US and Them

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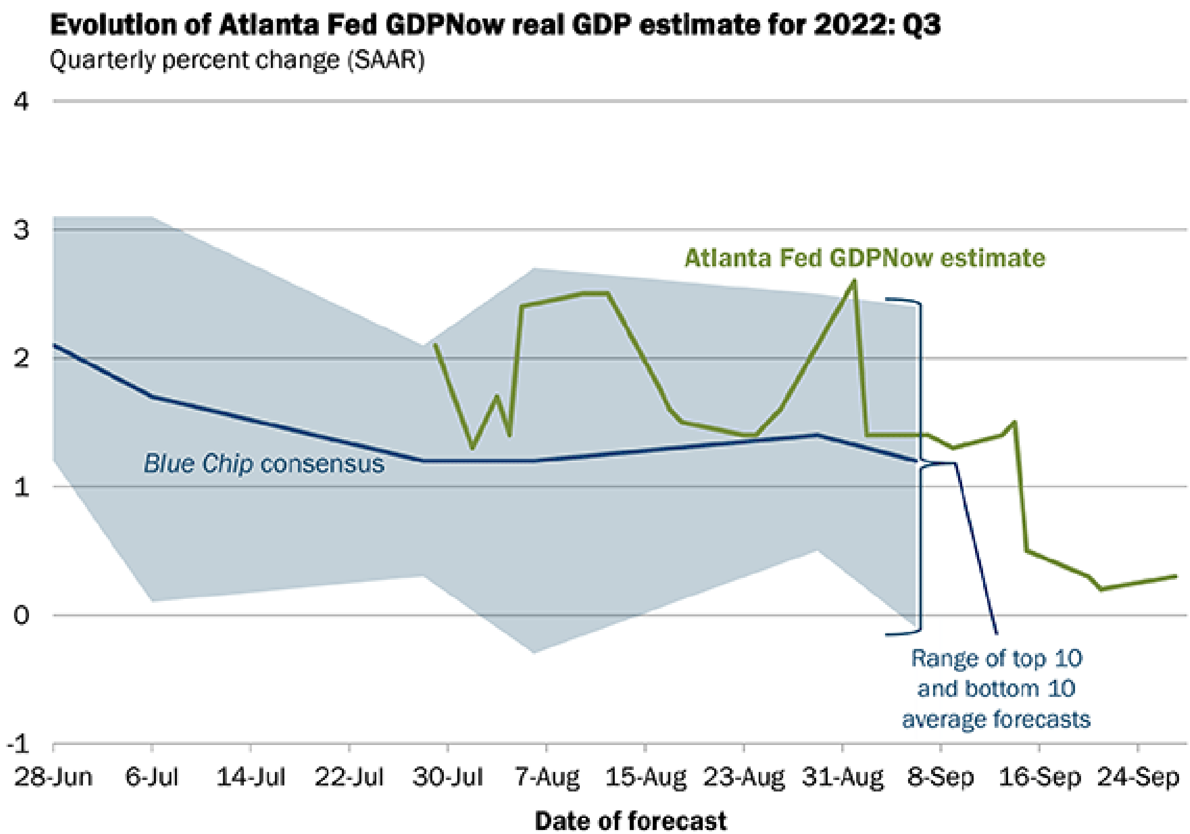
In comparison to Europe and some other parts of the world, US economic prospects look relatively good. The Atlanta Fed's GDP Now forecast for the third quarter that is about to end shows GDP growth of +0.3%. The Blue Chip consensus of economists, which lags the Atlanta Fed model, has a small negative GDP forecast of -0.1% for the third quarter.



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Richard Bernstein, Founder and CEO of Richard Bernstein Advisors and former Chief Investment Strategist at Merrill Lynch, expects corporate profit growth (compared to the prior year) to turn negative by the fourth quarter of 2022. He also expects profit comparisons to remain negative for several quarters, in the range of -5% to -10%.

Michael Smolyansky, Senior Economist at the Board of Governors of the Federal Reserve System, issued a research note earlier this month, titled "The Coming Long-Run Slowdown in Corporate Profit Growth and Stock Returns." A good portion of corporate profit growth during the last two decades has been a result of a decline in interest and tax expenses. Since the early 2000s, interest and tax expenses as a share of EBIT (earnings before interest and taxes) has declined from about 45% to 26% as of the first quarter, 2022 in the United States.

The US now has higher interest rates and higher corporate tax rates than a year ago. The recently passed Inflation Reduction Act included a 15% corporate minimum tax. Smolyansky writes, "It is possible that P/E (price/earnings) multiples in the future will fluctuate around the same historical median level. On the other hand, if profit growth is slower than in the past, there is good reason to believe that P/E multiples, averaged over time, will themselves contract." He concludes that with the expected slowdown in profit growth and an associated contraction in P/E multiples, "real longer-run stock returns are likely to be notably lower than in the past."

In Europe, the geopolitical situation has deteriorated further. A quick summary of some headlines from the last four days:

Sep 26 – Three deep water explosions destroy the Nord Stream pipelines.

Sep 27 – Four regions (Donetsk and Lugansk Peoples Republics, Kherson region, and part of Zaporozhye Region in southern Ukraine) vote to join Russia.

Sep 27 – Zelensky condemns referendums on joining Russia.

Sep 28 – Leaders of the Lugansk People's Republic and his counterpart in Kherson Region have officially asked President Vladimir Putin to accept them into the Russian Federation, following referendums where the overwhelming majority voted in favor.

Sep 28 – US Embassy warns Americans to leave Russia immediately.

Sep 28 - Moscow warns US against "using Zelensky regime" as a proxy.

Sep 28 – US preparing more weapons for Ukraine.

Sep 29 – Poland outlines condition for NATO intervention in Ukraine.

Sep 29 – Putin to give major speech on Friday as part of Ukraine annexation ceremony.

Sep 29 – Prague Rising: Thousands protest in Czech Republic Against NATO and EU destroying their way of life.

The referendum in the regions that want to join Russia had the following percentages for approval: Donetsk People's Republic 99%, Lugansk People's Republic 98%, Zaporozhye region 93%, and Kherson region 87%.

While the United States Government claims to promote democracy and self-determination, that is true only if it the results are consistent with US wishes. When Crimea had a referendum in 2014 to leave Ukraine and join the Russian Federation, 97% voted in favor of the change. The US still does not acknowledge the legitimacy of the 2014 Crimea referendum and, of course, disputes the legitimacy of the current referendums. If you wish to learn more about the origins of the conflict in Ukraine, "Ukraine on Fire" by Oliver Stone is a good documentary available on YouTube.

The prognosis for peace in Ukraine is poor. After the Russian Federal Assembly approves the addition of the four regions from Ukraine, any military action in those regions by Ukrainian or NATO forces will be viewed as an attack on Russia, which is prepared to take action beyond the prior "limited military operation."

It is likely to be a difficult winter in Europe. As the US, NATO and Ukraine attempt to restore Ukraine to its prior state, energy shortages will likely result in some closed businesses and deaths by freezing. The level of debt defaults will rise. Many European banks have low capital ratios, so they are more susceptible to insolvency than American banks. In Europe, insolvent banks will limit withdrawals from depositors and are likely to convert a portion of bank deposits to bank equity by issuing shares to depositors.

There is a high probability that problems in Europe will have an impact on the US economy and financial markets.

If you have any questions or comments, please contact me.

Sincerely,
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