NDR
NED DAVIS RESEARCH

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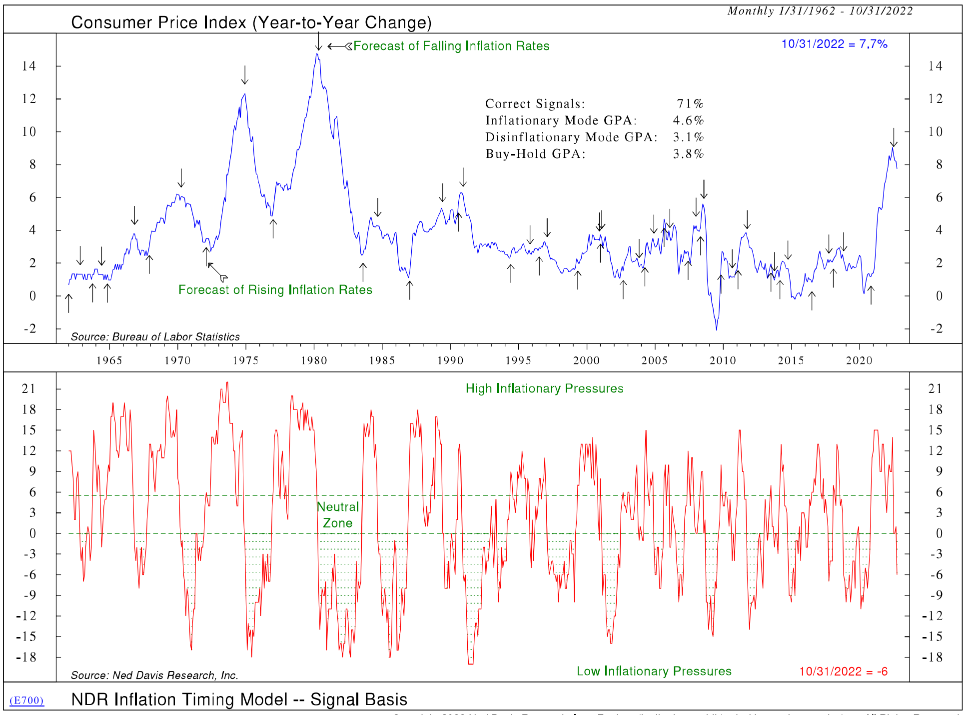
MACRO UPDATE

Bullish and bearish macro arguments for stocks

Key Takeaways

- The Inflation Timing Model is bullish for stocks and bonds, and both seem to be responding to that.
- Stock earnings yields are bearish for stocks versus interest rates, and a recession could really hurt earnings yields.
- Our Economic Timing Model is consistent with an upcoming recession, and Fed Policy, while not as hostile, is still unfavorable.

Inflation Timing Model showing lower inflation pressures



The Fab Five Composite Model remains cautious for stocks, and that is my benchmark for my market views on the primary trend. Nevertheless, for the first time in a while, I can make a potential bullish macro case for stocks and bonds.

Good news on inflation

The good news is based on consumer price inflation, which our models suggest peaked this summer. The NDR Inflation timing model had given an up signal for inflation in November 2020 and a down signal for inflation in July 2022, as shown on the chart above. Compare that to what the Fed had to say at those signal dates.

Turning to what the NDR inflation timing model might mean for stocks, see the chart at the top of page 2. The model in October fell into a zone of "low inflation pressures," which historically has been bullish for stocks. The model is also bullish for bonds. And the falling rate of industrial price inflation is confirmed on the chart at the bottom of page 2.

What should be happening and what is happening can sometimes be two different things, but I am encouraged when looking at bond yields at the top of page 3. It shows that upward momentum in bond yields has fallen to a bullish level for stocks.

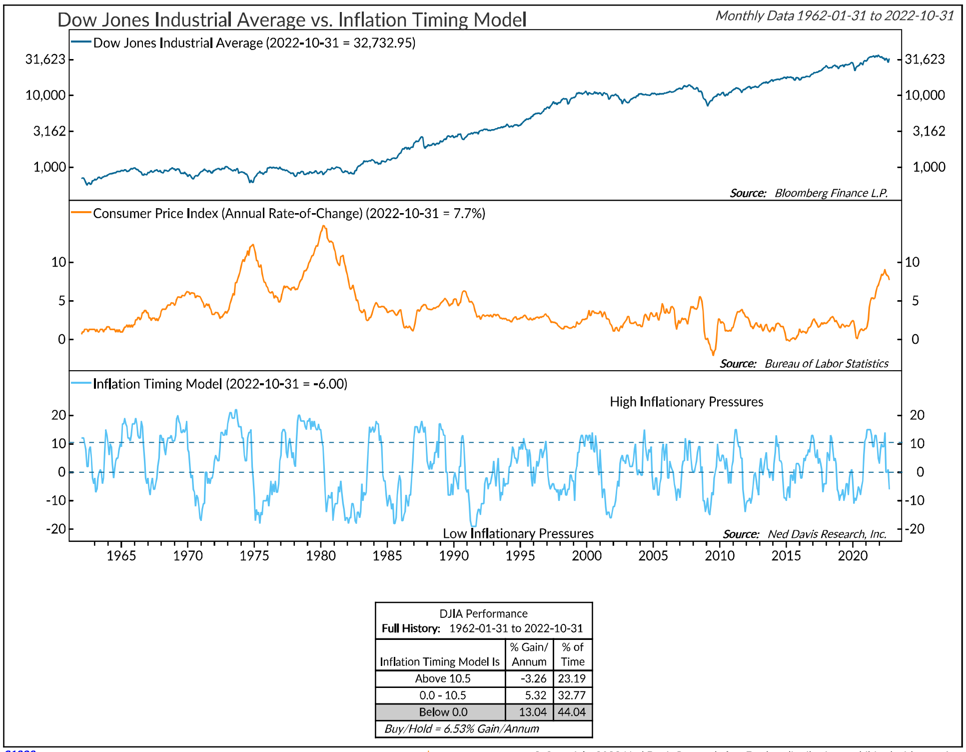
Many who agree that inflation is coming down are not bullish because they believe we are in, or on the verge of recession. I think that is valid, but I just want to point out that so far, the chart at the bottom of page 3, says we are not in a recession currently. So that is the bullish macro case for stocks.

Bad news on the economy

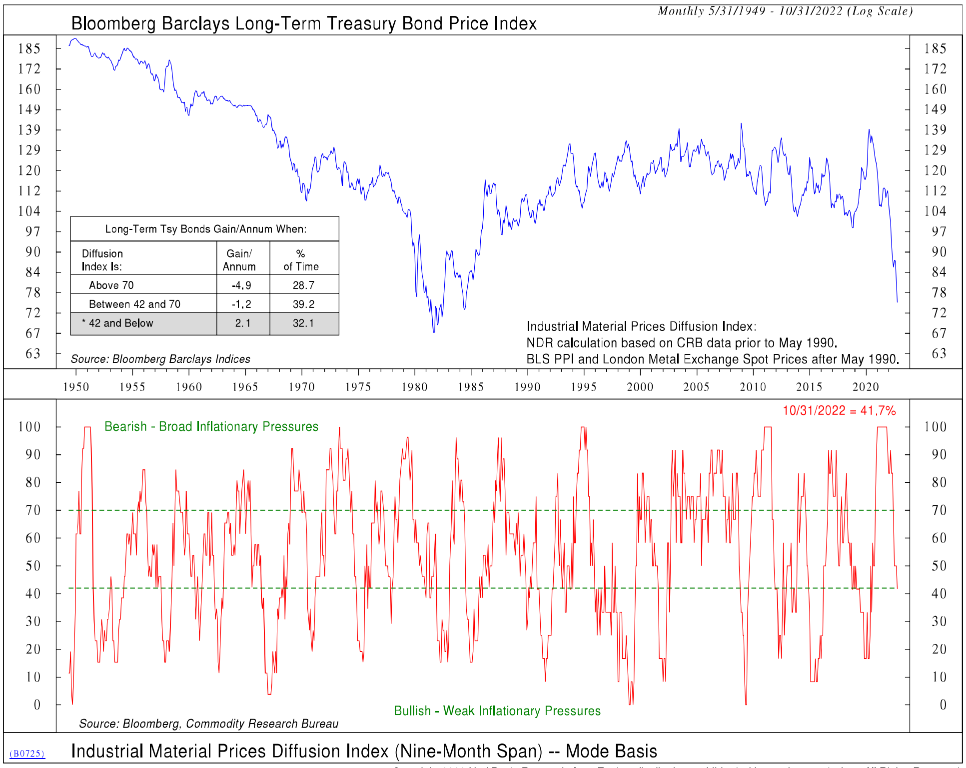
Turning to the still bearish macro case for stocks, see the charts on pages 4 and 5. Low stock earnings yields relative to rates, our Economic Timing Model, and Fed policy and money supply remain unfavorable.

Low Inflation Timing Model historically bullish for stocks

Our Inflation Timing Model, featured on the chart at right, has fallen into a zone of "low inflation pressures" in October. This has historically been bullish for stocks — hypothetically double-digit gains per annum.



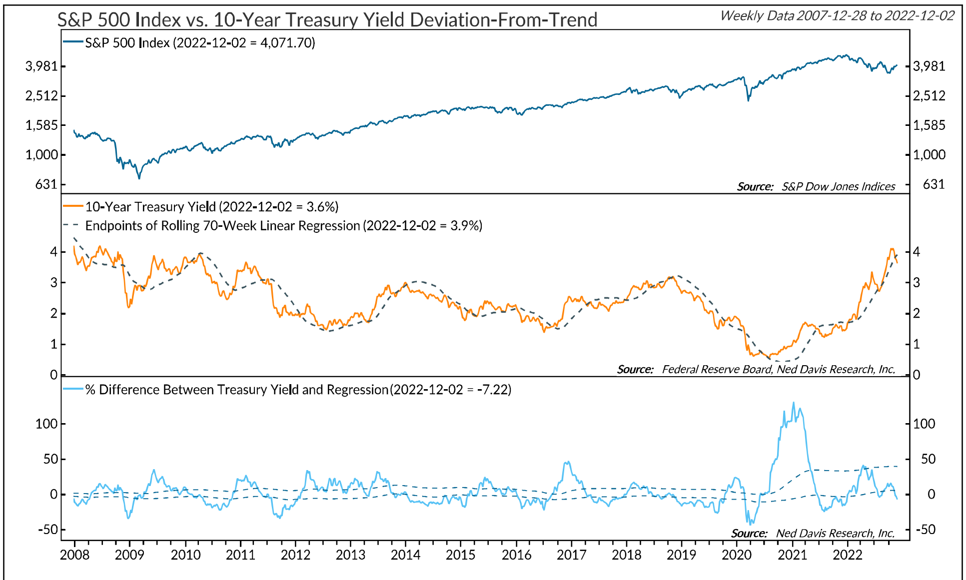
Industrial materials prices showing weak inflationary pressures



Falling rates of industrial price inflation are confirmed on the chart at left. This chart goes back to 1949 and shows bond prices have historically risen in this mode.

The chart at right shows that upward momentum in bond yields has fallen to a bullish level for stocks.

Falling 10-year yield from peak now bullish for stocks



S&P 500 Gain/Annum Performance Full History: 1969-04-25 to 2022-12-02		
Ind. In Bottom Clip	% Gain/ Annum	% of Time
Above Upper Bracket	-1.55	32.99
Between Brackets	4.66	30.08
Lower Bracket and Below	17.73	36.93
Buy/Hold = 7.12% Gain/Annum		

S&P 500 Gain/Annum Performance Chart View: 2007-12-28 to 2022-12-02		
Ind. In Bottom Clip	% Gain/ Annum	% of Time
Above Upper Bracket	0.16	34.95
Between Brackets	6.54	24.50
Lower Bracket and Below	13.60	40.55
Buy/Hold = 7.02% Gain/Annum		

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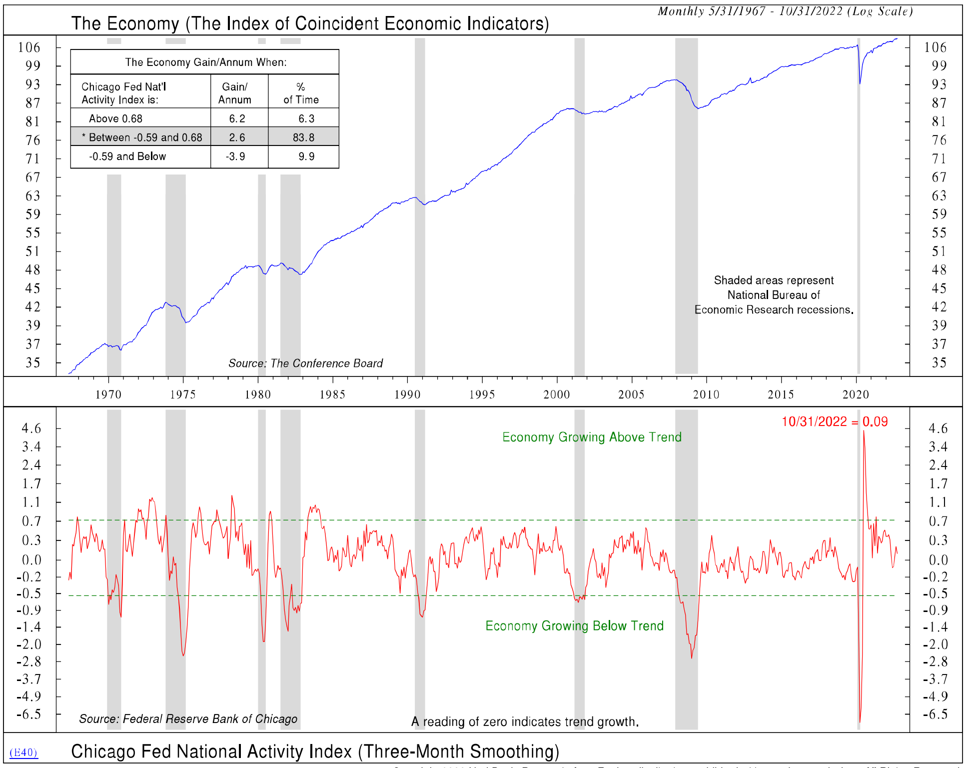
Smoothed National Activity Index remains above 0



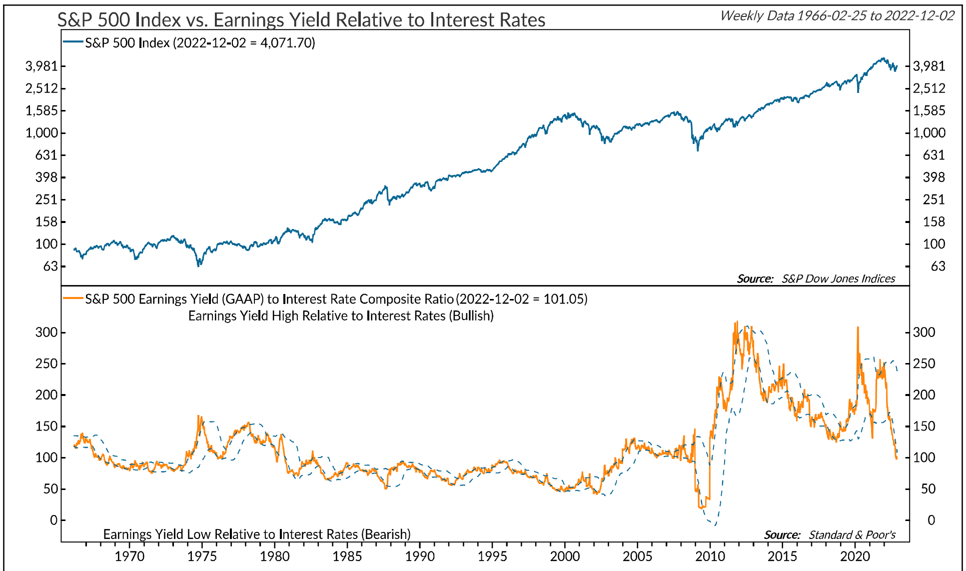
The Economy Gain/Annum When:		
Chicago Fed Nat'l Activity Index is:	Gain/ Annum	% of Time
Above 0.68	6.2	6.3
* Between -0.59 and 0.68	2.6	83.8
-0.59 and Below	-3.9	9.9

I'm not making a bullish argument on the chart at left, but the Chicago Fed National Activity Index says we are not in a recession currently and that is a very broad indicator.

My main concern is valuations on stocks, with stock earnings yields very low relative to interest rates, as shown at right. This is my version of the so-called Fed Model for stock valuations going back to 1966.

Yes, it may be true that bond yields have peaked, but the Fed will still raise short-term rates further, and that is a real problem.

S&P 500 earnings yields low and falling relative to bond yields



Data as of 2022-12-02:
S&P Earnings Yield = 4.6%
(Earnings Yield Based on Estimates for Latest Quarter Until Actual Earnings Released)
Interest Rate Composite = 4.6%
(Average of T-Bill Yield, 10-Year Treasury Yield & Moody's Baa Corporate Yield)

S&P 500 Index Performance
Full History: 1966-02-25 to 2022-12-02

Earnings Yield Rate Composite is	% Gain/ Annum	% of Time
Above Top Band	24.18	19.40
Between Bands	7.61	56.42
Below Lower Band	-6.60	24.18
Buy/Hold = 6.92% Gain/Annum		

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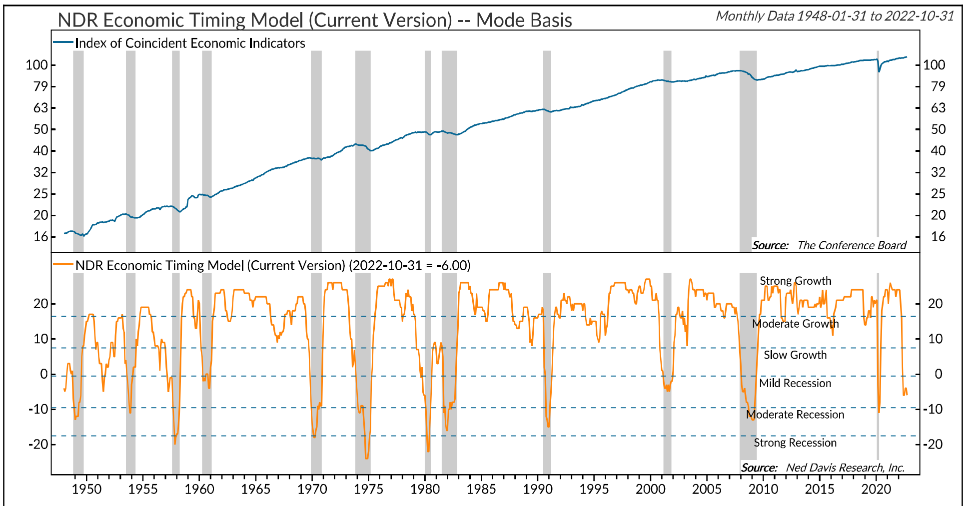
Economic Timing Model shows mild recession likely



Shaded areas represent National Bureau of Economic Research recessions

Coincident Index Performance
Full History: 1948-01-31 to 2022-10-31

Economic Timing Model Indicates	% Gain/ Annum	% of Time
Strong Recession	-7.96*	1.23
Moderate Recession	-4.08	4.88
Mild Recession	-2.91	8.84
Slow Growth	2.16	8.12
Moderate Growth	2.92	18.51
Strong Growth	4.19	58.42
Buy/Hold = 2.56% Gain/Annum		
** Cases less than one year are not annualized*		

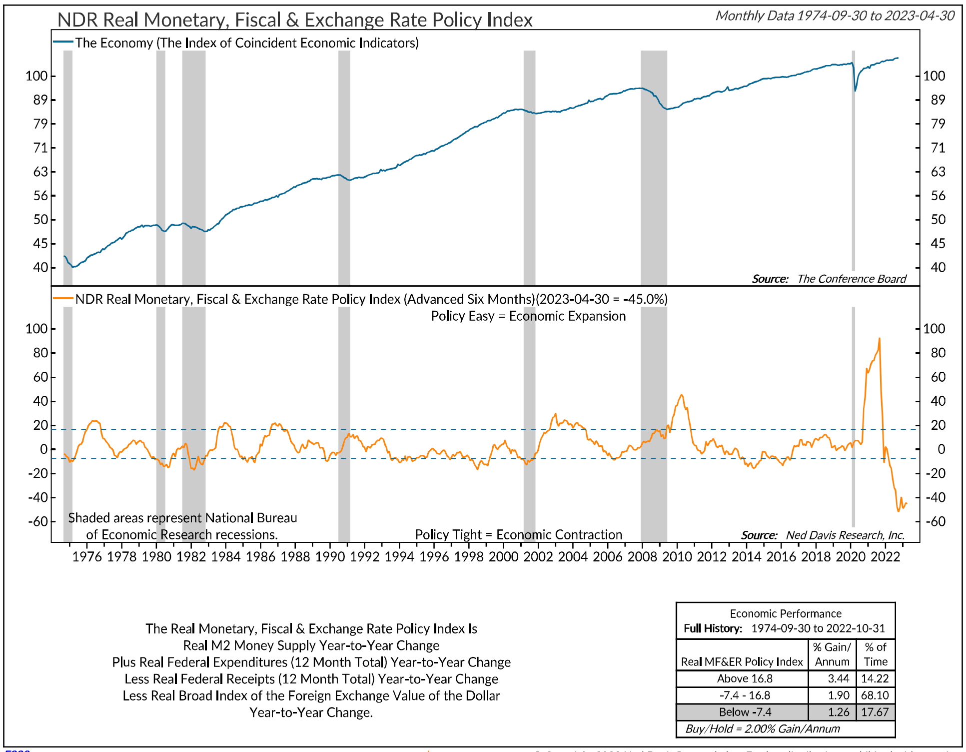
E2A

Just as big a problem is the outlook for earnings yields. The NDR Economic Timing Model, shown at left, leads us to conclude that at least a mild recession is likely next year. This tells me that the drop in earnings we have seen in 2022 (not widely acknowledged) is likely to continue next year, which will make the valuation problem worse.

For example, when the Economic Timing Model has been below zero, S&P 500 earnings have hypothetically fallen some 24% per annum since 1948. When the model was above +13, earnings rose some 16% per annum.

I don't like to "fight the Fed," even though I feel a lot of the rise in rates is behind us. When I look at the monetary, fiscal, and exchange rate policies on the chart at right, however, I see near-record restraint. This has been consistent with below-average economic growth.

Near-record tight monetary, fiscal, and exchange rate policy



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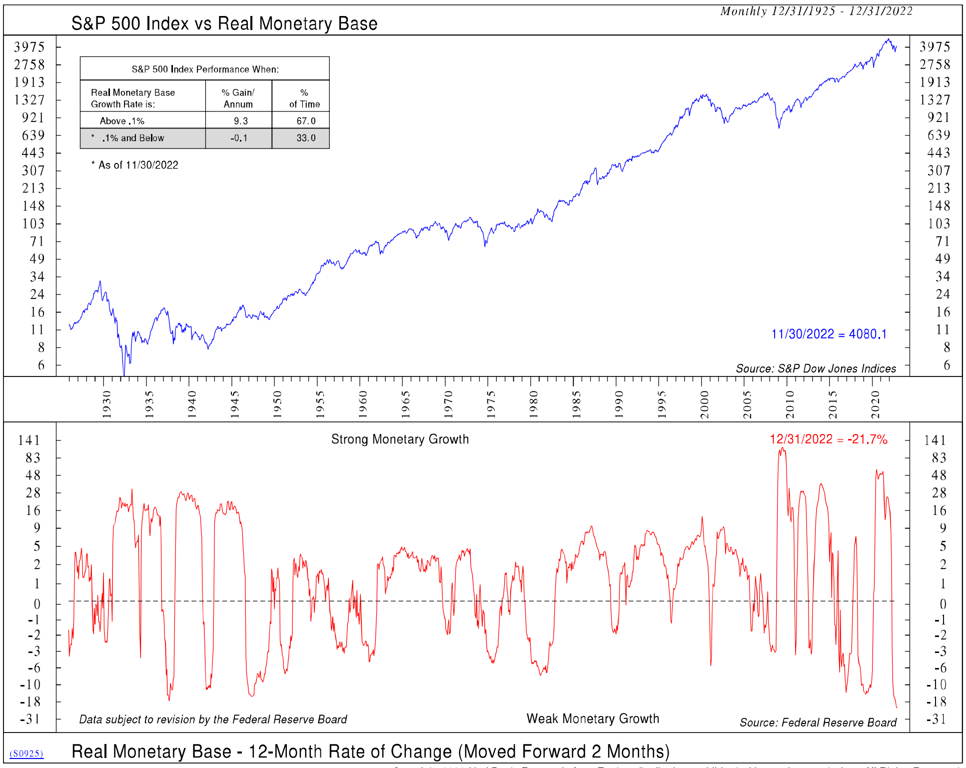
Record negative monetary growth remains bearish for stocks



(S0925)

The chart above is about economic growth, but the chart at left shows the stock market versus the real monetary base going all the way back to 1925. If the very impressive rally in stocks since October 12 is another bear market rally, I will likely bring this chart out to explain why.

In conclusion, I like to give all the most important evidence I can find so clients can make their own judgments. My guess is we will see more rallying to celebrate the peak in inflation and peak Fed hawkishness, but that the outlook for profits and valuations will weigh on stocks next year.

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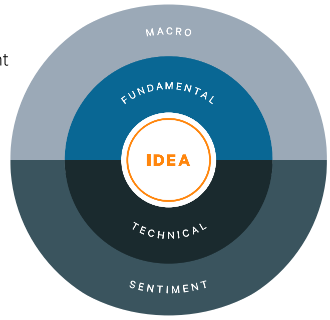

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