



MORNING BRIEFING

December 11, 2018

Bonds, Stocks & the Latest Recession Scare

See the [collection](#) of the individual charts linked below.

(1) Some irony in the bond yield's recent drop. (2) The curse of the yield-curve curse. (3) Explaining the divergence between bond yield and nominal GDP growth with the help of the Bond Vigilante Model. (4) The Dow Vigilantes saddle up. (5) No recession signal yet in official yield-curve spread. (6) Inflation is moderating. (7) US bonds mighty attractive compared to comparable foreign alternatives. (8) Seeing eye-to-eye with Leon Cooperman on algos. (9) Transportation indicators remain robust, as does M-PMI.

Credit: Bonds Having Fun Again. The drop in the 10-year US Treasury bond yield has unnerved stock investors recently. That's a bit ironic, since the yield fell partly on perceptions that Fed officials might pause their rate-hiking after they hike the federal funds rate at the December 18-19 FOMC meeting. They seem to be willing to move at an even more gradual tightening pace to reduce the risk of causing a recession. Stock investors should love that, but instead they are fretting that the lower bond yield is flattening the yield curve, which could be signaling that it's too late: Run for the hills, a recession is coming!

We don't agree. We think that lower inflation may be coming, and that other non-recessionary forces are causing bonds to have more fun than stocks. Consider the following:

(1) *A very short history of the bond yield.* The bond yield rose sharply at the end of 2017 and early 2018 after Republicans succeeded in passing the Tax Cuts and Jobs Act on December 20 ([Fig. 1](#)). The day before, the yield was 2.46%. It rose to 2.94% on February 21. It remained range-bound, mostly just below 3.00%, through September 17, when the range rose to 3.00%-3.25%. It dropped below 3.00% on December 3 from 3.24% on November 8; it was at 2.85% yesterday.

The recent drop in the bond yield was triggered by Fed Chairman Jerome Powell. After setting off alarm bells on October 3, when he said that the federal funds rate was "a long way from neutral," he said on November 28 that it was actually "just below" neutral. The bond yield's decline was also attributable to the latest stock market selloff on fears that the US-China trade war could escalate and cause a recession. The bond market has benefitted from risk-off trades lately.

There has been a good correlation between the trends in nominal GDP growth on a y/y basis and the 10-year US Treasury bond yield ([Fig. 2](#)). I've dubbed this the "Bond Vigilantes Model." I use the model to explain why the two aren't the same at any point in time. During the 1960s and 1970s, bond investors weren't vigilant enough, as the yield remained consistently below the rapidly rising growth rate in nominal GDP, led by soaring inflation. That reversed during the 1980s, when the yield remained consistently above nominal GDP growth as the Bond Vigilantes turned more vigilant about inflation. Inflation remained low and subdued during the 1990s, so there was less need to be vigilant. Since the financial crisis of 2008, the bond yield has been held down well below nominal GDP growth by the ultra-easy monetary policies of the Fed and the other major central banks.

(2) *Dow Vigilantes muscling in.* Now, the Dow Vigilantes may be the new force to be reckoned with in the financial markets. They are the ones who are reacting most aggressively to the increasingly incompatible mix of monetary, fiscal, and trade policies coming out of Washington. There was a significant correction at the beginning of this year and another one that started in late September, both protesting the disconnect of fiscal policy stepping on the economy's accelerator while monetary and trade policies tap on the brakes ([Fig. 3](#)).

Apparently, Fed officials have already gotten the message and are considering an even more gradual pace of monetary tightening. The initial fiscal stimulus from the tax cuts may be waning, though the resulting federal government deficits will continue to widen. Trade policy remains the biggest and most immediate concern for the Dow Vigilantes. If they are going to be vigilant, the bond posse doesn't need to be as vigilant.

(3) *Less curve in the yield curve.* The recent drop in the bond yield has flattened the yield curve. That's heightened recession fears, since the yield curve is one of the 10 components of the Index of Leading Economic Indicators (LEI). In the LEI, the yield-curve spread is measured as the 10-year yield minus the federal funds rate ([Fig. 4](#)). It has a good track record of calling recessions when it turns negative. It tends to lead the y/y growth rate in the Index of Coincident Economic Indicators by about 12 months.

The yield-curve spread remained at 72bps yesterday, the lowest reading since March 17, 2008 ([Fig. 5](#)). So it is still solidly in positive territory. As long as it stays that way, it will be a positive contributor to the LEI. Focusing on the weekly spread, Debbie observes that the yield curve inverted 74 weeks before the previous recession, 41 weeks before the one before at the start of the 2000s, and 77 weeks before the one in the early 1990s, though the latter turned positive before the recession began ([Fig. 6](#)).

Slicing and dicing the yield curve has become the new rage. Doomsters are looking for any yield-curve spread that is inverting. So they are especially alarmed about the 10-year versus 2-year spread, which fell to just 13bps yesterday. The 5-year versus 2-year spread was -1bp ([Fig. 7](#)).

(4) *Inflation indicators moderating.* In the 12/3 [Morning Briefing](#), Debbie and I observed: "Evidence mounted that following another likely rate hike at the FOMC meeting on December 18-19, the monetary policy committee might pause during the first half of next year to reevaluate the course of monetary policy. Not as widely noticed last week was that inflationary pressures may be ebbing, which would also argue for a pause."

This may also explain why the bond yield has declined lately. December's purchasing managers surveys showed that the M-PMI's prices-paid index dropped to 60.7 last month from a recent high of 79.5 during May ([Fig. 8](#)). On the other hand, the NM-PMI's prices-paid index remained relatively flat at 61.5, though that's down from a recent peak of 68.0 during May. Expected inflation as measured by the yield spread between the 10-year Treasury and its comparable TIPS fell to 1.86% yesterday, down from a recent high of 2.17% on October 9.

(5) *JGB and bund yields nearing zero again.* Also holding down the US bond yield is that comparable 10-year government bond yields in Japan and Germany have been moving back down even closer to zero recently ([Fig. 9](#)). On Friday, the yield on the Japanese JGB was only 0.07%, while the German bund yield was only 0.25%. I've heard that the cost of hedging the currency risk reduces the relative attractiveness of US bonds. Then again, there may be plenty of overseas investors who aren't hedging but instead are taking the currency risk, which may be relatively low in any event given the huge yield advantage in the US over both Japan and Germany.

(6) *Benefitting from algos gone wild.* Of course, the Dow Vigilantes may not be humans at all. Instead,

they may be algorithm-driven computer trading systems. They were designed and coded by humans. But like [HAL 9000](#), the rogue computer in the classic movie “2001: A Space Odyssey” (1968), they may have turned against us.

I agree with Leon Cooperman. In a 12/6 CNBC [interview](#) last Thursday, the founder of Omega Advisors blamed the SEC for failing to address the impact of algos on stock market volatility: “I think your next guest ought to be somebody from the SEC to explain why they have sat back calmly, quietly, without saying anything and allowing these algorithmic, trend-following models to wreak havoc with what has, up to now, been the best capital market in the world,” Cooperman told CNBC’s Scott Wapner on the *Halftime Report*. “In the mid-1930s, they instituted the Uptick Rule to deal with the abuses of 1929. It worked effectively for 70-odd years. They took it out in 2008 for some unexplainable reason,” he added. “And they created a wild, Wild West environment in the stock market.”

US Economy: No Recession in GDPNow. The stock market seems to have a sense of impending doom, or at least an imminent recession. The S&P 500 is also one of the 10 components of the LEI. Ironically, it has been down since peaking at a record high on September 20, partly on fears that the yield-curve spread is signaling a recession, which it isn’t so far as discussed above.

Meanwhile, both the LEI and the CEI rose to record highs during October ([Fig. 10](#)). That doesn’t mean that the LEI couldn’t soon be making a top, though we doubt it. Looking at the 10 components, we see some potential downside contributions to the LEI coming from initial unemployment claims, building permits, and the S&P 500 ([Fig. 11](#)). The other seven look alright to us.

The [GDPNow](#) model estimate for real GDP growth in Q4-2018 is 2.4% as of December 7, down from 2.7% on December 6. That’s still solid growth following a gain of 3.5% during Q3 and 4.2% during Q2. Here are a few other upbeat, and a bit offbeat, economic indicators:

(1) *Keep on trucking.* Notwithstanding all the chatter about a shortage of truck drivers, payroll employment in the truck transportation industry rose to a record high during November. It tends to be a good leading indicator of the economy too ([Fig. 12](#)).

Debbie and I also like to track the economy by tracking intermodal railcar loadings. The y/y growth rate in the 26-week average of this series is up at a solid 4.3% through the 12/1 week ([Fig. 13](#)). Interestingly, this series also tends to track the growth rate in the CEI.

(2) *Full employment.* Yesterday, we noted that full-time employment jumped by 543,000 to a new record high during November. Yesterday’s JOLTS report showed that job openings have exceeded the number of unemployed workers since March ([Fig. 14](#)).

(3) *M-PMI & S&P 500 revenues.* Another sign that the economy continues to perform well is November’s M-PMI, which remained elevated at 59.3 ([Fig. 15](#)). This series is highly correlated with the y/y growth rate of S&P 500 revenues per share, which has been surprisingly strong this year, rising 10.7% through Q3.

CALENDARS

US. Tues: Small Business Optimism Index 107.0, PPI-FD Total, Core, and Core Less Trade Services 0.0%/0.1%/0.2%. **Wed:** Headline & Core CPI 2.2%/2.2% y/y, Atlanta Fed Business Inflation Expectations, Treasury Budget -\$165.0b, MBA Mortgage Applications, EIA Petroleum Status Report. (Econoday estimates)

Global. Tues: Eurozone ZEW Economic Sentiment, Germany ZEW Current Situation & Expectations 55/-25, UK Employment Change (3m/3m) & Unemployment Rate (3m) 25k/4.1%, Japan Machine Orders 9.7%~~m/m~~/5.0%~~y/y~~. **Wed:** Eurozone Industrial Production 0.2%~~m/m~~/0.8%~~y/y~~, Mexico Industrial Production 1.7% ~~y/y~~. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose together for all three of these indexes for a second straight week, but remain below their record highs in October. The recent gains may be marking a pause in the declines that began in mid-October during the Q3 earnings reporting season, which is the worst since the beginning of 2016 when oil prices were tumbling. LargeCap's forward EPS rose 35 cents w/w to \$175.47 and is now just a penny below its record high of \$175.48 seven weeks ago. That's about the same as MidCap's, which is two cents below its record high of \$124.62 on October 19. However, SmallCap's remains 2.2% below its October 26 record high of \$61.42. Forward earnings activity had been relatively strong in the past 12 months: LargeCap's forward earnings has risen in 45 of the past 52 weeks, MidCap's in 46, and SmallCap's in 41. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016, but has clearly peaked. In the latest week, the rate of change in LargeCap's forward earnings remained steady at a seven-month low of 20.7% ~~y/y~~. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's ~~y/y~~ change was down to an 11-month low of 21.1% from 21.6%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's improved to 29.7% from a six-month low of 29.5%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (23.3%, 8.3%, 10.4%), MidCap (21.9, 10.4, 12.0), and SmallCap (24.3, 15.3, 14.4).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios reversed broadly lower again last week. LargeCap's weekly forward P/E tumbled w/w to 15.0 from 15.8, retesting its lowest level since January 2016. That compares to a six-month high of 16.8 in mid-September, a multi-year high of 18.6 on January 26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. However, last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E dropped to 14.3 last week from 15.1, and is now at the lowest reading since November 2012. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E tumbled to 15.1 last week from 16.0, and is at its lowest reading since December 2012. That's well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). Looking at the three indexes' daily forward price/sales (P/S) ratios, most improved w/w but are also down to their lowest levels since early 2016: LargeCap's P/S fell w/w to 1.86 from 1.95, which is down from a record high of 2.19 on January 26; MidCap's decreased to 1.15 from 1.21, which compares to its record high of 1.40, also on January 26; and SmallCap's dropped to 0.87 from 0.92, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Analysts paused cutting Q4 forecasts last week. However, the S&P 500's blended Q4-2018 EPS forecast of \$41.42 is down 2.7% since the end of Q3, up 6.5% ytd, and up 7.3% since the passage of the Tax Cuts and Jobs Act. The \$41.42 estimate represents a forecasted pro forma earnings gain for Q4-2018 of 16.8%, down from 17.1% a week earlier and from 20.1% at the end of Q3. That would mark the slowest growth since Q4-2017 and comes on heels of 28.4% ~~y/y~~ growth in Q3, which is sure to mark the peak of the current earnings

cycle. The blended Q4-2018 growth rate compares to Q3-2018's 28.4%, Q2-2018's 24.9%, Q1-2018's 26.6%, Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. The S&P 500's Q4-2018 forecasted earnings gain of 16.8% y/y would be its tenth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q4-2018, with seven rising at a double-digit percentage rate. That compares to all 11 positive during Q3, when 10 rose at a triple- or double-percentage rate. Four sectors are expected to beat the S&P 500's blended y/y earnings gain of 16.8% during Q4, compared to four beating the S&P 500's 28.4% gain during Q3. Analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago, with the pace slowing from Q3. The latest forecasted blended Q4-2018 earnings growth rates versus their Q3-2018 growth rates: Energy (81.0% in Q4-2018 versus 114.6% in Q3-2018), Financials (24.2, 44.7), Industrials (24.6, 19.0), Communication Services (17.8, 26.2), S&P 500 (16.8, 28.4), Consumer Discretionary (13.0, 25.3), Health Care (11.5, 16.6), Tech (11.7, 29.2), Real Estate (7.2, 5.3), Materials (6.2, 29.2), Consumer Staples (2.6, 11.4), and Utilities (-9.4, 10.9). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 14.2% y/y in Q4, below the 25.0% in Q3; that compares to 21.9% in Q2-2018, 24.5% in Q1-2018, 12.7% in Q4-2017, and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016). The Q4 estimate has fallen for 9/11 sectors since the end of Q3, and increased for two. Energy is the best performer, with its Q4-2018 forecast up 1.6% versus a 0.1% gain for Health Care and a 2.7% decline for the S&P 500. Materials is the biggest decliner, with its Q4-2018 forecast down 8.3% since the end of Q3, followed by Utilities (-8.1), Real Estate (-5.8), Industrials (-5.6), Consumer Discretionary (-4.2), Communication Services (-4.0), Consumer Staples (-3.9), Financials (-2.6), Tech (-2.2), and Consumer Staples (-3.9).

US ECONOMIC INDICATORS

JOLTS ([link](#)): Job openings in October recovered to within 214,000 of August's record high of 7.293 million. Openings rebounded 119,000 in October to 7.079 million after sliding -333,000 in September; openings are up 1.4 million ytd. Meanwhile, hirings climbed 196,000 to 5.892 million—within 14,000 of August's record high of 5.906 million. Total separations sank -223,000 during the two months through October to 5.556 million, after a three-month spurt of 360,000 to 5.779 million—which was the highest level since January 2001. The latest hiring and separations data yielded an employment advance of 336,000 for October, 99,000 above October's payroll increase of 237,000—overstating the increase for the first time in five months. Those quitting their jobs fell 134,000, to 3.514 million, since reaching a record high of 3.648 million in August. October's private-industry job-opening (4.8%) rate was once again little changed from August's record high of 4.9%, while the quit (2.6) rate was just below the 2.7% reading for the prior three months—which was the highest percentage since spring 2001; the total hire (4.3) rate is in a volatile flat trend around its cyclical high. October's ratio of unemployed workers per job opening was below 1.00 for the eighth month—at 0.86—barely budging from September's record low of 0.85.

Merchandise Trade ([link](#)): The real merchandise trade deficit widened in October for the fifth month, posting its biggest gap in the history of the series going back to 1994. That result suggests trade could once again be a drag on economic growth. October's deficit swelled to -\$87.9 billion, after narrowing sharply from -\$85.3 billion in February to -\$75.5 billion in May; October's gap was \$2.5 billion wider than Q3's average monthly deficit of -\$85.4 billion. Real exports fell for the fourth time in five months, by -0.8% in October and -2.3% over the period. Meanwhile, real imports (-0.2%) were stalled at September's record high, after climbing 4.2% the prior four months to a new record high. Since the real trade deficit began widening in June, real exports have dropped -2.3% while real imports have jumped 3.9%. Over the past five months, declines in real exports were posted by foods, feeds & beverages (-20.3%), autos (-6.2), and capital goods less autos (-2.3), while exports of industrial supplies & materials (3.7) and consumer goods less autos (1.3) were in the black. Meanwhile, the gain in real imports over the past five months was driven by consumer goods ex autos (11.5), autos (7.3), and industrial supplies

& materials (1.4)—which more than offset declines in capital goods less autos (-3.2) and food, feeds & beverages (-2.0). October's US nominal 12-month trade deficit widened to a record high -\$861 billion as deficits with China, the Eurozone, and Mexico swelled to -\$411 billion, -\$151 billion, and -\$79 billion, respectively, while Japan's narrowed to -\$68 billion.

GLOBAL ECONOMIC INDICATORS

Germany Manufacturing Orders ([link](#)): Orders in October unexpectedly rose for the third month, as foreign orders from within the Eurozone were once again up sharply. Total factory orders climbed 0.3%, after downwardly revised gains of 0.1% (from 0.3%) and 2.3% (2.5) the prior two months. Billings are within 1.8% of May's record high. Foreign orders advanced for the second time in three months, by 2.9% in October and 6.7% over the period, as orders from within the Eurozone soared 7.3% in October and 8.5% over the period—driven by a 16.0% surge in capital goods orders during the three-month span; consumer and intermediate goods orders were basically flat over the period. Meanwhile, billings from outside the Eurozone ticked up 0.3% after a -3.8% loss and a 9.4% gain the previous two months. Domestic orders continued their up-and-down pattern, falling -3.2% in October after a 2.8% increase and a -2.0% decrease during September and August, respectively—remaining in a multi-year flat trend.

Germany Industrial Production ([link](#)): Output in October continued to fluctuate in a flat trend just below May's record high. Germany's headline production—which includes construction—slumped -0.5% in October after a two-month gain of 0.5%. Excluding construction, output contracted for the fourth time in five months, by -0.6% in October and -2.2% over the five-month span; construction output was up 0.7% during the five months ending October. Factory production has contracted -2.3% since reaching a new record high in May. The main industrial groupings show consumer nondurable (-4.3%), consumer durable (-2.1), capital (-1.9), and intermediate (-1.8) goods output all in the red over the five-month period. Germany's M-PMI for November fell to a 31-month low of 51.8, as new orders contracted for the second time in as many months, and output rose at the slowest rate in over five and a half years.

UK Industrial Production ([link](#)): October data show industrial output hasn't posted a gain in three months, while manufacturing production fell for the third time in four months. Headline production contracted -0.6%, after no change in each of the prior two months; October's decline matched its biggest decline for this year—also recorded in April and May. Meanwhile, manufacturing production also matched its biggest decline this year, slumping -0.9% in October and -1.0% since June. Looking at the main industrial groupings, here's a tally for October and the four months through October: Consumer nondurable (-1.6% & -3.4%), capital (-1.1 & -0.4), intermediate (-0.3 & 0.3), and consumer durable (1.3 & 0.4) goods orders. November's M-PMI edged up from a 27-month low of 51.1 in October to 53.1—still one of the weakest performances of the past two and a half years. New orders rose following October's decline, though the level of new export business contracted for the second month—the first back-to-back decline since early 2016.

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