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email us

Jay Powell and his three bears update

Key Takeaways

- Recent inflation reports reduce the odds of the too hot scenario from 30% to 15%.
- Too cold remains our base case, with a powerful year-end rally but eventual recession.
- Boosting just right from 20% to 30%; a recession is not a foregone conclusion, in which case a new bull has begun or will begin soon.

Too cold base case, but just right odds are higher

Jay Powell and the Three Bears

Scenario	Odds	Short Description	Market Direction	What to Watch
Too Hot	15%	Inflation lingers, Fed continues to tighten aggressively, recession starts late 2022/early 2023	Bear resumes in Q4 2022	Alternative inflation metrics, geopolitics, labor market
Too Cold	55%	Inflation moderates, Fed slows pace, economy falls into recession in 2023	Rally in Q4, then bear resumes in 2023	Inflation expectations, yield curve, commodity prices, Growth/Value
Just Right	30%	Fed pivots correctly, avoids recession	Bear close to over	Investor sentiment, breadth thrusts, intermediate-term breadth confirmation

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Jay's bears

In July, we paraphrased the goldilocks parable to describe the relationship between Fed policy and the stock market, calling it Jay Powell and the three bears.

Too hot meant that inflation remained high, forcing the Fed to continue to raise rates aggressively. The likely outcomes would be that the economy would fall into recession sooner than later and the bear market would resume early in the second half.

Too cold described the scenario where inflation rolled over, allowing the Fed to pivot. The stock market would stage a powerful rally, but the damage would already be done. A recession would begin in 2023, and stocks would fall to new lows.

Under the goldilocks scenario, the Fed would pivot at the just right time by just the right amount to achieve a soft landing. Since the decline was already approaching the average non-recession bear in both time and price, it would mean that the lows were close to being made.

After consulting with Veneta Dimitrova and Joe Kalish, we initially assigned rough odds of 30% too hot, 50% too cold, and 20% just right. Our rational was that soft landings are hard to achieve any cycle, and this one is trickier than usual. Our macro team saw inflation peaking, but their models were showing recession risks were increasing.

Updating the odds

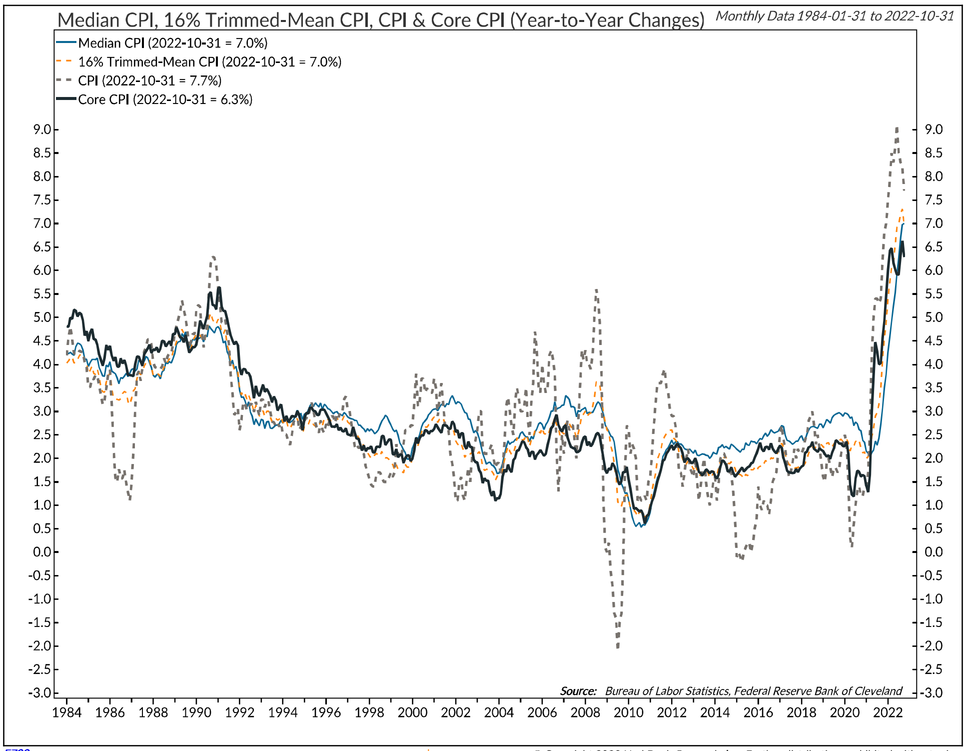
On recent client trips and calls, we have been asked if the probabilities have changed. Inflation reports, rate-sensitive economic sector data, and the autumn retest of the June lows combine to **decrease the odds of a too hot outcome from 30% to 15%** (table above). We bumped too cold from 50% to 55% and **boosted just right to 30% from 20%**. As before, these are rough estimates. Our models and indicators drive our recommendations.

Too hot to inflation lingers

The October Consumer Price Index and Produce Price Index reports showed the first true signs that inflation is peaking. The headline CPI likely peaked in June, but October was the first time the core, median, and trimmed-mean CPIs all fell (chart, right). We cut the odds for the too hot scenario in half from 30% to 15%.

From here, the risk is less that inflation skyrockets to new highs and more that it lingers at a higher rate than expected. Powell is committed to reestablishing the Fed's credibility, and under this scenario the Fed would not downshift rate hikes as quickly or pause as soon as expected. **While a different version of too hot than our original assessment, the results for the market are similar**: a recession sooner than later leading to a resumption of the bear market.

Several inflation metrics slowed in October



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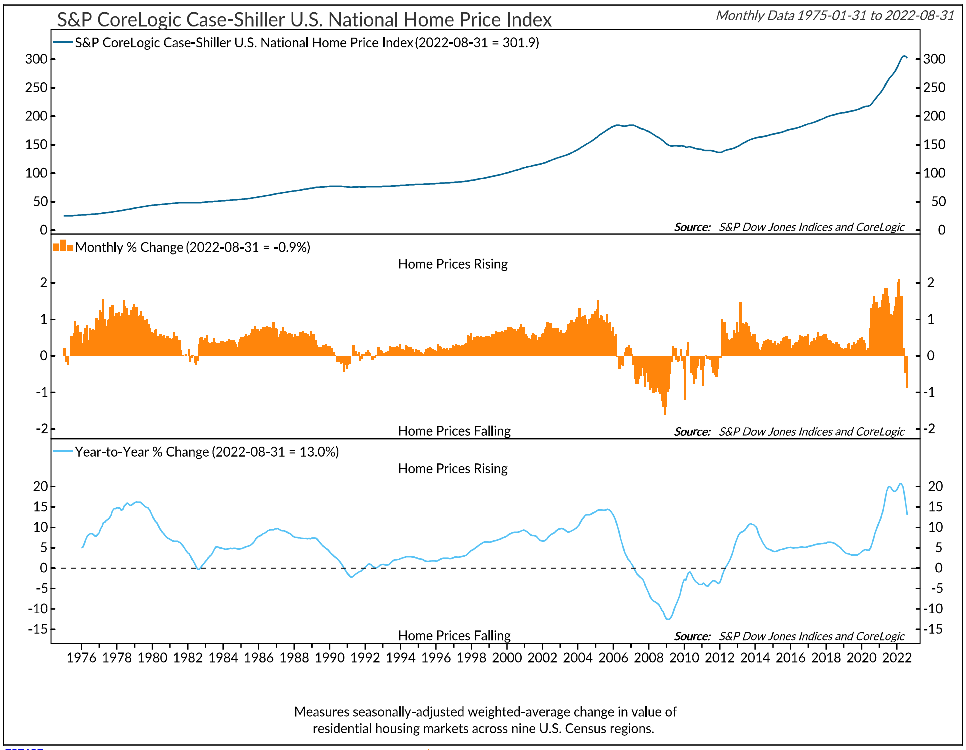
Housing feeling effects of rate hikes



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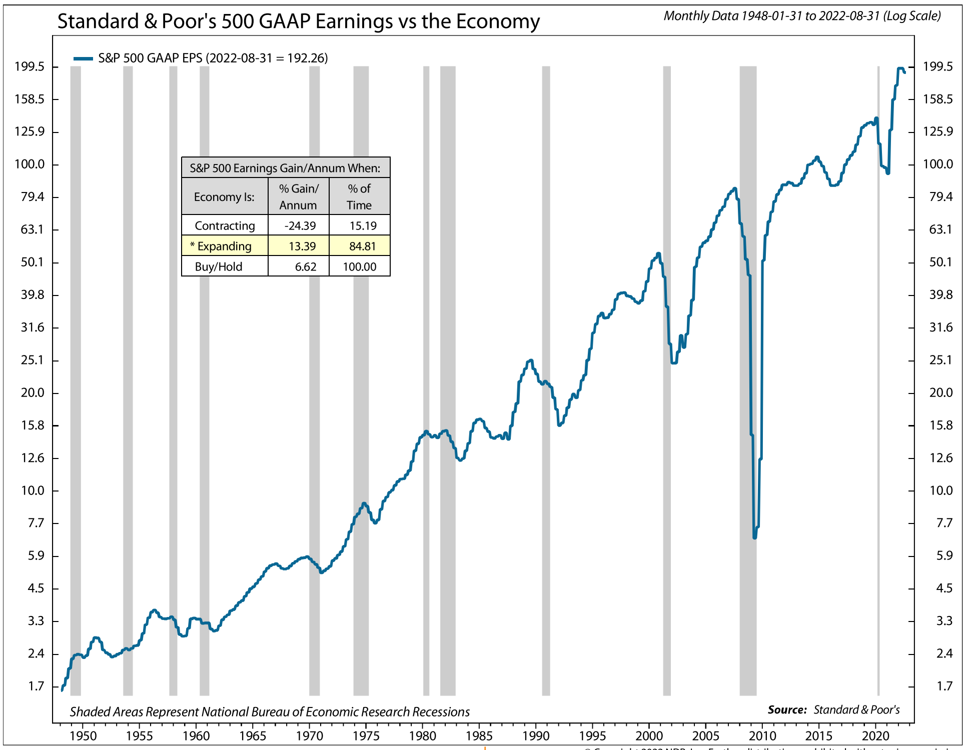
Too cold even more likely

This was the highest probability in July, and we increased it slightly from 50% to 55%. Recent inflation reports support the scenario. The debate shifts from when inflation peaks to whether the economy falls into a recession. The first glimpses that the series of 75 basis point rate hikes are **inflicting pain on interest rate sensitive parts of the economy** are showing up. Housing prices have fallen month/month, although they remain strong on a year/year basis (chart, left).

Under the too cold scenario, **earnings estimates** would need to be revised down significantly. Current consensus estimates call for S&P 500 GAAP earnings growth to trough at -7.4% in Q4 2022. During recessions, earnings fall at a 24.4% annual rate (chart, right).

Our top-down S&P 500 Earnings Model has fallen to an 18-month low, and several indicators based on economic growth, such as raw materials prices and the ISM Price Index, suggest the model will deteriorate further in the next few months.

Earnings fall at 24% annual pace during recessions, on average



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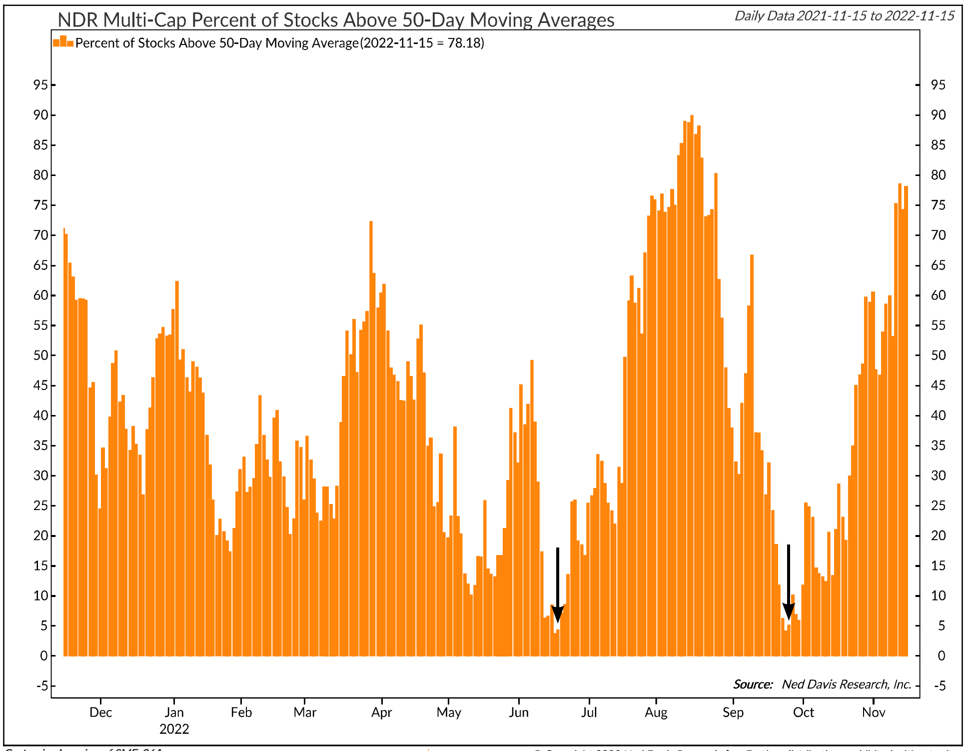
Breadth less extreme in October than in June



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Just right more likely?

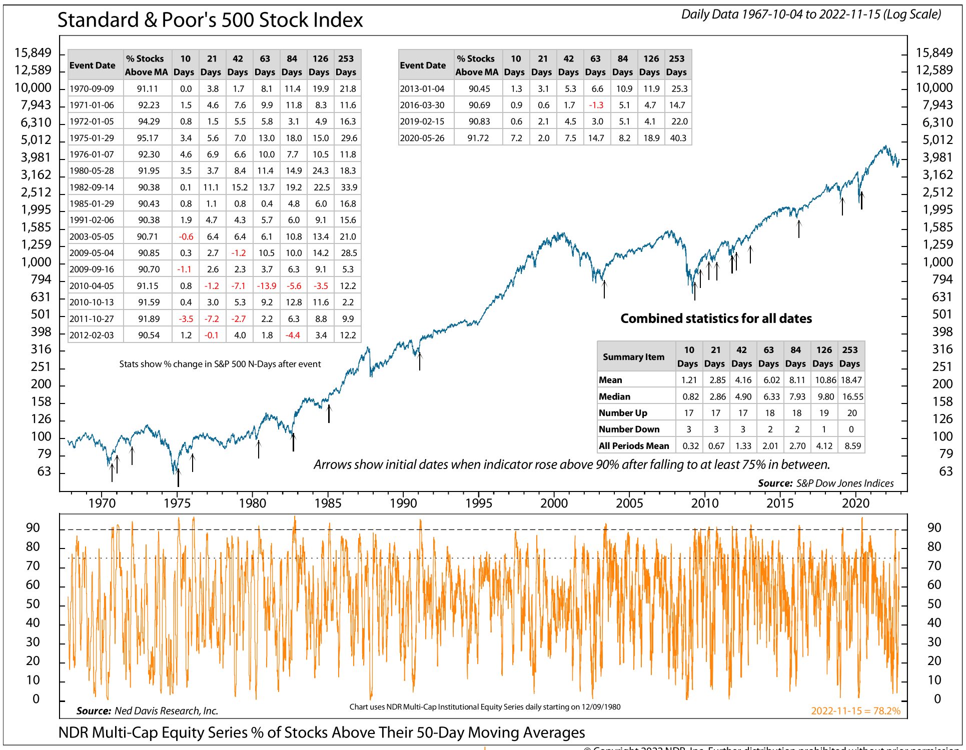
The main reason we increased the odds of the soft-landing scenario from 20% to 30% is that the risk of the too hot scenario is fading. But we also need to acknowledge that a **recession is not a foregone conclusion**. The labor market has slowed but not broken, and capital expenditures remain strong.

The stock market leads the economy, so the first pieces of information that tell us the Fed has achieved a soft landing are not likely to come from economic data or even the Fed, but from stock prices.

In October, we wrote that even though the popular averages broke their June lows, it was not a failed retest. Breadth measures like the percentage of stocks at new lows and percentage of stocks above their moving averages were less extreme than in June (chart, left).

The extreme volatility and changing underlying structure of how markets trade (ETFs, algos, no uptick rule, decimalization) mean that short-term breadth thrusts are more common. We still watch them but have shifted from a “trust the thrust” mantra to “trust but verify.” **Confirmation of the October breadth thrusts by intermediate-term breadth would signal that the market believes the Fed is getting the tightening cycle just right** (chart, right).

Watch for confirmation from intermediate-term breadth



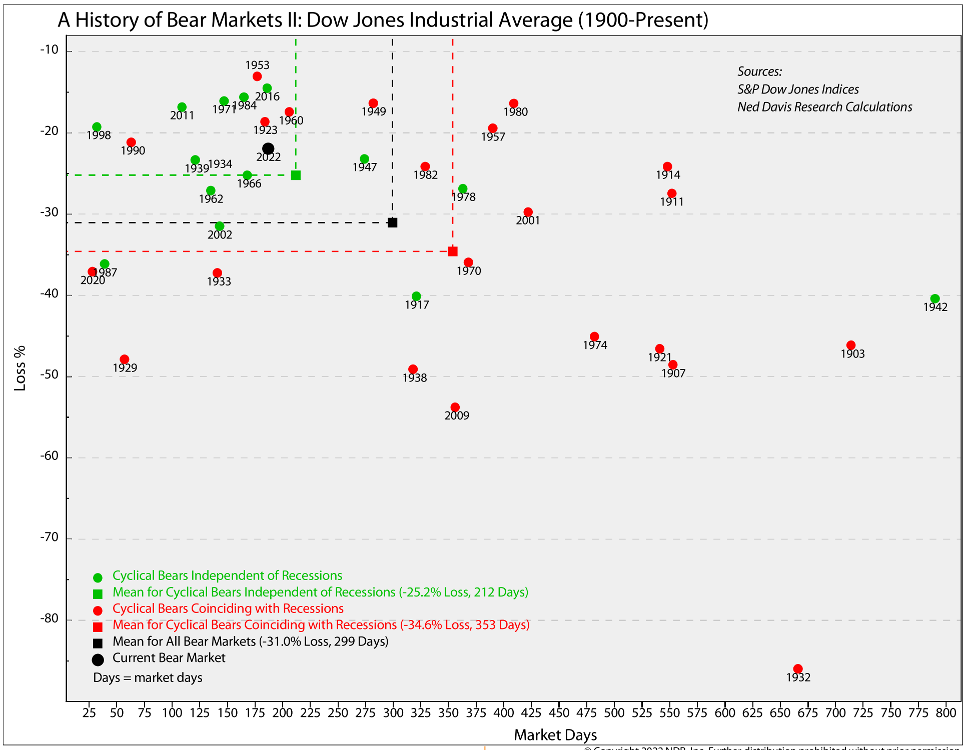
Event Date	% Stocks Above MA	10 Days	21 Days	42 Days	63 Days	84 Days	126 Days	253 Days
1970-09-09	91.11	0.0	3.8	1.7	8.1	11.4	19.9	21.8
1971-01-06	92.23	1.5	4.6	7.6	9.9	11.8	8.3	11.6
1972-01-05	94.29	0.8	1.5	5.5	5.8	3.1	4.9	16.3
1975-01-29	95.17	3.4	5.6	7.0	13.0	18.0	15.0	29.6
1976-01-07	92.30	4.6	6.9	6.6	10.0	7.7	10.5	11.8
1980-05-28	91.95	3.5	3.7	8.4	11.4	14.9	24.3	18.3
1982-09-14	90.38	0.1	11.1	15.2	13.7	19.2	22.5	33.9
1985-01-29	90.43	0.8	1.1	0.8	0.4	4.8	6.0	16.8
1991-02-06	90.38	1.9	4.7	4.3	5.7	6.0	9.1	15.6
2003-05-05	90.71	-0.6	6.4	6.4	6.1	10.8	13.4	21.0
2009-05-04	90.85	0.3	2.7	-1.2	10.5	10.0	14.2	28.5
2009-09-16	90.70	-1.1	2.6	2.3	3.7	6.3	9.1	5.3
2010-04-05	91.15	0.8	-1.2	-7.1	-13.9	-5.6	-3.5	12.2
2010-10-13	91.59	0.4	3.0	5.3	9.2	12.8	11.6	2.2
2011-10-27	91.89	-3.5	-7.2	-2.7	2.2	6.3	8.8	9.9
2012-02-03	90.54	1.2	-0.1	4.0	1.8	-4.4	3.4	12.2

Event Date	% Stocks Above MA	10 Days	21 Days	42 Days	63 Days	84 Days	126 Days	253 Days
2013-01-04	90.45	1.3	3.1	5.3	6.6	10.9	11.9	25.3
2016-03-30	90.69	0.9	0.6	1.7	-1.3	5.1	4.7	14.7
2019-02-15	90.83	0.6	2.1	4.5	3.0	5.1	4.1	22.0
2020-05-26	91.72	7.2	2.0	7.5	14.7	8.2	18.9	40.3

Combined statistics for all dates

Summary Item	10 Days	21 Days	42 Days	63 Days	84 Days	126 Days	253 Days
Mean	1.21	2.85	4.16	6.02	8.11	10.86	18.47
Median	0.82	2.86	4.90	6.33	7.93	9.80	16.55
Number Up	17	17	17	18	18	19	20
Number Down	3	3	3	2	2	1	0
All Periods Mean	0.32	0.67	1.33	2.01	2.70	4.12	8.59

To date, 2022 bear close to average non-recesssion bear



The modest new lows by the popular averages in late September and early October brought the 2022 cyclical bear market closer to the average non-recession bear in both time and price (chart, left).

A too cold scenario, which allows for a power year-end rally followed by renewed weakness, remains our base case. However, the door has opened a little wider for a soft landing. Mr. Market may write the last chapter of Jay Powell and the three bears.

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NDR HOUSE VIEWS (Updated November 10, 2022)

For global asset allocation, NDR recommends underweight allocation to stocks, overweight allocation to cash and marketweight allocation to bonds. We are underweight stocks in response to new lows and bearish model readings.

Equity Allocation

U.S. | We have a modest underweight to stocks in our asset allocation recommendation but are neutral on an absolute basis. The hawkish Fed has overwhelmed the positive tape development in the summer, but sentiment is extremely pessimistic. We favor small-caps over large-caps and Value over Growth.

INTERNATIONAL | We are overweight Europe ex. U.K. and marketweight on all other regions.

Macro

ECONOMY | The global economy is in a sustained slowdown due to waning monetary and fiscal support, stubbornly high inflation, and rising geopolitical risk. While the slowdown remains moderate, the risk of severe recession increases in 2023. Global inflation pressures are easing but will remain historically elevated in the foreseeable future.

FIXED INCOME | We reduced our bond exposure to 95% of benchmark duration and expect the yield curve to flatten. We are overweight Treasurys, MBS, and CMBS and underweight high yield. We are marketweight everything else.

GOLD | Downtrend intact with relatively restrictive central bank policies. We are bearish.

DOLLAR | We are neutral while keeping an eye on our dollar composite readings.

Economic Summary

November 14, 2022

Near term activity: ● Accelerating ● Neutral ● Decelerating

Global Economy (2.9%) | U.S. Economy (1.5%-2.0%) | U.S. Inflation (4.0%-4.5%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2022 forecasts.

Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- Overweight: Cash (15%)
- Marketweight: Bonds (35%)
- Underweight: Stocks (50%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation

- Overweight: Europe ex. U.K. (14%)
- Marketweight: U.S. (61%) | Emerging Markets (11%) | Japan (5%) | U.K. (4%) | Pacific ex. Japan (2%) | Canada (3%)
- Underweight:

Benchmark – U.S. (61.5%), Europe ex. U.K. (12%), Emerging Markets (11.2%), Japan (5.5%), U.K. (3.8%), Pacific ex. Japan (3%), Canada (3.1%)

Global Bond Allocation

- Overweight: Japan (19%)
- Marketweight: U.S. (55%) | Europe (25%)
- Underweight: U.K. (1%)

Benchmark: U.S. (57%), Europe (25%), Japan (15%), U.K. (4%)

U.S. Allocation

- Overweight: Cash (15%) | Small-Cap | Value
- Marketweight: Bonds (35%) | Mid-Cap
- Underweight: Stocks (50%) | Large-Cap | Growth

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors

- Overweight: Health Care (17%) | Energy (5%) | Materials (4%)
- Underweight: Consumer Discretionary (8%)

Benchmark: Technology (27.4%), Health Care (13.8%), Financials (10.7%), Communication Services (9.3%), Consumer Discretionary (12.1%), Consumer Staples (7.0%), Industrials (7.9%), Energy (4.0%), Utilities (2.7%), Real Estate (2.7%), Materials (2.5%)

U.S. Bonds — 95% of Benchmark Duration

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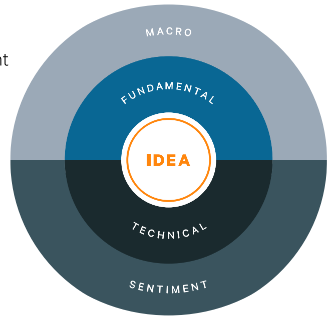

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