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DECISION ECONOMICS, INC.
Information for Decisions™

Sinai's Economic and Market Perspectives

February 25, 2022

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Side-by-Side

Allen Sinai and Rohan Kumar

Correction! Inflation, Fed, Interest Rates and Russian Risks Inflation, etc., Correction

"Hot" Economy, "Hot" Labor Market, "Hot" Inflation Spell Positive Earnings and Equity Bull Market

Tighter Monetary Policy and Rising Interest Rates Spell "Bear" Fixed Income Market—Negative Equities

Net—Side-by-Side Rising Interest Rates, Still An Equity Bull Market, Periodic Corrections

Correction—Inflation, Fed and Interest Rates, Geopolitical Risks, Inflation, Fed and Interest Rates, Correction

Surprisingly high CPI price inflation for January (released Thurs., Feb. 10) *triggered increased uncertainty over how much Federal Reserve Tightening, how soon, and how high short-term interest rates might go.*

Rising interest rates have been the source of an ongoing stock market Correction, huge volatility and fundamental portfolio shifts since early January.

Higher interest rates suggest lower valuations for stocks; hence, while the uncertainty goes on, a stock market Correction goes on, perhaps *as much as 10%-to-15% below* the previous closing high in the S&P 500 of 4797. How long always is difficult to calibrate since Corrections typically reflect short-term risks that do not become long-run realities. A Correction can last anywhere from hours, a day-or-so, to weeks, and sometimes months. This one has been almost two months.

This time, in addition, *the Russian invasion of the Ukraine*, a Geopolitical Uncertainty with lots of unknowns in the uncertain politics of Russia and President Putin and potential negative economic and inflationary Shocks to the Eurozone, Eastern Europe, U.K., U.S. and other economies, is intensifying and extending the Correction. Crude oil price increases and gas shortages to Europe and the Global Economy would *worsen* inflation, bring more interest rate angst,

and/or unexpected economy weakness.

Russia is the second largest supplier of crude oil behind the U.S. with Saudi Arabia third, in a War maybe cutting back on crude oil production or sanctions and because of West sanctions shutting down gas pipelines to Europe. *Further rises of inflation, already way too high, would hurt purchasing power and economies on this negative supply-side Shock of the 1970s variety.*

At this time, Geopolitical Risk has produced "Safe Haven" buying of the U.S. dollar and longer-term U.S. Treasury bonds but has added to the equity market Correction, spinning off a combination of higher inflation and inflation uncertainty as might affect coming Fed Tightening.

Side-by-Side the Bigger Picture Longer-Run—"Bear" Fixed Income, "Bull" Equity Market

For the first time in decades a trend *Bear Market in Fixed Income* but longer-run trend still an *Equity Bull Market is the big picture*.

Side-by-side are a "Hot" Economy and "Hot" Inflation bringing Strong Earnings to lift the equity market—but, also bringing tighter Federal Reserve monetary policy and rising interest rates. Rising interest rates are a negative for stocks, providing a Cash & Equivalent Alternative and reducing valuations.

A side-by-side pattern of rising interest rates and rising stock prices is not unusual in the Expansion Stage of the business cycle—just not seen for at least 15 years and only before in the early part of this century, from 2003-06, in the 1980s, 1960s, post-Korean War and post-WW.II..

"Hot" Inflation

The latest Inflation readings, CPI for January and the PPI, showed very "Hot" inflation.

The CPI was up 0.6% MoM (DE 0.5%, Consensus 0.4%) and 7.5% YoY, the latter a new 40-year high. Widespread quite high rates of inflation in virtually all consumer-related categories showed up. The PPI (Jan., released Feb. 15) jumped 1%; widespread very high inflation in both Goods and Services.

Both the CPI and PPI suggest another good-sized increase in the Consumption Price Deflator (PCE) for January, *a 0.6% estimate* (to be released Fri. Feb. 25). The PCE is the prime inflation indicator targeted by the Federal Reserve. *This would take the PCE inflation rate up to 6.1%, YoY, a new high.*

If so, the YoY figures for the PPI, CPI and PCE, January-over-January, would be 9.8%, 7.5% and 6.1%, respectively, perhaps still not having peaked, or if going to, likely, but not for sure, during the first quarter.

On reasonable month-by-month expectations for price inflation, the year-over-year rate would stay relatively high and if moving to lower rates, only grudgingly so (see Table 2 below).

This "Hot" Inflation follows the superstrong economy of Q4 2021, up 7% in Real GDP, at an annual rate, and a red "Hot" Labor Market, on the latest data (Jan., released Feb. 4) stunningly strong, *with the Unemployment Rate at 4%, historically sometimes the level of the Full Employment Rate of Unemployment*, the so-called Natural Rate (NAIRU).

Labor Market Beginning 2022—Really "Hot"

Recent Labor Market data underscore a "Hot" Labor Market, "Hot" Economy and "Hot" Inflation.

The Labor Market in January was "blowout" strong—Nonfarm Payrolls up an unexpected 467,000 (443,000 Private Sector) and a somewhat higher Unemployment Rate (4% from 3.9%). Nearly 1.4 million persons went looking for work, on a seasonally adjusted basis. There was a large increase in the Labor Force Participation Rate (LFPR), to 61.2 from 60.9. The Employment-Population ratio rose to 59.9 vs. 59.7 the month before. *These measures depict a rapidly increasing supply of labor*.

About 1.2 million additional persons found work, representing a *huge increase in labor demand, with the big jump in labor supply almost fully matched by demand*.

These increases are signs of *tremendous strength in the labor market and for the economy*.

Wages, measured by Avg. Hrly. Earnings (AHE)—income to households but costs to business—rose 0.7%, i.e., over 8% annualized, 5.7% YoY, up sharply compared with 4.9% YoY the previous month.

The increased Persons Working and so large *an increase and acceleration in Avg. Hrly. Earnings (AHE) indicate a big increase for Household Disposable Income* and strong Q1 Aggregate Consumption. But, it also suggests *rising compensation costs* and possible upward cost pressures on product prices, with potentially even higher inflation than the current running rate, and therefore an upside interest rate risk.

"Hot" Economy—Very, Very Hot

The "Hot" Economy (up 5.6% Q4-2021 over Q4-2020) and "Hot" Labor Market—Unemployment Rate down over two percentage points in the past year to 4% from 6.2%—represent the strongest since 1984, the years 2003-06, some portions of the 1990s, the 1980s overall (1982-88), go-go Kennedy-Johnson years (1962-69), post-Korean War (1952-53) and a post-W.W.II surge in Aggregate Consumption (1946-48).

Most recently, Retail Sales (Jan., released Feb. 16) jumped 3.8%, indicating continuing surprising strength for consumption early this year. Industrial Production (Jan.) was up 1.4%, very strong across-the-board. Inventories, wanted, are rising strongly.

Real GDP for Q1-2022 thus now is tracking a solid 3%-to-5%, way above what earlier had been thought would be because of the Omicron variant.

This "Boomy Expansion," the DE Basic Prospect (Odds 75%), thus is well in-train.

There still is much to go given the lags in economic activity behind past and current stimulative macroeconomic policies and the dynamic interactions that occur within the economy and financial system. *The Expansion seems well entrenched in comparisons with history and well supported by macro fundamentals.*

Table 1
Decision Economics, Inc. (DE) Basic Prospect "Boomy Expansion" (Odds 75%)
Key Forecast Dimensions
February 15, 2022
FOMC and WSJ Summaries of Economic Projections—Dec. 15, 2021 and Jan. 2022

	Quarterly					Annual				
DE 2/4/22	**Q1 21A**	**Q2 21A**	**Q3 21A**	**Q4 21F**	**Q1 22F**	**2019A**	**2020A**	**2021A**	**2022F**	**2023F**
Real GDP										
(Pct. Chg., Qtrly. Annual Q4 YoY)	6.3	6.7	2.3	7.0	3.1	2.6	-2.3	5.5	4.5	3.3
Inflation—Consumption Price										
Deflator (Pct. Chg. Ann.; YoY Q4)	3.8	6.5	5.3	6.5	5.8	1.5	1.2	5.5	4.3	3.5
Unemployment Rate (Pct.) (Q4 Avg.)	6.2	5.9	5.1	4.2	4.0	3.6	6.8	4.2	3.1	3.3
DE—Preseason S&P 500 Op. EPS ($s)	49.05	52.98	54.15	54.61	56.26	166.36	144.54	211.09	241.49	262.34
(YoY %)	45.8	87.3	36.7	27.0	14.7	1.2	-13.1	46.0	14.4	8.6
Bloomberg Consensus—Preseason										
S&P 500 Op. EPS ($s)	49.05	52.98	54.15	51.36	52.41	166.36	144.54	207.54	223.93	--
(YoY %)	45.8	87.3	36.7	19.4	6.9	1.2	-13.1	43.6	7.9	--
FOMC Forecasts 12/15/21										
Real GDP (Pct. Chg.) Q4-over-Q4	--	--	--	--	--	--	--	5.5	4.0	2.2
Inflation—Consumption Price										
Deflator (Pct.) Q4-over-Q4	--	--	--	--	--	--	--	5.3	2.6	2.3
Unemployment Rate (Pct.)-Q4 Avg.	--	--	--	--	--	--	--	4.3	3.5	3.5
WSJ Forecasts Jan. 2022										
Real GDP										
(Pct. Chg., Qtrly. Annual Q4 YoY)	6.3	6.7	2.3	5.8	3.0	--	--	5.3	3.3	2.4
Inflation—Consumption Price										
Deflator (Pct. Q4-over-Q4)	--	--	--	--	--	--	--	5.4	3.0	2.4
Unemployment Rate (Pct.—Q4 Avg.)	--	--	--	--	--	--	--	--	3.5	3.5

**A-Actual; F-Forecast; Real GDP Annual, Q4-over-Q4; Inflation Annual, Q4-over-Q4; Unemployment Rate Annual, Q4 Average; EPS Annual, Q4-over-Q4; WSJ Unemployment Annual.*
Sources: Decision Economics, Inc. (DE) "Basic Prospect", Bureau of Labor Statistics (BLS), Bureau of Economic Analysis (BEA), Federal Reserve Open Market Committee (FOMC), Bloomberg, Wall Street Journal (WSJ) Economic Forecasting Survey

Table 1 shows the "Basic Prospect" forecast of Decision Economics, Inc. (DE)—a "Boomy Expansion," along with the latest Federal Reserve published forecasts and a Consensus (WSJ Survey, Jan. 2022).

Essentially unchanged from previous DE forecasts—Real Growth, Inflation, the Unemployment Rate and Earnings show *a picture of a "Boomy Expansion,"* if not a Boom—1) well above-trend real economic growth; 2) high, although decelerating,

inflation; 3) an overshooting of full employment with a near 3% Unemployment Rate later in 2022; and 4) profits, as measured by the S&P 500 Op EPS, up over 14%.

Earnings Strength Stellar Though Easing

The double-digit earnings growth projected for 2022 has three main causes—

1) *Nominal GDP up over 9% in 2022 after 12.4%* (Actual) in 2021 *driving nominal company revenues and earnings* higher;
2) *Tight company management of costs and the bottom-line* in part from a smarter, well-educated, "new" new technology-equipped workforce;
3) *Transformation to a technology-based economy and the cost savings from "disruptive technology"*—the equipment, apps, software and methods of production that are a huge force in this Expansion and part of a "Technology Wave" that is raising productivity, lowering costs and prices, and companies are substituting less expensive production technology for more expensive labor, outsourcing to the Cloud and elsewhere;
4) the *normal productivity gains that occur* in a strongly growing economy.

The DE forecasts (Table 1) present a picture of a stronger U.S. economy, higher inflation, and a lower unemployment rate than the most recent Wall St. Journal (WSJ) Consensus and mid-December projections of the Federal Reserve.

Why?

- *COVID-19 rapidly fading* in its economic and financial market impacts as Omicron variant infections fall off sharply and no new variant appears as widespread;

- *Pentup demands—still huge, particularly for consumers*, frustrated and shut down for so long, with so many households having been cautious and hesitant to spend because of COVID-19. Household personal savings rates are high by historical comparisons and aggregate household financial conditions, as measured by DE, remain exceptionally strong (see Chart 1 below).

- *Household Financial Assets' values way up* over the past six quarters, with large increases to be used for spending or as collateral for borrowing and spending, the "Wealth" effect. This is mainly from sharply rising prices in Housing and the Equity Market.

  Just from these two assets alone, Household Equity and Residential Housing, in nominal terms Household Financial Assets have risen nearly $27 trillion since 2020:1.

  On DE quantitative estimates and after allowing for lags, this is *worth about $800 billion of increased consumption* over 2022 and 2023. The marginal propensity-to-consume used for these calculations is a relatively low 3% because of wealth inequality. In previous business cycle upswings, the propensity-to-consume was as

high as 6%. If near that, as much as $1 to $1-1/2 trillion of additional consumption spending would be expected.

- *Still Supportive Monetary Policy*—"catch-up" for the Federal Reserve in finishing Tapering, raising the federal funds rate and now, new, Quantitative Tightening (QT).

  The higher short- and long-term interest rates and reductions in holdings of U.S. Treasuries on the Federal Reserve's balance sheet, i.e., Quantitative Tightening (QT), represent a definite tightening of monetary policy, but *still will leave a tremendous amount of liquidity in the financial system and low or negative real interest rates that are stimulative*.

  The Tightening and Tighter monetary policy that is coming is unlikely to do major damage to the economy any time soon, with so many still strong underlying macroeconomic fundamentals. *Hopefully, although not necessarily so, monetary policy Tightening will just "Cool" the "Hot" Economy, not "Ice" it.*

- *Fading of historically unprecedented fiscal policy stimulus, over 2020-21 some 25% to 30% of GDP. The remaining stimulus still will be sizable, however,* with the lagged effects of a cumulative $6.5 trillion in outlays from six stimulus programs over the past 2-1/2 years.

  The latest, $550 billion of traditional Infrastructure spending—for roads, highways, buildings and broadband—will have the greatest impact in 2022-23 through States and Localities' disbursements of funds received from the Federal Government.

  Lagged spending of the substantial liquidity from the Transfers of prior fiscal stimulus still will be supportive for households and the economy, generally.

- *Stronger non-U.S. economies, the Global Economy in general,* as part of an economic upswing in China, Japan, South Korea, France, Germany, Italy, the Eurozone, Australia, Canada and parts of Latin America. *This should help U.S. exports and production.*

- *Internal business cycle dynamics—once in an upswing* the increased sales, production and inventories that bring increased jobs and higher consumer disposable income, then higher spending and saving induced by the increases in disposable income, increased sales and profits, greater capital outlays, increased production, more jobs, more income, more spending—the dynamics and interactions of the economic and financial system that produce a continuing upswing until rising inflation reduces purchasing power, interest rates rise to slow lending and borrowing, there is less spending, reductions in growth and production, less hiring, and a rising unemployment rate that reverse the cyclical dynamics of an entrenched upturn to a growth slowdown.

Major risks to the Basic Prospect?

Spiraling and/or too long unexpectedly higher inflation, and then, if so, potentially surprising and necessarily increasingly Hawkish Federal Reserve Tightenings to

"Cool" down the "Hot" Economy and "Hot" Inflation; 2) the *Geopolitics* of conflict between Russia, the U.S. and Western Europe, a War, with unpredictable but certainly negative stagflationary economic and financial effects; 3) *China-U.S. confrontations* although mainly on economics and governance; 4) *continuing political disarray and dysfunction in Washington* that depresses sentiment and spending; and 5) *unpredictable policies and potential macroeconomic policy errors* coming into the Midterm Elections.

With a relatively small, but *to be noted 10% assessed risk of Recession in 2022 or 2023, a "Boom-Bust" Scenario* possible outcome, *Consolidations and Corrections in the equity market are likely, increased volatility, but not an end to the Equity Bull Market.*

Interest rates, on average, are headed higher, rising with periodic interruptions, but in a "permanent" uptrend.

"Hot" Inflation—Deceleration But Nowhere so Low as Federal Reserve Expectations

The macroeconomic fundamentals underlying the U.S. economy have created *tremendous Demand-Pull upward pressure on prices and rising price inflation—very "Hot" Inflation* over 2021, most recently 5.5% Q4:2021-over-Q4:2020 (the Consumption Price Deflator PCE), 0.6% month-to-month and inflation YoY 7-1/2% for the CPI in January (released Feb. 10) and a *DE-expected 0.6% in January* (6.1% YoY) for the PCE.

This "Hot" Inflation is the main reason for the significant Tightening in monetary policy that is coming and a main ingredient in the rising interest rates that have occurred. Increased nominal demands for funds and a rise in inflation expectations are other key factors.

Table 2 shows a sharp acceleration in various measures of price inflation over the past 9-12 months for the PPI, CPI, and PCE and DE forecasts through midyear.

Table 2 – Recent U.S. Inflation—Accelerating to Decades-High Rates*
Recent History and Forecasts—Bold
(2021:Q1 to June 2022)

	PPI			CPI			PCE		
Qtr.	QoQ	QoQ Ann.	YoY	QoQ	QoQ Ann.	YoY	QoQ	QoQ Ann.	YoY
2020 Q1	0.0%	-0.1%	1.1%	0.3%	1.3%	2.1%	0.3%	1.3%	1.7%
2020 Q2	-1.3%	-5.2%	-1.0%	-0.9%	-3.4%	0.4%	-0.4%	-1.6%	0.6%
2020 Q3	1.1%	4.6%	0.0%	1.2%	4.8%	1.3%	0.9%	3.7%	1.2%
2020 Q4	0.9%	3.8%	0.7%	0.6%	2.2%	1.2%	0.4%	1.5%	1.2%
2021 Q1	2.1%	8.8%	2.9%	1.0%	4.1%	1.9%	0.9%	3.8%	1.8%
2021 Q2	2.6%	10.8%	6.9%	2.0%	8.2%	4.8%	1.6%	6.5%	3.9%
2021 Q3	2.5%	10.5%	8.4%	1.6%	6.7%	5.3%	1.3%	5.3%	4.3%
2021 Q4	2.0%	8.4%	9.6%	1.9%	7.9%	6.7%	1.6%	6.5%	5.5%
2022 Q1	**2.2%**	**9.2%**	**9.7%**	**1.8%**	**7.3%**	**7.5%**	**1.6%**	**6.5%**	**6.2%**
2022 Q2	**1.5%**	**6.2%**	**8.5%**	**1.3%**	**5.2%**	**6.8%**	**1.0%**	**3.9%**	**5.6%**

2022 Q3	**0.8%**	**3.1%**	**6.7%**	**0.8%**	**3.1%**	**5.9%**	**0.7%**	**3.0%**	**5.0%**
Month	MoM	YoY		MoM	YoY		MoM	YoY	
Mar	0.7%	4.1%		0.6%	2.7%		0.6%	2.5%	
Apr	1.0%	6.4%		0.6%	4.2%		0.6%	3.6%	
May	1.0%	6.9%		0.7%	4.9%		0.5%	4.0%	
Jun	0.8%	7.5%		0.9%	5.3%		0.5%	4.0%	
Jul	0.9%	7.8%		0.5%	5.3%		0.4%	4.2%	
Aug	0.9%	8.6%		0.3%	5.2%		0.4%	4.2%	
Sep	0.5%	8.8%		0.4%	5.4%		0.3%	4.4%	
Oct	0.7%	8.9%		0.9%	6.2%		0.6%	5.1%	
Nov	0.9%	9.9%		0.7%	6.8%		0.6%	5.7%	
Dec	0.4%	10.0%		0.6%	7.1%		0.4%	5.8%	
Jan	1.0%	9.8%		0.6%	7.5%		**0.6%**	**6.1%**	
Feb	**0.7%**	**9.7%**		**0.5%**	**7.6%**		**0.5%**	**6.3%**	
Mar	**0.6%**	**9.7%**		**0.5%**	**7.4%**		**0.4%**	**6.2%**	
Apr	**0.5%**	**9.1%**		**0.4%**	**7.2%**		**0.3%**	**5.9%**	
May	**0.4%**	**8.5%**		**0.4%**	**6.9%**		**0.2%**	**5.5%**	
Jun	**0.3%**	**8.0%**		**0.3%**	**6.3%**		**0.3%**	**5.3%**	

**Sources and Definitions: BEA; PPI—Producers Price Index; CPI—Consumer Price Index; PCE—Personal Consumption Deflator Bureau of Labor Statistics (BLS) and Bureau of Economic Analysis (BEA); Decision Economics, Inc. (DE).*
Forecasts - Bold

Increases and a significant acceleration clearly can be seen in all three measures.

The price increases are most pronounced in the PPI, Basic Commodities; next in the CPI with its heavy weight and high proportion from Housing (42%); and less so in the Personal Consumption Deflator (PCE)—the latter a more balanced inflation Index where the weights change with GDP.

The acceleration in the PPI, starting in March 2021, has been from 4.1% YoY to 9.8% in January, 5.7 percentage points, *perhaps* peaking in December.

For the CPI, over essentially the same time span and also including January, the increase was 4.8 percentage points.

For the PCE, the increase for inflation was from 2.5% in March YoY to 6.1% in December, a rise of 3.6 percentage points. Excluding Food-and-Energy, not shown, the "Core," the rises are smaller compared with the overall Indices, by 1 to 2 percentage points, but still a big acceleration in a short period of time.

On reasonable monthly projections going forward, representing some softening and base effects from the high inflation of a year ago, *some deceleration is likely. The peaks generally look to be in Q1-2022, but declines will be stubbornly slow.*

The *odds on getting to the Federal Reserve price inflation forecast shown in Table 1, 2.6% for the PCE, Q4-over-Q4, and even the Consensus expectation of 3%, look very low.*

A major fading to what now looks quite low, the Federal Reserve's inflation forecast, would require a much slower-growing economy, a big increase in aggregate supply, a major retreat in Crude Oil prices and for Energy costs, a rising unemployment rate, and/or wage inflation to stabilize—none likely!

Stubbornly High Inflation: A Theme

The DE forecast of price inflation in the "Boomy Expansion" Basic Prospect is a little over 4% for the PCE, Q4-2022-over-Q4-2021, and 3-1/2% next year—*perhaps optimistic* given current and prospective data.

Main sources of the stubbornly high inflation?

1) *strong aggregate demand* vs. aggregate supply; 2) *permanently higher wage and compensation* costs; 3) *Crude Oil prices (West Texas Intermediate, WTI) now above $100/barrel*, holding up and raising energy costs; 4) *a sharp rise in expected inflation* as more-and-more consumers, businesses, and financial markets accept as permanent higher actual inflation; 5) *a strong U.S. and strengthening Global Economy.*; and 6) the Russia-Ukraine-West conflict.

Classic Aggregate Demand-Pull Inflation

As a diagnosis, the "Hot" Inflation principally is the result of a Classic Demand-Pull Inflationary surge (Aggregate Demand far in excess of Aggregate Supply) and process.

Initiating the inflation paradoxically was the Pandemic and the reactions to this External Shock—1) after a shutting-down of the economy *Reopenings* ahead of the availability of supply; 2) *pentup demands* unleashed that is pressing supplies; 3) *Ultra-Easy Monetary Policy*, quick and big to cushion and prevent bankruptcies and business failures, i.e., Failure Fallout; 4) *massive fiscal stimulus*, mainly Transfers, that prevented personal bankruptcies, bankruptcies of companies, and credit fallout for financial institutions, very different from previous business cycle downturns; 5) *maintaining and "doubling-down" on the monetary stimulus with the Federal Reserve changing approach and inviting price inflation to exceed its Price Stability objective*; 6) *the stops-and-starts of COVID-19* and rapid development of vaccines with varying interruptions to trade and commerce depending upon the geographical location.

All these measures have been demand-stimulative, minimally focused on supply, the growth spurts far above anything seen in recent years, with Aggregate Demand pressing on Aggregate Supply—Demand-Pull, and hugely so, *quite clearly the motivating force of the higher-than-expected price inflation that has emerged.*

There has been some supply-side cost-push, e.g., shortages of workers relative to demand and associated rising wage costs; shortages in some consumer goods and services against demand, particularly Food and Energy; global supply-chain disruptions in a globally interconnected world of supply and demand, and significant shortages of certain components and inputs used in production, such as chips.

Supply-side shocks from COVID have created labor shortages, dropouts and changes in workers' attitudes, and shifts in the structure of production. The Geopolitics of tight crude oil supplies on crude oil prices and energy costs have lasted a long time. And, strains on the supply-side all over the Global Economy because of COVID-19 have added to the inflation.

But, the diagnosis has to be Classic Demand-Pull.

The phenomena being seen in the U.S., more-or-less, also is showing up globally—in the Eurozone, Japan, China, Korea, Australia, Canada and several other countries.

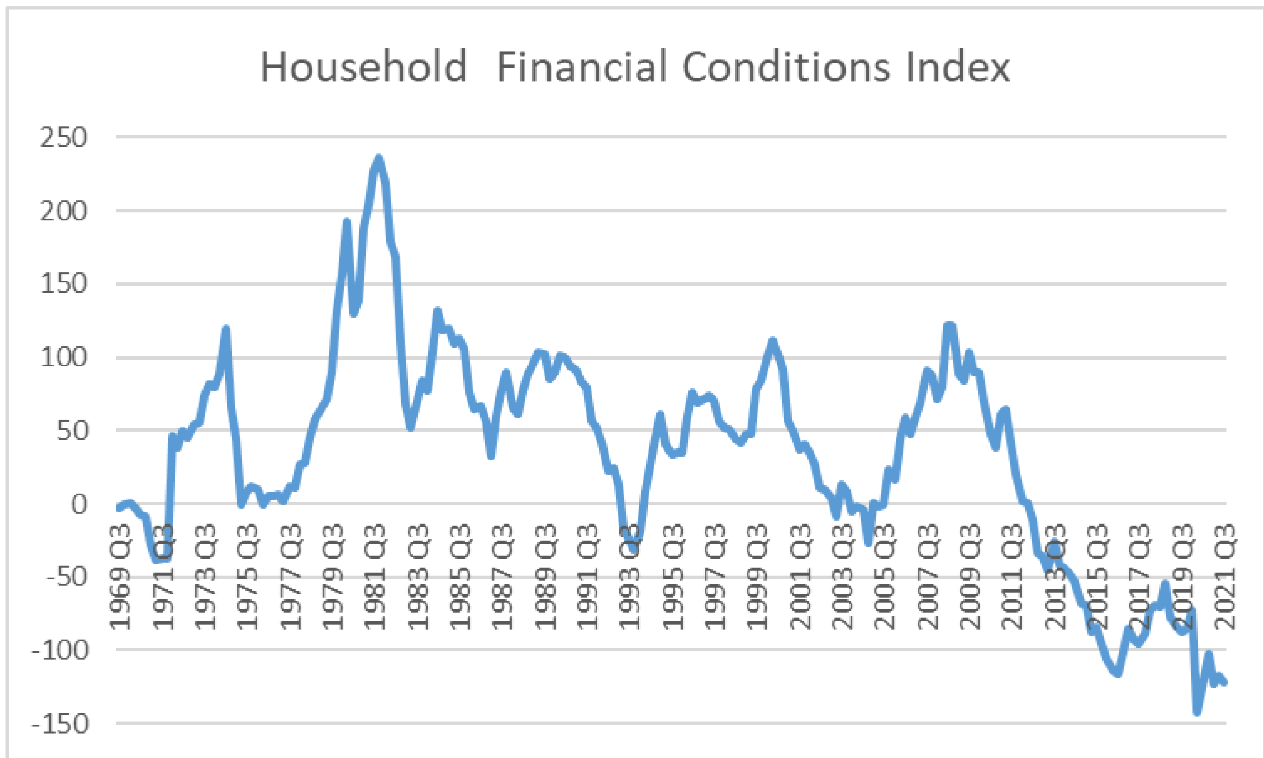
The Timeline so far is Classic Demand-Pull—at first rising commodities prices (Producers' Price Index (PPI)) including Crude Oil, with West Texas Intermediate (WTI) more than double the level of a year ago, now looking quite permanent, in part, from the geopolitical conflict between Russia and the West; a boom in asset prices, particularly housing and equities, in turn feeding and supporting demand through increased Disposable Income, the "Wealth" effect on Consumption, and lifts in personal savings to be spent, lent and used as collateral for borrowing; feeding back into and supporting the "Hot" Economy and "Hot" Labor Market; then with lags final product prices followed by rising wages in an ever tighter labor market.

Very likely, a big wave of technological change, denoted by DE as "New" New Technology, has helped prevent inflation from moving even higher, reducing costs of production and increasing personal saving and business saving for investments of all kinds, a huge dimension of this "Boomy Expansion."

The financial system of the economy is strong as indicated by the DE Index of Household Financial Conditions (Chart 1 below) and Nonfinancial Corporate Cash Flow relative to Outlays (Chart 2 below), also supporting aggregate demand. The Financial System, particularly banks, is resilient and has not yet engaged in the excessive lending and risk-taking as in many other business cycle episodes.

Recent Federal Reserve flow-of-funds data show a new low for the DE Index of Household Financial Conditions (Chart 1)—low figures indicating better financial conditions.

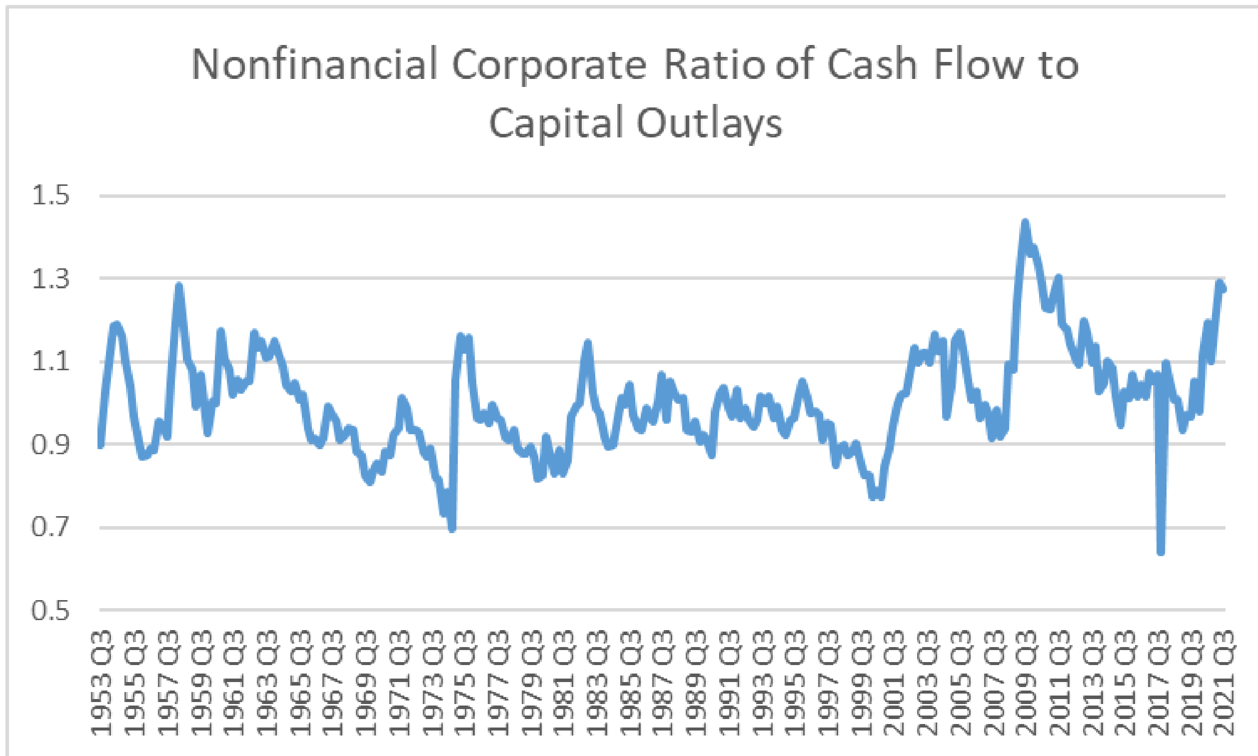
Chart 1
Decision Economics, Inc. (DE) Index of Household Financial Conditions
(1969:3 to 2021:3)



Sources: Federal Reserve Board and Decision Economics, Inc. (DE)

Chart 2 shows Nonfinancial Corporations' cash flow well in excess of outlays, a sensitive measure of business financial strength with internally generated funds more than covering outlays including inventory spending. Excess Nonfinancial Corporate saving thus is available for expansion, new ventures, share buybacks, hiring and capital outlays.

Chart 2
Nonfinancial Corporations Financial Position
Cash Flow vs. Outlays (Ratio) (1953:3-2021:3)



Sources: Federal Reserve Board and Decision Economics, Inc. (DE)

In previous Expansions, the financial condition of Households and Nonfinancial Corporations has been deteriorated (see in Chart 1, 2006-09; Chart 2, 2006-09 and 2018).

Such is not the case now.

Financial institutions, especially banks, are particularly strong, having weathered the COVID storm with a lot of help from the Federal Reserve's massive and quick injection of reserves into the financial system and tight regulations.

Implications—Good Times for "Main Street?"

These are Good Times for the American Economy—in the U.S. for "Main Street."

The economy is strong. The unemployment rate is very low and likely to move down even more as the year progresses. Spending is booming. The financial system is not extended nor deteriorated.

Price inflation *is* a negative, currently reducing inflation-adjusted disposable income but going forward likely to do so less as wages and earnings catch up with the initial burst of price inflation. *A "Hot" Labor Market suggests higher wage inflation will be forthcoming.*

Historically, a low unemployment rate and tight labor market matter most to the majority of people who thus feel good on the security of plentiful jobs and increasing compensation. This is in spite of rising inflation.

During the 1970s, supply-side crude oil price shocks *raised both price inflation and the unemployment rate*, producing a very uncomfortable combination, *not* good times for Main Street nor Wall Street.

"Wall St." Turbulence—Not Such Good Times

The "Wall Street" sky is no longer Clear Blue. It is Partly Cloudy with Occasional Showers and Thunderstorms (Bearish Consolidations and Corrections).

Rising inflation and increases of interest rates in response by the Federal Reserve present a different backdrop for Wall Street than when inflation was low, the expansion in its early stages and the Federal Reserve Ultra-Easy—what had been for a long, long time until 2017-19.

The changing prospect for interest rates, on average a rising trend, changes the backdrop for Wall Street, with more Consolidations and Corrections and limits on total returns.

The Easy Money associated with Ultra-Easy Monetary Policy and Accommodation is no longer so at such a time—hence, *good times for "Main Street" and not such good times for "Wall Street."*

Side-by-Side—"Boomy Expansion" the DE Basic Prospect (75% Odds) with Strong Earnings but also High Inflation and Rising Interest Rates…and Corrections

Side-by-side with a strong economy, strong labor market and high inflation, is now rising interest rates and a Federal Reserve in motion to Tighten—the U.S. central bank now well behind the curve of a "Hot" Economy, previously purposely so, but having made what looks in retrospect to have been a big *Policy Error* on letting price Inflation lag to become entrenched.

Given its Price Stability and Full Employment Dual Objective, the Federal Reserve now has to "catch-up" and "Cool" the "Hot" Economy and "Hot" Inflation. Policy Errors are easy to make at such times. Historically in the business cycle, Policy Errors have been a source and ingredient of Recessions.

Equity Market—New Fair Value and Ranges

A plus for Wall Street is strong company earnings as a consequence of the Side-by-Side patterns of strong economic growth and high inflation, with higher interest rates. Earnings still were surprisingly strong in Q4:2021 for the S&P 500 Op. EPS as tracked by DE, very close to the DE pre-season optimistic estimates. *There has been a surprisingly long string of strength in earnings growth.*

A *negative* is a "Bear" Fixed Income market, the first in decades, "Permanent" on the permanently higher inflation and Hot Economy—the strongest economy and highest price and wage inflation since the 1980s, 1960s, post-WWII, and 2003-2006.

With the ongoing DE forecasts of a "Hot" Economy and "Hot" Inflation—strong growth in Nominal GDP in or near double-digits, the DE S&P 500 Op. EPS

projections have not changed much; indeed, *now are running somewhat higher* on the additional revenues and earnings coming from rising sales, prices and the passage of time that takes some of future earnings gains into Forward Earnings.

Costs are rising as well, including compensation. But *these typically lag behind* price increases in an inflationary cycle.

Table 1 above shows the S&P 500 Op. EPS path through 2023—the near actual 2021 result of over $211, an actual about 46% increase over 2020; a forecast of $241 in 2022, up 14%; then $262, an 8.6% rise in 2023. Not shown, but still reflecting the later stages of Expansion in 2024, is a $275 longer-run projection.

The DE forecasted path of earnings has exceeded, and still does far exceed, Consensus (Table 1 above). The Consensus earnings forecasts have underestimated the actual results for several years now.

It should be noted that the DE path of higher earnings is contingent upon the Boomy Expansion and permanently higher price inflation that is raising price levels and expected over the next few years.

Fed and Interest Rates—The DE Fed Path and Interest Rate Forecast

Along with those forecasts, of course, are expectations on Federal Reserve monetary policy and the DE projections for interest rates, *some eleven increases in total for the federal funds rate —five in 2022, four in 2023 and two in 2024*, 2-3/4 percentage points cumulatively, i.e., permanently rising short- and long-term interest rates, on average, for the next several years. A 2-3/4% to 3% U.S. Treasury bond yield is the yearend forecast range.

Historically, rising interest rates lower the P/E multiples used to discount future earnings or future cash flows. Most typically, not until rising interest rates and other negative financial factors occur does the economy weaken and earnings growth head significantly lower or negative, however.

Much also depends on other factors affecting the economy such as fiscal policy, as in the 1960s and 1980s and 2003-06, or Pentup Demands Post-WW.II and after the Korean War.

Other factors may intervene this time—the Global Economy is much more important to the U.S. than previously, there is the pronounced shift toward a techno-centric economy and production structure rather than labor-centric, and changes in the efficiency of companies at keeping profit margins up and costs down. *And, of course, Geopolitics*.

Equity "Bull" Market Still, Longer-Run, Fair Value and Ranges

But, so long as the Expansion continues and if followed by a Boom, or the "Boomy Expansion" Basic Prospect, earnings growth should continue to rise nicely, although at a slower rate, to be discounted to the present on a rising "discount" rate, in the case of DE a weighted average after-tax cost of debt and equity.

With this in mind, pricing Forward Earnings at $245, about 12 months ahead with some earnings pulled forward from 2023, and using a lower P/E multiple than previously, now 18 instead of 20, produces a Point Fair Value of 4400 to 4425 on the S&P 500, with a downside bound, if it were to occur, of 15% from the previous peak S&P 500, 4795, to about 4050. Upside is assessed at about 4900 (on a 20 P/E).

Table 3 shows Fair Values on different P/E multiples and DE earnings estimates, reflecting a range of possibilities because of rising interest rates as used in discounting the forecasted DE future stream of S&P Op. EPS.

Table 3
Fair Value (Point and Ranges)
Sensitivity to P/E Multiples

P/E Multiples	2022 Forward EPS (2/22 to 2/23)	S&P 500 Fair Value	2023 Forward EPS (2/23 to 2/24)	S&P 500 Fair Value
16	245	3925	265	4250
17	245	4175	265	4500
18	245	4410	265	4775
19	245	4650	265	5025
20	245	4900	265	5300

Source: Decision Economics, Inc. (DE)

It should be noted that, at this point, the DE Op. EPS is some $15 to $20 above Consensus, so if pricing Consensus EPS significantly lower Fair Values are suggested.

In the P/E multiples used by DE, there is an upward effect from unusually strong growth and high inflation, analogous to a high growth stock, that adds to the multiple.

This, too, should be kept in mind in looking at the Fair Value Ranges that are indicated.

Some Historical Perspective

Historically, in many business cycle upswings with underlying fundamentals similar to now, an Equity Bull Market goes on as interest rates rise, although with a different backdrop punctuated by more volatility, Consolidations and Corrections, but nonetheless still an Equity Bull Market.

The early stages of rising interest rates in a strong economy and rising inflation are accompanied by strong earnings growth and its continuing prospect. The factors surrounding those forecasts, and it, the earnings, dominate.

Such a pattern often has been associated with Federal Reserve Tightening in its beginning stages. If what is *the major driving force for rising interest rates and Federal Reserve Tightening is a strong economy and rising prices—side-by-side, but not always at the same time, are rising interest rates and rising stock prices.*

This is not unusual! Rising interest rates often do *not* necessarily indicate a coming Recession nor the Equity Bear Market that always precedes a Downturn.

But, the "Bear" Fixed Income market does go on relentlessly, although with ebbs and flows—it is present until near the end of the upswing, an Expansion which often turns into an outright Boom that induces excesses, one of which is too high inflation, Tight and Tighter Money, interruptions of funds flows, and other problems and reactions within the dynamics of the economy and financial system that over time moves the economy toward and then into a Recession.

But, all of this can take many quarters, indeed years, to unfold.

In the Recession or when there is much less growth is where inflation can stabilize at a lower and more acceptable rate, the Unemployment Rate rises, inflation diminishes, and before that a "Bear" Equity Market.

The current business cycle situation seems far from this!