MORNING BRIEFING
August 13, 2019

Less Than Zero: From FOMO to FONIR

See the collection of the individual charts linked below.

(1) Long trip to Boston. (2) Like the weather, the stock market is volatile this summer. (3) More nervousness about recession scenario. (4) Credit crunches cause recessions. (5) Is the Fed listening to the yield curve, Trump, or both? (6) Sentiment remains bullish on balance. (7) TINA, FOMO, and FONIR. (8) Trump has NIRP envy. (9) NIRP not doing much to revive Eurozone and Japan. (10) US bond yields tethered to yields in Germany and Japan.

Equities: Stocks in Beantown. I visited some of our accounts in Boston last week. The weather kept thwarting my travel arrangements. My morning flight on the way up was cancelled, as thunderstorms kept the plane from reaching LaGuardia (LGA) the night before. All other flights to Boston were either cancelled or full. I managed to get on the 7:00 a.m. Acela train from Stamford, Connecticut, which required taking a car service from my Long Island home. A drawbridge stuck in the open position delayed the train ride; I just barely made it to my first meeting. On the way back, I had to scramble to catch a 4:00 p.m. flight from Logan to LGA. While waiting on the tarmac, the pilot announced that we had to return to the terminal and disembark—more thunderstorms! Five hours later, the flight was cancelled. I made it home the next morning.

Such volatility is typical of what summer travelers face, I suppose. There's also been quite a bit of volatility in the stock market this summer—typical of what investors have faced throughout the current bull market. By our count, there have been 64 panic attacks followed by 63 relief rallies in the S&P 500 since early 2009. Joe and I expect that the current panic attack will also pass. So we are still predicting that this index will continue to rise into record-high territory, with our targets of 3100 before the end of this year and 3500 sometime next year.

In Boston, I sensed that our accounts are turning more cautious and defensive, with a few expecting a recession before the end of the year. I acknowledged their main concern, i.e., about the escalating trade war with China. However, US nominal GDP is around $21 trillion, while US exports to China totaled just $108 billion over the past 12 months through June, and imports from China totaled $509 billion over the same period.

My mantra continues to be: "No boom, no bust." Another way to put it is: "No credit crunch, no recession." Booms lead to speculative excesses financed by debt binges; the resulting inflation in consumer and/or asset prices forces the Fed to raise interest rates. In the past, such scenarios have triggered a financial crisis for a few borrowers and lenders, which rapidly has morphed into a widespread credit crunch, which caused a recession (*Fig. 1*).

The inverted yield is also a nagging concern among many of our accounts (*Fig. 2*). It has been a very good predictor of previous recessions. Our 4/7 study titled "The Yield Curve: What Is It Really Predicting?" addressed this question as follows: "More specifically, inverted yield curves don't cause recessions. Instead, they provide a useful market signal that monetary policy is too tight and risks triggering a financial crisis, which can quickly turn into a credit crunch causing a recession. If so, then the Fed's recent decision to be patient and pause its rate-hiking may reduce the chances of a recession."

Of course, since we wrote that, the Fed decided to cut the federal funds rate range from 2.25%-2.50% to 2.00%-2.25% on 7/31 (*Fig. 3*). The 12-month federal funds futures yield was down to 1.25% at the end of last week (*Fig. 4*). That implies three or four 25bps cuts in the federal funds rate by next summer.

The Fed seems to have gotten the message from the yield curve: Ease up or risk a credit crunch and a recession.

Equities: Stocks in Wonderland. One day after the Fed cut the federal funds rate, President Donald Trump escalated the US-China trade war on 8/1 when he announced that a 10% tariff will be slapped on $300 billion of China's exports to the US at the beginning of September. That's in addition to the 25% tariff that had already been imposed on another $250 billion of such goods.

The latest escalation caused the Bull-Bear Ratio compiled by Investors Intelligence to decline from 3.35 during the 7/30 week to 2.69 during the 8/6 week (*Fig. 5*). That isn't much of a drop, actually. Most of it is attributable to the percentage of survey participants expecting a market correction, i.e., up from 25.7% to 34.0%. Bearish sentiment upticked from 17.1% to 17.9%.

It's widely known that August can be a turbulent month for stocks. So can September and October. So can all the months of the year. In any event, this coming September and October, investors can look forward to another rollercoaster ride. The 10% tariff on China hits on 9/1. The European Central Bank (ECB) is likely to lower its official interest rate further into negative territory and restart QE on 9/12. The FOMC meets on 9/17-9/18 with the possibility of another rate-cut decision. On 10/15, the Q3 earnings reporting season gets going. The Brexit deadline is 10/31.

Given all this commotion, why is the S&P 500 down only 4.7% from its record high on 7/26 as of yesterday's close? While I am getting the impression from my meetings with accounts recently that fears of an impending recession are mounting, it's hard to see that in the stock market's performance or in sentiment indicators so far.

Some investment strategists explain the ongoing bull market with the notion that There Is No Alternative to Stocks, or TINA. Last week, I argued that bonds have been a great alternative, with both bonds and stocks beating cash, for sure. Other strategists have attributed the bull market to Fear of Missing Out, or FOMO.

I propose an alternative acronym: FONIR, or Fear of Negative Interest Rates. Investors continue to scramble into both bonds and stocks, fearing that the ECB will go more negative with its official rate, which is currently -0.40% (*Fig. 6*). The Bank of Japan (BOJ) is at -0.03% and might also go lower. In the US, the federal funds rate was cut at the end of July. It remains well above zero but is widely expected to be heading closer to zero through next year, as evidenced in the federal funds futures market.

Putting lots of pressure on the Fed to lower interest rates is President Trump, who has a severe case of NIRP (Negative Interest Rate Policy) envy. He keeps wondering out loud why interest rates in the US are so much higher than they are in the Eurozone and Japan. He has figured out that by escalating his trade war with China, he puts pressure on the Fed to cut interest rates. He believes he needs the Fed to do so to support the economy to win his trade war with China.

NIRP in the Eurozone and Japan and NZIRP (near-zero interest rate policy) in the US are fueling a global-reach-for-any-yield-north-of-zero panic. So this is bullish for bonds and also bullish for stocks, especially those with a dividend yield. Fear is a powerful emotion. FONIR should continue to be a powerful driver of the bull markets in bonds and stocks.

Credit: Bonds in Neverland. The 8/11 *WSJ* included an article titled "Investors Ponder Negative Bond Yields in the U.S." As a result of the negative interest rate polices of the ECB and BOJ, "there is more than $15 trillion in government debt around the world with negative yields." In other words: "That means, essentially, that savers holding these bonds are paying the government to store their money."

So far, NIRP isn't doing much to revive the economies of the Eurozone and Japan. It may actually be doing more harm than good: "In Europe and Japan, subzero yields were brought about by slow growth, low inflation and aggressive central-bank stimulus, including negative interest rates and extensive asset purchases. That has helped alleviate economic pain. But the subzero yields haven't led to a true revival in those economies. They have also hurt savers and threatened the financial system by curtailing the ability of banks to generate profits."

Consider the following related developments:

(1) *Bond yields here and there.* On Friday, the 10-year government bond yields in Germany and Japan were down to -0.57% and -0.19%, respectively (*Fig. 7*). The comparable US yield was down to 1.74%; it dropped again, to 1.65%, yesterday.

Since the start of this year, here are the declines in these yields through Friday: US (-95bps), Germany (-82), and Japan (-20). Since last year, my Modern Tethered Theory (MTT) of the US bond yield has been that it is falling in response to the gravitational pull of negative yields in the Eurozone and Japan.

(2) *US TIPS yield almost negative.* The 10-year US Treasury TIPS yield is down 90bps over the same period, from 0.98% at the start of this year to just 0.08% on Friday (*Fig. 8*). It may be on the verge of turning negative, which is what it did during 2012.

(3) *Inflationary expectations subdued.* A widely followed proxy of the expected annual US inflation rate over the next 10 years is the yield spread between the 10-year US Treasury bond and the comparable TIPS (*Fig. 9*). On Friday, it was back down to the year's low of 1.66%.

(4) *Unreal real rates*. In the US, the core CPI y/y inflation rate was 2.1% during June (*Fig. 10*). It was 0.9% through July in the Eurozone and 0.3% through June in Japan.

That means that both the inflation-adjusted federal funds rate and 10-year US Treasury bond yield are around zero (*Fig. 11*).

In the Eurozone, the inflation-adjusted official deposit rate of the ECB and the German 10-year government bond yield were -1.3% and -1.2%, respectively, in July (*Fig. 12*).

In Japan, the BOJ's inflation-adjusted official rate and the 10-year government bond yield both were at -0.4% in June (*Fig. 13*).

CALENDARS

US. Tues: NFIB Small Business Optimism Index 104.0, Headline & Core CPI 1.7%/2.1% y/y, NY Fed Q2 Household Debt & Credit Report. **Wed:** Eurozone GDP 0.2%q/q/1.1%y/y, Eurozone Industrial Production -1.4%m/m/-1.5%y/y, Germany GDP -0.1%q/q/0.1%(wda)y/y, UK Headline & Core CPI 1.9%/1.8% y/y, China Retail Sales 8.6% y/y, China Industrial Production 6.0% y/y, China Fixed Assets Ex Rural (ytd) 5.9% y/y. (DailyFX estimates)

Global. Tues: Germany ZEW Survey Current Situation & Expectations -5.9-/28.0, Germany CPI 0.5%m/m/1.7%y/y, UK Employment Change 62k 3m/3m, UK Unemployment Rate (3-mth) 3.8%, Japan Machine Tool Orders -1.1%m/m/-1.0%y/y. **Wed:** Import Prices -0.1%m/m/-2.0%y/y, MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings dropped simultaneously for all three indexes for the first time since mid-April, but remain in the uptrends that began during March. LargeCap's has risen during 21 of the past 26 weeks, MidCap's 14 of the past 22 weeks, and SmallCap's 11 of the past 20 weeks. LargeCap's is down 0.1% from its record high a week earlier, while MidCap's and SmallCap's weakened to 1.6% and 6.3% below their mid-October highs. At their bottoms earlier in 2019, 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. In the latest week, the rate of change in LargeCap's forward earnings dropped to a 34-month low of 2.4% y/y from 2.7%. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change slipped to a 40-month low of 1.2% from 2.3%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -4.2% y/y is the lowest since December 2009. That compares to an eight-year high of 35.3% in early October. 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%, 1.8%, 11.4%), MidCap (22.7, -0.9, 13.5), and SmallCap (22.4, 0.3, 17.7).

S&P 500/400/600 Valuation (*link*): Valuations mostly edged down last week to eight-week lows for these three S&P market-cap indexes. LargeCap's forward P/E fell 0.1 point w/w to an eight-week low of 16.5 from a 17-month high of 17.2 at the end of July. That compares to a five-year low of 13.9 during December and 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 was steady at an eight-week low of 15.5, down from a 12-week high of 16.0 at the end of July. That's also 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 dropped 0.1 point w/w to an eight-week low of 16.2, which compares to an 11-week high of 16.7 at the end of July. That's still well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E was below LargeCap's P/E for an 11th 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 Q2 earnings season nearly complete and mostly awaiting July-quarterly results, the earnings hook continued to rise in the latest week. The S&P 500's blended Q2-2019 EPS forecast rose 8 cents w/w to $41.25. That represents an earnings gain of 0.6% y/y compared to the prior week's forecasted earnings gain of 0.4%, and should continue to improve as more companies report in the coming weeks. That's above our forecast of $41.00 for Q2 EPS and flat earnings y/y. On a pro forma basis, the blended Q2 earnings growth rate is 2.8% y/y, which would be the 12th straight y/y rise and compares to 1.6% in Q1, 16.9% in Q4, and 28.4% in Q3 (which marked the peak of the current earnings cycle). Seven of the 11 sectors are expected to record positive y/y earnings growth in Q2-2019, versus six a week earlier, with only three rising at a double-digit percentage rate. That compares to six positive during Q1, when just one rose at a double-digit percentage rate. Four sectors are expected to beat the S&P 500's Q2 growth rate, down from five during Q1. Communication Services, Financials, and Materials are the only sectors currently posting better (or less worse) growth on a q/q basis during Q2. Here are the latest Q2-2019 earnings growth rates versus their Q1-2019 growth rates: Communication Services (17.1% in Q2-2019 versus -9.9% in Q1-2019), Health Care (10.1, 10.3), Financials (10.0, 8.0), Real Estate (4.1, 6.2), Consumer Discretionary (1.2, 8.1), Utilities (1.1, -0.5), Consumer Staples (1.0, 1.0), Information Technology (-3.1, -1.1), Energy (-8.9, -26.1), Industrials (-9.0, 6.9), and Materials (-13.1, -13.4). On an ex-Energy basis, S&P 500 earnings are expected to be up 3.5% y/y in Q2, up from 3.0% in Q1 and well below the 14.2% y/y gain in Q4. Looking ahead to the future, analysts as usual are trimming their forecasts for the next quarter. The S&P 500's Q3-2019 EPS forecast dropped 37 cents w/w to $41.82. The consensus' $42.19 estimate is down 2.7% in the five weeks since the start of the quarter, which now represents an earnings decline of

2.0% y/y. On a pro forma basis, the consensus Q3 estimate represents an earnings decline of 1.4% y/y and flat earnings y/y ex-Energy. That compares to a forecast decline of 0.7% a week earlier and a gain of 0.8% at the end of Q2.

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2 earnings season over 90% complete for the S&P 500, the results compared to the same point during Q1 show that revenues are beating by a greater amount; a higher percentage of companies is reporting positive revenue surprises; the earnings surprise is a tad smaller; and y/y earnings growth is only 1.4ppts lower despite Boeing's dismal Q2 results. Of the 451 S&P 500 companies that have reported through midday Monday, 74% exceeded industry analysts' earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 1.6% and exceeded forecasts by an impressive 6.1%. Ex-Boeing, Q2's y/y earnings growth improves 1.7ppts to 3.3%. On the revenue side, 57% of companies beat their Q2 sales estimates so far, with results coming in an impressive 1.3% above forecast and 4.2% higher than a year earlier. Q2 earnings growth results are positive y/y for 66% of companies, versus a lower 64% at the same point in Q1, and Q2 revenues have risen y/y for 67% versus a similar 67% during Q1. Looking at earnings during the same point in the Q1-2019 reporting period, a higher percentage of companies (76%) in the S&P 500 had beaten consensus earnings estimates by a higher 6.7%, and earnings were up a higher 3.0% y/y. With respect to revenues at this point in the Q1 season, a slightly lower 57% had exceeded revenue forecasts by a sharply lower 0.2%, and sales rose a higher 5.4% y/y. Compared to 2018's stellar results, these readings for Q2 indicate a continuation of a marked slowdown in revenue and earnings growth and a slight deterioration in profit margins. But that should come as no surprise to investors. Q1-2019 had marked the 11th straight quarter of positive y/y earnings growth and the 12th of positive revenue growth. However, earnings growth trailed revenue growth during Q1-2019 for the first time since Q2-2016. That has happened just five times in the 42 quarters since the bull market started in Q1-2009. With the earnings season nearly complete, it looks like Q2-2019 will make the sixth.

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