MORNING BRIEFING
October 18, 2017

Yellen Sees Rational Exuberance

See the collection of the individual charts linked below.

(1) Group of 30 gabfest. (2) Yellen says valuations are normal in New Normal. (3) Yellen channeling Greenspan on valuation question. (4) Back to the '90s: Long-term expected earnings growth estimates going up again led by Tech. (5) Trump's election seems to have boosted LTEG on expectations of deregulation and tax cuts. (6) Meet John Taylor, who might be next Fed chair. (7) Taylor says rules beat discretion, which is prone to chaos. (8) Rules may not rule without some discretion if Taylor rules. (9) For Fed watchers: Anybody but Taylor, please!

The Fed I: Yellen Reviving Fed's Stock Valuation Model. The world's major central bankers met on Sunday at the Group of 30 International Banking Seminar in Washington, DC. Fed Chair Janet Yellen spoke. Her prepared remarks were a rehash of her recent pronouncements. Nothing new here, so move along, folks. More interesting were her impromptu remarks as reported by the 10/15 *WSJ*: "While asset valuations today are 'high in historical terms,' that may reflect investors' expectations of a 'new normal' of lower interest rates for the foreseeable future than in the earlier decades, she said, adding that financial stability risks remain 'at a moderate level.'"

Could it be that Yellen is reviving the Fed's Stock Valuation Model? Sure seems that way. It all brings back lots of nostalgic memories for me:

(1) *Greenspan's question.* The valuation question isn't as existential as Hamlet's "To be or not to be" soliloquy. The question is: "How can we judge whether stocks are overvalued or undervalued?" I've been working on answering this question for many years. I started thinking more about it after Alan Greenspan, former chairman of the Federal Reserve Board, famously asked the valuation question near the end of a 12/5/96 speech, "The Challenge of Central Banking in a Democratic Society."

This was the first time any Fed chairman had ever mused publicly about the impact of monetary policy on the interaction of the inflation rate for goods and services and the valuation of equities. Notice that he asked a question rather than making a statement on valuation: "Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

(2) *Greenspan's answer.* After Greenspan famously worried out loud for the first time about irrational exuberance, his staff apparently examined various stock market valuation models to help him evaluate the extent of the market's exuberance. One such model was made public, albeit buried in the Fed's 7/22/97 *Monetary Policy Report* to the Congress that accompanied Greenspan's Humphrey–Hawkins testimony. It included a chart showing a strong correlation between the US Treasury 10-year bond yield and the S&P 500 forward earnings yield—i.e., the ratio of the year-ahead forward consensus expected operating earnings to the price index for the S&P 500 companies (*Fig. 1*). The monthly chart compared

the two series starting in 1982 and extending through July 1997.

This model was first developed in the mid-1980s by Dirk van Dijk at I/B/E/S, which had started compiling the forward earnings series on a monthly basis during September 1978. I first wrote about my discovery of the "Fed's Stock Valuation Model," as I dubbed it at the time, in my 8/25/97 commentary, a week after noticing it in the 7/22 report to Congress. In his testimony, as so often in the past, Greenspan played the role of a "two-handed economist." I pointed out, though, that he was clearly inclined to be bullish: "Without question, the exceptional economic situation reflects some temporary factors that have been restraining inflation rates. In addition, however, important pieces of information, while suggestive at this point, could be read as indicating basic improvements in the longer-term efficiencies of the economy."

(3) *Long-term earnings growth.* The Fed's Model showed that stocks were fairly valued at the end of 1996, but 17.8% overvalued during July 1997 (*Fig. 2*). By June 1999, stocks were 42.5% overvalued relative to bonds. Along the way, in a 9/5/97 speech at Stamford University, Greenspan explained: "And the equity market itself has been the subject of analysis as we attempt to assess the implications for financial and economic stability of the extraordinary rise in equity prices—a rise based apparently on continuing upward revisions in estimates of our corporations' already robust long-term earnings prospects."

The Fed II: LTEG All Over Again. While he never said so specifically and it wasn't a variable in the simple version of the Fed's Model, Greenspan obviously was tracking a data series collected by I/B/E/S on consensus annual long-term earnings growth (LTEG) for the S&P 500, because it is the only one available for such expectations (*Fig. 3*). The monthly data start in January 1985 and are based on industry analysts' annualized growth projections for the next three to five years. In July 1997, the consensus LTEG forecast was 13.5%, the highest recorded since the start of the data.

The LTEG series rose even higher during the next few years, peaking at a record 18.7% during August 2000. That was mostly because technology analysts in the late 1990s were under the influence of extreme irrational exuberance. Their LTEG expectations for the S&P 500 Information Technology sector soared to a record 28.7% during October 2000 (*Fig. 4*).

What's the latest with the valuation question that Yellen says isn't a problem? Consider the following:

(1) The Fed's Model has been signaling that stocks are cheap relative to bonds since 2003. Since the beginning of the current bull market, stocks have been relatively cheap by 50% or more.

(2) Greenspan suggested that the Fed's Model needs to account for LTEG. This measure of long-term expected earnings growth jumped from 9.6% during January 2016 to 13.7% during September for the S&P 500. That's the highest since May 2002. In a sign of déjà vu all over again, the S&P 500 Technology sector's LTEG is back up to 15.7%, the highest since June 2008.

(3) It seems that the election of President Donald Trump has boosted LTEG. Joe tracks the weekly data for the 11 sectors of the S&P 500. Here is where they are now during the first week of October versus the first week in November, just before the election: Energy (25.6% from 29.6%), Consumer Discretionary (20.1, 18.9), Information Technology (15.9, 14.4), S&P 500 (13.6, 12.5), Financials (13.2, 7.7), Real Estate (12.3, 13.4), Materials (12.0, 7.2), Industrials (11.2, 8.2), Health Care (10.3, 10.6), Consumer Staples (8.0, 8.5), Utilities (3.9, 4.1), and Telecommunication Services (2.5, 1.9) (*Fig. 5*).

This suggests that the run-up in stock prices since Trump's election reflects expectations that a more pro-business administration (compared to the previous one), by providing deregulation and corporate tax cuts, should boost earnings growth over the next three to five years.

The Fed III: Taylor's Rule? As Melissa and I noted yesterday, what Yellen says or thinks may be irrelevant if she is replaced by President Trump when her term as Fed chair expires on February 3, 2018. Monday's Bloomberg reported that the president "gushed" about Stanford University professor John Taylor after their one-hour meeting last week. The 10/12 *WSJ* included an article, "What You Need to Know About John Taylor." Here are some of the key excerpts:

(1) "Mr. Taylor is perhaps best known for his 'Taylor Rule,' first spelled out in 1993, that he says provides a mathematical formula to set the proper level of interest rates. The rule relies on the gap between actual inflation and output and their targeted levels as well as on the interest rates that would perfectly match the supply of and demand for credit."

(2) "During the long recovery from the financial crisis and the recession, the rule would have called for considerably higher interest rates than the Fed put in place. Fed officials say higher rates during that period would have harmed the economy. Mr. Taylor, though, has spent the past few years calling for higher interest rates. By some economists' estimates, his rule would currently prescribe the Fed's benchmark federal-funds rate to be 3.5%, well above its current range between 1% and 1.25%."

(3) "Mr. Taylor backs Mr. Trump's claim that he can raise annual U.S. economic growth to a sustained 3%. In an essay co-authored with Stanford colleagues Kevin Warsh and John Cogan as well as with Glenn Hubbard of Columbia University, Mr. Taylor argued that tax cuts, deregulation and government spending cuts could boost private sector investment and productivity."

Taylor spoke on Friday, October 13 at an economic conference hosted by the Federal Reserve Bank of Boston. The 10/15 *WSJ* provided a transcript. He reiterated that he believes that the Fed should adopt a rules-based approach to running monetary policy. In his opinion, the choice isn't rules vs. discretion, but rather versus "chaos."

He believes that the FRB/US econometric model used by the Fed is too complicated and favors a rule that is "relatively simple that would not create shocks and could react to shocks well." He isn't dogmatic: "I don't think rules should be viewed as ways to tie central bankers' hands. They are meant to help policy makers make better decisions ..."

The Fed's 7/7 *Monetary Policy Report*, which accompanied Yellen's congressional testimony, included a section titled "Monetary Policy Rules and Their Role in the Federal Reserve's Policy Process." The basic message was that the FOMC does pay attention to models such as the Taylor Rule, which prescribe the level of the federal funds rate. However, the Fed's policymakers believe that these models ignore too many "considerations" that require their judgment when setting the federal funds rate. In the "rules versus discretion" debate, they clearly favor the latter approach.

For Fed watchers like me, discretion means that we will continue to find gainful employment as profilers of Fed officials. If Taylor turns out to be the next Fed chair, though, all bets are off.

CALENDARS

US. Wed: Housing Starts & Building Permits 1.170mu/1.230mu, MBA Mortgage Applications, Atlanta Fed Business Inflation Expectations, EIA Petroleum Status Report, Beige Book, Fischer, Kaplan, Dudley. **Thurs:** Leading Indicators 0.1%, Jobless Claims 240k, Philadelphia Fed Manufacturing Index 20.2, Weekly Consumer Index, EIA Natural Gas Report. (Bloomberg estimates)

Global. Wed: UK Employment Change & Unemployment Rate 150k/4.3%, Japan Merchandise Trade Balance (yen) 559.5b. **Thurs:** UK Retail Sales 2.2% y/y, China GDP 1.7%q/q/6.8%y/y, China Retail Sales 10.2% y/y, China Industrial Production 6.4% y/y, Australia Employment Change & Unemployment Rate 15k/5.6%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q3 Earnings Season Monitor (*link*): With 9% of S&P 500 companies finished reporting Q3-2017 earnings and revenue results, their surprise and y/y growth results are mixed compared to the same point during the Q2 earnings season, but more companies are reporting a positive surprise. Of the 45 companies in the S&P 500 that have reported, 84% exceeded industry analysts' earnings estimates by an average of 6.0%; they have averaged a y/y earnings gain of 15.5%. At the same point during the Q2-2017 reporting period, a lower percentage of companies (78%) in the S&P 500 had beaten consensus earnings estimates by a lower 5.7%, and earnings were up a higher 36.0% y/y. On the revenue side, 76% beat sales estimates so far, with results coming in 1.2% above forecast and 6.9% higher than a year earlier. At this point in the Q2 season, a lower 70% had exceeded revenue forecasts by a slightly higher 1.3%, and sales rose a lower 5.2% y/y. Q3 earnings results are higher for 82% of companies vs 72% at the same point in Q2, and revenues are higher for 87%, the same percentage as a quarter ago. Although these figures will change markedly as more Q3-2017 results are reported in the coming weeks, the early results are encouraging. Q3-2017 should mark the fifth straight quarter of positive y/y earnings growth despite the negative impact of the three hurricanes. However, growth is likely to fall back into the low single digits following double-digit percentage growth in Q1 and Q2, which was the first double-digit growth seen since Q3-2011.

US ECONOMIC INDICATORS

Industrial Production (*link*): Headline output in September rose 0.3% and would have been 0.25ppt higher if not for the continued effects from Hurricanes Harvey and Irma, according to the Fed. Meanwhile, August's (to -0.7% from -0.9) decline was less negative than first reported, while July's (-0.1 from 0.4) increase was revised to a slight loss. The Fed reports that output contracted 1.5% (saar) last quarter, though would have increased at least 0.5% excluding the effects of the hurricanes. Factory output edged up 0.1% last month after falling the prior two months, by -0.2% (vs. -0.3% preliminary) in August and -0.4% (vs. flat) in July. During Q3, manufacturing production contracted 2.2% (saar). However, both consumer goods (0.5%) and business equipment (0.8) output rebounded during the final month of Q3. The former saw both durable (0.9) and nondurable (0.4) consumer goods output higher in September, while the latter showed a 2.1% jump in output of industrial equipment more than offsetting a 1.1% drop in transit equipment production; information processing (0.1) output was little changed for the third month.

Capacity Utilization (*link*): The headline capacity utilization rate edged up in September to 76.0% after falling the prior two months from 76.6% in June to a six-month low of 75.8% in August. It's 3.9ppts below its long-run (1972-2016) average. Manufacturing's capacity utilization rate was unchanged at 75.1%, nearly a percentage point below April's high for this year of 76.0%; it's 3.3ppts below its long-run average. Hurricane Harvey interrupted a long string of gains in the mining capacity utilization rate in August, pushing it down 0.4ppt to 83.4%, it ticked up to 83.5% last month. The utilities capacity utilization rate rebounded to 74.8% after sinking 3.8ppts to 73.7% in August.

Import Prices (*link*): Import prices in September accelerated for the second month to 2.7% y/y after decelerating steadily from February's five-year high of 4.7% to 1.2% in July; the rate had bottomed at -11.6% in September 2015. The yearly rate for petroleum prices was in double digits for the second month at 20.2% y/y, up from a recent low of 3.2% in June. September's rate is still considerably below

February's seven-year high of 74.1%. Nonpetroleum products advanced 1.2% in the 12 months through September, hovering around that rate most of this year; the yearly rate had turned positive last December (0.3% y/y) for the first time since November 2014. Total import prices increased for the second month by 0.7% m/m and 1.3% over the period after a three-month decline of 0.4%. Nonpetroleum import prices rose 0.5% over the two months ending September, after no change the prior three months.

GLOBAL ECONOMIC INDICATORS

European Car Sales (*link*): In September, EU passenger car registrations—a proxy for sales—fell 2.0% y/y, though comes from a high basis of comparison; ACEA notes the September 2016 figure was the highest total on record to date. Results among the five largest markets show declines in the UK (-9.3% y/y) and Germany (-3.3), which were partially offset by gains in Italy (8.1), Spain (4.6), and France (1.1). Through the first nine months of this year, EU sales grew 3.7% over the same period a year ago. Sales in Italy (9.0), Spain (6.7), France (3.9), and Germany (2.2) expanded, while demand contracted in the UK (-3.9). The September report noted the strong performance of the new EU member states, where registrations were up 13.8% over the period.

Eurozone CPI (*link*): September's CPI rate was 1.5% y/y—matching both the flash estimate and August's rate and continuing to remain below the ECB's goal of just under 2.0%. (Monthly rates been below the goal since May; April's 1.9% rate was in line with it.) Looking at the main components, energy (to 3.9% from 4.0% y/y) had the highest annual rate, ticking down slightly after accelerating steadily from June's three-month low of 1.9%. Meanwhile, the yearly rates for the remaining components show food, alcohol & tobacco (1.9 from 1.4) accelerating and services (1.5 from 1.6) decelerating slightly; the non-energy industrial goods (0.5) rate matched its August reading. The core rate—which excludes energy, food, alcohol, and tobacco—ticked down to 1.1% y/y from a four-year high of 1.2% the prior two months. Of the top four Eurozone economies, inflation rates in Germany (1.8% y/y) and Spain (1.8) were above the Eurozone's 1.5%, while Italy's (1.3) and France's (1.1) were below. Ireland (0.2) and Cyprus (0.1) had the lowest rates.

Contact us by email or call 480-664-1333. (L1)

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