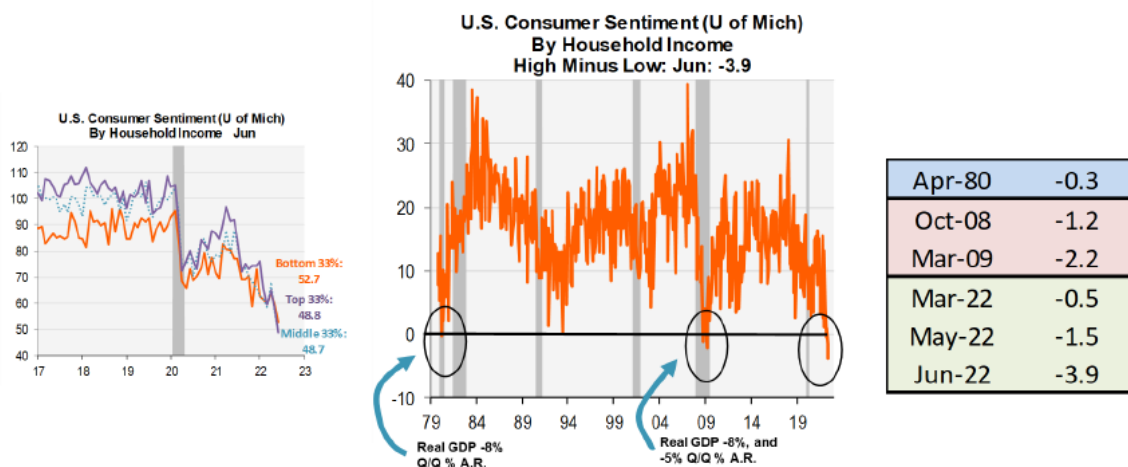
- 1. Moving Into A Recession In 3Q.**
- 2. Popping Of The Stay-At-Home Bubble Pulling Forward The Recession.**
- 3. The Writing Is On The Wall: 2Q Profit Hit.**
- 4. Unemployment Needs To Increase For A Sustained Inflation Slowdown.**
- 5. Tightening Financial Conditions Spell Trouble Ahead.**
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## Nancy's Weekly Narrative

### Moving Into A Recession In 3Q.

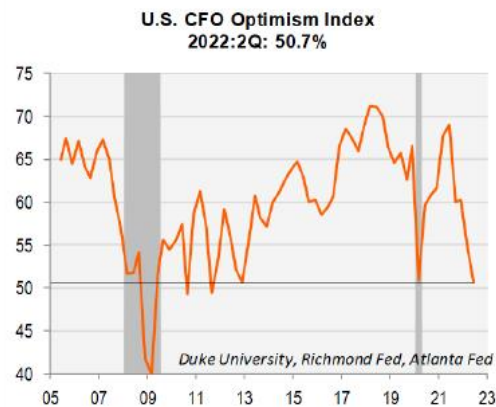
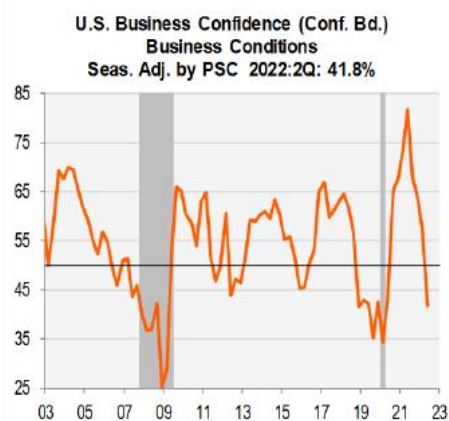
Not only have we shifted to a U.S. recession call for 2022, we're beginning to fear it could start this quarter:

1. **High income consumer confidence is now weaker than low income consumer confidence**, which has only happened 2 other times in history, both in severe recessions. S&P's -20% decline and 8% inflation are at work, crushing real consumer net worth (-5% y/y in 2Q ... in and of itself, a recession signal). The worry is that the high income cohort will be reluctant to spend their excess savings, causing real consumer spending to fall. It's still on track to increase at a 1.0% q/q a.r. in 2Q, but May's -0.4% m/m drop sets the stage for a decline in 3Q. The cycle low in our headline Daily consumer confidence survey sure points that way.

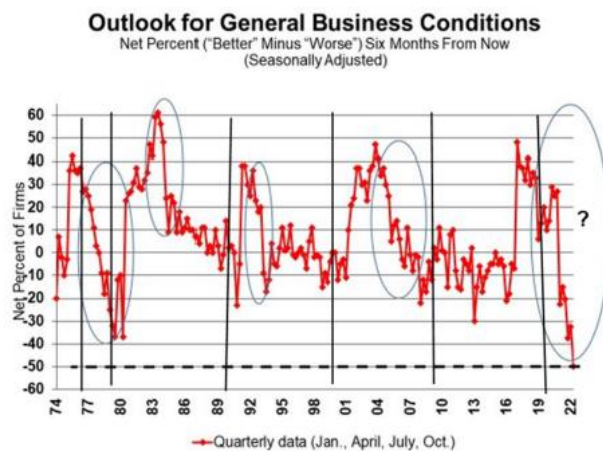


2. **Business confidence is plunging**, which has been an important leading indicator for swings in GDP, PMIs, and S&P earnings this

cycle.



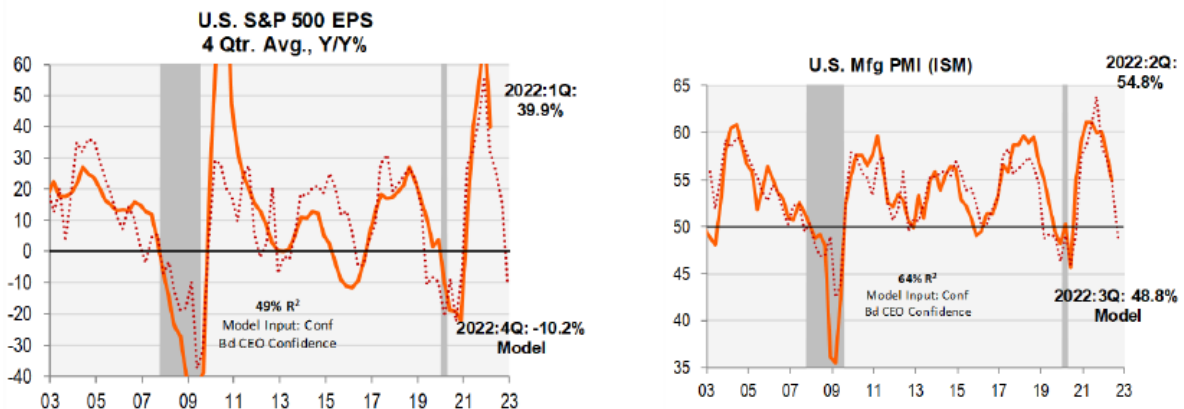
And this morning (yes, the 4<sup>th</sup>), the NFIB (small businesses) reported a plunge in their General Business Conditions Outlook index to a recession level ... indeed a record low.



3. S&P earnings are deteriorating right now ... much more than our base case (based on #2 above). That's driving businesses to cut costs – labor and capex. Indeed, our layoff tally is climbing, and

capex – the strongest component of GDP -- is on track to miss our 4% call for 2Q.

Based on business confidence alone, **2022 S&P EPS could plunge -10.2% yy to \$180**. That's probably too extreme, but it highlights extreme downside to our base case of \$217. 2Q earnings season will be brutal. In addition, declining business confidence suggests that the mfg PMI moves down below 50% in 3Q (the decline in new orders in June to 49.2%, suggests the same).



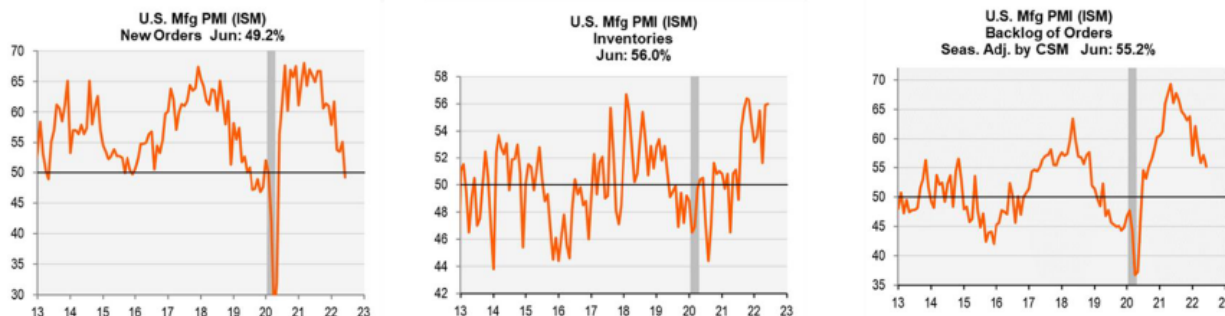
There's even a risk 2Q real GDP prints negative. We're still at +1% q/q a.r., but the Atlanta Fed GDPNow has -2.1%. (They include a plunge in inventories we don't see ... yet.) If they're right, that would give us 2 consecutive negative GDP quarters in a row – a technical recession. But under the surface, 1Q's decline (-1.6%) was mainly due to trade (surging imports). Domestic demand was still healthy, with consumer spending up 1.8% q/q a.r., & capex +10.0%. And employment was robust.

But with a recession now on the horizon, the big risk is deteriorating earnings, leading to weaker employment & capex.

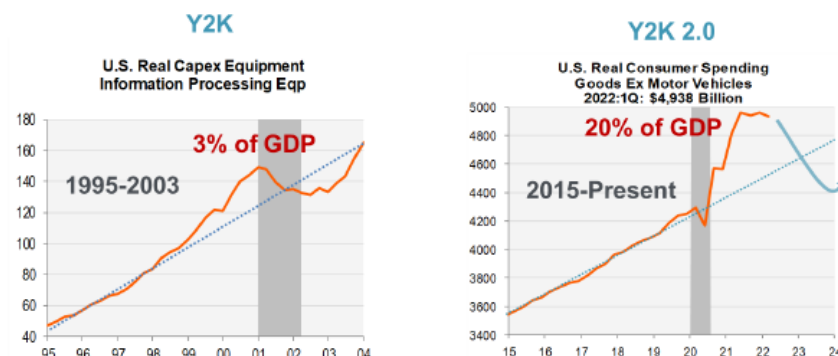
### **Popping Of The Stay-At-Home Bubble Pulling Forward The Recession.**

We call this cycle Y2K 2.0, because the huge Covid/stimulus demand pull-forward (Amazon, Peloton, Netflix, etc.) echoed 2000's tech pull-forward (on fears computers would fail on 1/1/2000). In both cases, the excessive demand wasn't sustainable. And as in 2000, classic long term drivers of growth were headwinds coming into this year, with Global central banks tightening, bond yields rising, and oil surging. Finally, again as in 2000, there were vulnerable excesses. This year, it's the stay-at-home bubble. Back in 2000 it was the surge in tech eqp. Unwinding the excesses accelerates and deepens the downturns. While our models had the impending downturn in 4Q 2022-1H2023, the popping of the stay-at-home bubble is pulling it forward.

But, the ISM for June confirmed what the S&P mfg PMI had already shown, that mfg new orders were declining (sooner than we expected), due to the surge in retail inventories, reflecting double ordering, and now-weak demand for many of those stay-at-home goods, hitting mfg orders, leading to mfg inventories growing, and once-troubling backlogs easing significantly.



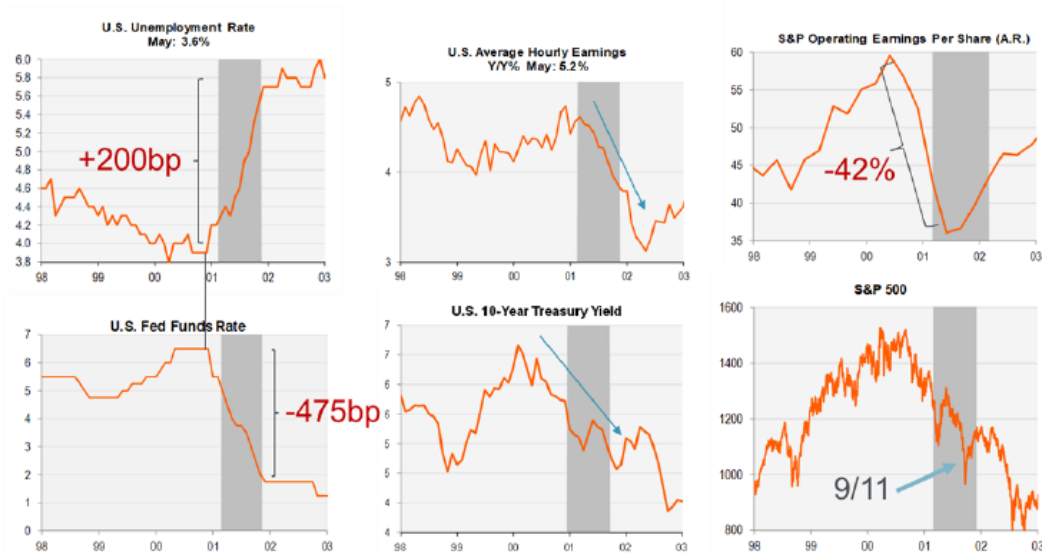
The BIG difference between Y2K 2.0 and the original Y2K? Today's Y2K 2.0 bubble is nearly 7 times bigger -- consumer spending on goods is 20% of GDP – tech capex is just 3%.



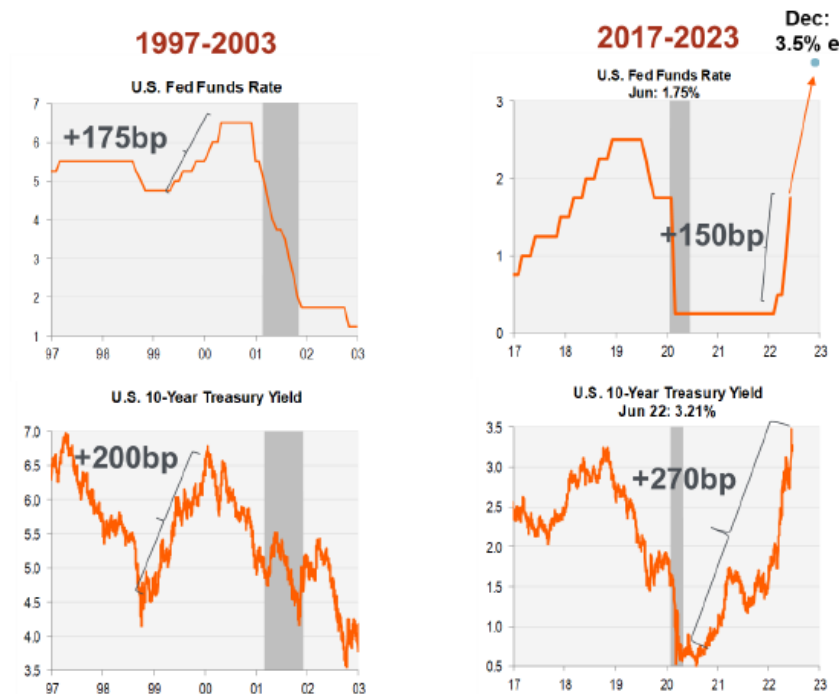
In the Y2K bubble, real tech capex overshot its trend by 17%, and then over the next year undershot -14%, before reverting back. Y2K 2.0's stay-at-home spending overshot its pre-bubble trend by 11%. If it now undershoots by 9%, that would pull real consumer spending on goods-ex autos down to \$4.4t by 4Q of 2023, knocking real GDP down 2.5ppts. That hit may be happening now, given May's weak real consumer spending.

Back in Y2K, the lagged impacts of Fed tightening, higher bond yields, and the popping of the tech bubble hammered the economy, taking earnings down sharply, boosting unemployment, and slowing inflation – leading to a Fed easing cycle, and falling bond yields. But, as our strategy team highlights, it wasn't until earnings bottomed, that the market truly bottomed. And historically, the economy/earnings bottom at least a year AFTER the y/y bp change in rates peaks. That hasn't happened yet.

### Popping Of The Y2K Bubble Was Painful ... Very Painful.



Today's Y2K 2.0 cycle features much worse inflation than the 1.0 era. So yields have risen more, and the Fed is much more hawkish. Inflation is now poised to slow, potentially significantly, but it will be painful, as lower prices hit company earnings, forcing more and more layoffs, etc.



With recession now a “when” not “if” (for all the reasons in the first section), maybe the Fed won’t be as aggressive as the market fears. But in the meantime, watch for the pulled-forward 2022 downturn – and at least a -1% 2023 contraction, to give S&P earnings a severe beatdown.

### The Writing Is On The Wall: 2Q Profit Hit.

Companies – across a broad spectrum of industries -- aren’t pulling punches about the slowdown, and what it means for earnings & employment.

- 1. RH’s CEO in March appropriately set the negative tone for 1Q earnings. And last week the company said it now “expects sales to decline between 2% and 5% in the current fiscal year, a change from flat to 2% growth.” (WSJ 7/1).**

2. Meta's Zuckerberg said the company was facing one of the "worst downturns that we've seen in recent history." (*NYT* 7/2) With the *NYT* writing: "It enjoyed strong growth in the early parts of the pandemic, but has more recently grappled with upheaval in the global economy as inflation and interest rates rise." We would add, and the popping of the stay-at-home bubble is impacting even tech companies.
3. "Amazon cancels, delays wave of warehouse plans as e-commerce demand cools." (*SupplychainDive*).
4. "TSMC sees clients scale back orders." (*DIGITIMES* 7/1).
5. "Tesla's Bumpy Quarter Might Be About More Than Lockdowns in China." (*WSJ* 7/3). "Tesla Cuts 200 Staff In Shutting Valley Site." (*WSJ* 6/29).
6. "Micron issued a subdued revenue outlook. ... Micron ... had enjoyed a major upswing in sales and profit during the pandemic, benefiting from surging demand for electronics amid the work-from-home shift. But personal computer and smart phone sales are on the decline." (*WSJ* 7/1).
7. "Tech companies ramping up layoffs. Aggressive hiring in recent years a factor." (*USAToday* 6/28). Indeed, as we've noted, the stay-at-home bubble, created an employment bubble.
8. "Walgreens Sales Drop As Vaccinations Fall." (*WSJ* 7/1).
9. "Bed Bath & Beyond Burned Cash." (*WSJ* 7/2).
10. "Nike's Sales, Net Income Decline As Stores Report Excess Inventory." (*WSJ* 6/28).

Even the “positive” comments were “negative”. Some companies said revenue was up despite falling sales, due to pricing power. That’s not sustainable. If unit sales are falling because consumer real incomes are down, how can aggressive pricing stick? Put differently, some company earnings are being supported by higher inflation ... and the Fed is trying to crush inflation – yes, they’re fighting the Fed. Here are a couple of examples of pricing strategies we don’t believe are sustainable:

1. **“CarMax ... reported that its total revenue grew 21% y/y in the quarter ended May 31.” That said “this was the second consecutive quarter of declining units sold y/y.” (WSJ 6/25).**
2. **“FedEx revenues rose 8% in its fourth quarter as higher shipping rates and fuel surcharges offset a small volume of packages shipped.” (WSJ 6/24).**
3. **“General Mills said higher prices helped lift sales in the recently ended quarter even as the food maker sold fewer items across the board.” (WSJ 6/30). How many of you stocked up on cereal, and other staples during the pandemic? I did. Now, even staples are at risk from the bubble unwind.**

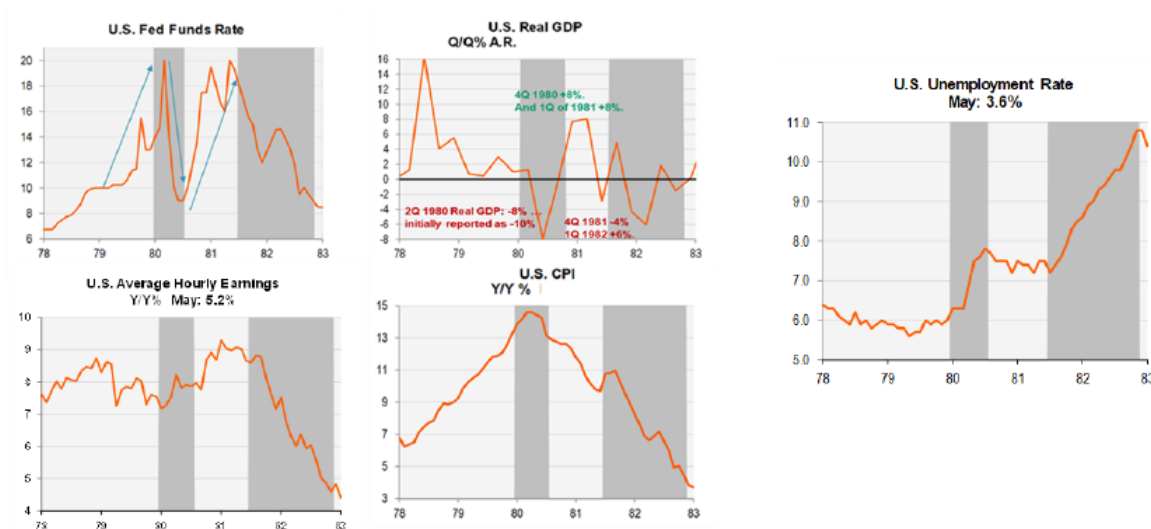
We will be digging more into how inflation is distorting profits on the high side ... the last time this happened was in the 1970s. Hmm. Maybe it’s not a coincidence that the S&P had its worst first half since 1970. Stay tuned.

### **Unemployment Needs To Increase For A Sustained Inflation Slowdown.**

With the economy now suffering the highest inflation since 1980, let’s look at how prices were tamed back then. It took a harsh tightening cycle, raising the unemployment rate, slowing wage growth, and in turn, cooling core inflation. But it wasn’t a straight line -- Volcker blinked in 2Q of 1980 when GDP contracted -8%, prompting him to ease aggressively. That boosted the

economy and markets (stocks & bonds) – and reaccelerated wage inflation. Whoops. He then tightened significantly, creating a double-dip GDP decline. Fast forward to today. The markets are already pricing in a sharp 2023 easing cycle. But if the Fed eases too much too soon, it risks not creating enough labor slack to ensure a sustained shift down in inflation. A Volcker-esque whipsaw – and GDP double-dip – would be a risk.

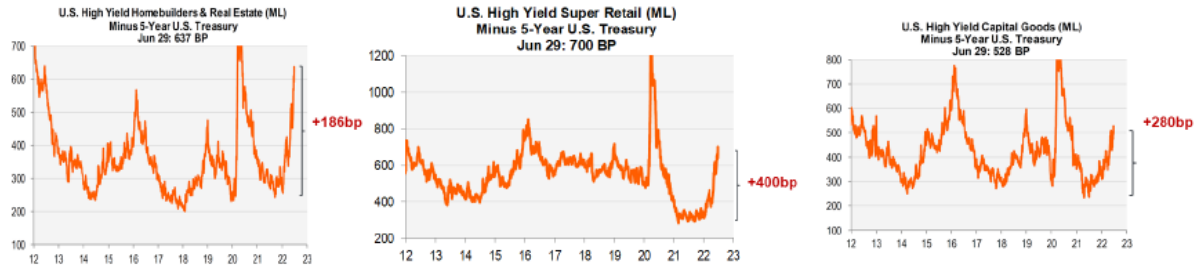
*The 1980-1982 Double-Dip Recession  
... Triggered By The Fed. To Combat Inflation.*



We expect the unemployment rate to rise to 4.0% by year-end, and 4.5% by year-end 2023, both with significant upside. Crushing inflation will NOT be pretty – GDP, EPS, and jobs will all suffer. But on the other side, inflation will have been tamed, laying the foundation for a healthy and sustainable expansion. I remember August 1982 ....

**Tightening Financial Conditions Spell Trouble Ahead.**

As we've written many times, during every tightening cycle, financial strains/crisis always unfold. This time, SPACs and crypto are on the leading edge. And while broad BAA spreads are still tame, junk spreads for highly cyclical sectors have widened significantly, most notably housing, retail, and cap goods -- signaling the economy ended 2Q/started 3Q on a deteriorating note, i.e., a recession signal. Spreads are good coincident indicators, leading by maybe a quarter.



Elsewhere in the capital markets, the news was uniformly bleak:

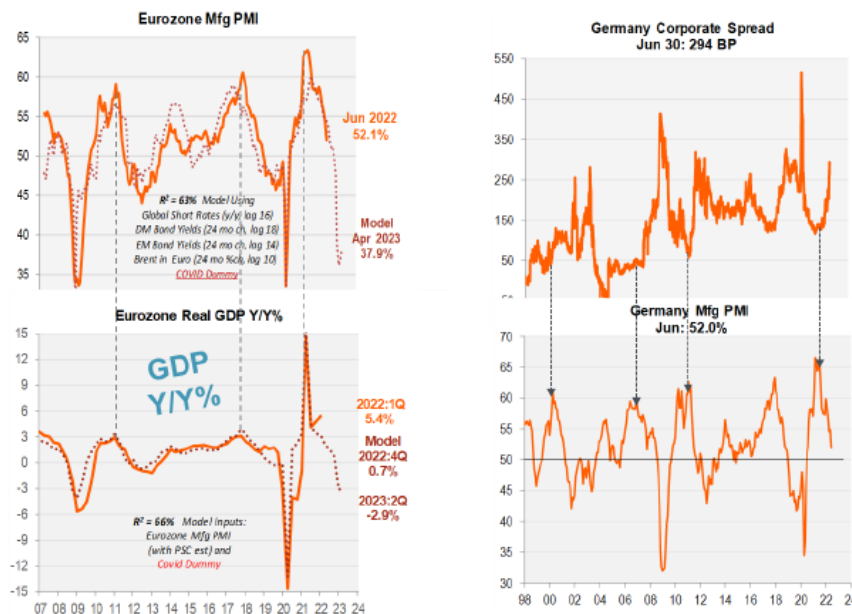
1. **“New sales of convertible bonds have all but dried up and the ICE BofA U.S. Convertible Index has slide about 18%. Issuance of convertible debt exploded during the pandemic because it allows young companies to raise money relatively cheaply without selling stock.” (WSJ 6/28).**
  2. **“Global companies have pulled more debt sales in the past six months than in all of 2020.” (BBG 7/1).**
  3. **“\$60b U.S. junk bond sales in 1H, down from \$250b in 1H of 2021, the slowest start since 2009.” (Barron’s 7/2).**
  4. **“Investment Banks Prepare for Lean Times as Deal Spree Sputters.” (WSJ 7/3).**
  5. **“Bank of America, Credit Suisse and Goldman Sachs are among banks that could collectively lose billions on buyout loans they agree to provide when demand was high.” (WSJ 7/3).**
  6. **“VC Funding Set to Hit Lowest Level Since 2020.” (BBG 6/28).**
- 7. “Airport Turmoil Is Sending Airline Bonds Into Distressed Zone.” (BBG 6/29).**

We worry the stimulus-pumped stay-at-home bubble spawned a related financial assets bubble. That puts the recession-bound economy – and EPS -- even more at risk, as the Fed continues its aggressive tightening cycle.

## Foreign Financial Conditions Tightening, Including Germany.

As we've noted, dollar strength and the Global recession are severe headwinds to many EMs. The weakest links include: "Default jitters mount in Argentina as local yields top 70%" (*BBG* 6/28). Turkey's inflation soars to 80%. Russia ... defaulted on foreign debt obligations for the first time in 100 years (*NY Post* 6/28).

And we're also watching the Eurozone closely. Worryingly, German credit markets are deteriorating significantly – a 3Q recession sign for the bloc. Even before Russia invaded Ukraine, we feared a sharp Eurozone slowdown. Now the only question is, how deep will their recession be?



Indeed, except for China experiencing a modest rebound (that could/will fade if Covid picks up again), this is indeed, a Synchronized Global Recession, most likely starting here in 3Q.

### Editorial Comment: Yes, Washington Can Help. Pass The Chips Act.

I am definitely out my league here .... I always leave DC politics/fiscal policy issues to Andy and Don. But when Washington is looking for ways to cushion the impending recession – and make the economy more resilient – here's a no-brainer: Just pass the Chips Act, which provides federal subsidies for semi plants (unfortunately Andy doesn't think it will pass this year). At a conference last week, I heard Intel's CEO say, if Congress doesn't pass it, instead of building a plant in Ohio, which will create thousands of jobs, he'll site it in Europe. Taiwan Semi said they will slow the pace of the construction of its Arizona plant, given the delay in DC. As the *Washington Post* outlined last week: "Once completed, the Arizona factory and surrounding cluster of suppliers, including a Taiwanese chemical company that has also started investing in the site, will create several thousand jobs." (*WP* 7/1). The article went on to note that TSMC is training workers and engineers to handle their sophisticated equipment. Fantastic. And last week, GlobalWafers announced it is planning a factory in Sherman, Texas. Fantastic!

So, here I go again. The most underappreciated part of GDP is capex. Such Mfg Renaissance investments have been unfolding for a dozen years, and were making a clear difference before the Covid recession, with goods producing jobs posting their biggest increase since the 1970s, a clear increase in the prime age labor force participation rate, and perhaps most important, a rising trend in the productivity growth. Secular stagnation was ending, as a result of the sustained shift up in U.S. capex from 2010-2019, i.e., real median family incomes rose sharply, with the poverty rate declining. Today, Covid, China, and Russia, all highlight the obvious need to reconfigure supply chains – not just here, but globally. For Congress not to embrace a bill that would support a sustained investment cycle in the U.S., creating thousands of high-paying jobs, and boosting productivity, is just sad.

## Key U.S. & International Data Releases.

### U.S. Data Releases

7/6 **June ISM Services PMI** is forecast to soften to 54.0%, from May's 55.9%.

7/6 **May JOLTS Job Openings** are projected to slip to 11.00 million, from Apr's record 11.40m.

7/7 **Unemployment Claims** for the week ending July 2nd are expected to tick down 1k, to 230k, with continuing claims up a touch to 1.330m (vs. 1.328m).

7/8 **June Payroll Employment** is projected to print 270k (vs. May's 390k), with average hourly earnings y/y slowing 0.2%, to 5.0%. The unemployment rate is expected to hold steady at 3.6%.

### International Ex China Data Releases

7/4-7/5 **Jun Foreign ex China Svc PMIs** are expected to weaken m/m, on lingering inflation worries, and mounting recession concerns. And there's downside ahead. Indeed July Global Sentix investor confidence (out today) dropped -6.6 pts m/m to -14.5; and their **Eurozone Sentix Investor Confidence** -- with a good STOXX fit -- plunged -10.6 pts to -26.4 (vs -20.0

7/8 **Jun Russia CPI** is seen growing 15.9% -- a touch slower than May's blistering 17.1%, and April's two-decade high 17.9%. That said, the pace of super-fast monthly gains is waning; indeed, the headline CPI is expected to decline -0.35% m/m from May's 0.12%, April's 1.6%, and March's whopping 7.6% m/m. The stronger ruble -- driven by Russia's intervention policies -- is helping. The CBR has now eased a cumulative 1,050, to 9.5%, after catapulting their key rate by 1150bp to 20% in Feb. The pre-war rate was 8.50%. Russia (and China) are outliers, easing in the face of an aggressive Global tightening cycle elsewhere.

## **China Data Releases**

7/4 Caixin June Svc PMI will likely surge m/m, as China re-opened its economy.