Yardeni Research

MORNING BRIEFING
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The Fed: Rounding up the Usual Suspects

See the collection of the individual charts linked below.

(1) Running out of basis points. (2) Bernanke's presidential address. (3) Bernanke promotes QE as permanent tool for Fed. (4) QE plus forward guidance = 300bps cut in federal funds rate, according to Big Ben. (5) Yellen and Powell agree with Bernanke. (6) Summers sees "last hurrah" for central banks. (7) FOMC's annual rotation still leaves the Fed on hold. (8) A roundup of the views of Fed officials. (9) "In a good place." (10) Powell is patient again. (11) The global economy remains relatively weak, and is on Fed's radar screen.

Fed I: When the Unconventional Becomes Conventional. Has the Fed run out of room to boost the US economy in the event of a recession? It would seem so, at least in terms of interest rates. At 1.50%-1.75%, the federal funds rate range is a mere handful of 25bps cuts above zero. During the Great Recession, the Fed cut rates by effectively 525bps from a peak of 5.25% down to a range of 0.00%-0.25% (*Fig. 1* and *Fig. 2*). During the previous recession, the federal funds rate was cut by 550bps from the 6.50% peak to the 1.00% trough.

Nevertheless, the current and two previous Fed chairs recently claimed that the Fed can utilize what were previously considered unconventional monetary policies to combat a future recession. Let's review their individual views:

(1) *Bernanke's take.* In a 1/4 speech, former Fed Chair Ben Bernanke questioned the notion that central bankers have "run out of room." He presented his thoughts during the 2020 American Economics Association Presidential Address. While the Fed may not have much room for "conventional" interest-rate cuts, he said, newer tools could be useful.

Bernanke's own new research showed quantitative easing (QE) programs to be effective even when interest rates were as low as zero. Moreover, bond purchases should not be viewed as a last resort for central bankers but part of "the standard toolkit," he said. According to Bernanke, a combination of QE and forward guidance by central bankers could produce "the equivalent of about 3 additional percentage points of short-term rate cuts." Additionally, using negative interest-rate policy (NIRP) should not be ruled out, he said.

(2) *Yellen's take.* Bernanke again shared these views in a panel discussion on 1/4 alongside former Fed Chair Janet Yellen and current Fed Chair Jerome Powell (see the video here). Yellen agreed that "the tools [used to pull the US economy out of the Great Recession] were effective, should remain in the toolkit, and potentially can be strengthened."

(3) *Powell's take.* Powell clearly values the opinions of his predecessors, saying: "I would agree with … both Ben and Janet … that the tools that we used in the crisis after hitting the zero lower bound generally worked. … [W]e use all of our tools to the extent appropriate. We'll use the balance sheet. We'll use the tools that we had."

(4) *Summers' doubts.* Former Treasury Secretary Lawrence Summers dismissed Bernanke's optimism. In an interview on Bloomberg Television's "Wall Street Week," he said Bernanke's speech was "a kind of last hurrah for the central bankers." He added that he thinks it's "pretty unlikely" that the Fed would lower interest rates by as much again "given that in recessions we usually cut interest rates by 5 percentage points and interest rates today are below 2%."

Fed II: On the Same Page. Last year, Fed officials disagreed on the course of monetary policy in the face of persistently low inflation and global "crosscurrents," to borrow an often-used phrase by Powell. Split votes were apparent in four out of eight Federal Open Market Committee (FOMC) meetings last year. Most recently:

(1) *The 9/18/19 FOMC meeting.* While the September meeting saw the majority vote to lower the federal funds rate by 25bps for the second time in 2019, the meeting's statement identified three dissenters. Two preferred to maintain rates, and one favored a 50bp cut. Such dissension among the committee's dissenters is a first in our memory.

(2) *The 12/11/19 FOMC meeting.* By the next policy meeting, the last of 2019, the dissension was gone, with all officials voting to leave rates unchanged. That meeting's Minutes, released Friday, and recent comments from officials noted below show FOMC participants are starting off the year with their thinking much more aligned than a few months ago.

With the new year, the regional Fed presidents underwent their annual voter rotation on the FOMC (see note below). This year's rotation isn't as impactful for vote outcomes as often is the case given the FOMC's apparent do-nothing-in-2020 unanimity at present.

So after last year's three rate cuts, Fed watching this year may be relatively dull—that is, barring an unexpected surge in inflation, a recession, or a stock-market meltup/meltdown. Geopolitical events are also a wildcard.

Here's a roundup of the latest comments from regional Federal Reserve Bank (FRB) presidents:

(1) *Bullard (nonvoter).* St Louis FRB President James Bullard, a nonvoting FOMC participant this year, recently changed his tune, no longer lobbying for deeper rate cuts. He said in a speech on Thursday: "The current baseline economic outlook for 2020 suggests a reasonable chance that [a] soft landing will be achieved" following last year's three interest rate cuts. Before adjusting monetary policy again, "we should wait and see what the effects are," he told reporters.

(2) *Mester (voter).* Cleveland FRB President Loretta Mester told reporters recently: "I think most of us think that we are well-calibrated now." She noted that "the committee thinks a flat [rate] path ... is appropriate." While she did not get a vote in 2019, Mester was among the officials last year arguing against rate cuts.

(3) *Barkin (voter).* Richmond FRB President Thomas Barkin, another nonsupporter of last year's rate cuts, observed in a speech on Friday that "the economy is still healthy. … I'm encouraged by recent jobs reports and the pace of holiday spending."

(4) *Kashkari (voter).* Minneapolis FRB President Neel Kashkari said in a 1/9 Fox Business Network interview that he would opt to hold steady "for the foreseeable future, the next six months, next year, but it will depend." The "pause mode," he said, puts the Fed "in a much better position. And if the labor market continues to draw people back in, wages continue to rise, eventually that should bleed through to help and get inflation back to our 2% target." He said that he would be in favor of "more accommodation" only if "inflation continues to weaken or inflation expectations continue to slide."

(5) *Evans (nonvoter).* Chicago FRB President Charles Evans favored last year's rate cuts. But Evans implied in a 1/3 CNBC interview that he is content with the economic growth trajectory

in the US.

(6) *Clarida (permanent voter)*. One of the Fed's favorite new catch phrases is "in a good place." FRB Vice Chairman Richard Clarida, who voted for last year's rate cuts, used those words to describe the US economy during a 1/9 speech in New York: "The shift in the stance of monetary policy that we undertook in 2019 was … well timed and has been providing support to the economy and helping to keep the U.S. outlook on track. [M]onetary policy is in a good place and should continue to support sustained growth, a strong labor market and inflation running close" to the Fed's 2.0% objective, he said.

(7) *Powell (permanent voter).* Fed Chair Powell said in the panel discussion with Bernanke and Yellen that "notwithstanding" recent manufacturing data, US data "seem to be on track to sustain good momentum into the new year." However, he added: "you do have this difference between, on the one hand, strong data, and some tension between financial markets that are signaling concern and downside risks," particularly about US and China trade tensions.

While policy "is not on a preset path," Powell concluded, the Fed "will be patient as we watch to see how the economy evolves." His use of the word "patient" takes us back to early 2019, when Fed monetary policy statements used it often to describe its wait-and-see approach (later replaced with the word "appropriate" as rates were decreased).

Note: The voters rotating onto the FOMC for 2020 are the presidents of the FRB banks of Cleveland (Loretta Mester), Philadelphia (Patrick Harker), Dallas (Robert Kaplan), and Minneapolis (Neel Kashkari). Out of the voter rotation are the presidents of the FRB banks of St Louis (James Bullard), Chicago (Charles Evans), Kansas City (Esther George), and Boston (Eric Rosengren). The Fed chair (Jerome Powell) and New York Fed president (John Williams) hold permanent voting seats on the Fed for their tenure as officials, as does the Fed's Board of Governors (Michelle Bowman, Lael Brainard, Richard Clarida, and Randal Quarles).

Fed III: Waiting Minutes. At their 12/10-12/11/19 meeting, FOMC officials "discussed how maintaining the current stance of policy for a time could be helpful for cushioning the economy from the global developments that have been weighing on economic activity," the Minutes stated. They remained more concerned about global economic weakness and geopolitical matters than a return of US inflation. Powell said during his post-meeting press conference that he'd like to see persistent upward momentum in inflation before raising interest rates again.

The messaging of the Minutes jibes with officials' recent comments indicating their general contentment with the current accommodative stance of monetary policy. If something were to change that stance, we think an interest-rate cut would be a more likely next move than a hike. That's because inflation is unlikely to return, and the latest indicators suggest a relatively weak global economy:

(1) *OECD leading indicators.* For example, yesterday we learned that the composite leading indicator for the OECD countries rose for the first time since year-end 2017. But get your magnifying glass out: The index for November ticked up to 99.3, from 99.2 in October (*Fig. 3* and *Fig. 4*). The OECD-Europe index posted 99.4, up from 99.3 previously, with the UK and Germany rising, while Italy and France remained the same and Spain fell (*Fig. 5*). The US headline for the index also held steady, posting 98.9 for the fourth month in a row. We suppose that's better than another downtick. Apparently (hopefully), global growth may have turned a corner.

(2) *Global PMIs.* The good news is that the global composite PMI rose to 51.7 during December, up from a recent low of 50.8 during October (*Fig. 6* and *Fig. 7*). Over this same two-month period, the C-PMI for advanced economies advanced from 50.3 to 51.2, while the same index for emerging economies edged down from 52.7 in November to 52.2 in December. The only bad news was that the manufacturing PMI for advanced economies edged down from 49.5 during November to 49.1 in December, though it's still above its recent low of 48.6 during September and October.

(3) *Commodity prices.* Debbie and I devised a homebrewed Global Growth Barometer (GGB) by averaging the CRB raw industrials spot price index and the nearby futures price of a barrel of Brent crude oil (*Fig. 8*). It is starting out the new year moving higher, with both of its components doing the same (*Fig. 9*). Not surprisingly, our GGB is highly correlated with the Goldman Sachs Commodity Index (*Fig. 10*). We like ours better because we can track its two components separately as well.

In any event, both indexes are inversely correlated with the trade-weighted dollar, which is down 3% from last year's peak through 1/13 (*Fig. 11*). As we've observed before, a weaker dollar combined with rising commodity prices implies that the global economy (excluding the US) is picking up.

CALENDARS

US: **Tues:** Headline & Core CPI 2.4%/2.3% y/y, NFIB Small Optimism Index 104.9, Williams. **Wed:** PPI Final Demand 0/2%m/m/1.3%y/y, Empire State Manufacturing Index 3.5, MBA Mortgage Applications, DOE Crude Oil Inventories, Beige Book, Harker, Kaplan. (DailyFX estimates)

Global: **Tues:** Mersch, Kuroda. **Wed:** Eurozone Industrial Production 0.3%m/m/-1.0%y/y, Eurozone Trade Balance €22.0b, Germany GDP (2019) 0.6% y/y, Germany Public Finances Balance-GDP Ratio (2019) 1.2%, UK Headline & Core CPI 1.5%/1.7% y/y, Japan Machine Orders -5.4% y/y, Saunders. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): The forward earnings of LargeCap rose to a record high last week, for the first week since 9/20/19, and SmallCap's rose for an eighth week in a row. MidCap's was down for the first time in eight weeks. These indexes began a forward-earnings uptrend during March but stumbled from July to November. LargeCap's forward earnings has risen during 34 of the past 48 weeks, MidCap's 26 of the past 44 weeks, and SmallCap's 25 of the past 42 weeks. While LargeCap's is at a record high now, MidCap's and SmallCap's are 3.2% and 4.8% below their October 2018 highs. Index changes for the SMidCaps at the end of 2019 helped MidCap's forward earnings improve from November's 18-month low, while SmallCap's is up from September's 17-month low. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings jumped to a six-month high of 2.9% y/y from 2.1% and is up from a 38-month low of 1.0% in early December. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's improved w/w to -2.2% y/y from -2.8%, and compares to -5.5% in mid-November, which was the lowest since December 2009. That also compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -1.1% y/y reading improved w/w from -3.5%, and is up markedly from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 during late 2018, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, -0.2%, 9.6%), MidCap (22.7, -6.1, 12.0), and SmallCap

(22.4, -2.6, 15.5).

S&P 500/400/600 Valuation (*link*): Valuations were mixed last week for these three indexes. However, they remain near their highest levels in over a year. LargeCap's forward P/E rose w/w to a 24-month high of 18.4 from 18.2. That compares to a five-year low of 13.9 during December 2018 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 remained steady w/w at 17.0, which compares to a 22-month high of 17.4 in mid-December. That's up from 13.0 during December 2018, 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 fell w/w to 17.4 from 17.8, and is down from mid-December's 16-month high of 18.1. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is back below LargeCap's again. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With the books closed on Q4 and earnings season about to begin, earnings revisions activity is in its typical negative-bias period as analysts await the release of results. The Q4 EPS forecast dropped 11 cents w/w to $40.48. That represents a decline of 1.7% on a frozen actual basis and a drop of 0.6% y/y on a pro forma basis. That compares to a 0.3% decline in Q3 and y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). If the y/y earnings decline comes to pass in Q4-2019, it would be the second straight decline and the first drop since earnings fell y/y for four straight quarters through Q2-2016. However, seven of the 11 sectors are expected to record positive y/y earnings growth in Q4, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. The same seven sectors are expected to beat the S&P 500's 0.6% decline in Q4 as in Q3; that's up sharply from just three beating the S&P 500 during Q2. Four sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Financials, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 1.9% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1 but is well below ex-Energy's 25.0% and 14.2% y/y gains in Q3- and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their final Q3-2019 growth rates: Utilities (13.9% in Q4-2019 versus 6.7% in Q3-2019), Financials (11.4, 2.6), Health Care (6.3, 8.8), Real Estate (3.9, 5.9), Communication Services (2.0, -1.4), Consumer Staples (1.0, 3.7), Information Technology (0.6, -1.7), Industrials (-6.3, 3.4), Materials (-11.6, -10.9), Consumer Discretionary (-11.1, 1.8), and Energy (-38.5, -37.8).

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In November, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—continued to reflect stable growth momentum in the OECD area as a whole, though were below long-term trends in most advanced economies. November's OECD ticked up to 99.3 after holding at a decade-low 99.2 the previous five months. Among the major economies, stable growth momentum remained the assessment for the Eurozone (99.2) as a whole—including France (99.5) and Italy (99.2)—as well as Japan (99.2) and Canada (99.1). Meanwhile, the signs of stabilization tagged in October's report for the UK (99.1), US (98.9), and Germany (98.9) were confirmed in November's report. Among the major emerging economies, stable growth momentum continues to be the assessment for Russia (99.8) as well as China's (99.3) industrial sector. Meanwhile, growth in Brazil (102.4) is expected to gain momentum, while India's CLI (98.8) still points to easing growth momentum.

UK GDP (*link*): Real GDP growth contracted 0.3% in November after downwardly revised gains of 0.1% in each of the prior two months. In November, construction rebounded 1.9% from October's 2.2% decline, while other major sectors lost ground during the month, including services (-0.3%)—which accounts for roughly 80% of the UK economy. Production industries, which include manufacturing, fell 1.2% in November, its third decline in four months, dragged lower by a 1.7% drop in manufacturing. On a rolling three-month basis, overall GDP eked out a 0.1% uptick, boosted by another solid increase in construction of 1.1% after gains of 0.8% and 1.2% the prior two months, while services edged up only 0.1%—its weakest showing since July 2016. Growth in production industries sank 0.6% over the comparable three-month period, with manufacturing contracting 0.8%. On a y/y basis, real GDP expanded only 0.6%, its weakest yearly growth since June 2012, with services (0.8% y/y) posting its weakest yearly performance since October 2011. Construction (2.0) was above a year ago, after a brief dip into negative territory in October (-0.3). Meanwhile, growth in production industries (-1.6% y/y) matched the weakest yearly performance since August 2013, led by a sharp drop in manufacturing (-2.0).

UK Industrial Production (*link*): Output in November slumped to its lowest level since March 2017 as factory production sank to its lowest since November 2016, falling 1.2% and 1.7%, respectively, during the month. Since reaching a new cyclical high in March, manufacturing production has tumbled 5.0%, with all main industrial groupings except energy in the red. Declines were notable, both on a monthly and eight-month basis, for consumer nondurable (-1.1%m/m & -5.8% since March peak), intermediate (-1.3 & -5.7), capital (-2.6 & -3.9), and consumer durable (-2.0 & -2.5) goods. Looking ahead, IHS Markit's M-PMI in December remained below 50.0 for the eighth month, dipping to 47.5—its second weakest level in almost 7.5 years, August 2019's (47.4) being the weakest. Output, new orders, and new export orders all fell sharply at the end of 2019, with job losses reported for the ninth consecutive month.

Germany Industrial Production (*link*): Headline and manufacturing production rebounded in November after sinking in October to their lowest levels since May 2016 and August 2014, respectively. Germany's headline production—which includes construction—jumped 1.1% in November after sliding four of the prior five months by a total of 2.9%, with manufacturing output up 0.9% and down 3.7% over the comparable periods. Excluding construction, output rose 0.9% in November and fell 3.6% during the five months ending October. Among the main industrial groupings, only production of intermediate goods (-0.5%) recorded a decline in November, while capital goods (2.4) recorded a sizeable increase—though after steep declines the prior two months. Compared to a year ago, consumer durable goods orders (3.4% y/y) posted its best yearly growth rate since March 2018, while the remaining groupings contracted: capital goods (-4.9), energy (-4.3), intermediate goods (-4.2), and consumer nondurable goods (-1.2). Looking ahead, IHS Markit's M-PMI fell to 43.7 in December—remaining firmly in contractionary territory. However, the report notes there were some encouraging developments, as "December's decrease in new orders was the slowest in the whole of 2019 and manufacturers' output expectations showed a further—albeit marginal—improvement."

Contact us by email or call 480-664-1333.

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, 570-775-6823