Pivot is the Wrong Word

Peak tightening, fiscal folly, real, not nominal, contraction, monetarism and the show that didn't drop

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Peak Tightening Expectations

- *It will 'likely be appropriate to slow increases at some point'*
- *Forward guidance is done, at least for now*
- *The front-loading process is complete*

Two important themes came together this week. First, the Fed completed the 'front-loading' process, confirming the critical inflection point for markets, peak tightening expectations, occurred at the June FOMC meeting. Like the November '94 75bp hike, the FOMC's 11th hour decision to hike 75bp in June created the conditions for the '22 Fed policy tightening low in the equities market. There was a plethora of evidence prior to the June FOMC meeting that inflation was peaking, however equities couldn't stabilize until the Fed confirmed that policy was turning data dependent. Pivot is an inappropriate characterization of the Fed's policy stance, and although forward guidance has thankfully been scrapped, the Fed is still likely to continue hiking their policy rate. We have 25bp at each of three remaining 2022 meetings penciled in based on our expectations that the two rounds of inflation, housing and labor market data prior to the September 21 FOMC meeting will soften.

The second theme was our nuanced view of the highly political recession debate. For equity investors, a contraction in real growth accompanied by continued expansion in nominal output implies more resilient earnings growth than a bank credit financed malinvestment bust like commercial real estate in '91, telecom and technology in '01 and residential real estate in '08. 2Q earnings tracking 8%, revenues 12%, a 0.9% contraction in real 2Q22 GDP, and nominal output increasing 7.8% was consistent with

our outlook for a real, but not nominal, economic contraction. The first estimate of gross domestic income will have to wait until next month's revision, however with corporate earnings growing close to 10% and labor income (average hourly earnings times hours worked) increasing 10.6% in 2Q22, we suspect nominal gross domestic income grew robustly and real income expanded. The stage is set for the equity market to reverse in 2H the losses from 1H as inflation falls towards our 2023 4% forecast. We got out of the S&P 500 price target business when we resigned as Barclays Head of Equity Strategy in 2014, however we did provide a 4900 year-end 2022 forecast to the CNBC Fed Survey. While equities, and cyclical sectors in particular are attractive, the Treasury market looks exceptionally overvalued, and we suggest fading market expectations of rate cuts in 2023.

Figure 1: Average hourly earnings flattened in 2Q while the Atlanta Fed Wage Tracker continued higher. The employment cost index tipped the scales towards the Atlanta Fed series, though as we have discussed it is not yet clear whether diminished slack or increased dynamism are driving wages. The former is more inflationary than the latter.

The data was mixed last week, as house price and activity data continued to show the impact of the mortgage rate shock. With the July employment report looming large, the 4-week moving average of jobless claims continued its march higher, the Conference Board Labor differential showed a marginal increase in labor slack and the employment cost index was stronger than expected. Regional Fed surveys showed a marginal increase in capital spending plans and core capital goods orders were strong. We will discuss the advanced estimate of 2Q22 GDP at length — it was all about continued pandemic rebalancing and doesn't tell us much about the outlook. Next week's employment report will provide more information about the 3Q outlook and whether there will be a debate within the National Bureau of Economic Research about whether the US economy is contracting.

The fiscal policy outlook darkened this week. We are ambivalent about the CHIPS Act; however, the Inflation Reduction Act is reminiscent of the Revenue and Expenditure Control Act of 1968 that placed a 'temporary' 10% income tax surcharge on individuals and corporations that lasted until 1971. Like the '60s, increased government spending and an expansion of government support programs can be directly tied to inflation acceleration. The Democratic Party solution to take money from the private sector through taxes ($313 billion from a 15% corporate minimum tax) and price controls ($288 billion from prescription drug price caps) to reduce inflation did improve government finances in the late '60s, but it did not slow inflation and is unlikely to do so now. Like monetary policy, policy tightening is targeting weaker demand but is as likely to reduce supply. Raising taxes on the corporate sector into a secular deglobalization trend even as another bill increases tax credits for investment in a particular sector is counterproductive and likely to lead to capital misallocation. Price controls were effective politics and counterproductive policy during the Great Inflation, and the same outcome is likely in the 2020s. It is standard political practice to blame Arthur Burns and the Fed for the Great Inflation: this approach facilitates expansion of the government's role in the allocation of resources. We suggest reading Burns' analysis of the Great Inflation, "The Anguish of Central Banking". On balance our confidence in our bullish 2H22 outlook increased this week, unfortunately our concerns about intractable inflation darkening the 2023 outlook intensified due to misguided fiscal policy.

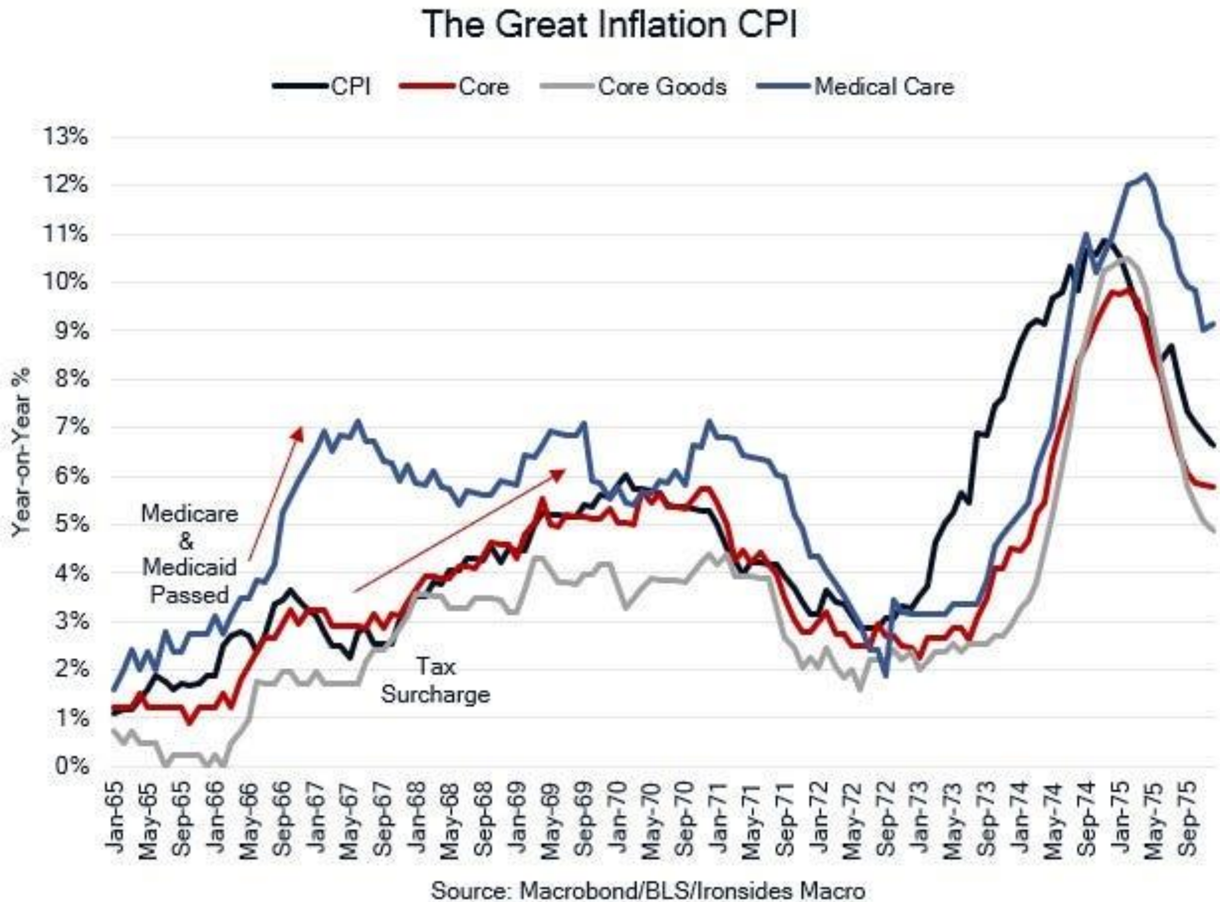

Figure 2: LBJ's tax surcharge did not slow inflation, nor will the Democrats corporate tax hike and price control scheme.

"PWBM estimates that the Inflation Reduction Act would reduce non-interest cumulative deficits by $248 billion over the budget window with no impact on GDP in 2031. The impact on inflation is statistically indistinguishable from zero. An illustrative scenario is also presented where Affordable Care Act subsidies are made permanent. Under this illustrative alternative, the 10-year deficit reduction estimate falls to $89 billion."
[*INFLATION REDUCTION ACT: PRELIMINARY ESTIMATES OF BUDGETARY AND MACROECONOMIC EFFECTS*]

A Real, Not Nominal, Contraction in Expenditures, Not Income

The contraction in the expenditure method of guesstimating US total output, real GDP, was primarily attributable to surging imports and a drop in government spending in 1Q. In 2Q a second consecutive decline was primarily attributable to a drop in inventory investment as well as another quarter of weaker government spending. While two quarters of negative real growth has triggered a largely political debate about whether the US is in recession, nominal growth has continued to expand at a rate the '10s could only dream about. Meanwhile our preferred measure, gross domestic income, expanded in 1Q and based on corporate results and labor income, likely did in 2Q as well. Additionally, as we have noted frequently, the mix matters. Here are the details. In 1Q22 real GDP contracted 1.6% quarter-on-quarter annualized, NGDP (nominal) expanded 6.6%, GDI increased 1.8% and NGDI by 10.2%. The drivers of the contraction in 1Q GDP were a surge in imports (-3.23% contribution), and a drop in government spending (-0.51%), albeit from the highest level relative to GDP since WWII. Personal consumption expenditures weakened to 1.8% from the torrid 2021 pace, but the real message was that the rebalancing from goods (-0.3%) to services (3.0%) had begun. The pent-up demand for services that was impaired by government mandated pandemic restrictions accelerated further in 2Q with service spending rising 4.1%, while goods expenditures contracted 4.4% with the slowdown in goods spending broadening to both durables and nondurable spending. The flat reading on nonresidential fixed investment was curious, as structures investment dropped 11.7% after a 0.9% decline in 1Q. Equipment investment dropped 2.7% after the inflation adjustment, nominal investment increased 5%, much slower than the 9% increase in core capital goods shipments or 12% quarter-on-quarter annualized increase in S&P 500 capex. Intellectual property product investment increased 9.2% after rising 11.2% in 1Q driven by a 10.3% increase in software and 13.9% in R&D. We suspect structures and investment will be revised higher, while business confidence has weakened, it effects spending with at least one quarter lag and there are a number of secular and cyclical reasons why investment is likely to prove resilient. Residential investment contracted sharply as we detailed in last week's note, this is likely to be a factor in the FOMC slowing the rate hikes.

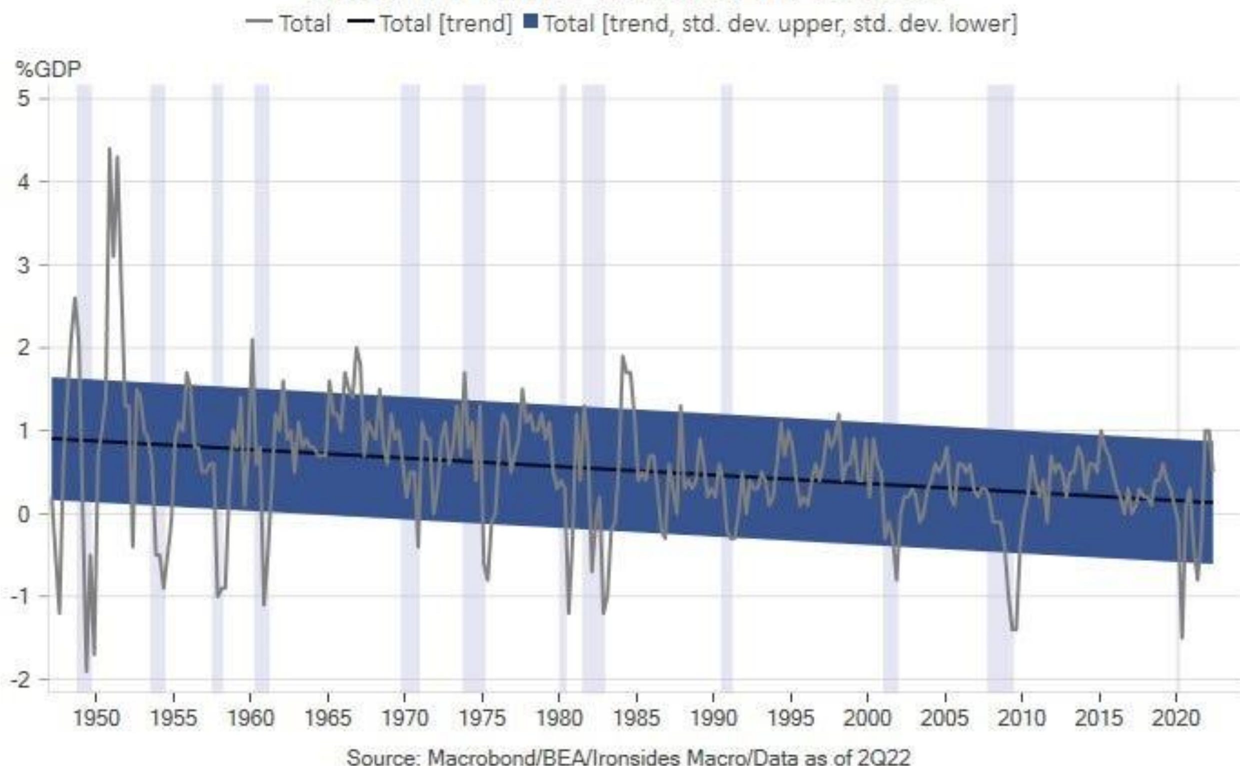

Figure 3: Inventory investment slowed from $188.5 billion in 1Q to $81.6 billion in 2Q. This is another example of rebalancing from the pandemic given the contraction was the largest as a percent of GDP (-1.5%) since the post-war era. The NBER is not going to declare a surge in imports and a slowdown in inventory investment a recession.

The largest negative contribution (-2%) came from inventories. Not to minimize the pain for sellers of goods, this is part of the pandemic rebalancing process. Walmart's pain is likely to be the consumer's gain as they cut prices to move merchandise. Allan Greenspan made his mark forecasting inventory cycles when they were a major driver of economic expansions and contractions. The 2020 contraction was the largest since the post-war period, though the rebound was much smaller than post-recession restocking in the '50s, 60s, 70s or '80s. In other words, prior to just-in-time inventory management and global supply chains. It's just not that big a deal. So, we don't know much about 3Q, we have seen a handful of soggy regional Fed manufacturing and service sector surveys and a couple of weeks of rising jobless claims as well as some commentary from bank CEOs that spending remains strong. Next Friday's July employment report will be the first important data point in determining whether there will be an economic contraction

that is pervasive, prolonged and persistent enough for the National Bureau of Economic Research to declare a 2022 recession. For investors, this is virtually meaningless: if we are in the midst of one, equities bottom 100 days before the end of the recession and the 24% decline was equivalent to the median recession related drop, in other words, sufficient for a real, not nominal, recession.

NBER Recession Begins	NBER Recession Ends	Duration (Months)	Real GDP Decline	Nominal GDP Decline	S&P 500 Earnings Decline	S&P 500 Index Decline	Mkt Low to Recession End	Peak Cycle CPI	Peak Policy Rate	Recession Cause
Nov-48	Oct-49	11	-1.70%	-3.46%	-3.3%	-20.6%	-110	19.7%	1.25%	Inflation shock
Jul-53	May-54	10	-2.42%	-1.63%	-1.6%	-14.8%	-229	9.4%	2.00%	Korean War demobilization
Aug-57	Apr-58	8	-2.96%	-2.48%	-17.0%	-21.6%	-161	3.7%	3.50%	MP, pandemic
Apr-60	Feb-61	10	-0.67%	-0.40%	-11.7%	-13.9%	-99	1.7%	4.00%	MP, gold outflows, steel strike
Dec-69	Nov-70	11	-0.59%	4.59%	-12.9%	-36.1%	-159	6.2%	9.19%	Tax Hikes & MP
Nov-73	Mar-75	16	-1.99%	9.50%	-14.8%	-48.2%	-149	12.3%	11.00%	OPEC Embargo
Jan-80	Jul-80	6	-2.18%	4.74%	-4.3%	-17.1%	-96	14.8%	20.00%	MP & Carter Credit Controls
Jul-81	Nov-82	16	-2.64%	6.31%	-13.7%	-27.1%	-81	11.8%	20.00%	MP
Jul-90	Mar-91	9	-1.32%	0.42%	-23.8%	-19.9%	-141	6.3%	9.70%	MP, Savings & Loan Crisis
Mar-01	Nov-01	8	-0.32%	1.25%	-31.6%	-49.1%	342	3.8%	6.50%	TMT Bubble
Dec-07	Jun-09	18	-4.00%	-3.30%	-56.5%	-56.8%	-84	5.4%	5.60%	Housing Bubble
Feb-20	Apr-20	3	-10.10%	-10.22%	-28.4%	-35.4%	-38	2.9%	2.50%	Pandemic
Median		**10**	**-2.08%**	**0.01%**	**-14.2%**	**-24.4%**	**-105**	**6.3%**	**6.05%**	
Average		**11**	**-2.57%**	**0.80%**	**-18.3%**	**-30.1%**	**-84**	**8.2%**	**7.94%**	

Source: Macrobond/Bloomberg/Ironsides Macro

Figure 4: Recession related earnings declines were fairly small until the globalization/end of the Cold War era credit cycle recessions. If we have a real, not nominal recession, worst case is a Great Inflation size decline. Best case is the small declines during the post-war inflation booms and busts.

Too Many Dollars

Ahead of last week's FOMC meeting there was an op-ed in the Wall Street Journal and an interview on CNBC with former FDIC Chair Shelia Bair that asserted Paul Volcker's inflation fight was misunderstood and the focus should return to the Milton Friedman's monetarist thesis; "inflation is caused by too much money chasing after too few goods". Bair asserted, as we have, that the Fed's passive balance sheet contraction risked leaving excess money in the system. Let's begin by addressing two assertions about monetarism. The first is that it has been proven that controlling the money supply doesn't work. The second is that QE didn't cause consumer price inflation in the '10s. In our view, these are related in the sense that a key assumption of monetarism, stable money velocity, was the flaw, or better yet, complexity that relates the money supply to credit and economic output. In Friedman's "A Monetary History of the United States", there is little discussion of velocity other than an unanswered question about why velocity increased steadily from the end of WWII through the end of the book in 1961. That period, like the '10s, were periods of exceptionally tight bank regulatory policy that

impaired credit creation and reduced the velocity of money while the '80s and '90s were periods of banking disintermediation and deregulation that had the opposite effect on velocity. The '20s are likely somewhere in between, and the sheer magnitude of the expansion of the monetary base and passive Fed balance sheet contraction is an ongoing inflation risk. Our chart below shows bank reserves falling sharply in 2022. This is being driven by stronger loan growth, and the spread between their balance sheet and reserves is widening, hinting that velocity may be accelerating. Powell responded to a question about the balance sheet at the FOMC Meeting press conference that it will be 2 to 2 1/2 years before the balance sheet is reduced to their estimate of the optimal level of bank reserves. This risk is an input to our view that inflation will stall at 4% in 2023.

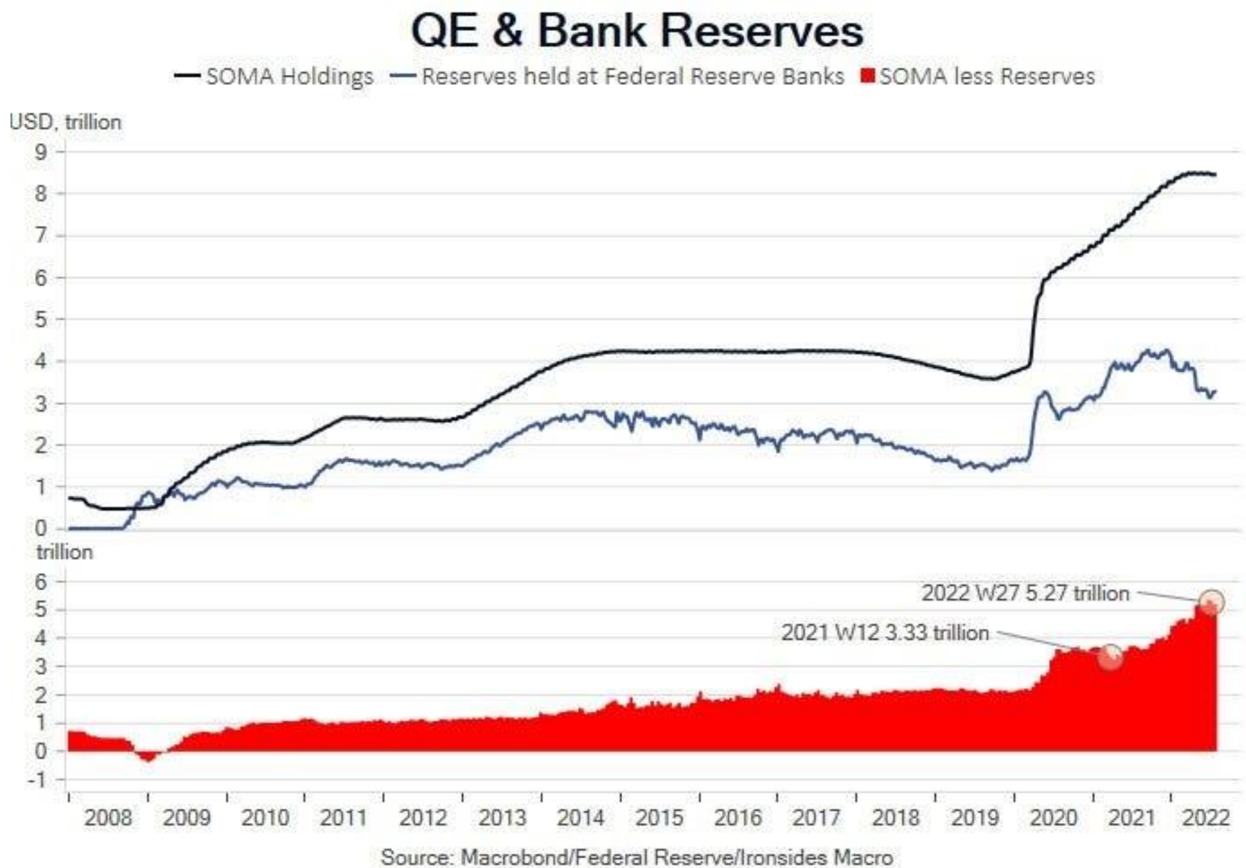

Figure 5: QT, what QT? The widening spread between the Fed's balance sheet and bank reserves implies the money is not trapped in the banking system and is making its way to the private economy. Too many dollars chasing too few goods.

The Shoe That Didn't Drop

With 56% of S&P 500 companies and 68% of the market cap reporting results, earnings are beating forecasts by 4.2%, revenues by 2.1% and the average one-day reaction is a 0.8% increase in the share price. Bloomberg's model uses reported results and consensus to derive an estimate, currently earnings are tracking 6% and revenues 13.8%. If surprise holds up, earnings will increase 8%. There are two outlier sectors: financials were a large drag on results (-25%) due to the procyclical effect of the loan loss provisioning accounting standard change and investment banking revenue decline. On the other side, the energy sector (+298%) boosted results. Although the market response to megacap results was favorable, their results were in line and the technology sector has the second worst earnings surprise at 0.4%. Our overweight sectors did well relative to expectations, energy +10.0%, healthcare +7.8%, materials +4.8%, industrials +4.0%, and financials +3.4%. Capital investment is +22% year-on-year and 12.3% quarter-on-quarter annualized (GDP math). R&D expense is +14.5% y/y and 12.7% q/q annualized. While strong investment is encouraging and consistent with strong cash flow, there was a decent drop in capital spending plans in regional Fed manufacturing and service sector surveys in 2Q. These surveys lead core capital goods orders by 3 months and S&P capex by 6 months. We expect the tepid rebound in July to extend further as the shock from the Fed's front loading of the rate hike and 20+% decline in the stock market, like 2011, fades. A corporate tax hike is another risk. Finally, earnings revisions are falling but still not as sharply as they did during the 2018-19 trade war or oil price and Chinese heavy industry collapses in 2015-16.

Figure 6: Prices paid are falling sharply, prices received are falling as well. The contraction of the spread and plunge in input prices is good news for inflation and margins.

US Equity Market Valuation Index/Sector	PE	Fwd PE	P/S	P/B	EV / Sales	EV / EBITDA	Z-score	Ironsides Strategic Weighting	ERP	ERP Z-Score
SPX	20.45	17.87	2.49	4.04	2.79	13.32	0.86	Market	5.42%	-0.22
SPW (equal weight)	19.19	16.10	1.72	3.02	2.18	12.34	0.74	Overweight	6.03%	-0.54
Discretionary	33.92	26.58	2.12	9.17	2.34	16.12	1.73	Market	3.58%	0.18
Financials	12.68	13.19	2.28	1.48	2.40	7.10	-0.45	Overweight	7.40%	-0.48
Technology	26.24	22.46	5.87	8.77	5.91	17.39	1.25	Market +	4.27%	0.09
Comm Services	16.34	15.66	2.63	3.06	3.30	10.53	0.65	Market	6.20%	-0.33
Industrials	22.92	18.84	1.95	4.93	2.26	13.96	1.09	Overweight	5.13%	-0.14
Materials	14.26	13.01	1.86	2.80	2.20	9.56	0.31	Overweight	7.51%	-1.29
Energy	12.87	7.73	1.24	2.35	1.47	7.38	0.25	Overweight	12.76%	-2.59
Healthcare	18.62	16.24	1.85	4.95	2.03	14.59	0.03	Overweight	5.98%	-0.22
Staples	22.10	21.59	1.64	6.57	1.87	15.66	1.38	Underweight	4.45%	0.08
Utilities	22.06	21.01	2.77	2.39	4.53	13.59	2.38	Underweight	4.58%	0.67
Real Estate	42.33	37.53	7.63	7.63	10.48	23.27	0.12	Underweight	2.48%	1.49
Russell 2000	78.03	21.55	1.06	2.14	47.34	2.34	0.23	Overweight	4.63%	-0.54

Source: Bloomberg/Ironsides Macro/Data as of July 2022

Figure 7: The discount rate for our equity risk premium model, the 10-year TIPS yield began 2022 at -1.10%, peaked at 0.82% at the June FOMC meeting and has dropped to 0.12%. We are back to stocks looking exceptionally cheap relative to Treasuries, in part because Treasuries are very rich.

Key Investable Themes & Asset Allocation:

- *Deglobalization & Capital Spending Boom: Industrials XLI -0.14%↓, Semis SMH -0.75%↓*
- *Real, Not Nominal Recession: Materials XLB 0.22%↑, Financials XLF -0.97%↓ IAT 0.00, Energy XLE -0.86%↓ XOP -0.67%↓, Small Caps IWM -0.40%↓*
- *Technology Innovation Diffusion: Healthcare IYH 0.00, Industrials XLI -0.14%↓ and Financials XLF -0.97%↓*
- *Global Equity Allocation: Overweight US equities SPY -0.38%↓, underweight export dependent economies (China FXI -1.20%↓, Germany EWG -0.48%↓, Japan EWJ -0.34%↓)*
- *US Asset Allocation: Overweight equities SPY -0.38%↓, underweight Treasuries TLT 1.16%↑, equal weight credit LQD 0.09%↑*
- *Portfolio Hedging: Equity index skew (downside puts) is cheap*

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