MORNING BRIEFING
June 12, 2017

White Swans

See the collection of the individual charts linked below.

(1) Bullish chowder. (2) Frothy valuations. (3) Swamp sickness. (4) Betting on downsized Trump agenda. (5) Benchmark model pinpoints next recession in March 2019. (6) NBx2 scenario: No Boom, No Bust! (7) Price inflation is keeping a lid on wage inflation. (8) Are bond investors seeing less growth or less inflation or both? (9) Big Three central bank balance sheets remain ultra-easy, on balance. (10) Fed's priority is probably to raise rates more before reducing balance sheet. (11) Update of quarterly valuation ratios shows mixed picture.

Strategy I: New England Is Bullish. I visited with some of our institutional accounts in New England last week. I am sensing that a consensus is emerging among them and our other accounts in the US and abroad. They are less concerned about frothy valuation multiples in stocks, and less bearish on bonds than they were earlier this year. They are much less concerned about the Fed too, figuring that rate hikes will remain very gradual and that the central bank won't shrink its balance sheet for a while. In any event, they see better values in European and EM stock markets. They have mixed views on the FAANGs.

No one was able to come up with any new and credible black-swan event that might trip up the bull market in stocks. I observed that white swans typically outnumber black ones over time. We all agreed that one possible perverse black swan might be a melt-up that leads to a meltdown. Investors increasingly are either irritated or bored with the daily swamp opera in DC, and mostly tuning it out. There usually aren't any swans of any color in swamps, just too many swamp people and alligators. Investors aren't betting the farm on Trump's economic agenda. If a significantly downsized version is eventually enacted, that's okay. If nothing changes, so be it. There's plenty to keep the bull charging ahead.

Investors seem to be coming around to our long-held view that this economic expansion could last for a very long time. In other words, they are considering the possibility that the biggest surprise might be how long the current bull market lasts. In this scenario, both inflation and interest rates would remain surprisingly low for a surprisingly long time. Valuation multiples might stay high for a long time too. Again, historically speaking, white swans tend to outnumber black swans.

Debbie and I have been arguing that the Trauma of 2008 reduced the likelihood of a boom-bust scenario for the economy as both consumers and businesses remained relatively cautious and conservative in their spending and borrowing activities. Among the most telling confirmations of our hypothesis is that wage inflation, as measured by the yearly growth rate in average hourly earnings, remains around 2.5%. In the past, the current record number of job openings and the cyclical low in consumers reporting that jobs are hard to get was associated with wage inflation of 3.0%-4.0% or higher (*Fig. 1* and *Fig. 2*). This is consistent with our NBx2 scenario, i.e., No Boom, No Bust.

About two and a half years ago, back on October 27, 2014, Debbie and I first discussed the possibility that the current economic expansion might last until March 2019. That was based on a simple benchmark model of the business cycle. We noted that during the previous five business cycles, the recovery periods lasted 26 months on average, measured from the trough of the Index of Coincident Economic Indicators back to the previous cyclical peak (*Fig. 3*). The remaining expansion phases lasted 65 months on average after the recovery phase. That would put the next cyclical peak during March 2019.

Traditional business-cycle economists have been expecting tighter labor market conditions to boost wages, which would lift price inflation. This is based on the classic demand-pull and cost-push models of inflation, including the Output Gap and Phillips Curve. These inflation models don't recognize the possibility that there may be powerful secular forces keeping a lid on price inflation, which keeps a lid on wage demands even in a tight labor market. These forces include competition resulting from globalization, inherently deflationary technological innovations, and demographic drag from aging populations. The proof is in the numbers: Since the mid-1990s when the three forces started to kick in, price inflation remained below, and tended to act as an anchor for, wage inflation, which has been much more sensitive to the business cycle (*Fig. 4*).

Strategy II: Are Bonds Bearish? In my meetings last week, one of the concerns we discussed was the drop in the US Treasury 10-year bond yield from a recent high of 2.62% on March 13 to last week's low of 2.14% on Tuesday (*Fig. 5*). That's the lowest since November 9, the day after Election Day. A related concern was frequently expressed about the flattening of the yield curve from a recent high of 213 bps on December 14 to last week's low of 123 bps on Tuesday (*Fig. 6*). That's the narrowest since October 3. Both suggest a much weaker assessment of economic growth than in the weeks following Election Day. On a short-term basis, both are responding to the plunge in the Citigroup Economic Surprise Index from a recent peak of 57.9 on March 15 to Friday's reading of -43.4, near last Monday's -44.7, which was the lowest since February 18, 2016 (*Fig. 7*).

According to the Bond Vigilante Model, the 10-year bond yield is the fixed-income market's assessment of the current growth rate in nominal GDP on a y/y basis (*Fig. 8*). The former is currently about half as much as the latter, which was 4.1% during Q1 of this year. There are alternative possible explanations for the drop in the bond yield other than the bond market predicting a significant drop in already weak economic growth. Consider the following:

(1) *Falling inflationary expectations.* It may be that some investors see much more risk in stocks, given their historically high valuations, than in bonds. However, bonds certainly don't look cheap, unless bond investors are reassessing the long-term outlook for inflation. As noted above, competition, technology, and demography are powerful secular forces subduing inflation. Sure enough, expected inflation, as embedded in the yield spread between the US Treasury 10-year bond and its comparable TIPS, dropped from a recent high of 2.08% on January 27 to 1.78% at the end of last week (*Fig. 9*).

(2) *Near-zero yields abroad.* Of course, the US bond yield, at 2.21%, still looks awfully attractive compared to the 10-year government bond yield in Germany at 0.26% and Japan at 0.07% (*Fig. 10*). Last Thursday, the ECB dropped its downside risk warning for economic growth, saying the risks were now "broadly balanced." It also dropped its guidance that interest rates might be cut again, while scaling back its inflation forecasts for the next two years. Nevertheless, ECB President Mario Draghi remained very dovish, saying that the ECB will continue its quantitative easing program of bond-buying for the foreseeable future and adding that it "will be in the market for a long time."

The Fed ended its QE program at the end of October 2014. Since then, it has rolled over its maturing securities so that the Fed's assets have remained around $4.4 trillion since then (*Fig. 11*). Meanwhile, over the same period, the ECB has increased its assets by $2.0 trillion to $4.6 trillion, while the BOJ's assets are up $1.8 trillion to $4.5 trillion. So the total of the three major central banks is up $3.8 trillion since October 2014 to a record $13.5 trillion (*Fig. 12*).

Last Thursday, BOJ Governor Haruhiko Kuroda said, "While the policy approach has steered Japan's economy in the right direction, our intellectual journey has not yet been completed. The rate of change in the consumer price index recently has been around 0 percent and there is still a long way to go until the price stability target of 2 percent is achieved." Now in the fifth year of its unprecedented quantitative easing, the BOJ has expanded its balance sheet to nearly the same size as Japan's economy.

(3) *Fed's balance sheet.* In Boston last week, I was asked a couple of times about when the Fed might start to reduce its balance sheet. It seems to me that in normalizing monetary policy, Fed officials are probably most interested in raising the federal funds rate back closer to 2.00%. It is currently 0.88%. If so, then they are likely to signal that they are in no hurry to reduce their balance sheet since that might make it tougher to raise rates. Melissa and I will be paying close attention, along with everyone else, to the Fed's communication on this subject following the FOMC meeting on Wednesday, June 14.

We do expect a quarter-point rate hike at this meeting. While it is true that payroll employment has been surprisingly weak in recent months (averaging just 162,000 per month from March-May), that may be because the economy is at full employment. In other words, employment is weak because we've run out of warm bodies to hire rather than because of weak demand for workers.

Perhaps the best way to think about full employment is this: Full employment occurs when the number of job openings equals the number of unemployed workers. During April, the former was a record 6.0 million during April, while the latter was 7.1 million. The ratio of unemployed workers to job openings was 1.17, the lowest since January 2001. April's unemployment rate of 4.4%, therefore, mostly reflected so-called "frictional" unemployment caused primarily by geographic and skills mismatches. Besides, the financial markets were very calm about the rate hike earlier this year. Fed officials would be foolish to let this opportunity to normalize some more slip by.

The bottom line is that the US Treasury bond yield mostly remained in our 2.00%-2.50% range during the first half of 2017. We still expect a range of 2.50%-3.00% during the second half of the year. That's because we expect that the Fed remains committed to gradually raising the federal funds rate.

Strategy III: Quarterly Valuation Ratios. The Fed updated its *Financial Accounts of the United States* publication last week with Q1-2017 data. It shows that the value of all equities in the US rose to a record $40.8 trillion (*Fig. 13*). That's up a whopping $27.4 trillion since the bear market low during Q1-2009. The Q1-2017 total includes $33.1 trillion in US equities and $7.7 trillion in foreign issues. US residents held 18.7% of their equity portfolios in foreign stocks during the first quarter (*Fig. 14*). By the way, the S&P 500 rose to a record-high market capitalization of $20.7 trillion at the end of May, up $13.8 trillion since March 2009. Now consider the following valuation metrics:

(1) *The Buffett Ratio*, which divides the market cap of all stocks less foreign ones by nominal GNP, rose to 1.72 during Q1-2017 (*Fig. 15*). That's the highest since Q1-2000, and is fast approaching that quarter's record high of 1.80. Meanwhile, the comparable ratio for the S&P 500 using the market cap of the index divided by its aggregate revenues rose to 2.00 during Q1-2017, matching its record high during Q4-1999.

(2) *The Laffer Ratio* is similar to the Buffett Ratio but uses after-tax corporate profits from current production in GNP rather than GNP (*Fig. 16*). It edged up to 21.1 during Q1-2017. That's the highest since Q4-2015, but well below its record high of 36.5 during Q1-2000. (For more on Laffer's valuation measure, see Jon Laing's 1/5/2004 *Barron's* article titled "Altitude Adjustment.")

(3) *The Tobin Ratio* is also relatively subdued on the valuation question (*Fig. 17*). It is the ratio of the market value of equities to the net worth of corporations, including real estate and structures at market value and equipment, intellectual property products, and inventories at replacement cost. It edged up to 1.04 during Q1-2017, still well below the record high of 1.61 during Q1-2000.

(4) *The forward P/S* is available weekly and is highly correlated with the Buffett Ratio (*Fig. 18*). This is the forward price-to-sales ratio of the S&P 500. It was awfully high at 1.93 at the start of June.

The bottom line is that stocks are extremely overvalued based on the Buffett Ratio. The same can be said of stocks using both the S&P 500 market-cap-to-revenues ratio and the forward price-to-sales ratio. On the other hand, stocks seem somewhat more reasonably priced using the Laffer Ratio and Tobin Ratio.

In our opinion, the longer that the current expansion continues with inflation and interest rates remaining subdued, the more bullish it is for stocks.

CALENDARS

US. Mon: None. **Tues:** NFIB Small Business Optimism Index 104.0, Headline & Core PPI-FD 0.1%/0.2%, FOMC Meeting Begins, Dudley. (Bloomberg estimates)

Global. Mon: Japan Machine Tool Orders. **Tues:** Germany ZEW Economic Sentiment 21.8, UK Headline & Core CPI 2.7%/2.3% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index fell 0.40% last week, ranking 24th of the 49 markets as 17 rose in US dollar terms—compared to 20th a week earlier, when it rose 1.0% as 35 markets moved higher. The AC World ex-US index trailed the US MSCI, falling 0.7% compared to a 1.1% gain a week earlier. EM Asia was the best-performing region last week, with a gain of 0.8%, followed by BRIC (0.6%), EM Latin America (-0.4), and EM Eastern Europe (-0.6). EAFE was the week's worst-performing region, with a decline of 1.2%, followed by EMEA (-1.0) and EMU (-0.9). Peru (3.7) was the best-performing country, followed by Pakistan (2.1) and Austria (1.9). Argentina (-2.9) was the worst performer, followed by Greece (-2.7), Switzerland (-2.7), and South Africa (-2.4). The US MSCI is up 8.8% ytd, with its ranking edging down w/w to 36/49 from 35/49, and it continues to trail the AC World ex-US (12.9) on a ytd basis. Forty-six of the 49 markets are positive ytd, led by Argentina (45.5), Poland (33.4), Austria (31.5), Korea (29.5), Turkey (26.4), and Spain (26.2). The worst country performers ytd: Russia (-12.3), Pakistan (-3.7), Morocco (0.0), Jordan (0.3), and Canada (0.7). EM Asia is the best-performing region ytd with a gain of 22.8%, ahead of EMU (17.3) and BRIC (17.0). The worst-performing regions: EM Eastern Europe (-1.5), EMEA (1.9), EM Latin America (8.3), and EAFE (12.4).

S&P 1500/500/400/600 Performance (*link*): LargeCap underperformed for a second straight week as it fell 0.3%, behind SmallCap's 1.4% gain and MidCap's 0.4% rise. Twenty of the 33 sectors rose, down from 29 rising a week earlier. LargeCap ended the week 0.3% below its record high on June 2, MidCap was less than 0.1% below its March 1 record, and SmallCap closed at a record high on Friday for the first time since April 26. Financials dominated last week's top gainers: SmallCap Financials (5.2%), MidCap Financials (3.7), LargeCap Financials (3.6), SmallCap Materials (2.9), and LargeCap Energy (2.1). Last week's worst performers: MidCap Telecom (-3.7), LargeCap Tech (-2.2), LargeCap Consumer Discretionary (-2.0), and MidCap Tech (-1.7). Twenty-four of the 33 sectors are positive ytd, with LargeCap (8.6) beating MidCap (5.8) and both easily ahead of SmallCap (3.1). The biggest sector gainers ytd: MidCap Health Care (19.7), LargeCap Tech (18.5), SmallCap Health Care (15.9), MidCap Tech (13.8), and LargeCap Health Care (12.2). Energy and Telecom dominate the worst performers ytd: SmallCap Energy (-33.9), MidCap Telecom (-30.4), MidCap Energy (-28.2), LargeCap Energy (-12.3), and LargeCap Telecom (-9.4).

S&P 500 Sectors and Industries Performance (*link*): Five of the 11 sectors rose last week, and five outperformed the S&P 500's 0.3% decline. This compares to nine sectors rising a week earlier, when eight outperformed the S&P 500's 1.0% gain. Financials' 3.6% gain made it the best-performing sector for the first time in 14 weeks—and was followed by Energy (2.1%), Materials (1.4), Telecom (0.2), and Health Care (0.1). Tech's 2.2% decline made it the worst-performing sector for the first time in 23 weeks, and was followed by Consumer Discretionary (-2.0), Utilities (-1.2), Consumer Staples (-1.1), Industrials (-0.5), and Real Estate (-0.3). So far in 2017, nine of the 11 sectors are higher, and six have outperformed the S&P 500's 8.6% gain. The best performers in 2017 to date: Tech (18.5), Health Care (12.2), Consumer Discretionary (10.9), Utilities (9.7), Materials (9.5), and Consumer Staples (9.3). The five sectors underperforming the S&P 500: Energy (-12.3), Telecom (-9.4), Financials (4.1), Real Estate (4.1), and Industrials (7.8).

Commodities Performance (*link*): Twelve of the 24 commodities we follow rose last week, up from seven rising a week earlier. Food-related commodities dominated the week's best performers: Kansas Wheat (6.7%), Wheat (5.8), Corn (5.3), Sugar (4.7), and Soybeans (2.6). Last week's laggards: Unleaded Gasoline (-5.1), Cotton (-3.8), Crude Oil (-3.5), Heating Oil (-3.3), and Brent Crude (-3.1). The best performers in 2017 so far: Lean Hogs (24.4), Feeder Cattle (23.2), Aluminum (12.6), Corn (11.5), and Wheat (11.3). The energy-related commodities are no longer dominating this year's laggards: Sugar (-26.2), Natural Gas (-17.9), Heating Oil (-16.9), GasOil (-15.1), and Brent Crude (-14.1).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 10/24 commodities, 2/9 global stock indexes, and 17/33 US stock indexes compared to 5/24, 5/9, and 29/33 rising a week earlier, respectively. Ten commodities trade above their 200-dmas, down from 11 a week earlier as Unleaded Gasoline turned negative w/w. Commodities' average spread remained steady w/w at -0.8%. Among assets, Commodities walked away the top spot last week: Lean Hogs leads all commodities and all assets at 28.0% above its 200-dma, followed by Feeder Cattle (18.1%). Kansas Wheat (7.2) performed the best of all commodities and all assets last week as it improved 6.4ppts. Sugar (-25.3) trades the lowest of all commodities and all assets, but Unleaded Gasoline (-3.8) tumbled 5.5ppts last week for the worst performance of all commodities and all assets. The global indexes trade at an average of 6.4% above their 200-dmas, down from 6.9% above in the prior week. Eight of the nine global indexes trade above their 200-dmas, unchanged from a week earlier. South Korea (13.4) leads the global indexes, but China (5.3) was the group's best performer last week with a 2.5ppts advance. Brazil (-1.1) is trading at the lowest relative to its 200-dma of the global assets, but Chile (10.1) had the weakest performance of its country peers last week, falling 1.7ppts. The US indexes trade at an average of 3.4% above their 200-dmas, with 27 of the 33 sectors above, up from a 3.3% average a week earlier, when 28 sectors were above. MidCap Consumer Staples (-0.5) turned negative w/w. The US stock indexes no longer dominate the top ten assets trading above their 200-dmas as they did in early March. MidCap Health Care now leads all US stock indexes at 14.2% above its 200-dma, followed by LargeCap Tech (11.9) which fell 3.2ppts for the worst performance among US stock indexes. SmallCap Financials (6.1) rose 5.0ppts w/w for the biggest improvement among US stock indexes. SmallCap Energy trades 24.0% below its 200-dma, the lowest among the US stock indexes and followed closely by MidCap Telecom (-23.6).

S&P 500 Technical Indicators (*link*): The S&P 500 index remained in a Golden Cross last week for a 59th week (after 17 weeks in a Death Cross). The index's 50-day moving average (50-dma) relative to its 200-dma improved marginally for a second week after falling for nine straight weeks, but was steady at 4.7% above its 200-dma. That's down from a 34-month high of 5.4% in early April and compares to a six-month low of 2.0% in early December and a 52-month low of -4.5% in March 2016. The S&P 500's 50-dma moved higher for a 31st week as the index closed above its 50-dma for a seventh week, after trading below for two weeks for the first time since the November election. The S&P 500 dropped to 1.9% above its rising 50-dma from an 11-week high of 2.5% a week earlier, but is up from a 23-week low of -1.0% in mid-April; these readings are down from a 38-week high of 4.8% above the index's rising 50-dma on December 13 and compare to a 52-month high of 6.2% in March 2016. The S&P 500 dropped to 6.7% above its rising 200-dma last week from an 11-week high of 7.4% a week earlier. That's up from mid-April's 19-week low of 4.2%, but down from a 38-month high of 9.4% on March 1. The 50-dma and 200-dma both rose together for a 28th week.

S&P 500 Sectors Technical Indicators (*link*): Only four of the 11 sectors improved w/w relative to their 50-dmas and 200-dmas: Energy, Financials, Materials, and Telecom. Nine of the 11 sectors trade above their 50-day moving averages (50-dmas), up from eight a week earlier, as Financials rose above again. Energy remained below for a 21st straight week and Telecom for a 12th week. Still, that's up from just three in mid-April, which was the lowest since the election. All 11 sectors had been above their 50-dmas during mid-January, and all 11 were below levels the week before the election, for the first time since December 11, 2015. Nine of the 11 sectors were above their 200-dmas last week, unchanged from a week earlier, as Energy remained below its 200-dma for a 16th week and Telecom for a 12th. Nine sectors are in a Golden Cross, with 50-dmas higher than their 200-dmas, unchanged from a week earlier and leaving Energy and Telecom still out of the club. All 11 had been in a Golden Cross during a 21-week streak that ended October 24, the longest such stretch since October 2014. Nine of the 11 sectors have rising 50-dmas, up from eight a week earlier, as Financials' 50-dma rose for the first time in 10 weeks; Energy's dropped for an 18th week, and Telecom's fell for a 17th. Eight sectors have rising 200-dmas, unchanged from a week earlier. These three sectors continued their 200-dma downtrends: Real Estate's fell for a 14th week, Telecom's for a 12th, and Energy's for an eighth.

GLOBAL ECONOMIC INDICATORS

Eurozone GDP (*link*): Real GDP in the Eurozone reached a new record high last quarter, expanding 2.3% (saar)—the fastest pace in two years—accelerating steadily from Q2-2016's 1.4%. From the expenditure side, real gross fixed capital investment was once again the largest contributor to GDP growth, expanding a robust 5.3% (saar) after soaring 14.3% during the final quarter of 2016. Household spending advanced 1.4% (saar) during Q1, the weakest rate since Q2-2014, though in line with the prior three quarters, which all recorded gains just below 2.0%. Meanwhile, real government spending (1.4%, saar) was the strongest in a year, though remained subdued. Trade once again was a drag on growth, as exports (4.8) grew at a slower pace than imports (5.3). Of the four largest economies, only Spain (3.3%, saar) exceeded the Eurozone's Q1 pace, while Germany's (2.4) virtually matched it, while France (1.8) and Italy's (1.8) were below. Of the four, only France showed a slowing in growth from Q4.

Germany Industrial Production (*link*): Industrial production was on a tear the first four months of 2017, jumping to a new record high. April's headline production, which includes construction, expanded sharply in three of the first four months of 2017, jumping 0.8% in April and 3.9% ytd. Excluding construction (which is how other Eurozone economies report output), production rose 1.0% and 3.3% over the comparable periods. Factory output grew for the fourth straight month by 0.4% m/m and 3.3% over the period. Available May data bode well for production up ahead. Germany's M-PMI resumed its upward trajectory in May, rising for the fifth time in six months to 58.2, signaling the strongest overall improvement in manufacturing business conditions in Germany since April 2011. The upward movement in the M-PMI reflected stronger growth rates for output, new orders, and employment, as well as a more substantial lengthening of suppliers' delivery times. German businesses confidence was the highest on record, according to Ifo, which has tracked the data since 1991; manufacturers' confidence reached a new cyclical high last month.

France Industrial Production (*link*): Industrial production in April contracted, continuing its up-and-down pattern so far this year. Headline production, which excludes construction, sank 0.5% after a 2.2% gain and a 1.7% loss the previous two months. So far this year, output is basically flat, eking out a 0.2% advance. Factory output fell for the fourth time in five months, dropping 1.2% in April and 1.1% over the period, as a 2.8% jump in March output helped to offset some of the losses in prior months. Over the five-month period, only consumer durable goods output (5.1%) was in the black; capital (-1.7), intermediate (-1.2), and consumer nondurable (-0.4) goods production all fell. Meanwhile, France's M-PMI remained in expansionary territory for the eighth straight month, edging down from April's cyclical high of 55.1 to 53.8 last month.

UK Industrial Production (*link*): UK industrial output in April increased for the first time this year. It edged up 0.2% after a three-month slide of 1.8%, with manufacturing up 0.2% and down 2.2% over the comparable periods. April's increase was led by the first gains in intermediate (0.8%) and consumer (0.5) goods production this year, with the latter's reflecting a 0.7% advance in nondurable goods output. Output of capital goods contracted 0.2% after a 1.3% loss in March. Energy output edged up 0.2% after a two-month drop of 3.5%. May's M-PMI (56.7) remained near three-year highs as factory orders and production expanded at above-survey-average rates, and job creation was the best in 35 months.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823