Yardeni Research, Inc.

MORNING BRIEFING
June 29, 2017

The Third Mandate

Happy Fourth of July! We will be back on July 6.

See the collection of the individual charts linked below.

(1) Fed officials need our attention. (2) Four rate hikes later, no tightening tantrum. (3) Stock and bond investors responding to Fed with benign neglect. (4) Bond yield, yield curve, and expected inflation all telling Fed "no mas." (5) Fed should fear that halting rate hikes will send stocks to the moon. (6) Melt-ups are not conducive to financial stability. (7) Williams, Fischer, Yellen all weigh in on the subject. (8) The Fed's "great unwinding" is winding down the road. (9) Furniture sales on flying carpet.

Strategy I: Benign Neglect. Like most of us, Fed officials don't like to be ignored. A few of them crave attention. That's why Fed officials love giving speeches and appearing on CNBC. However, over the past year or so, investors have moved on. They seem to have lost their interest in the Fed. That was not the case at the beginning of 2016 when two Fed officials—namely, Fed Vice Chairman Stanley Fischer and FRB-SF President John Williams—warned investors that four rate hikes were likely over the rest of the year. They were hammering home the message of the December 15-16, 2015 meeting of the FOMC, when the committee hiked the federal funds rate for the first time during the current expansion and released a dot plot indicating four rate hikes in 2016.

The S&P 500 plunged 13.3% early last year from its high on November 3, 2015 to a low of 1829.08 on February 11, 2016 (*Fig. 1*). The two Fed officials realized that they were getting too much attention and backed off, toning down their market-rattling rhetoric in subsequent clarifications of what they really meant. The 25bps rate hike at the end of 2015 to 0.25%-0.50% was followed by another "one-and-done" hike in 2016 to 0.50%-0.75% at the end of 2016, a third hike on March 15 this year to 0.75%-1.00%, and a fourth to 1.00%-1.25% on June 14.

However, there were no tightening tantrums in the financial markets. Investors simply lost interest in the Fed and adopted an attitude of benign neglect, much to the consternation of attention-needy Fed officials. Consider the following:

(1) *Stocks.* The stock market mostly ignored all those hikes, proceeding to melt up from last year's low by 34.1% to a record high of 2543.46 on June 19. Yesterday, It closed only 1.4% below that level on Tuesday. The forward P/Es of the S&P 500/400/600 rose from 14.8, 14.8, and 15.2 in early on February 2016 to 17.4, 18.0, and 19.2 on Tuesday (*Fig. 2*).

The Buffett ratio, which is the market value of US stocks traded in the US divided by GNP, rose to 1.72 during Q1, nearing its record high of 1.80 during Q1-2000 (*Fig. 3*). The similar ratio of the S&P 500 market capitalization divided by the composite's revenues rose to 2.00 during Q1, matching the previous record high. A comparable weekly measure using the S&P 500 stock price index divided by forward revenues per share rose to a record 1.95 during the week of June 22 (*Fig. 4*).

(2) *Bonds.* Initially, the reaction in the bond market to the Fed's rate hikes was also extremely benign

(*Fig. 5*). The US Treasury 10-year bond yield plunged 93 bps from 2.30% on December 16, 2015 to a record low of 1.37% on July 8 of last year. The yield curve spread narrowed from 215 bps to 97 bps over this period (*Fig. 6*). Last year's lows in both were made on July 8, a few days after the Brexit vote. Yields fell and the yield curve narrowed during the first half of last year because the economy looked weak according to the Citigroup Economic Surprise Index (CESI) (*Fig. 7*). In addition, inflationary expectations over the next 10 years remained subdued around 1.5% (*Fig. 8*).

From last year's low, the bond yield jumped to this year's high (so far) of 2.62% on March 13. The yield curve spread widened to 196 bps on the same day. The Brexit vote didn't precipitate a financial crisis as was feared by many. The CESI rebounded smartly from last summer's low of -25.4 to peak at 57.3 on March 15 of this year as the economy recovered from the energy industry's rolling recession. Of course, much of the surge in the bond yield and the yield curve spread occurred after Election Day when Donald Trump's ambitious and stimulative agenda of tax cuts and infrastructure spending suddenly looked possible. Animal spirits soared according to surveys of consumer and business confidence. So did stock prices.

However, the CESI, which peaked on March 15 at 57.9 proceeded to plunge to the most recent low of -78.6 on June 16. The 10-year yield was down to 2.21% on Tuesday, and the yield curve spread was 105, near Monday's 98, which was the narrowest since right after the Brexit vote! Expected inflation over the next 10 years was 1.73% yesterday, down from the recent peak of 2.08%.

(3) *Currencies & commodities.* The currency markets have also mostly ignored the Fed. Despite the March and June rate hikes, the JP Morgan trade-weighted dollar peaked on January 6, and fell 17% through yesterday (*Fig. 9*). The FOMC's latest Summary of Economic Projections shows that the Committee is aiming to raise the federal funds rate maybe three to four more times to achieve the median projection of 2.1% by the end of next year. Yet the dollar remains weak. Usually, a weak dollar should be bullish for commodities. Instead, the price of a barrel of Brent crude oil has fallen from a recent high of $57.10 to $47.23 yesterday (*Fig. 10*). Over this same period, the CRB raw industrials spot price index has stalled after rising smartly since late 2015.

Strategy II: Fed Raid. Fed officials may be coming around to believe that further rate hikes may be a mistake given the weakness in the CESI, the drop in bond yields, the flattening of the yield curve, and the decline in expected inflation. However, they may be increasingly concerned that if they signal a halt to rate hikes, stock prices might continue to melt up. Their congressional mandate is to aim for full employment with price stability. Their third, though unofficial, mandate is to maintain financial stability. This would explain the recent spate of comments by Fed officials on this subject. They are clearly trying to get our attention. Consider the following:

(1) *Williams*. "The stock market seems to be running pretty much on fumes," FRB-SF President John Williams said in an interview in Sydney, as Reuters discussed on Tuesday. "It's something that clearly is a risk to the U.S. economy, some correction there—it's something we have to be prepared for to respond to if it does happen," he said. On the one hand, the bank president said that he is concerned about the "complacency in the market," citing low measures of market volatility. On the other hand, Williams doesn't foresee a major crash coming because the market is underpinned by a fundamentally sound US economy, in his opinion.

For Williams, the bottom line seems to be that the course of reducing monetary stimulus will continue to be slow and steady. That would be in keeping with his concerns about the market and remarks he made in a speech in Sydney on Tuesday that the US economic expansion will be sustained, but slow. During his speech, Williams focused on long-term demographic drivers weighing on growth, productivity, and inflation. Prior to his speech, Williams told reporters that just three rate hikes this year and three to four hikes next year would be fine. Williams gets to participate in FOMC meetings this year, but he doesn't get a vote.

(2) *Fischer*. FRB Vice Chairman Stanley Fischer has more weight than Williams because he gets a permanent vote on the Committee given his position on the Fed's Board of Governors. Fischer too warned against market complacency in a 6/27 speech. Fischer's broad assessment is that leverage and liquidity risk in the financial markets is "relatively low." However, Fischer seemed to be most worried about the market's nonplussed attitude toward perceived risks inherent in elevated asset valuations.

Fischer concluded: "Prices of risky assets have increased in most major asset markets in recent months even as risk-free rates also rose. In equity markets, price-to-earnings ratios now stand in the top quintiles of their historical distributions, while corporate bond spreads are near their post-crisis lows. Prices of commercial real estate (CRE) have grown faster than rents for some time … The general rise in valuation pressures may be partly explained by a generally brighter economic outlook, but there are signs that risk appetite increased as well. For example, estimates of equity and bond risk premiums are at the lower end of their historical distributions, and, relative to some non-price-based measures of uncertainty, the implied volatility index VIX is particularly subdued."

For what it's worth, as of April, Fischer seemed to be in the three-rate-hikes-this-year camp along with Williams. During mid-June, Fischer spoke about his concerns over assets prices, specifically global housing, but made no mention of the path of rate hikes. Fischer's most recent speech didn't mention his thoughts on the course of rate hikes either.

(3) *Yellen.* Of course, Fed Chair Janet Yellen carries the most weight in the FOMC. Like Fischer, she too spoke on Tuesday, describing asset valuations as "somewhat rich if you use some traditional metrics like price earnings ratios," according to Bloomberg. She said so when answering audience questions at an event in London. The good news is that she doesn't foresee another financial crisis "in our lifetime," reported CNBC. She is a bit older than me, but much older than Melissa.

Fed: The Great Unwinding. Besides rates, several Fed officials have taken a position on what Melissa and I have referred to as the inevitable "great unwinding" of the Fed's $ 4.4 trillion in assets on the balance sheet. Last month, for example, Williams indicated that the balance sheet will be "much smaller" in about five years than it is today. Tempering the possibility of a repeat 2013 "taper tantrum" when global markets panicked at the mere mention of a possible tapering of asset purchases, Williams said that the Fed will start with a "baby step" likely later this year and be quite "boring" and in the "background."

FRB-SL Fed President James Bullard, not a voter this year, also said that he has been an advocate for getting started on balance-sheet reduction, in a 6/22 interview with the *WSJ*. "We're going to do it in a very controlled and passive way that I think will be easy for markets to digest, and so I'm not expecting anything too dramatic. But I think it is important to create some policy space for the future," he said.

Melissa and I think that the Fed will probably commence the great unwinding this year, or at least outline a plan for doing so. That insight is based not only on recent comments from Fed officials, but also the latest Statement on Monetary Policy. Depending on the Fed's approach to the great unwinding, the pace of rate hikes could slow even further, because the Fed will want to avoid a "great unravelling" of markets should the great unwinding unnerve otherwise complacent investors.

Consumer Discretionary I: Furniture Is Flying. Overlooked amid all the gloom and doom in retail is the boom going on in the home furnishings category. It reflects positive trends in housing and the economy, in general, and parallels the favorable fundamentals of the home improvement category. And so far, home furnishings has continued to defy even the Great Disruptor that is Amazon. Fundamentals are expected to stay strong for the industry for the foreseeable future on expectations for higher household formations, increasing home sales, and continued low unemployment. Consider the following:

(1) *Sales.* US furniture and home furnishings sales have risen every year since 2010 (*Fig. 11*). During April, they totaled a record $193 billion (saar), with furniture at $110 billion and furnishings at $83 billion. The inflation-adjusted total rose to a record $1,965 (saar) on a per household basis, doubling since November 1999 (*Fig. 12*).

(2) *Orders.* New orders in the home furnishings market have been strengthening since August 2016, and a recent survey by accounting and consulting firm Smith Leonard shows that new orders in March were up by 12% y/y, a significant advance from February's 4% y/y gain.

(3) *Online.* While online furniture sales—from the likes of Wayfair (W) and Amazon (AMZN) and Williams-Sonoma's (WSM) West Elm units—still represents only about 10% of total U.S. furniture sales, it's a swiftly growing segment.

A 5/12 *WSJ* article quoted a CEO whose trucking company makes large e-commerce deliveries saying "Just in the last year, furniture has taken off." Furniture is his company's number-one business-to-consumer shipment item, recently usurping TVs.

(4) *Hot stuff*. What's flying off stores' floors? Demand for sofas and bedding is high, in particular, while outdoor furniture and vintage furniture are also popular. The vintage trend is new and noteworthy: Vintage Ikea furniture is fetching big bucks at auctions, and virtually all furniture websites now feature a vintage selection.

(5) *Amazing Amazon*. Amazon has been turning more attention to its online furniture business. "Furniture is one of the fastest-growing retail categories here at Amazon," furniture general manager Veenu Taneja told the *WSJ* in the article cited above. He said the company is expanding its furniture-related offerings, adding custom-furniture design services as well as Ashley Furniture sofas to its lineup. Amazon also has been speeding up delivery to one or two days in some cities.

One well-known furniture retailer has decided that joining forces with Amazon is a better strategy than trying to beat the world's biggest retailer at its own game: Ethan Allen Interiors (ETH) announced in April that it will launch the Ethan Allen Design Studio on Amazon to sell its furniture.

(6) *Good performance*. The strong showing hasn't gone completely unnoticed by investors: Through Tuesday's close, the S&P 500 Home Furnishings industry, representing manufacturers, is up 16.9% ytd and 26.9% y/y. That's in line with the performance of the S&P 500 Home Improvement Retail industry (home- and garden-related stores), up 11.8% ytd and 15.4% y/y. In contrast, the S&P 500 Homefurnishing Retail industry (which has home furnishing retailer Bed Bath & Beyond as its sole member) hasn't fared as well: It's down 24.4% ytd and 26.6% y/y.

Consumer Discretionary II: Lots of Shoppers. News from many of the publicly traded furniture retailers bears out the positive top-down trends. To furnish some details:

(1) *Big Lots* (BIG) posted record earnings in its Q1, its sixth straight quarter of positive earnings, and gave an upbeat forecast for the year. It has been expanding its furniture offerings this summer. Company executives recently said that customers are buying higher-quality and higher-priced goods in

bed and bath, and the store is selling out items at prices that are higher than it ever carried before, e.g., a $1,000 patio set. As a result, Big Lots is expanding certain departments, including furniture. A newly remodeled Columbus, OH store will feature a new "Store of the Future" format emphasizing its strongest categories—furniture, soft home goods, and décor.

(2) *Bassett Furniture* (BSET) saw Q1 sales rise 4% y/y, on the strength of products made domestically. Domestically made or finished and assembled products represented 71% of its wholesale shipments. US-made furniture is increasingly perceived as better made and available for faster delivery, a critical feature in an increasingly Amazon Prime-driven one-day shipping world.

(3) *TJX Companies* (TJX)—parent of off-price retailers TJ MAXX and Marshall's and one of the few retailers to navigate successfully the wrenching changes in retail—plans to expand its Home Goods chain and launch a related concept called "HomeSense," which already operates in Canada and Europe but will have a different format in the US.

(4) *RH* (RH), formerly known as "Restoration Hardware," is pursuing an "un-Amazonable" strategy and totally redefining its approach to selling furniture. While it posted a 23% Q1 revenue gain, its stock plunged recently on the negative earnings impact from liquidating merchandise and adding restaurants to some of its stores.

(5) *Bed Bath & Beyond* (BBBY), one of the retailers included in Bespoke Investment Group's "Death by Amazon" index, bought online furniture seller One King's Lane last fall as a way to deflect the Amazon threat: The younger shoppers attracted to One King's Lane tend to shop less at Amazon. It plans to open a pop-up seasonal shop in Southampton, NY this summer, the first brick-and-mortar presence for One King's Lane, and in a former library no less. Take that, Amazon!

(6) *Wayfair* (W), the only pure-play online furniture seller, is benefiting doubly from both hot demand for furniture and the online channel's increasing popularity as a furniture outlet. Furniture is one of the fastest-growing segments of US online retail, growing 18% in 2015, second only to groceries, according to Barclays. Wayfair's direct retail revenues popped more than 32% in Q1. The S&P 500 Internet and Direct Marketing Retail industry has been a sweet spot, rising 45.9% y/y through Tuesday.

CALENDARS

US. Thurs: Real GDP, PCE, and GDP Price Deflator 1.2%/0.6%/2.2%, Jobless Claims 241k, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Personal Income & Consumption 0.3%/0.1%, Headline & Core PCED 1.5%/1.5% y/y, Consumer Sentiment Index 94.5, Chicago PMI 58.2, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. Thurs: Germany CPI 0.0%m/m/1.4%y/y, Germany Gfk Consumer Confidence, Japan CPI Headline, Core, and Core-Core 0.5%/0.4%/0.1% y/y, Japan Jobless Rate 2.8%, Japan Industrial Production -3.0%m/m/6.8%y/y. **Fri:** Eurozone Headline & Core CPI 1.2%/1.0% y/y, Germany Unemployment Change & Unemployment Rate -10k/5.7%, Germany Retail Sales 0.3%m/m/2.8%y/y, UK GDP 0.2%q/q/2.0%y/y, Canada GDP 3.4% y/y, Japan Housing Starts 986k, China M-PMI 51.0. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) climbed to 2.95 this week after falling the prior two weeks from 3.05 to 2.65—which was near its low for the year of 2.60 recorded four weeks ago. (The BBR has been bouncing around 3.00 the past couple of months.)

Bullish sentiment climbed 4.9ppts the past two weeks to 54.9% after dropping 5.8ppts to 50.0% two weeks ago, which was near its low for the year of 49.5%. Bearish sentiment reversed last week's move up, falling to 18.6% from 19.4%, which was a high for this year. The correction count fell for the second month to 26.5% after rising from 25.9% to 31.4% two weeks ago, which was just a percentage point below its high for the year recorded in late March. The AAII Ratio edged up to 53.0 last week after slipping 54.5% to 52.3% the prior week. Bullish sentiment ticked up from 32.3% to 32.7%, while bearish sentiment fell from 29.5% to 28.9%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues rose 0.2% w/w to its first record high in three weeks, but forward earnings was at a record high for a 12th straight week. The forward profit margin forecast edged down slightly w/w, but remained at a record high of 11.0%. The profit margin's record high is its first since September 2015 and up from a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 was steady w/w to 5.3%, and is down from 5.8% in late January, which was the highest since May 2012 and compares to a cyclical low of 2.7% in February 2016. Forward earnings growth of 11.3% was steady near a five-month high, which is down from 11.7% in January; that was the highest since October 2011 and compares to a cyclical low of 4.8% in February 2016. S&P 500 forward revenues and forward earnings growth are enjoying a tailwind now due to easy y/y comparisons for Energy and improving prospects for Financials, but currency translation is likely to be a slight drag. However, Energy's contribution to forward growth peaked at the start of 2017. Looking at last week's results for the S&P 500 ex-Energy, the forward growth rates for revenues (4.6%) and earnings (9.1) are lower, but improving. The ex-Energy forward profit margin edged down 2/2 to 11.5% from a record high of 11.6%, which was its first since August 2007. Valuation edged down w/w to 17.7 from 17.8, which compares to a 13-year high of 18.0 in early March and a 15-month low of 14.9 in January 2016. Ex-Energy valuation was steady at a three-month high of 17.4, but is down from a 13-year high of 17.6 in early March.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 5/11 sectors, and forward earnings rose for 4/11 sectors. Materials and Tech were the only sectors that had both measures rise w/w. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy's forward revenues has slipped to a seven-month low now after stalling at a 15-month high since March, and its forward earnings is stalled at early June's 21-month high. The forward P/S and P/E ratios rose w/w for 4/11 sectors: Health Care, Real Estate, Tech, and Utilities. Health Care is surging recently; its P/E of 16.5 and P/S of 1.74 are at their highest levels since August 2015, but remain well below their early 2015 highs of 17.9 and 1.88, respectively. Financials' P/E is up from 12.0 before the election to 13.7, and is approaching the post-election high of 14.6 in early March. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.28 compares to a record high of 1.56 in May 2016, and its P/E of 24.5 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, but margins are expected to improve in 2017 for all but Real Estate and Utilities. However, Real Estate's forecasted margin should improve as the year progresses when gains on property sales are included in the forecasts. Here's how the 11 sectors rank based on their current 2017 forecasts: Information Technology (to 19.9% in 2017 from 19.2% in 2016), Real Estate (16.9, 25.2), Financials (15.5, 14.3), Telecom (11.3, 11.2), Utilities (10.9, 11.4), S&P 500 (10.6, 10.1), Health Care (10.4, 10.3), Materials (9.9, 9.4), Industrials (9.2, 8.9), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.7, 6.5), and Energy (4.4, 1.1).

US ECONOMIC INDICATORS

Pending Home Sales (*link*): The Pending Home Sales Index—measuring sales contracts for existing-home purchases—fell for the third month in May to 108.5, putting the index 1.7% below a year ago—the second consecutive y/y decline and the most recent since November and December of last year.

According to NAR's chief economist, "Monthly closings have recently been oscillating back and forth, but this third consecutive decline in contract activity implies a possible topping off in sales. Buyer interest is solid, but there is just not enough supply to satisfy demand." Prospective buyers are being sidelined by both limited choices and accelerating prices. None of the regions saw an increase in contract activity last month, and only sales in the Northeast (3.1% y/y) are above year-ago levels.

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