**MORNING BRIEFING**
**May 29, 2019**

## Bonds Have More Fun

*See the collection of the individual charts linked below.*

(1) Wrong-way bond forecasts. (2) Tethered at the hip. (3) Bond Vigilantes vs Yield Reachers. (4) US bond yields remain outstanding in a world of NZIRP, ZIRP, NIRP, and QE. (5) Low inflation driving bond yields. (6) Economic surprise index also driving bond yields. (7) Yields fall as consumer optimism rebounds. (8) The trade war's impact. (9) Summers and Krugman attack Kelton's MMT. (10) Our argument against MMT: Too much debt weighs on growth and can be deflationary.

**Bonds I: Tethered to Inflation.** Last year, when the 10-year US Treasury bond yield first rose above 3.00% on 5/14, there was lots of chatter about how it was likely to rise to 4.00% and even 5.00% (*Fig. 1*). Those levels were last seen in 2008 and 2007, respectively. Those bearish forecasts for bonds were based on the widespread perception that Trump's tax cuts would boost economic growth, inflation, and the federal deficits. In addition, the Fed had started to taper its balance sheet during October 2017, and was on track to pare its holdings of Treasuries and mortgage-related securities by $50 billion per month (*Fig. 2*).

It was also widely expected that the Fed would hike the federal funds rate four times in 2018, which is what happened, and that the rate-hiking would continue throughout 2019 and into 2020, which is now less likely to happen (*Fig. 3*). Furthermore, the Fed would stop paring its balance sheet by the end of September.

Last year, I surmised that the bond yield might be "tethered" to the near-zero yields for comparable JGBs in Japan and bunds in Germany (*Fig. 4*). I also argued that based on my 40 years' experience in our business, I've never found that supply-vs-demand analysis helped much in forecasting bond yields. It's always been about actual inflation, expected inflation, and how the Fed was likely to respond to both.

Last year, the 10-year US Treasury bond yield peaked at 3.24% on 11/8. The 98bps drop in the 10-year US Treasury bond yield since then (to 2.26% yesterday) was driven by a 64bps decline in the comparable TIPS yield and a 34bps narrowing of the yield spread between the two (*Fig. 5* and *Fig. 6*). The spread, which is widely perceived to reflect inflationary expectations over the next 10 years, fell from 2.07% on November 8, 2018 to 1.73% yesterday. Now consider the following related developments:

(1) *Yield Reachers.* What is the opposite of a Bond Vigilante? How about a "Yield Reacher?" My Bond Vigilantes Model shows that there has been a close relationship between the 10-year bond yield and the y/y growth in nominal GDP (*Fig. 7* and *Fig. 8*). However, since the Great Financial Crisis, the former has been consistently below the latter, and they have increasingly diverged. Nominal GDP growth was 5.1% during Q1, while the 10-year yield was down to 2.5% during April.

The Bond Vigilantes are less vigilant because inflation remains subdued. Furthermore, their influence has been significantly reduced by the major central banks that have been providing ultra-easy monetary conditions with their near-zero-interest-rate, zero-interest-rate, negative-interest-rate, and quantitative easing policies, a.k.a. NZIRP, ZIRP, NIRP, and QE.

With short-term interest rates so low, there has been a global reach for better yields in the bond markets. Among the major industrial economies, the yield on the 10-year US Treasury has stood out as particularly attractive. It did so at 3.24% late last year, and still does at 2.26% yesterday,

(2) *Tethered to inflation.* The growth rate in nominal GDP seemed to be a major driver of the bond yield in the past. However, since the Great Financial Crisis, the bond yield has tracked the actual inflation rate, using the GDP deflator, very closely (*Fig. 9* and *Fig. 10*). During Q1, the latter was only 1.86%.

The same can be said about the relationship between the bond yield and the inflation rate using the core PCED (*Fig. 11*). The latter was up just 1.6% during March. By the way, the Fed's flavor of the month seems to be the Dallas Fed's trimmed PCED, which was up 2.0% during March (*Fig. 12*).

(3) *Disappointing economic indicators.* The drop in the bond yield since late last year coincided with weakness in the Citigroup Economic Surprise Index (CESI) for the US (*Fig. 13*). Since 2010, this index has had a tendency to turn negative during the first half of the year. The 13-week change in the bond yield has been positively correlated with the CESI (*Fig. 14*).

(4) *Happy economic indicators.* Some of the weakness in April's economic indicators was weather-related. That suggests better numbers ahead should boost the CESI and put some upward pressure on the bond yield, maybe. Then again, the yield continued to fall yesterday despite an upbeat consumer confidence report.

Debbie and I compile our Consumer Optimism Index by averaging the Consumer Sentiment Index and the Consumer Confidence Index (*Fig. 15*). In May, it rebounded back to last year's cyclical high, as did its current conditions and expectations components.

In the consumer confidence survey, the percentage of respondents saying that jobs are plentiful rose to a new cyclical high of 47.2%, while those saying that jobs are hard to get fell to 10.9%, the lowest reading since September 2000 (*Fig. 16*). This suggests that the unemployment rate could soon fall below April's 3.6% (*Fig. 17*).

(5) *War and peace.* Of course, the decline in the bond yield from 2.52% at the start of May to 2.26% yesterday was in response to the escalating US-China trade war. That's despite concern in some quarters that the Chinese might retaliate by selling their hoard of US Treasuries, and despite concerns that higher tariffs might boost inflation. The bond market's reaction suggests that Yield Reachers believe that an escalation of the trade war will weigh on global growth and keep a lid on inflation. It might also force the Fed to lower interest rates.

**Bonds II: Untethered from Debt.** Most people who have heard of Modern Monetary Theory (MMT) are either for it or against it. The preacher side of me is against it. It is sinful. The empiricist side of me concedes that it has been working for the past 10 years: Federal government deficits have ballooned. Government debt continues to expand rapidly since the Great Financial Crisis. Yet inflation remains subdued. Most importantly, the bond market certainly isn't siding with the preachers.

First introduced in 1905 in Georg Knapp's "The State Theory of Money," MMT centers on the principle that budget deficits don't matter as long as they don't boost inflation. In October, well-known MMT advocate and Stony Brook University professor Stephanie Kelton gave a 50-minute talk on the subject that's worth watching. She argued that when sovereign governments borrow in a national currency that they alone issue, that debt has no risk of default, as these governments can always print more money to make good on future promises. Countries run into trouble when they borrow in currencies that they themselves can't print. The US does not have that problem, so future generations of Americans needn't worry that their Social Security payments won't be covered in the future even as the national debt continues to rise into the trillions.

Fiscal conservative that I am, my instinct is to oppose MMT, since it justifies larger government deficits with debt continuing to pile up. However, the concept of running up the national debt (to an extent) without consequence has become popular among politicians on both sides of the aisle because the theory has been tried in practice for the past 10 years as debt swelled yet inflation remained dormant.

Democratic leaders announced on 4/30 that they've agreed on a $2 trillion infrastructure plan with President Donald Trump, specifically to promote jobs, commerce, and quality of life. But they've left open the question of how to pay for it. Some say the plan should be deficit-neutral, meaning it should be "paid for" with some sort of offset such as an increase in the federal gas tax, for example. On the other hand, White House Chief of Staff Mick Mulvaney said on 4/30 at the Milken Institute Global Conference that the existing debt "does not appear to be holding us back." Is Mulvaney, who has always been a fiscal conservative, now drinking from the MMT well?

In a 3/4 op-ed for the *Washington Post* titled "The left's embrace of modern monetary theory is a recipe for disaster," left-leaning economist Larry Summers wrote that MMT could have ugly consequences, namely higher interest rates, hyperinflation, and a collapsing exchange rate. Similarly, Paul Krugman, a left-leaning *NYT* columnist, confrontationally posed four questions to Stephanie Kelton about MMT in a 2/25 NYT op-ed. Kelton responded in a 3/1 Bloomberg opinion piece, and the dispute continued, with Kelton further clarifying her points in a 3/4 Bloomberg article titled, "The Clock Runs Down on Mainstream Keynesianism."

Kelton told CNBC in a 3/1 interview, "you don't have a deficit problem … unless you have an inflation problem." Summers claims that his position on hyperinflation is not just theory, citing historical examples where MMT led to just that. The problem with his examples is that they might not be applicable in today's world. Furthermore, I have often argued that inflation is bound to stay low because of secular forces keeping a lid on it, namely technological innovation, population aging, and globalization.

The debate between Krugman and Kelton makes my head spin. I won't subject you to their mind games. Instead, let me observe that debt-financed government spending is losing its stimulative impact. It seems that we have reached an inflection point where too much debt is weighing on economic growth rather than stimulating it. This certainly helps to explain why bond yields are falling as government debt continues to mount, increasingly becoming a source of deflation rather than inflation.

**Fake News: Lost in Translation.** I was quoted in a 5/28 CCN story titled,
"Dow Struggles as Analyst Savages Trump's 'Game of Thrones' Strategy." The article stated: "Meanwhile, one stock market analyst says that he has had enough of Trump's 'Game of Thrones' presidency and its utterly 'disappointing' results. … [Yours truly] savaged the former television star for treating his presidency like an episode of 'Game of Thrones.'"

That was all based on the following item on CNBC that correctly quoted me as follows:

"'Trump is playing a Game of Thrones with both foreign and domestic adversaries,' said Ed Yardeni, president and chief investment strategist at Yardeni Research. 'Since he is the President of the world's greatest economic and military power, he claimed that he will consummate lots of deals with them that will greatly benefit the US in short order. The results have been mostly disappointing so far.'"

According to CCN's website, it is a part of Hawkfish AS. "All journalists and editors follow the Code of Ethics of the Norwegian Press. CCN is an unbiased financial news site with a special focus on cryptocurrencies and US Markets. Journalists on CCN are free to write stories they want to cover. Op-eds are always marked and the views of the journalist or writer should not be attributed to CCN."

## CALENDARS

**US. Wed:** Richmond Fed Manufacturing Index 6, MBA Mortgage Applications. **Thurs:** Real GDP & PCE 3.1%/1.2%, GDP Deflator & Core PCED 0.9%/1.3%, Jobless Claims 214k, Advance Merchandise Trade Balance -$72.3b, Pending Home Sales 0.5%m/m/-0.2%y/y, Wholesale Inventories 0.1%, DOE Crude Oil Inventories, EIA Natural Gas Report, Clarida. (DailyFX estimates)

**Global. Wed:** Germany Unemployment Change & Unemployment Claims Rate -7k/4.9%, France GDP 0.3%q/q/1.1%y/y, BOC Rate Decision 1.75%, ECB Financial Stability Review, Kuroda. **Thurs:** UK Gfk Consumer Confidence 012, Japan CPI Headline, Core, and Core-Core 1.2%/1.2%/1.0% y/y, Japan Jobless Rate 2.4%, Japan Retail Trade 0.6%m/m/1.0%y/y, Japan Industrial Production 0.2%m/m/-1.4%y/y. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** (*link*): LargeCap's forward earnings rose w/w for a sixth straight week, but MidCap's and SmallCap's fell for a second week following four straight gains. The recent trend remains positive, though: LargeCap's has risen during 12 of the past 15 weeks; MidCap's eight of the past 11 weeks; and SmallCap's six of the past nine weeks. LargeCap's forward EPS is just 0.3% below its record high of $175.48 in late October; MidCap's is 1.4% below its mid-October high; and SmallCap's is 6.6% below its mid-October high. At their bottoms, LargeCap's forward EPS had been the most below its record high since June 2016, and MidCap's was the lowest since May 2015. SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but tumbled as y/y comparisons became more difficult. But that may be ending soon too. In the latest week, the rate of change in LargeCap's forward earnings improved to 4.7% y/y from a 29-month low of 4.5% 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 rose to 4.5% from a 30-month low of 4.2%, 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 rose to 2.0% from a 40-month low of 1.6%, 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. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 3.1%, 11.8%), MidCap (22.7, 1.8, 14.1), and SmallCap (22.4, 3.0, 19.0).

**S&P 500/400/600 Valuation** (*link*): Forward P/E ratios fell for a third week for all these indexes, but they remain well above their multi-year lows in late December. LargeCap's weekly forward P/E dropped to 16.1 from 16.4, which compares to a 13-month high of 16.9 in early May and is up from a five-year low of 13.9 during December. That also compares to a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E dropped 0.2pt to 15.2. That's down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. 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. However, 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 weakened to 16.0 from 16.3, which is well above its seven-year low of 13.6 during December. That's still 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). SmallCap's P/E was a tad below LargeCap's P/E for a second straight week, after being below for much of December for the first time since 2003.

**S&P 500 Sectors Quarterly Earnings Outlook** (*link*): With the Q1 earnings season 96% complete, the blended Q1 estimate/actual surged—forming the positive earnings surprise "hook" chart pattern that's become typical in earnings seasons. Last week saw the S&P 500's blended Q1-2019 EPS forecast rise yet another 3 cents w/w to $39.01, which is in line with our forecast of $39.00. The $39.01 estimate represents a forecasted pro forma earnings gain for Q1-2019 of 1.5%, up from a forecasted decline of 2.3% in early April and a forecasted gain of 5.3% at the end of Q4. Q1's gain is the 11th straight y/y rise, but down from 16.8% in Q4 and 28.4% in Q3 (which marked the peak of the current earnings cycle). Just six of the 11 sectors recorded positive y/y earnings growth in Q1-2019, with only one rising at a double-digit percentage rate. That compares to 10 positive during Q4, when seven rose at a double-percentage rate. Five sectors beat the S&P 500's Q1 growth rate, which compares to just four during Q4. Real Estate and Utilities are the only sectors to post better growth on a q/q basis during Q1. Here are the latest blended Q1-2019 earnings growth rates versus their Q4-2018 growth rates: Health Care (10.3% in Q1-2019 versus 13.3% in Q4-2018), Financials (8.0, 15.6), Industrials (6.8, 27.0), Consumer Discretionary (8.1, 18.1), Real Estate (6.3, 6.2), Consumer Staples (0.6, 4.6), Utilities (-0.5, -10.4), Information Technology (-1.6, 10.3), Communication Services (-9.9, 26.4), Materials (-13.4, 6.1), and Energy (-26.1, 81.4). On an ex-Energy basis, S&P 500 earnings rose 2.9% y/y in Q1, well below the 14.2% y/y gain in Q4 and the lowest ex-Energy growth rate since Q2-2016.

**S&P 500 Q1 Earnings Season Monitor** (*link*): With 96% of the S&P 500 companies finished reporting revenues and earnings for Q1-2019, the y/y growth rates in revenues and earnings have slowed substantially from Q4. The revenue surprise metrics have weakened substantially, but earnings continue to beat forecasts. Of the 482 companies in the S&P 500 that have reported through Tuesday, 76% exceeded industry analysts' earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 3.1%, and exceeded forecasts by an average of 6.5%. On the revenue side, just 57% of companies beat their Q1 sales estimates so far, with results coming in 0.2% above forecast and 4.9% higher than a year earlier. Earnings growth is trailing revenue growth for the first time since H1-2016. Q1 earnings growth results are positive y/y for 64% of companies, vs a higher 71% at the same point in Q4, and Q1 revenues have risen y/y for 68% vs a higher 74% during Q4. These figures are not likely to change markedly as the remaining Q1-2019 results are reported in the coming weeks. Looking at earnings during the same point in the Q4-2018 reporting period, a lower percentage of companies (70%) in the S&P 500 had beaten consensus earnings estimates by a lower 3.5%, but earnings were up a higher 14.3% y/y. With respect to revenues at this point in the Q4 season, a higher 60% had exceeded revenue forecasts by a higher 0.5%, and sales rose a greater 5.7% y/y. The Q1 results indicate a slowdown in revenue and earnings growth from Q4, but that comes as no surprise to investors. Q1-2018 marks the 11th straight quarter of positive y/y earnings growth and the 12th of positive revenue growth. Looking at the Q1 results ex-Financials and Real Estate, the earnings surprise improves to 6.6% from 6.5% and growth falls to 2.3% from 3.1%. The ex-Financials and Real Estate revenue surprise drops to 0.1% from the 0.2% rate with all sectors included, and revenue growth drops to 4.8% from 4.9%.

## US ECONOMIC INDICATORS

**Consumer Confidence** (*link*): US consumers remain very optimistic, despite a shaky stock market and heightened trade tensions between the US and China, boosting May's confidence back near 18-year highs. According to Lynn Franco, senior director of economic indicators at the Conference Board, "Consumers expect the economy to continue growing at a solid pace in the short term, and despite weak retail sales in April, these high levels of confidence suggest no significant pullback in consumer spending in the months ahead." Consumer confidence has increased three of the past four months to a six-month high of 134.1 this month from 121.7 at the start of this year, which was the lowest reading since September 2017. Strong job growth drove the present situation component to its highest reading since December 2000, climbing from a recent bottom of 163.0 in March to 175.2 this month, while the expectations component jumped to a six-month high of 106.6 since bottoming at 89.4 in January—which was the lowest reading since just before the 2016 election. Consumers' assessment of the labor market was very upbeat in May: The percentage of respondents saying that jobs are plentiful (to 47.2% from 46.5%) bounced to its the highest reading since January 2001, while those saying jobs are hard to get (10.9 from 13.3) sank to its lowest percentage since September 2000. The six-month jobs' outlook also improved as the spread between the percentage expecting more jobs (to 19.2% from 16.7%) and the percentage expecting fewer jobs (12.5 from 13.2) widened to 6.7ppts. It had turned negative back in January for the first time since August 2016.

**Regional M-PMIs** (*link*): Four Fed districts now have reported on manufacturing activity for May—Philadelphia, New York, Kansas City, and Dallas—and show growth accelerated slightly this month. We average the composite, orders, and employment measures as data become available. The composite (to 8.3 from 6.4) index shows May growth was double February's (4.3) pace, though half last November's (16.6) rate. The New York region's composite (17.8 from 10.1) measure posted its best growth this year, while Philadelphia's (16.6 from 8.5) rebounded back toward its 2019 high of 17.0 at the start of the year. Meanwhile, Kansas City's (4.0 from 5.0) slowed from March's two-month high of 10.0, while Dallas' (-5.3 from 2.0) is contracting again, deteriorating steadily from February's 11.6. The new orders gauge (6.8 from 10.8) eased a bit from April's rate, but was much improved over February's 0.4—which was the weakest reading July 2016. Orders in the New York (9.7 from 7.5) region accelerated at its best pace of 2019 to date, while Philadelphia's (11.0 from 15.7) slowed, though beat New York's rate. Gauges for both Kansas City (4.0 from 10.0) and Dallas (2.4 from 9.8) show orders growth heading back down toward zero. The employment (9.9 from 8.3) index improved from April's rate—and virtually matched its average so far this year. Regionally, it was a mixed bag: Factories in Philadelphia (18.2 from 14.7) added to payrolls at the best pace since the end of last year, while New York's (4.7 from 11.9) growth was among the weakest in two years. Dallas' (11.6 from 4.6) measure was more than double last month's rate, while Kansas City's (5 from 2) improved slightly from April, though was roughly a third of March's pace.

**Regional Manufacturing Price Indexes** (*link*): Available May data show inflationary pressures remain on an easing trend for New York, Philadelphia, Kansas City, and Dallas manufacturers, based on the prices-paid measures, while prices-received measures were a mixed bag. Here's a look at the prices-paid indexes for May versus their respective peaks during 2018: Philadelphia (to 23.1 from 60.0), Kansas City (13.0 from 52.0), New York (26.2 from 54.0), and Dallas (7.4 from 54.3)—with only Philadelphia showing a slight acceleration for the second month. Meanwhile, New York's prices-received measure eased for the third month, to 12.4, after accelerating the prior two months from 12.8 to 22.9—nearly matching its recent peak of 23.3 last June. The prices-received index for the Philly region eased for the second month, dropping to a 16-month low of 17.5 this month, after hovering in a flat trend around 26.0 the prior six months; it peaked at 35.0 last July. Kansas City's prices-received index has been more volatile than the rest; it accelerated for the second month in May to 15.0, after dropping from 23.0 to 7.0 the prior two months; it was at 8 at the end of last year. Meanwhile, Dallas' sank to 0.7 this month—the lowest since September 2016; it's been on a steep disinflationary trend since last June's 26.2 peak.

## GLOBAL ECONOMIC INDICATORS

**Eurozone Economic Sentiment Indicators** (*link*): The Economic Sentiment Index (ESI) in the Eurozone (+1.2 points to 105.1) rose this month for the first time in 13 months, while the ESI for the EU (+0.2 point to 103.8) remained broadly stable. These measures were the lowest since September 2016 and August 2016, respectively, last month, after peaking at 18-year highs of 114.5 and 114.3 at the end of 2017. Among the largest Eurozone economies, France (+4.0 points to 104.8) posted the most impressive gain by far, though ESIs for both Italy (+1.7 to 101.7) and Spain (+1.3 to 105.4) also rose markedly. Meanwhile, Germany's ESI (+0.4 to 105.5) ticked up, while the Netherlands' (-1.3 to 104.3) was the only one in the red—it was the only one in the black in April. At the sector level, sentiment was mixed, with the ESI for industry (+1.4 points to -2.9) posting the biggest gain and construction (-2.4 to 4.1) the biggest loss. Meanwhile, consumer (+0.8 to -6.5) sentiment improved, while services (+0.4 point to 12.2) sentiment recorded a small uptick and retail trade's (-0.1 to -1.2) barely budged.

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