



## MORNING BRIEFING

February 4, 2020

### The NABNAB Scenario

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

(1) Taking a break from the virus, and DC too. (2) The secret formula is NABNAB 2-2-2. (3) Failing to stall. (4) The Trauma of 2008 is still boosting profit margins today. (5) Productivity could be a game changer. (6) Consumers continue to spend, especially on health care. (7) Real wages at record high and rising along a trend line of 1.2% real annual growth. (8) Capital-spending growth falls along with CEO confidence. (9) Tech-related capital spending at record high. (10) Some evidence of Millennials turning from renters to homeowners. (11) Other possible sources of GDP strength in 2020: defense, infrastructure, and trade.

**GDP I: Muddling Along at Stall Speed.** Let's take a break from the coronavirus outbreak. We can even take a break from the impeachment of President Trump. That's because the Senate is likely to vote against impeaching him before the end of this week.

Let's instead focus on the US economy, which continues to grow at a slow but steady pace, with neither a boom nor a bust (NABNAB). That's an ideal environment for prolonging the current economic expansion, which turned into the longest one on record last year during July ([Fig. 1](#)). It's also an ideal scenario for the stock market, as long as we all remain healthy. Consider the following:

(1) *The 2-2-2 scenario.* In our NABNAB scenario, inflation remains subdued below 2.0%. The Fed remains on hold, keeping the federal funds rate in a 1.50%-1.75% range. The 10-year US Treasury bond yield remains below 2.00%. S&P 500 earnings growth rebounds to a moderate 5.0% rate this year and next year. How long might NABNAB last? Until further notice.

NABNAB is the 2-2-2 scenario with real GDP growth around 2%, inflation around 2%, and the bond yield around 2%, or thereabouts.

(2) *Rooting for a breather.* Even more ideal would be if the S&P 500 were to stall around last year's close of 3230.78, buying time for earnings to catch up with stretched valuation multiples

([Fig. 2](#)). In a perfect NABNAB scenario, the S&P 500 would rise to 3500 by the end of this year and 4000 by the end of 2021.

(3) *No boom, no bust*. In the NABNAB scenario, real GDP continues to grow around 2.0% y/y, as it has been doing since 2010 ([Fig. 3](#)). During previous business cycles, 2.0% turned out to be the economy's "stall speed." Every time it slowed to 2.0%, economic growth stalled and the economy fell into a recession. That occurred during each of the previous 11 downturns since 1948. This time is different because it is different this time: The economy hasn't fallen into a recession, even though it's been growing at the stall speed since 2010!

Why is that? In the past, prior to falling to the stall speed, the economy was booming at faster and unsustainable growth rates as a result of late-cycle economic booms. The resulting business, inflation, and credit excesses set the stage for the inevitable busts. Another bust is less likely anytime soon as long as economic growth continues to muddle along at the stall speed without a boom. Our mantra remains the same: "No boom, no bust." Or, simply: "NABNAB" (neither a boom nor a bust).

(4) *Traumas and margins*. Why haven't we had a boom so far? Everyone (with a few exceptions) seems to have turned more cautious since the Trauma of 2008. Booms tend to occur a few years after busts, when the busts have been mostly forgotten. The Great Recession and the Great Financial Crisis have yet to be forgotten. They are still (mostly) keeping a lid on economic and financial excesses. The best evidence of that is how S&P 500 companies are keeping their profit margins at record highs. They aren't going on capital-spending and hiring binges as they did during previous booms ([Fig. 4](#)). The sum of compensation of employees and business capital spending as a percentage of nominal GDP was 66.6% during Q4-2019, well below the previous peaks that preceded recessions ([Fig. 5](#)).

(5) *Productivity making a comeback*. Debbie and I aren't ruling out faster real economic growth if productivity growth has started making a comeback, as we expect. The five-year average annual growth rate in nonfarm business productivity is up from a recent low of only 0.5% during Q4-2015, doubling to 1.0% during Q3-2019 ([Fig. 6](#)). That may not seem like much, but it means that half, rather than one-quarter, of real GDP growth is being driven by productivity.

**GDP II: Healthy & Wealthy Consumers.** Continuing to lead the economy's growth has been real personal consumption expenditures (PCE), which was up 2.6% y/y during Q4-2019 ([Fig.](#)

7). The comparable growth rates were also solid for the major components of real PCE: durable goods (5.7%), nondurable goods (3.3), and services (2.0).

Americans continue to spend lots of money to be healthy. In current dollars, PCE accounted for 68% of nominal GDP during Q4-2019 ([Fig. 8](#)). Excluding health care, PCE has been hovering around 54% of nominal GDP since the mid-1960s. PCE on health care has increased from 4.4% of GDP at the end of 1966 to 14.5% currently ([Fig. 9](#)).

Relative to GDP, Americans are spending less on motor vehicles and residential fixed investment. (The latter category is a separate item in GDP, i.e., it is not included in PCE). The sum of the two accounted for 6.2% of nominal GDP during Q4-2019, which is up from the most recent cyclical low of 4.7% during Q2-2011 but remains well below all but one of the previous lows since 1948 ([Fig. 10](#))!

Driving consumer spending are solid gains in employment and real wages. Full-time employment rose to a record high of 131.8 million at the end of last year ([Fig. 11](#)). Inflation-adjusted wages (based on average hourly earnings) rose to a record high late last year, and continues to track along a 1.2% annual growth path, as it has since the mid-1990s ([Fig. 12](#)). If productivity growth makes a comeback, as we expect, real wage gains should accelerate.

Consumers should continue to have the means and the will to spend. Our Consumer Optimism Index—which is the average of the Consumer Sentiment Index and the Consumer Confidence Index—has been fluctuating at a cyclical high over the past two years, with its current conditions component at a new cyclical high during January, at the highest reading since November 2000 ([Fig. 13](#)). Boosting confidence is the perception that jobs remain plentiful.

**GDP III: Cautious CEOs.** Sadly, CEOs aren't as upbeat as consumers. Their confidence is down and depressing their capital spending, though not their hiring. The Business Roundtable CEO Outlook index fell from a record high of 118.6 during Q1-2018 to 76.7 during the final quarter of 2019 ([Fig. 14](#)). That's the lowest reading since Q4-2016. This index is highly correlated with the y/y growth rate in real capital spending, which fell to zero during Q4-2019, the weakest since Q2-2016.

Undoubtedly, mounting concern about Trump's escalating trade wars during 2018 and 2019 was a major cause of the drop in business confidence, notwithstanding the significant cut in

the corporate tax rate at the beginning of 2018 and ongoing business deregulation. Now that the President has been deescalating his trade wars recently, the confidence of CEOs and their business spending should rebound. But first, there needs to be more confidence that the coronavirus outbreak won't significantly disrupt global commerce and tourism. As we suggested yesterday, we expect that the crisis will dissipate by the spring.

While there was widespread weakness in spending on structures, spending on industrial equipment and information-processing equipment has been growing. So has spending on software and R&D. Indeed, the sum of tech-related capital spending, which accounted for nearly 47% of total spending in current dollars during Q4-2019, rose to a record high at the end of last year ([Fig. 15](#) and [Fig. 16](#)).

**GDP IV: Busy Homebuilders.** Residential investment in real GDP rose 5.8% (saar) during Q4-2019, following a 4.6% gain during Q3. Homebuilders should continue to be positive contributors to real GDP this year. Since 2017, there have been slight upward trends in the homeownership rates of the younger age groups, especially under 35 and 35-44 years old ([Fig. 17](#)). This suggests that the Millennials are slowly but surely turning from renters to homeowners.

**GDP V: Strength Through Defense, Infrastructure & Trade.** Federal and municipal government spending is also boosting real GDP. Federal government spending rose 4.3% y/y during Q4-2019, led by a 4.5% increase in real defense spending ([Fig. 18](#)).

State and local government spending in real GDP rose 2.2% over the same period. Near-record-low yields in the muni bond market are a big windfall for state and local governments that must be taking advantage of easy credit conditions to spend more, especially on infrastructure. Sure enough, construction put in place by the public sector has been on an uptrend since 2014 and rose at the end of last year back to previous record highs ([Fig. 19](#)).

Conceivably, another source of economic growth this year might be a narrowing trade deficit if Trump's renegotiated bilateral trade agreements succeed in boosting US exports and bringing manufacturers to the US. The jury may be out for a while determining that.

## CALENDARS

**US:** **Tues:** Factory Orders 1.1%, Auto Sales. **Wed:** ADP Employment Change 160k, Trade Balance -\$47.8b, ISM & IHS Markit NM-PMIs 55.1/53.2, MBA Mortgage Applications, DOE Crude Oil Inventories, Brainard. (DailyFX estimates)

**Global:** **Tues:** China Caixin NM-PMI 52.0, Lowe. **Wed:** Eurozone Retail Sales - 1.1%/m/m/2.3%/y/y, Eurozone, Germany, France, and Italy C-PMIs 50.9/51.1/51.5/49.4, Eurozone, Germany, France, and Italy NM-PMIs 52.2/54.2/51.7/50.5, UK C-PMI & NM-PMI 52.4/52.9, Lagarde, Guindos, Lane, Wilkins, Masia. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** ([link](#)): LargeCap's forward earnings rose to a fourth straight record high last week and its first since 9/20/19. SmallCap's rose for an 11th week in a row, and MidCap's was up for the tenth time in 11 weeks. These indexes began a forward-earnings uptrend during March but stumbled from July to November. LargeCap's forward earnings has risen during 37 of the past 50 weeks, MidCap's 29 of the past 46 weeks, and SmallCap's 28 of the past 44 weeks. While LargeCap's is at a record high now, MidCap's and SmallCap's are 2.6% and 4.2% below their October 2018 highs. Index changes for the SMidCaps at the end of 2019 helped MidCap's forward earnings improved 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 rose to an eight-month high of 4.4% y/y from 3.7% 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 a five-month high of -0.5% y/y from -1.4%, 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 improved w/w to an eight-month high of 0.6% y/y from 0.0%; that's 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%, 0.1%, 9.3%), MidCap (22.7, -6.3, 12.3), and SmallCap (22.4, -1.7, 14.3).

**S&P 500/400/600 Valuation ([link](#)):** Valuations were lower last week for these three indexes. LargeCap's forward P/E fell w/w to 18.0 from 18.5. That compares to a five-year low of 13.9 during December 2018 and an 18-year high of 18.7 during mid-January—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E declined w/w to 16.5 from 17.1. 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 22-month high of 17.4 in mid-December 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 16.7 from 17.3, 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 Q4 earnings season in full steam, earnings revisions activity is entering its typical positive bias period as analysts digest the release of results. The Q4 EPS forecast rose 56 cents w/w to \$41.08. That represents a decline of 0.2% on a frozen actual basis, but a gain of 1.1% 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 1.1% gain 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 3.9% 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 Q3-2018 and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their final Q3-2019 growth rates: Utilities (13.3% in Q4-2019 versus 6.7% in Q3-2019), Financials (11.2, 2.6), Health Care (7.8, 8.8), Information Technology (7.5, -1.7), Real Estate (3.9, 5.9), Communication Services (3.8, -1.4), Consumer Staples (2.0, 3.7), Consumer Discretionary (-



6.7, 1.8), Industrials (-9.7, 3.4), Materials (-12.2, -10.9), and Energy (-41.6, -37.8).

## US ECONOMIC INDICATORS

**Construction Spending** ([link](#)): Construction expenditures in December ticked down 0.1%, after a five-month surge of 3.5%. Private residential investment finished 2019 very strong, rising 8.2% over the final six months of the year—with home improvement and single-family construction expenditures soaring 12.3% and 9.5%, respectively, over the period, while multi-family investment sank 8.2%. Meanwhile, private nonresidential investment posted only one monthly gain over the six-month period, contracting 2.0% over the period. Public construction spending took a minor step back in December, after climbing 3.5% the prior five months, and is within a fraction of a new record high.

## GLOBAL ECONOMIC INDICATORS

**Global Manufacturing PMIs** ([link](#)): Global manufacturing activity in January expanded at its best pace in nine months, though held just above the breakeven point of 50.0. Since bottoming at 49.3 last July, the index slowly improved to 50.4 by January, its third reading above 50.0, following six months below. The improvement was driven by the M-PMI for developed countries, which is nearing the 50.0 level for the first time since last April, improving from a recent low of 48.6 to a nine-month high of 49.8 in January. Meanwhile, the M-PMI for emerging economies has been flat at 51.0 since September. M-PMIs signaled expansions for 14 out of the 30 countries for which January data were available. The strongest expansions were seen in India (to 55.3 from 52.7) and Greece (54.4 from 53.9), with Colombia (53.4 from 52.4), Myanmar (52.7 from 52.0), and the Philippines (52.1 from 51.7) rounding out the top five—and the US (51.9 from 52.4) finishing sixth. The Eurozone's M-PMI (47.9 from 46.3) showed the area contracted for the 12th month, as Germany's M-PMI (45.3 from 43.7) finished 29 out of 30 again last month. The remaining Eurozone M-PMIs show Ireland (51.4 from 49.5) and France (51.1 from 50.4) accompanied Greece in expansionary territory, while the Netherlands (49.9 from 48.3), Austria (49.2 from 46.0), Italy (48.9 from 46.2), and Spain (48.5 from 47.4) continued to contract—though at a slower pace. Meanwhile, China's (51.1 from 51.5) manufacturing sector continued to expand, while Japan's continued to contract (48.8 from 48.4); manufacturing conditions in the UK (50.0 from 47.5) stabilized.

**US Manufacturing PMIs** ([link](#)): Manufacturing activity in January expanded for the first time in six months, according to ISM's survey, as a waning in trade tensions boosted exports. In the

meantime, IHS Markit's survey reported a slowing in growth last month as exports contracted. ISM's M-PMI (to 50.9 from 47.8) jumped to its highest reading since July after falling to its lowest reading since January 2016 at the end of last year. January's M-PMI is consistent with roughly a 2.4% annualized increase in real GDP, based on the past relationship of the two measures. Both the new orders (52.0 from 47.6) and production (54.3 from 44.8) components moved convincingly back above the breakeven point of 50.0 last month—as the former got a big boost from exports. The new export orders (53.3 from 47.3) sub-index soared to a 16-month high; it was at only 41.0 in September—which was the weakest performance since March 2009. The remaining three components of the M-PMI showed employment (46.6 from 45.2) continued to contract, though at a slightly slower pace, while inventories (48.8 from 49.2) contracted for the eighth month, though is hovering just below 50.0. The supplier deliveries (52.9 from 54.6) index eased from December's eight-month high. On the inflation front, ISM's price (53.3 from 51.7) index was above 50.0 for the second month, after six months below, reaching its highest reading since last March. IHS Markit's M-PMI eased for the second month in January, to 51.9, after climbing steadily from 50.3 in August to a seven-month high of 52.6 in November. According to the report, "The survey data are consistent with factory production falling moderately, meaning the manufacturing sector looks set to act as a drag on the overall economy once again in the first quarter." In the meantime, business expectations for the year ahead improved, coinciding with an easing of trade tensions and the signing of new North American and Chinese trade deals.

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