



MORNING BRIEFING

May 20, 2020

Parallel Universe

Check out the accompanying [chart collection](#).

(1) Headlines for tabloids. (2) An antenna named “ANITA” finds a parallel universe. (3) Surreal developments. (4) Will killing the economy save lives? (5) Trump takes antimalarial drug against swamp fever. (6) Fed chair is now MMT’s biggest booster. (7) Fed can print ammo. (8) Powell won’t be entering negative universe for now. (9) Forward P/Es soar as stock prices rebound while earnings expectations dive. (10) Joe normalizes forward P/Es using 12-month forward EPS ending 18 months from now. (11) An update on Growth versus Value.

The Twilight Zone: Part II. In the April 27 [Morning Briefing](#), I noted parallels between the Great Virus Crisis (GVC) and *The Twilight Zone*. I started writing the current issue of the *Morning Briefing* on Monday evening. I’ve found that once I mentally outline the subjects I intend to cover, an appropriate title almost always seems to pop into my head. If this career doesn’t work out, I plan to be a movie reviewer. If that doesn’t pan out, then I could write headlines for a tabloid magazine. Sure enough, the title of this piece popped into my head right away.

Here’s the freaky part of my tale: I Googled “parallel universe,” and among the first few links that popped up was an [article](#) in *Tech Times* posted the very same day (May 18) and titled “NASA Scientists Might Have Found a Parallel Universe ‘Next to Ours’ After an Antarctica Experiment.” Is that weird, or what? Fans of science fiction are familiar with the notion that when the Big Bang happened, two universes were formed, and the one we’re not familiar with runs in reverse. A cosmic ray detection experiment conducted by physicists working on NASA’s Antarctic Impulsive Transient Antenna (ANITA) has found particles that just could be from outside our universe. ANITA detected tau neutrinos coming “up” out of the Earth rather than down from space, implying that these particles are actually travelling backwards in time.

Meanwhile here on Earth, it seems that some of us humans are living in one universe while the rest occupy a parallel one. For example, some of us believe that shutting down the global

economy was a huge costly mistake and that there were less draconian measures for dealing with the GVC. The others believe it was the only way to impose social distancing and to “flatten the curve” of cases and deaths. Now, submitted for your approval are the following surreal developments:

(1) *Swamp man*. President Donald Trump is in one universe and the Democrats are in a parallel one. Anything that Trump supports, the Democrats reject. For example, Trump promoted taking the antimalarial drug hydroxychloroquine to prevent getting COVID-19. Democratic state governors countered by banning its use as either a COVID-19 preventative or cure on grounds that there is no evidence that it works. It might also have some bad side effects.

On Monday, Trump told reporters that he has been taking the medication for about a week and a half. That might explain why he hasn’t been wearing a mask even though some of his staff have gotten sick with the virus. Trump’s willingness to be the Guinea-Pig-in-Chief is commendable in some respects, though others might call it recklessly foolhardy.

In any case, it makes sense on some level to take an antimalarial drug when you are working in Washington, DC’s swamp, which has gotten bigger, deeper, and full of more pests during Trump’s first term. Our political leaders are following a variation on Obama administration Chief-of-Staff Rahm Emanuel’s rule (a.k.a. Rahm’s Rule): Never let a serious virus crisis go to waste. The rule tells us that major crises can provide cover for distributing benefits to targeted special interest groups. The greater the magnitude of a given crisis and the shorter the interval for forming legislation to deal with it, the larger the spread of pork that can be packed into the final legislation.

(2) *MMT man all for more government stimulus*. Fed Chair Jerome Powell has shown a remarkable ability for time travel between the two alternative universes. In his February 26, 2019 congressional testimony on monetary policy, he [trashed](#) Modern Monetary Theory (MMT) and rejected the idea that the Fed ever would help combat the impact of spiraling deficits by keeping interest rates low.

Specifically, Powell said, “The idea that deficits don’t matter for countries that can borrow in their own currency I think is just wrong.” Furthermore, “US debt is fairly high to the level of GDP—and much more importantly—it’s growing faster than GDP, really significantly faster. We are going to have to spend less or raise more revenue.” During his congressional testimony,

he refused to cross the border between monetary and fiscal policies: “And to the extent that people are talking about using the Fed—our role is not to provide support for particular policies,” Powell said. “Decisions about spending, and controlling spending and paying for it, are really for you.”

What a difference a GVC makes! Now Powell is all for MMT all the time, or at least until there is a vaccine. In his April 29 press conference, he crossed the line, mentioning the word “fiscal” 11 times. A central theme of his comments was that “[t]his is the time to use the great fiscal power of the United States to—to do what we can to support the economy and try to get through this with as little damage to the longer-run productive capacity of the economy as possible.” He implied that the Fed would do everything possible to enable more fiscal stimulus. That all adds up to MMT.

Last Wednesday, May 13, the S&P 500 plunged 1.8% after Powell [warned](#) in a speech that the future is “highly uncertain and subject to significant downside risks.” Once again, he pushed for more fiscal stimulus: “Additional fiscal support could be costly, but worth it if it helps avoid long-term economic damage and leaves us with a stronger recovery. This tradeoff is one for our elected representatives, who wield powers of taxation and spending,” he said.

Keep in mind, Trump signed the \$2 trillion CARES Act only a few weeks before, on March 27, causing the Congressional Budget Office to project a record-smashing \$3.7 trillion federal budget deficit during the current fiscal year. The Fed has already purchased \$1.9 trillion in Treasury securities since the start of the current fiscal year, well on the way to financing the entire deficit this year. That's lots of MMT.

(3) *Ammo man knows no limits.* In a CBS *60 Minutes* [interview](#) on Sunday, May 17, Powell said that the outlook for the economy depends on “what happens with the coronavirus.” In fact, he doesn’t expect that the economy can fully recover until there is a vaccine. Nevertheless, he tried to be more optimistic than he had been a few days before, saying, “In the long run, and even in the medium run, you wouldn’t want to bet against the American economy. This economy will recover.”

He clearly stated that the Fed has lots of fire power left: “Well, there’s a lot more we can do. We’ve done what we can as we go. But I will say that we’re not out of ammunition by a long shot. No, there’s really no limit to what we can do with these lending programs that we have.

So there's a lot more we can do to support the economy, and we're committed to doing everything we can as long as we need to."

(4) *Zero man between positive and negative universes.* On March 15, the Fed lowered the federal funds rate by 100bps to zero. In Trump's universe, negative interest rates would be a great way to both revive the economy and to force investors to pay for the privilege of financing the federal government's budget deficit. In his CBS interview, Powell resisted Trump's gravitational pull, saying, "I continue to think, and my colleagues on the Federal Open Market Committee continue to think, that negative interest rates is probably not an appropriate or useful policy for us here in the United States." He rightly observed that negative rates have existed in the Eurozone and Japan universes without success, and "it introduces distortions into the financial system ..." The Fed obviously knows something about how to distort the financial markets!

Valuation: Discounting More Normal Earnings. In the 2002 Vietnam War movie "We Were Soldiers," Mel Gibson starred as Lieutenant Colonel Hal Moore. When the combat unit under his command was surrounded and in danger of being overrun, he had his forward air controller radio "broken arrow" to his superiors. That was the signal to call in every available combat aircraft for support. The COVID-19 pandemic and the ensuing lockdowns caused an historic collapse in the economy. The Fed's response to "broken economy" since March 23 has been to carpet-bomb it with B-52 money.

As the market indexes have recovered from their lows on March 23, valuations have soared past their prior bull market highs because stock prices recovered as earnings plunged. Current valuation multiples are looking past the current freefall in forward earnings and anticipating that they might bottom soon and begin to improve, as we expect they will by mid-year. Only then will forward P/E multiples begin to return to normal.

Indeed, the rates of decline in forward earnings expectations are easing even now, as Joe discusses below. He has devised a way to derive normalized P/Es by using the 12-month-ahead forward earnings ending 18 months from now rather than 12-month-ahead forward earnings, which is the current time-weighted average of analysts' consensus expectations for the current year and the coming year. Consider the following:

(1) *Forward earnings dropping at a slower pace.* Joe notes that forward earnings fell for the S&P 500/400/600 yet again last week, but the rates of decline continued to decelerate from

their peaks five weeks ago. LargeCaps' forward earnings dropped 0.9% w/w, while MidCaps' fell 3.0% and SmallCaps declined 1.3%. Those are big improvements from the prior eight weeks when S&P 500 LargeCaps' forward earnings fell an average of 2.7% per week. The average weekly decline for S&P 400 MidCaps over that time span was 3.9% and 5.7% for S&P 600 SmallCaps.

Since it peaked at a record high of \$179.01 on January 31, the S&P 500 forward earnings has fallen 21.2% through the week of May 14 ([Fig. 1](#)). The S&P 400 and S&P 600 forward earnings have tumbled 30.5% and 40.0% respectively, over the same period.

(2) *Forward P/Es soar.* The rapid decline in earnings has caused the forward P/Es to soar as S&P 500/400/600 stock prices rebounded 32.0%, 37.4%, and 28.2% since March 23 through Monday's close ([Fig. 2](#)). The S&P 500's forward P/E was 20.9 on Monday ([Fig. 3](#)). That's the highest since March 2002 and surpasses this year's prior high of 19.0 on February 19. The similar measures for the S&P 400 and S&P 600 indexes were 19.8 and 21.6 on Monday. That's MidCaps' highest level since May 2002 and a new record high for SmallCaps!

(3) *A more normal P/E measure.* The forward P/E measure of valuation is based on 12-month forward earnings. Currently, that covers the time-weighted average of analysts' consensus expected earnings for this year and next year from May 14, 2020 to May 14, 2021, using weekly data. To arrive at a more normalized valuation, it makes sense to look past the near-term collapse in earnings expectations over the next six months, and to focus instead on the expected 12-month forward earnings from November 14, 2020 to November 14, 2021, when earnings are expected to be much higher.

Using this measure of more normal earnings, valuations are still high, but look more reasonable. The S&P 500's forward P/E drops 2.4 P/E points to 18.5 from 20.9 ([Fig. 4](#)). The SMidCaps shows a big drop too. MidCaps gets revalued to 17.7 from 19.8, and SmallCaps drops to 18.8 from 21.6.

Joe recently created a weekly [publication](#) showing tables and charts of forward P/Es based on both of these measures for the S&P 500 sectors and its 130+ industries. Through May 7, the S&P 500's forward P/E would be 17.8 instead of 20.1. Here's how the sectors' valuations stack up using 12-month forward earnings ending 18 months from now instead of the usual 12 months from now: Consumer Discretionary (25.3 in 18 months, 32.8 in 12 months), Consumer Staples (18.3, 19.1), Energy (41.8, 145.4), Financials (11.3, 13.2), Health Care (14.9, 16.0),

Industrials (16.2, 20.5), Information Technology (20.4, 21.9), Materials (16.7, 18.8), Real Estate (38.9, 41.5), and Utilities (16.2, 16.7).

Strategy: Growth Still Going Strong. The S&P 500 Growth index's market capitalization share of the S&P 500 reached 58% on May 7 ([Fig. 5](#)). That's a record high dating back to 1995. That comes as no surprise considering how well the FAANGM (Facebook, Amazon, Apple, Netflix, Google's parent Alphabet, and Microsoft) stocks have done so far this year. While Growth hasn't been entirely immune to the GVC, this investment style has weathered the economic downturn better than Value. Then again, Value had a very good day on Monday. Consider the following:

(1) *Lots of lane changes.* All of the style indexes have scored double-digit percentage gains since the market bottomed on March 23. But it has been an uneven road as investors have rotated frequently between Growth and Value, or LargeCap and SMidCaps. On Monday, Value surged 4.1% higher compared to a 2.5% rise for Growth ([Fig. 6](#)). That followed the good news about a possible vaccine and about the re-opening of the economy.

(2) *Not like the old bull.* During the prior 11-year bull market—which began March 9, 2009 and ended on February 19, 2020—the Growth price index rose 482.5%, while Value gained 320.9% ([Fig. 7](#)). The beginning of that bull market marked the end of troubles for the deeply discounted Financials, traditional members of the Value index. Growth lagged Value for more than two years until August 2011, and finally pulled ahead for good beginning in July 2014, juiced by the returns of the FAANGM stocks.

Growth lagged Value during the first four weeks of the new bull market. Now, Growth is in the lead with a gain of 34.8% since March 23, ahead of the 28.3% rise for Value. This early lead for Growth didn't happen during the last bull market of 2009-2020.

(3) *The bear facts.* Value's price index fell 37.0% during the 33-day bear market that ended March 23, more than the 31.4% decline for Growth. The S&P 500's forward earnings peaked at record high on January 31. Since then, Value's forward earnings has tumbled 25.7%, more than twice the 11.7% decline for Growth ([Fig. 8](#) and [Fig. 9](#)). It's the same story for the forward profit margin. Growth's forward profit margin is down to a two-year low of 15.0% from 16.2% at the end of March. Meanwhile, Value's profit margin has dropped to an eight-year low of 8.1% from 10.1% ([Fig. 10](#)).

CALENDARS

US: Wed: MBA Mortgage Applications, EIA Crude Oil Inventories, FOMC Minutes.

Thurs: Leading Indicators -5.9%, Jobless Claims 2.4m, Existing Home Sales -18.9%, M-PMI & NM-PMI Flash Estimates 38.0/30.0, Philadelphia Fed Manufacturing Index -41.5, EIA Natural Gas Storage, Powell, Brainard, Clarida. (DailyFX estimates)

Global: Wed: Eurozone Headline & Core CPI 0.4%/0.9% y/y, Eurozone Consumer Confidence Flash -24, UK Headline & Core CPI 0.9%/1.5% y/y, Canada CPI -0.6%/m/-0.1%/y/y, ECB Non-Monetary Policy Minutes, Lowe, Lane. **Thurs:** Eurozone, Germany, and France C-PMI Flash Estimates 25.0/34.1/32.0, Eurozone, Germany, and France M-PMI Flash Estimates 38.0/39.2/36.1, Eurozone, Germany, and France NM-PMI Flash Estimates 25.0/26.6/27.8, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 25.0/36.0/25.0, BOJ Rate Decision. (DailyFX estimates)

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): Housing starts took a nosedive in March and April as the effects from the coronavirus spread throughout the economy, though builder optimism improved in May, raising hopes that the housing market could begin to stabilize. Housing starts tumbled a record 30.2% in April, and 43.1% during the two months through April, to 891,000 units (saar)—the lowest rate since February 2015. Starts were at a cyclical high of 1.617mu (saar) at the start of this year. Over the two-month period, both single-family (-37.1% to 650,000 units, saar) and multi-family (-54.8 to 241,000 units) starts collapsed, sinking to their lowest levels since March 2015 and June 2013, respectively. Building permits plunged 20.8% in April—the biggest monthly decline since the Great Recession—to 1.074mu (saar), the lowest level since January 2015. Permits were at a cyclical high of 1.536mu (saar) at the start of 2020. Single-family permits plummeted a record 24.3% in April to 669,000 units (saar), down 31.5% from its cyclical high of 977,000 units in January, while multi-family permits tanked 14.2% last month to 405,000 units (saar), the lowest since March 2016. In the meantime, NAHB's Housing Market Index (HMI) climbed 7 points in May to 37, after plunging a record 42 points in April to 30—the lowest builder confidence since mid-2012 and the first reading in negative territory (below 50) since mid-2014. All three measures of the HMI moved off their lows this month: current sales (to 42 from 36), future sales (46 from 36), and traffic of prospective buyers (21 from 13).

GLOBAL ECONOMIC INDICATORS

European Car Sales ([link](#)): EU passenger car registrations (a proxy for sales) posted its biggest monthly decline on record, crashing 52.3% in April—the first full month with COVID-19 restrictions in place. With most showrooms across the EU closed last month, sales collapsed 76.3% y/y (to 270,692 units this April from 1.143 million units last April). Each of the 27 EU markets posted double-digit declines compared to a year ago, with Italy (-97.6% y/y) and Spain (-96.5) recording the biggest losses. The two largest economies, Germany and France, contracted 61.1% and 88.8% y/y, respectively. Meanwhile, sales plunged 38.5% during the first four months of this year compared to the comparable period a year ago—as the coronavirus pushed sales sharply lower during both March and April. Looking at the four key EU markets, year-to-date sales fell sharply in all: Italy (-50.7% y/y), Spain (-48.9), France (-48.0), and Germany (-31.0).

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