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Sinai's Economic and Market Perspectives

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Here-and-Now (Main St. Gloom) and Wall St. Cheer (Looking Ahead)

Widespread weakness was shown in the January Employment Report, underscoring a big slide down in growth for the U.S. Economy exiting 2020 and entering 2021.

Slowdown? Yes! Recession? No! Better coming? Yes!

Retail Sales popped up (5.3%) in January, however, reflecting stimulus from the late December $908 billion Relief Bill. Industrial Production rose nicely, 0.9%, a positive surprise, but still in-line with the generally weak exit of the Economy from 2020 and beginning 2021.

And, a possible drop in Aggregate Consumption, inflation-adjusted, for Q1-2021 suggests at the least a weaker quarter for Real GDP than the 4% of Q4-2020.

Even if a negative Q1 were to happen—that would not mean a Recession! One quarter of declining Real GDP doesn't do it—at least two negative quarters and three-to-five months of declines in certain key high-frequency monthly indicators are required.

So, there was a Here-and-Now deterioration, striking in the Employment Report and previous downward revisions—with still an "Army of Unemployed"—*"Main Street" Gloom even as the Equity Market (Wall St. Cheer) was reaching new highs.*

"Beginning-of-Better"

But, the beginnings of a better future for the economy seem to be emerging—a Slowdown but not "Double-Dip," continuing Recovery and then Expansion. This remains the DE Basic Prospect (Odds 65%).

The numbers on the Pandemic are improving significantly, although still high, and there is a *step up in the pace of vaccinations*, slow but gathering steam.

Some reversals of the Restrictions and Shutdowns of Q4 and into early 2021 are in-process, providing an *Exogenous Lift* to business activity.

Pentup Demands by consumers may have started in January, perhaps contributing to the strong Retail Sales that occurred.

The ongoing Forward Guidance of the Federal Reserve is a plus—the Fed having announced again-and-again that Full Employment is its main objective and *Treasury Secretary Janet Yellen emphasizing the same* in her first one-on-one TV interview with Jake Tapper two weeks ago and in her speeches.

The Fed and Treasury both have underscored a Full Employment objective as primary, thus continuation of Ultra-Easy Monetary Policy plus massively stimulative fiscal policies that will underpin continuing positive economic growth.

Then, there is the increased likelihood for passage of the American Rescue Plan, likely by mid-March.

And, a strong upward growth path for China has emerged, in-train with benefits to countries like Japan, South Korea, Germany and Southeast Asia generally.

Company earnings results for Q4 have been stunning, incredibly strong relative to expectations, suggesting increased business spending and some increased hiring.

Finally, *there is an improved "Mood of America"* as the business of the Federal Government under President Biden gets more business-like. So far, the President's approval rating is the highest since President Reagan.

This all speaks to improving conditions—the "Beginning-of-Better."

Most important and striking, and new because of its extent, is the performance of company earnings, in the fourth and third quarters, far above expectations, indicating a surprisingly positive YoY earnings path going forward.

Those earnings and the return of double-digit profit margins for the S&P500 in many Sectors signal better times now and going forward.

It is Company Earnings, measured by the S&P500 Op. EPS as a proxy, with its stunningly and surprisingly strong results in Q4 and before in Q3 that likely are most responsible for the surge up in the Equity Bull Market and the Wall Street Cheer.

But now the "Beginning-of-Better" should add to that!

"Double-Dip?" No!

The question of whether the Economy will fall back into a "Double-Dip" or "W" Recession—the Collapse in Q1 also Q2, upturn in the third and fourth quarters, and then two quarters of negative Real GDP growth—increasingly looks like no.

DE's answer has been no—with Odds on a "Double-Dip," even after the Gloom recently, steady at 15%; still to be noted and watched but perhaps to head down in likelihood.

Still at 65% Odds as the DE "Basic Prospect" is a Slowdown, not another drop into Recession; a fly-by over any possible Recession; and pickup in growth *thereafter, now looking more likely to start in the second quarter, earlier than prior expectations, and then the economy to be significantly stronger in the second half.*

"Army of Unemployed"

Paradoxically, a "K" pattern for the Labor Market is one of the reasons why company earnings have been so good.

The Labor Market in January showed a big drop in the Labor Force (-400,001) and a decline in the Labor Force Participation Rate (LFPR), to 61.4 from 61.5 and 63.4 in February 2020; more Firing than Hiring; and an "Army of Unemployed" of around 10 million persons. *This is the "K" Recovery for the Labor Market with Hiring and a Lack of Hiring side-by-side.*

The earnings that go with the Hiring—along with generally solid financial positions for those who are working—*that's the upper-part of the "K."* The declining jobs growth over the past few months and those remaining unemployed—*that's the bottom-part of the "K."*

In the January Jobs Market Report there was a big decline in the Unemployment Rate—to 6.3% from 6.7%. But that really came from the big decline in the Labor Force, people looking for work, and a declining LFPR—*a sign of weakness not strength*.

About 200,000 persons found work—that's a good number but hardly dents the outstanding "Army of Unemployed"—10 to 11 million persons who haven't found work since the beginning of the Recovery last May. Nine months have passed since then, with eight-of-nine showing pluses in Nonfarm Payroll Employment, but a striking diminishing of momentum over the last three months.

That "K" Labor Market is going to remain—Hiring but at the same time Not Hiring!

It is the main reason for the Slowdown in Real GDP growth in the fourth quarter and a slower path of Real GDP growth in the first quarter, mainly from weak Aggregate Consumption. The weakness in the economy also was a result of the Pandemic, its worsening, the round of shutdowns, restrictions, and lockdowns in the fourth quarter that contributed to jobs losses and a lack of hiring.

Will that "Army of Unemployed" stay? The answer is "yes."

It has been there for a long time. This is why it is an "Army of Unemployed," an economic and societal problem. *And it will stick because it's built into the dynamics of the business cycle, has been for many years, and into the way companies run businesses to Maximize Shareholder Value (SVM).*

Previous early stages of business cycle upturns have seen an unemployment rate that hangs high even as the economy grows, but not until much of the slack between actual and potential output is nearly eliminated, business very active and strong, and companies actually having to hire more people does the unemployment rate come down, then steadily so, *but only after lagging real economic activity for a long time.*

This "Army of Unemployed," the "K" depiction for the pattern of the labor market, the societal pain of those 10 or 11 million people who have not come back to work yet, and likely Sticky-High Unemployment Rate for some time means that a Democratic-controlled Congress, having promised help for the bottom "K" part of the economy and for small business, will do everything it can to make good on that. The American Rescue Plan (proposed $1.9 trillion fiscal stimulus on top of last year's almost $4 trillion stimulus) is one means.

By no later than March, funds from the American Rescue Plan should come into the economy. Major benefits to growth should show up in an acceleration of Real GDP in the second quarter and beyond.

Earnings Stunning—Almost Incredible, Striking, A Pattern Worth Noting

Incredibly noticeable and striking is the outperformance of earnings relative to GDP and the Labor Market in the horrible 2020 "Year of the Pandemic" (Q3 and Q4 2020) and what looks like also in 2021, the "Year of the Vaccines."

Why is this?

The weakness in the Labor Market provides one explanation for the superstrong levels of company earnings that have been occurring.

Companies affected by the Pandemic and those not so affected used the Collapse and Downturn to reduce jobs and stop hiring with technology-intensive saving on labor and related costs in order to maintain profit margins and to set up for an economy that in the future will never be the same.

Maximization of Shareholder Value (SVM) is a mantra of American business, that is maximizing share price not just profits, an objective and way of operating business in-place for many decades.

Evidence of this is a Sticky-High Unemployment Rate and lags in jobs creation after a downturn. This can be seen since the early 1990s.

The biggest cost for business is labor and related costs, i.e., total compensation, the first and quickest place for companies to reduce expenses when confronted with less sales and revenues or, in the latest situation, the unexpected External Shock of the Coronavirus.

That companies are following this mantra can be seen in the stunning S&P500 Op. EPS results of Q3 and Q4 2020, with declines far less than might have occurred under similar conditions in the past.

The side-by-side appearance of a huge jobs gap and some 10 million unemployed persons, the "Army of Unemployed," is indirect evidence.

*For Q4, so far, the track on the S&P500 Op. EPS shows a **plus** YoY of over 1%.* Bottom-up *Consensus* pre-Earnings Season was for a -8% to -9% decline in YoY S&P500 Operating Earnings.

For DE, its more optimistic upside view was a range of -3% to -6% for the S&P500 Op. EPS YoY.

The actual results so far for 412 companies is a positive 1.1%, $42.44, some three plus dollars in level above the optimistic DE pre-Earnings Season projection of -3% YoY.

Besides the SVM mantra of business and cyclical "Army of Unemployed" that is reducing labor costs, *what else explains the stunning earnings results* for the S&P500, out-of-line relative to Nominal GDP and Real GDP than historically?

A second reason is Technology generally, its ongoing use in the replacement of workers with innovations that lower costs, permit companies to reduce costs but maintain sales and revenues, e.g., the Cloud and other Cloud companies that start up, prosper and grow by using technology-intensive methods of production and technology-savvy and technology-trained workers to perform functions that previously were situated in a company but very costly.

Artificial Intelligence (AI) is one of the technologies that permits replacement of workers and production of the same output at lower costs. Voice recognition provides another example. Call Center intermediation for orders on almost everything is yet another.

A third reason is "New" New Technology, more visible now because of the Pandemic and necessary use of technology rather than conventional methods of production and distribution that have, and are, changing how people live, work, communicate, eat, travel, think, provide and receive services of all kinds, as well as the payment mechanisms for them. Zoom and Square are examples. PayPal is another.

This last reason is nothing short of a Revolution, a kind of Rewiring and Restructuring, Rejiggering of changing U.S. and Global Economies, immutable and inevitable now because of the economic forces that reduce costs, keep inflation low, and permit a new and different technology-intensive economy to function and operate with lower cost functions and higher productivity.

The usual published data do not capture this phenomenon! But it is all around us!

This is similar to other technological revolutions in the past that have swept the economy, especially the U.S., which is uniquely set up for new technologies to emerge, take hold, be financed, and placed in operation. This New New Technology also speeds innovation and adoption. And very importantly, *it is Global*.

Nowhere is this more visible than in the numerous companies that are now part of everyday life and will be so for some time; for example Amazon, Google, Facebook, Spotify, DocuSign, Grubhub, Uber, Zoom, Alibaba, Mercabre Libre and so many more, U.S. and worldwide, quickly and highly valued by a forward-looking Equity Market.

There are layers and layers of these companies, many of them based on Apps, with purchases and uses that now fit what goes on in production, distribution, and consumption.

Earnings Projections, New Fair Value Ranges, and a Shifting Distribution of Risks Around the DE "Basic Prospect"

The stunning and surprising upside results for the S&P500 Op. EPS in 2020 Q3 and Q4 have led to a significant rise in the *level* of Earnings for 2020 and on the given DE Basic Prospect (65% Odds), essentially still roughly intact and on track as forecasted through most of 2020, *increases in the levels of earnings expected in 2020, 2021 and 2022*.

Table 1 shows the current forecasts for the path of growth in Real GDP, the federal funds rate, 10-Year U.S. Treasury yield, and S&P500 Op. EPS earnings levels and percent changes.

Table 1
Parameters of the DE "Basic Prospect"
(Pct. Chg., YoY, unless otherwise indicated)

	2019A	2020F	2021F	2022F	2023F
Real GDP (% Chg., Q4 YoY)	2.3	-2.5	4.7	4.2	3.5
Fed. Funds (%, Q4 Avg.)	0.08	0.09	0.12	0.65	1.13
U.S. 10-Yr. Treasury (%, Q4 Avg.)	0.86	0.89	1.87	2.45	2.86
S&P500 Op. EPS—Level ($s) Ann. Avg. (Pct. Chg.)	166.32 1.0	143.86 -13.5	179.88 25.0	199.60 11.0	215.50 8.0

A – actual; F – forecast

The current track for 412 S&P500 companies as of Feb. 19 was $42.44, a 1.1% *positive* YoY result. The DE projection for all 500 companies is $42.50, a Q4 average.

The YoY result, also that for Q3, have been far above Consensus expectations and even the more optimistic DE projection for Q4 which was -3% YoY. The reasons for this were spelled out in the previous Section **Earnings Stunning—Almost Incredible, Striking, A Pattern Worth Noting**.

The earnings results have been stunning and surprisingly better-than-expected and have caused significant changes in DE monitoring of the S&P500 Op. EPS and Fair Value Equity Market assessments.

Eight months ago, the expectation for the S&P500 Op. EPS in 2020 was a near 25% decline or a level of $125 and for 2021, a 27% gain to $161. At a 21 P/E against Forward Earnings of $161 in 2021, a near 3400 Fair Value was the point estimate.

The DE "Basic Prospect" Scenario is roughly the same now as it was then—a Slowdown, no "Double-Dip," a sustained and sustainable Recovery and then Expansion for at least 3-to-5 years. But since the path of earnings relative to the growth path of Real GDP appears out-of-sync with history, over the past six months a series of upgrades in expectations for the S&P500 Op. EPS has occurred for 2020, 2021, and 2022.

For 2021, from the now approximately $144 estimate for 2020, the estimate for the S&P500 Op. EPS is $180 (seen in Table 1). For 2022, it is approximately $200, YoY 25% and 11% in 2022, respectively.

The quarterly pattern shows *increasing* YoY comparisons, hugely so, in Q1 through Q3 2021 and beyond.

The expected path for Federal Reserve policy is unchanged, with the federal funds rate essentially zero through 2022; on the DE forecast moving up somewhat late in 2022.

The U.S. 10-Year Treasury yield always had been projected to rise, but now the increases are more pronounced. The estimated Q4 average yield is between 1-3/4% and 2%; then a good deal higher in 2022.

On these new earnings projections with the essentially *same and given* DE Macro Scenario, the P/E valuation being used against 12-month ahead Forward Earnings is still 21.

With part of 2021 now history, the first two-or-three months of next year's higher earnings gets pulled into Forward Earnings so that the Forward Earnings being priced is $183.

At 21 times, the *Point Fair Value* is approximately 3850. The Fair Value Upper Bound is 4100 and Lower Bound, if there were to be a 5% or 10% Correction, 3450.

The Point Fair Value estimate has been raised time-and-again and quickly so as these stunning earnings results have continued and the DE "Basic Prospect" received support in the key underlying working assumptions and determining factors.

In addition, DE is changing its distribution of risks around the "Basic Prospect," tilting away from the "Double-Dip" or "W" downturn, to Odds of 10% from 15%, and adding an upside Macro Risk Scenario—"Boom."

This change in the distribution of risks already has been accepted by the equity market and provides support to the S&P500 at current levels, currently somewhat higher than the Point Fair Value estimated by DE.

The bottom-line is an intact Equity Bull Market in a confirmed uptrend that also will be sustained and sustainable, and that as time passes will produce rising Fair Value and Fair Value Ranges.

The corresponding Asset Allocation thus is *strategically Strongly Bullish* for U.S. Equities as an asset class on a Relative Value basis, 80% vs. 55% Neutral.

Interest Rates—Up—"Bear Market?" Asset Allocation Implications

Along with the Beginning-of-Better, Reopenings, unleashing of Pentup Demands, Ultra-Easy Monetary Policy and massive Fiscal Stimulus, a recovering non-U.S. Global economy, and the dynamics of the interactions within a business upcycle, a stronger economy and higher actual inflation will likely raise expected inflation and cause increases in long-duration U.S. Treasury yields.

This description for the fundamentals surrounding the Prospect for Interest Rates is familiar and characteristic of a rising interest rate environment.

This likely is the beginning of a Fixed Income Bear Market given the upcycle prospect, rising expected inflation, and eventually a less Easy Monetary Policy is the likely set of fundamentals underlying the fixed income market.

Concluding Perspectives

It is quite typical for rising long-term interest rates and rising stock prices to appear side-by-side in the Recovery and Expansion stages of a business upcycle.

Such now appears to be the case.