MORNING BRIEFING
July 7, 2020

More on MAMU & MAMD

Check out the accompanying chart collection.

(1) No rest for the wary as meltup refuses to rest. (2) Forward earnings just starting to recover. (3) Comparing MAMU now and MAMU in 1999. (4) Greenspan's 1996 question about irrational exuberance. (5) Fed forcing everyone out of bonds and into stocks. (6) If MAMU is followed by MAMD, will Fed buy stocks and push yields below zero? (7) Chinese officials are stock-market cheerleaders. (8) Services economy rebounding in China and US. (9) Buffett is back at the M&A buffet. (10) No contest between bond yield and dividend yield. (11) Real rates turn negative, which is good for gold and maybe for other commodities too. (12) Fed officials want to make sure we know they will accommodate us.

Strategy I: Meltups Are Followed by Meltdowns. Joe and I have some advice for the stock market: Give it a rest, please!

In our ideal world, the S&P 500 would move sideways over the rest of this year, consolidating its gains since March 23 and giving earnings, along with the economic fundamentals, time to catch up with the extraordinary rally since then. The S&P 500 stock price index is up 42.1% since the March 23 low through yesterday's close (*Fig. 1* and *Fig. 2*).

The index would have to rise just 6.5% to match the February 19 record high of 3386.15. Back then, S&P 500 forward earnings hit a record high of $179.01 per share with the forward P/E rising to 19.0 (*Fig. 3* and *Fig. 4*). Currently, forward earnings is $144.81, and the forward P/E is 22.0. Forward earnings has recovered very modestly for the past seven consecutive weeks, but it still remains 19.1% below its record high.

All we are saying is give forward earnings a chance—a chance to catch up. Nevertheless, we've recently recognized that the meltup that started on March 24 might continue, leading to the Mother of All Meltups (MAMU), or at least might challenge the MAMU of 1999, when the S&P 500 jumped 63.5% from August 31, 1998 through March 24, 2000. Over that same period, the Nasdaq soared 231.0%. Currently, this index is up 52.1% since March 23.

In his December 5, 1996 speech, then-Fed Chair Alan Greenspan famously asked: "But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy?"

In yesterday's *Morning Briefing*, I asked a similar question: "What should the forward P/E of the S&P 500 be when the federal funds rate is zero, the 10-year US Treasury bond yield is below 1.00%, and the Fed is providing plenty of liquidity to facilitate the resulting rebalancing from bonds to stocks?" I also observed that prior to the Great Virus Crisis (GVC), we all thought that the S&P 500's fair-value P/E was around 15.0. Under the current circumstances, it might be twice as much. When we hear more investors saying the same, let's remember to get out of stocks, since MAMUs tend to be followed by MAMDs (Mothers of All Meltdowns).

Then what? Well, the Fed might start buying stocks, after lowering the federal funds rate below zero. I'm just thinking out loud about where this is all heading. We are still very much in the Twilight Zone, with no obvious way out.

Contributing to yesterday's stock-market rally in the US were the following developments:

(1) *Chinese stocks soaring*. CNBC reported: "A front page editorial in state-owned *China Securities Journal* is getting credit for fueling a strong rally in Chinese markets overnight that spread to global equities. Shanghai stocks jumped 5.7%, after the publication said investors should look forward to the 'wealth effect of the capital markets' and the prospect for a 'healthy bull market.'" Shanghai's gain was on top of a jump of 5.8% last week (*Fig. 5*).

On Friday, we learned that China's Caixin Services PMI rose to 58.4 during June, up from the February lockdown low of 26.5 (*Fig. 6*). That's the highest reading in a decade.

(2) *US services sector rebounding.* Yesterday, we learned that June's NM-PMI in the US jumped to 57.1 from its lockdown low of 41.8 during April (*Fig. 7*). The increase was led by the production (66.0) and new orders (61.6) sub-indexes, while the employment component remained well below 50.0 at 43.1 but up from the recent low of 30.0 during April.

(3) *Buffett is buying.* Warren Buffett's Berkshire Hathaway finally pulled the trigger yesterday. The conglomerate is spending $4 billion to buy the natural gas transmission and storage assets of Dominion Energy. Including the assumption of debt, the deal totals almost $10 billion.

It's Berkshire's first major purchase since the coronavirus pandemic and subsequent market collapse in March. As one of our savvy accounts observed: "[I]t is sensible that energy assets—valued at minimal levels—would move from weak hands (cash-starved utilities) to strong hands (portfolio acquirers, both private and public). Acquisitions often signal bottoms. Are we at a bottom for strategic energy assets?"

Strategy II: Nominal Interest Rates Are Nominal. For now, the federal funds rate remains at zero, and the rest of the US Treasury yield curve remains slightly above zero. The yield-curve spread between the 10-year bond yield and the federal funds rate has been slightly positive in recent weeks after it fell slightly below zero late last year and early this year (*Fig. 8*). The 10-year yield has been consistently below 1.00% since March 20 (*Fig. 9*).

The S&P 500 dividend yield was 1.92% during Q2-2020, or more than twice as much as the bond yield during June (*Fig. 10*). A very simple valuation model is our Blue Angels framework showing the implied fair-value levels of the S&P, which we calculate by dividing four-quarter trailing S&P 500 dividends by dividend yields of 1% to 6% (*Fig. 11*). At 1.92%, the S&P 500 is currently trading where it should be according to the model.

S&P 500 dividends totaled a record $494.3 billion during the four quarters through Q2-2020 (*Fig. 12*). The actual Q2 payout was $118.6 billion, up 0.3% y/y and down 6.6% q/q. The quarterly total might very well start to recover during H2 given that the economy bottomed during April and showed signs of a V-shaped initial rebound during May and June.

As long as investors believe that the GVC recession is likely to be a short one that doesn't significantly dent the dividend-paying power of the S&P 500, then the case for stocks remains compelling. That's because bonds are yielding close to nothing, while stocks are yielding more than twice as much and have the capacity to grow dividends.

Strategy III: Real Interest Rates Are Unreal. While nominal US Treasury interest rates remain north of zero, they are negative on an inflation-adjusted basis. That makes the case for rebalancing out of bonds and into stocks even more compelling, since dividends tend to grow faster than inflation (*Fig. 13*). Since Q1-2009 through Q1-2020, inflation-adjusted S&P 500 dividends are up 75.4%. Here are the current dividend yields on an S&P 500 portfolio purchased in 1970 (69.2%), 1980 (44.0), 1990 (18.0), 2000 (4.5), and 2010 (4.7) (*Fig. 14*). Those all beat the inflation rate in the US, which has been mostly under 2.0% since 2012. Now consider the following:

(1) *Really negative.* During May, the inflation rate in the US was only 1.02% based on the yearly percent change in the personal consumption expenditures deflator excluding food and energy (*Fig. 15*). As noted above, the 10-year bond yield has been below 1.00% since March 20. The inflation-adjusted bond yield was -0.35% during May (*Fig. 16*). Not surprisingly, it is highly and closely correlated with the 10-year TIPS yield, which was -0.76% on Monday, the lowest reading since December 12, 2012 (*Fig. 17*).

(2) *Good for gold*. The price of an ounce of gold is highly correlated with the inverse of the 10-year TIPS yield (*Fig. 18*). The price has rallied 51% from a 2018 low of $1,178 on August 17 to $1,773 on Friday. Over the same period, the TIPS yield has dropped from 0.79% to -0.73%, widening to -0.76% yesterday.

The strength in the price of gold has yet to show up in a solid rebound in the CRB raw industrials spot price index (*Fig. 19*). However, the price of copper, which is one of the components of the CRB index, is up 29% from its recent low on March 23. Not surprisingly, the price of copper is highly correlated with the China MSCI stock price index (in yuan) (*Fig. 20*).

The Fed: An Extremely Accommodative Message. One of the reasons why the stock market rally is continuing so far this month is this: In the Minutes of the June 9-10 meeting of the Federal Open Market Committee (FOMC), released on July 1, the adjective "accommodative" appeared seven times:

(1) "The [econometric model] simulations suggested that the Committee would have to maintain highly accommodative financial conditions for many years to quicken meaningfully the recovery from the current severe downturn."

(2) "Various participants noted that the economy is likely to need support from highly accommodative monetary policy for some time …"

(3) "Participants agreed that asset purchase programs can promote accommodative financial conditions by putting downward pressure on term premiums and longer-term yields."

(4) "These participants noted, however, that large-scale asset purchases could still be beneficial under current circumstances by offsetting potential upward pressures on longer-term

yields or by helping reinforce the Committee’s commitment to maintaining highly accommodative financial conditions.”

(5) “Participants agreed that lowering the federal funds rate to its ELB [effective lower bound] had established more accommodative financial conditions and that the Federal Reserve’s ongoing purchases of sizable quantities of Treasury securities and agency MBS had helped restore smooth market functioning to support the economy and the flow of credit to U.S. households and businesses.”

(6) “Participants also regarded highly accommodative monetary policy and sustained support from fiscal policy as likely to be needed to facilitate a durable recovery in labor market conditions.”

(7) “Participants noted that a highly accommodative stance of monetary policy would likely be needed for some time to achieve the 2 percent inflation objective over the longer run.”

In addition, the noun “accommodation” appeared six times in the context of monetary policymaking. We will spare you the excerpts. Our point is that the FOMC’s use of forms of this word have proliferated with the latest Minutes release; in the previous Minutes, for the April meeting, the adjective appeared just once, while the noun didn’t appear at all!

CALENDARS

US: Tues: API Crude Oil Inventories, Quarles, Bostic, Daly. **Wed:** Consumer Credit -$15.5b, MBA Mortgage Applications, EIA Crude Oil Stocks. (DailyFX estimates)

Global: Tues: Germany Industrial Production 10.0%, Japan Leading & Coincident Indicators. **Wed:** UK Supplementary Budget, China CPI & PPI 2.5%/-32.% y/y, European Commission Forecasts, Guindos, Buch. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose for two of these three indexes last week. LargeCap’s forward earnings has risen for seven straight weeks, MidCap’s edged down for its first drop in five weeks, and SmallCap’s jumped 0.9% w/w for its fourth gain of the past six weeks. LargeCap’s forward earnings is now up 2.7% from its lowest level since August 2017; MidCap’s has risen 6.2% from its lowest level since May 2015; and SmallCap’s is up 4.5% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November until mid-February, before tumbling due to the COVID-19 economic shutdown. LargeCap's is now 19.1% below its record high at the end of January. MidCap's and SmallCap's are 29.4% and 42.8% below their October 2018 highs, with the former up from an 11-year low and the latter at a record low. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings improved to -17.6% y/y from -18.1%. That's up from mid-May's -21.2%, which was the lowest since October 2009, and down from 23.2% in September 2018, which was the highest since January 2011. The yearly rate of change in MidCap's forward earnings fell w/w to -29.0% y/y from -28.7% y/y, but is up from a record low of -32.7% five weeks earlier; that compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's rate rose w/w to -39.4% y/y from -40.9% y/y and is up from a record low of -41.5% in early June. SmallCap's prior record low in its y/y percent change occurred during July 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October 2018. Analysts' y/y earnings growth forecasts for 2020 are down substantially since early March, but have been relatively stable since late May as analysts await the Q2 earnings season. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-23.4%, 30.9%), MidCap (-35.3, 49.1), and SmallCap (-52.4, 82.6).

S&P 500/400/600 Valuation (*link*): Valuations were up across the board last week, but remain below their cyclical and record highs in early June. LargeCap's forward P/E rose 0.7pt w/w to 21.6 from 20.9. Its early June reading of 22.4 was the highest since May 2001 and up from 13.3 in mid-March, which was the lowest since March 2013. MidCap was up 0.7pts w/w to 20.2, which is down 2.7pts from its record high of 22.9, which dates back to 1999 when the SMidCap series began. SmallCap gained 0.4pts w/w to 23.4, but is down 3.3pts from its record high of 26.7. That compares to MidCap's 10.7 and SmallCap's 11.1 in mid-March, which were their lowest readings since March 2009. LargeCap's forward P/E before COVID-19 decimated forward earnings had been at 18.9 during mid-February, which was the highest level since June 2002. Of course, that high was still 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 P/E was below LargeCap's P/E again last week, where it mostly has been since August 2018. It was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E is still above LargeCap's, though. It had been mostly below from May 2019 to May 2020 after being solidly above from 2003. During mid-March, SmallCap's P/E was briefly below

MidCap's for the first time since July 2008.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Analysts are finally beginning to adjust their Q2 estimates lower amid a "withdrawn guidance" environment ahead. The Q2 EPS forecast dropped 25 cents w/w to $23.16, but the pace of decline in recent weeks is substantially less than usually seen at this point in the quarter. That $23.16 estimate represents a decline of 43.9% y/y on a frozen actual basis and -43.1% y/y on a pro forma basis. That compares to a 12.8% decline in Q1-2020, a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). The last time earnings fell markedly y/y was during the four quarters through Q2-2016. Five of the 11 sectors recorded positive but low-single-digit y/y earnings growth in Q1, but none is expected to be positive in Q2. That compares to eight positive during Q4, when two rose at a double-digit percentage rate. Seven sectors beat the S&P 500's pro-forma 12.8% decline in Q1. That's similar to the six that beat the index in Q4-2019 and seven in Q3-2019, but up sharply from just three during Q2-2019. Looking ahead to Q2, all sectors are expected to post worse growth on a q/q basis due to the COVID-19 economic shutdown, and two are expected to report a loss: Consumer Discretionary and Energy. Here are the latest Q2-2020 earnings growth rates versus their final Q1-2020 growth rates: Utilities (-2.5% in Q2-2020 versus 4.3% in Q1-2020), Information Technology (-8.0, 7.2), Real Estate (-15.0, -3.8), Consumer Staples (-15.7, 6.8), Health Care (-15.0, 6.5), Materials (-38.0, -12.3), Financials (-48.3, -37.8), Industrials (-89.0, -32.8), Consumer Discretionary (-114.2, -52.8), and Energy (-153.4, -30.1).

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (*link*): The global economy moved closer to stabilization last month as contractions in both manufacturing and services slowed considerably. The JP Morgan Global Composite Output Index (C-PMI) rebounded to 47.7 in June after a pandemic-related plunge from 52.1 in January to a record low of 26.2 in April. The service sector accounted for much of the improvement the past two months, as well as most of the recent declines. The Global NM-PMI rebounded 24.3 points during the two months through June to 48.0, after plunging 29.0 points the prior three months, from 52.7 at the start of the year to a record low of 23.7 in April. Meanwhile, the Global M-PMI climbed 8.2 points the past two months, to 47.8 in June, after falling 10.7 points the prior three months, from 50.3 in January to 39.6 in April. C-PMIs for both the emerging (to 49.7 from 34.6 in April) and advanced (46.9 from 22.2) economies continued to contract at considerably slower rates in June, with the former just shy of the breakeven point of 50.0 and the latter not too far behind. Of the 14 countries for which C-PMI data are calculated, three expanded in June—China (to 55.7 from 47.6 in April), Australia (52.7 from 21.7), and France (51.7 from 11.1), up from only China in May. The remaining nations all saw their respective rates of contraction slow sharply compared to May.

US Non-Manufacturing PMIs (*link*): The US service sector expanded in June at a fast pace, according toISM's measure, but is still contracting according to IHS Markit's, though nearing the 50.0 breakeven point. ISM's NM-PMI has reversed virtually all the ground lost during the pandemic, climbing for the second month, to 57.1 in June, after falling from 57.3 in February to 41.8 in April. Three of the four components moved up from near-record lows in April: business activity (to 66.0 from 26.0 in April), new orders 61.6 from 32.9), and employment (43.1 from 30.0)—though the latter shows the service sector is still cutting jobs. Meanwhile, the supplier deliveries' component fell for the second month, to 57.5, from April's record high of 78.3—which moved higher due to supply-chain problems triggered by the coronavirus rather than to strengthening demand. The IHS Markit NM-PMI continued to rebound from April's record low of 26.7, climbing to 47.9 in June. According to the report, 'The marked easing in the rate of output contraction was in part linked to the reopening of service providers and the gradual return of customer demand. The pace of decline was the slowest in the current four-month sequence of decline." The loosening of the lockdown measures contributed to a broad stabilization of new orders—with export sales advancing for the first time this year. As a result, the rate of jobs cuts has eased dramatically, with some firms hiring again to keep up with demand.

Eurozone Retail Sales (*link*): Retail sales bounced back at a record rate in May as lockdowns put in place to contain the spread of COVID-19 began to ease. Sales skyrocketed a larger-than-expected 17.8% after plunging 21.4% during the two months through April, leaving the sales level 7.4% below February's reading (the month before the lockdowns became widespread). The biggest monthly gains in May occurred within non-food products, excluding fuel, which rebounded 34.5% after a two-month slide of 33.9%. Within that category, clothing sales soared 147.0% after tumbling 55.5% and 54.7% the prior two months. Also posting impressive gains in May were electrical goods & furniture (37.9%) and computer equipment (26.8), which had tanked 40.5% and 44.8%, respectively, during the two months ending April. Spending on auto fuel in specialized stores jumped 38.4% after contracting 28.8% and 26.5% during April and March, respectively. Consumption of food, drinks & tobacco climbed 2.2% in May following a 5.9% shortfall in April; these sales had increased 9.0% during the three months through March. The biggest sales gains in the Eurozone occurred in Luxembourg

(28.6%), France (25.6), and Austria (23.3), with Spain (18.0), Germany (13.9), Portugal (13.1), and Ireland (10.7) also posting double-digit gains. Germany (7.2% y/y) recorded the biggest yearly increase, with Austria (4.8) also finishing in the top three.

Germany Manufacturing Orders (*link*): "The orders data signal that the manufacturing sector recession has overcome its low point. But the low level of orders also shows that the recovery process is far from over," according to the Economy Ministry. Factory orders advanced a record 10.4% in May, though that was a third less than forecast, and mediocre given that orders plunged 37.3% during the two months through April. Both domestic (12.3%) and foreign (8.8) orders rebounded in May, though the rebound was disappointing following the declines of 32.9% and 40.4%, respectively, over the prior two months. The increase in foreign orders was driven nearly entirely by billings from within the Eurozone (20.9); orders from outside the Eurozone were up only 2.0% after plunging 38.7% the previous two months. By market group, May's rebound in orders was centered in consumer durable and capital goods. Here's a look at performances by market group for total, domestic, and foreign orders, respectively: consumer durable goods (28.9, 55.6, and 14.6), capital goods (20.3, 24.3, and 17.4), intermediate goods (0.4, 1.7, -0.9), and consumer nondurable goods (-2.8, -3.6, -2.3).

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