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A Profit Recession Is Brewing, Expert Says. Hunker Down in Cash.

By Randall W. Forsyth Follow Updated May 20, 2022 7:13 pm ET / Original May 20, 2022 12:01 am ET

Target stock plunged 28.7% on Wednesday and Thursday.
Joe Raedle/Getty Images

If there is one person who wasn't shocked by the massive misses in big retailers' results this past week, it's our longtime (but no way old) pal, Stephanie Pomboy, who heads the MacroMavens institutional economic advisory. Even though she has been coping with a (thankfully) mild case of Covid-19, she's still as sharp, and acerbic, as ever in sizing up the current situation.

Not to lose the short-attention-span types, here are some of Steph's searing insights:

We're now experiencing withdrawal pangs after the massive injection of fiscal and monetary stimulus of the past two years, which actually boosted asset values more than real economic activity. With manna no longer falling from Washington, consumers are resorting to credit cards to pay the soaring costs of incidental items, such as food, energy, and rent. Companies also are getting squeezed. Producer prices are racing farther ahead of consumer prices by the biggest margin on record.

There's also some good news. Amid the shortages of everything out there, the supply of one thing—labor—might improve. Some folks enriched by the soaring prices of assets, whether stocks, houses, or cryptocurrencies, joined the leisure class for a while. As asset prices start to deflate, some of these nouveau riche face the chastening prospect of actually having to return to work.

Pomboy says that both Wall Street and the Federal Reserve have woefully underestimated stimulus policies' role in the current recovery. After Uncle Sam injected approximately $10 trillion in fiscal and monetary largess into the U.S. economy, nominal gross domestic product increased by about $2.3 trillion, a pathetic bang for the buck. Household net worth ballooned by $34 trillion, however, which compares with the $24 trillion U.S. economy. In effect, U.S. consumers were handed roughly two full years of income, via the increased value of their houses and of their 401(k) accounts and other securities holdings.

Now the movie is on rewind. The notion of consumers sitting on an ample cushion of savings is wrong, Pomboy says, with personal savings back to the December 2019 level. Credit-card balances, which were slashed after America received its government stimulus fix, are ramping up at a record 16% annual clip. It's hard to imagine consumers taking on double-digit interest charges on plastic if they weren't strapped to pay the escalating tabs at the checkout counter, gas pump, and rental office, she adds.

The stresses that dominate the everyday lives of most Americans shocked Wall Street via the first-quarter earnings reports from retailers this past week, highlighted by the 28.7% two-day swoon by Target (ticker: TGT) on Wednesday and Thursday. The soaring food, energy, and housing expenses are crowding out discretionary spending, Pomboy says. Retailers who cater to the hoi polloi can't pass on their rising costs, resulting in massive margin squeezes that are decimating their stocks.

Yet to be seen is the effect of the now-deflating asset bubble. She passed along a chart of the JOLTS (Job Openings and Labor Turnover Survey) overlaid with the Wilshire 5000 **W5000FLT 0.00%** index, which measures the broad U.S. stock market in dollars. Through the most recent reading in March, the tightening in the labor market indicated by JOLTS moved in virtual lockstep with the Wilshire.

Sometime soon, however, the reverse could happen. According to Wilshire Associates, the U.S. stock market has shed some $10.1 trillion in value, or 19.9%, this year through Thursday. The losses are relatively recent, with $7.1 trillion of that drop coming since the current quarter began, including $2.6 trillion in May, $1.7 trillion of which was torched just in Wednesday's rout.

That doesn't take into account the approximately trillion dollars in cryptocurrency wealth that's evaporated globally this year, according to Goldman Sachs' economic team, led by Jan Hatzius. Declines in household wealth point to a significant drag on spending, not so much from crypto as from conventional assets. Equities accounted for about 33% of household wealth at the end of 2021, compared with just 0.3% for crypto, they write in a client note.

Labor-force participation among younger males—crypto's main fan base—has nearly fully recovered, the Goldman economists say. Prior academic studies have found that the wealth effect mainly affects labor-force participation among those near retirement age, who might be more apt to take their money and run.

On the surface, the jobs numbers appear to show labor demand continuing to stay ahead of supply. But peering beneath the surface, Pomboy sees confusing data. While April's establishment survey found a solid 428,000 increase in nonfarm payrolls, the separate survey of households showed a 353,000 decline in employment. While the household series (from which the headline jobless rate is derived) tends to be more volatile month to month, she has never seen such a wide split, suggesting there's something amiss in the figures.

And recently, some big tech companies, including Meta Platforms FB -8.20% (FB), Amazon.com (AMZN), and Uber Technologies (UBER), have announced more restrained hiring policies. Initial claims for unemployment insurance have been creeping up, to 218,000 in the week ended May 14. That's an historically modest level, but it's still up from the 53-year low of 166,000, touched in March. As profit margins are squeezed, labor costs are certain to go under the microscope.

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At the same time, Pomboy adds, Fed Chairman Jerome Powell wants to come across as "Volcker 2.0," a reference to the Fed chief who vanquished inflation four decades ago with 20% interest rates and back-to-back recessions. And equity analysts have yet to seriously pare their earnings forecasts, with those for consumer-discretionary companies still pointing to 30% gains for 2022, she observes.

Pomboy's conclusion: We're in the early innings of an unfolding profit recession. The Fed would likely welcome wage gains if the jobs market weakens. Meanwhile, she advises investors to resist any temptation to buy the dips. Instead, she advises, hunker down in cash; the lows are still a distance away.

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