



MORNING BRIEFING

July 28, 2020

Welcome to Oz

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

(1) So real or surreal? (2) Washington is more like Oz than Kansas. (3) The Wizard of MMT. (4) Kelton's dreamland is a nightmare for conservatives. (5) One of the enlightened authors of the Biden-Sanders progressive manifesto. (6) Oz was about a bad dream. (7) Pay no attention to the seven reasons to worry lurking behind the curtain. (8) Precious metals join stocks as preferred alternatives to bonds. (9) Falling TIPS yield is bullish for gold and other assets. (10) The case for and against the dollar.

MMT: Professor Kelton's Dreamland. We live in surreal times. I've previously compared them to the TV series *The Twilight Zone*. However, a more apt comparison would be with the land that Dorothy and her dog Toto visited in the movie *The Wizard of Oz*. When a tornado ripped her house from its foundation, causing it to crash-land in Oz, she emerged safe and sound, looked around in wonder and famously marveled, "Toto, I've a feeling we're not in Kansas anymore." Oz had a colorful cast of characters, including assorted Munchkins, the Good Witch of the North, the Bad Witch of the West and her Winkie Guards, and a blustery wizard—not unlike Washington today. And the news these days showcases plenty of national and local leaders behaving like cowardly lions, heartless tin men, and brainless straw men.

The analogy with Oz was first provided by none other than the Wizard of MMT, Professor Stephanie Kelton. In her book [The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy](#), she wrote: "Like Dorothy and her companion in *The Wizard of Oz*, we need to see through the myths and remember once again that we've had the power all along."

Kelton was referring to Dorothy's power to go back home to Kansas simply by clicking the heels of her ruby-red slippers three times. Similarly, Kelton believes that the US government has always had the power to run huge budget deficits and should be doing so now to cure all our ills. As a result of the Great Virus Crisis (GVC), her theory has taken on a life of its own beyond her wildest dreams. Governments around the world are spending massively on stimulative fiscal policies to offset the recessionary forces unleashed by the GVC.

Most of those contractionary forces have been driven by the extreme government lockdown policies adopted to impose social distancing to slow the spread of the virus. So far, all the government stimulus has provided some support for the global economy. But the virus is still out there, and so are the recessionary forces. As a result, price inflation remains subdued even though much of the ballooning fiscal deficits are being financed by central banks' purchases of government securities, which MMTers also support.

In Kelton's dreamland, that's a perfect outcome, because she and her merry band of arm-linked MMTers believe that the only limit on deficit-financed government spending is price inflation. Sure enough, the US government has responded precisely as she advocates, producing one stimulus program after another. Another one is imminent, sized to the tune of \$1.0 trillion, which will most likely cause the Congressional Budget Office to raise its current fiscal 2020 budget deficit estimate from \$3.7 trillion to \$4.7 trillion...click, click, click ([Fig. 1](#) and [Fig. 2](#)). No problem: The Fed will continue to buy more Treasuries...click, click, click ([Fig. 3](#) and [Fig. 4](#)).

Melissa and I have written previously about MMT. Our latest analysis, titled "Modern Monetary Theory: In Theory & In Practice," was in our July 8 [Morning Briefing](#). We wrote:

"Kelton argues that the federal government can and should run large budget deficits as long as inflation remains subdued. MMT opponents' main objection is that the theory provides a blank check for the government to get much bigger. It provides the government with too much power to allocate resources. Free-market capitalists believe that markets do a much better job of doing so than politicians and bureaucrats. Kelton clearly disagrees. ... But whether one is for MMT or against it, Kelton's book leaves no doubt about what MMT is all about: It's an agenda for more big government and higher taxes." In brief, it legitimizes a massive power grab by the government for our own good.

Kelton probably would welcome the opportunity to be Treasury secretary if the Democrats win the White House in November. Ironically, her views already are reflected in the current Republican administration's fiscal policymaking! By the way, Kelton contributed to the 110-page [Biden-Sanders Unity Task Force Recommendations](#). Other contributing luminaries included former US Secretary of State in the Obama administration and former Senator (D-MA) John Kerry, Representative Alexandria Ocasio-Cortez (D-NY), former US Attorney General under Obama Eric Holder, former White House Chief Economist under Obama Jared

Bernstein, and American Federation of Teachers President Randi Weingarten. So Professor Kelton is either in good company or bad company depending on your political leanings.

We concluded our analysis: “But remember, the story was all a bad dream Dorothy had after getting hit on the head. Free market capitalists might exclaim: ‘Pay no attention to the professor behind the curtain!’” We like to think of “The Wizard of Oz” as a long episode of *The Twilight Zone*.

Gold: In Oz, It’s ‘In Bullion We Trust.’ Gold and silver are leading a meltup in precious metals prices ([Fig. 5](#)). That makes sense in Oz, which is currently experiencing: i) a pandemic; ii) violent civil unrest; iii) extreme political partisanship; iv) a rapidly escalating Cold War between the US and China; v) a game of chicken between the US and Iran in the Strait of Hormuz; vi) out-of-control MMT fiscal and monetary policies; and vii) a possible left-wing regime change on November 3.

The price of an ounce of gold is up 24.7% since March 23, when the Fed embraced MMT with QE4Ever, through Friday’s close. QE4Ever set the stage for the Fed to finance the CARES Act, which was signed by President Trump on March 27. The price of an ounce of silver is up 76.0% over that same period. The S&P 500 and the Nasdaq registered meltups of 44.8% and 53.6% through yesterday’s close ([Fig. 6](#)).

Many investors have concluded that there is no alternative to stocks now that the 10-year Treasury bond yield has been below 1.00% consistently since March 20. Many investors have moved rapidly to rebalance their portfolios, lowering their bond weighting and increasing their stock weighting since March 23. However, some investors see precious metals as an alternative to bonds and maybe even to stocks, which have become overvalued based on historical measures of valuation. Consider the following related developments:

(1) *Gold & industrial commodity prices.* In the past, gold tended to signal the underlying trend in the CRB raw industrial spot price index ([Fig. 7](#)). The latter is more volatile than the former, but their trends have coincided. However, the two have been diverging for a while. The price of gold is up 49% since the end of 2018 through Friday, while the CRB index is down 10% over that same period.

The divergence may be resolved by a rebound in industrial commodity prices if the global pandemic is halted by a vaccine, leading to a big rebound in world growth. Or else, it may be a

worrisome sign that we aren't in Kansas anymore. We may be in Oz. If so, that strange land—as noted above (if I may repeat myself for emphasis)—is currently experiencing: i) a pandemic; ii) violent civil unrest; iii) extreme political partisanship; iv) a rapidly escalating Cold War between the US and China; v) a game of chicken between the US and Iran in the Strait of Hormuz; vi) out-of-control MMT fiscal and monetary policies; and vii) a possible left-wing regime change on November 3. In other words, it's a breeding ground for Gold Bugs.

(2) *Gold & TIPS*. The 10-year TIPS yield continues to plummet below zero. It was down to a record-low -0.92% on Friday, and was little changed at -0.90 yesterday ([Fig. 8](#)). We have long observed that it is highly inversely correlated with the price of gold. That relationship continues to work even in Oz. What's different in Oz is that yesterday gold broke out to a new record high.

The inverse correlation between the price of gold and the TIPS yield is a widely recognized fact. In fact, the concept was generalized to other assets besides gold in a July 17 *WSJ* [article](#) titled "Beneath Bond Market's Surface, Tumbling Real Yields Boost Other Assets." It observed that while the 10-year nominal yield has been relatively stable around 0.60%, the comparable TIPS yield has been turning more negative, implying that the expected inflation rate embedded in the spread of the two jumped from a recent low of 0.50% on March 19 to 1.52% yesterday ([Fig. 9](#) and [Fig. 10](#)).

The article put an interesting spin on these developments: "Taken together, the increase in inflation expectations and decline in real yields both echo and help explain the strong performance of stocks in recent months. A rising break-even rate is typically associated with an improved economic outlook. Falling real yields, meanwhile, can boost the economy by weakening the U.S. dollar and spurring investors to buy riskier assets because inflation is causing them to lose money on their bonds."

That's a very insightful interpretation of these variables. The TIPS yield is falling because investors expect inflation to rebound, which is why they are buying inflation-protected bonds and driving down those bonds' yields. The nominal yield is flat because investors believe that the Fed is aiming to boost inflation and that it will do so by keeping short-term rates down near zero. That would tend to be bearish for the dollar; a downward-headed dollar would boost both inflation and trade-led growth by boosting exports and depressing imports.

(3) *Gold & the dollar*. From 1994 through 2015, the price of gold was broadly inversely correlated with the trade-weighted dollar ([Fig. 11](#)). Since then through 2019, the two have trended in the same direction. This year, the dollar peaked on March 23 and was down 6.3% through yesterday, while gold is now in record-high territory. In other words, the inverse relationship between the two may be making a comeback.

By the way, the foreign-exchange value of gold surpassed its previous record high of \$1,797 on August 5, 2019 ([Fig. 12](#)). It rose to yet another record high of \$2,383 on Friday.

US Dollar: Reservations About the Reserve Currency in Oz. Is gold signaling a collapse in the dollar? Yes, it is. But Melissa and I aren't convinced that gold's prediction will pan out, though there are some good arguments in favor of it. First and foremost might be that, while the US came out of the Great Financial Crisis in much better shape than most of the rest of the world, the same cannot be said for the US's handling of the GVC, so far. Several European and Asian countries seem to be doing a much better job of re-opening their economies while keeping the virus from spreading anew, so far.

We can see this in July's Markit purchasing managers flash estimates. They show that the M-PMIs were close during the month for the US (51.3) and the Eurozone (51.1). However, the NM-PMIs of the US (49.6) and the Eurozone (55.1) diverged ([Fig. 13](#)). Re-opening the services economy has been slower going in the US than in the Eurozone.

In addition, the recent agreement by the members of the Eurozone to issue "corona bonds" is widely deemed as a vote of confidence in the monetary union, which already seems to be benefiting the euro ([Fig. 14](#)). Now consider the following counterarguments:

(1) *Reserve currency*. Data compiled by the International Monetary Fund (IMF) show that non-gold international reserves totaled \$12.3 trillion during May ([Fig. 15](#)). The IMF's quarterly data show total foreign exchange reserves of \$11.7 trillion during Q1-2020, with allocated reserves at \$11.0 trillion. The dollar remains a key currency, accounting for 62% of allocated reserves ([Fig. 16](#)).

(2) *Capital flows*. Melissa and I have devised a proxy for world ex-US capital flows by subtracting the 12-month sum of the merchandise trade surplus with the US (i.e., the US trade deficit multiplied by -1.0) from the 12-month change in non-gold international reserves ([Fig. 17](#) and [Fig. 18](#)).

Our proxy shows capital outflows from the rest of the world into the US of \$592 billion over the past 12 months through May. Notwithstanding the problems we have in the US, foreign investors continue to find plenty of opportunities here. The trade-weighted dollar tends to be inversely correlated with our proxy. When the latter is negative (because capital is flowing into the US from the rest of the world), the yearly percent change in the dollar tends to be positive.

(3) *Oil price*. Finally, for today, one of the closest correlations we've observed is the one between the price of a barrel of Brent crude oil and the inverse of the trade-weighted dollar ([Fig. 19](#)). I simply am not convinced that there is much further upside for the price of oil given the weakness of the global economy. I may change my mind if a vaccine is developed soon that gets us all out of Oz and back to Kansas.

CALENDARS

US: **Tues:** Consumer Confidence 94.5, Richmond Fed Manufacturing Index, S&P Case-Shiller Home Price Index 4.0% y/y, API Crude Oil Inventories. **Wed:** Merchandise Trade Deficit Advance Estimate -\$74.3b, Pending Home Sales 15.3%, MBA Mortgage Applications, EIA Crude Oil Inventories, Fed Interest Rate Decision 0.13% (0.00% to 0.25%). (DailyFX estimates)

Global: **Tues:** Australia Inflation -0.4% y/y. **Wed:** France Consumer Confidence, ECB Non-Monetary Policy Meeting. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of these indexes last week. LargeCap's forward earnings has risen for ten straight weeks, MidCap's is up in seven of the past eight weeks, and SmallCap's posted its seventh gain of the past nine weeks. LargeCap's forward earnings is now up 4.3% from its lowest level since August 2017; MidCap's has risen 10.4% from its lowest level since May 2015; and SmallCap's is up 7.5% 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 17.9% below its record high at the end of January. MidCap's and SmallCap's are 26.7% and 41.1% 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 -16.6% y/y from -17.0%. 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 rose w/w to -26.1% y/y from -27.7% y/y, and is up from a record low of -32.7% at the end of May; that compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's rate rose w/w to -37.3% y/y from -38.2% 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 wait to digest the Q2 earnings results. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-23.4%, 30.9%), MidCap (-33.8, 47.6), and SmallCap (-52.7, 82.8).

S&P 500/400/600 Valuation ([link](#)): Valuations edged down across the board last week, and remain below their cyclical and record highs in early June. LargeCap's forward P/E fell 0.1pt w/w to 21.9. 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 down 0.3pt w/w to 20.2, which is down 2.7pts from its record high of 22.9 in 1999 when the SMidCap series began. SmallCap eased 0.1pt w/w to 23.6, and is down 3.1pts 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 in mid-February—before COVID-19 decimated forward earnings—was 18.9, 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 since 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 coming off the sidelines and adjusting their future forecasts higher as Q2 earnings results come in. Indeed, the S&P 500's Q2 blended EPS estimate/actual rose 58 cents w/w to \$23.60. That \$23.60 estimate represents a decline of 42.9% y/y on a frozen actual basis and -40.3% y/y on a pro forma

basis. For Q3, the estimate rose 21 cents w/w to \$31.91, which represents an earnings decline of 24.3%, or 23.4% 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. None of the sectors are expected to record positive y/y earnings growth during Q2 and Q3, down from five recording positive but low-single-digit y/y earnings growth in Q1. Looking ahead to Q3, all 11 sectors are expected to post less worse growth on a q/q basis, reflecting the reopening of the US economy, and only Energy is expected to report a loss. Here are the S&P 500 sectors' latest Q3-2020 earnings growth rates versus their blended Q2-2020 growth rates: Utilities (-1.6% in Q3-2020 versus -1.8% in Q2-2020), Information Technology (-2.1, -4.4), Health Care (-2.8, -4.8), Consumer Staples (-6.7, -13.9), Real Estate (-14.4, -15.1), Communication Services (-21.1, -31.6), Materials (-23.9, -36.7), Financials (-24.6, -44.8), Consumer Discretionary (-50.0, -114.1), Industrials (-62.5, -89.0), and Energy (-107.7, -159.1).

S&P 500 Q2 Earnings Season Monitor ([link](#)): With 26% of S&P 500 companies finished reporting revenues and earnings for Q2-2020, revenues are beating the consensus forecast by a whopping 2.6%, and earnings have crushed estimates by 12.6%. The large upside surprises are primarily due to a lack of financial guidance from the companies that analysts follow, which mirrors the experience of the Q2-2009 earnings season on the heels of the Great Financial Crisis. At the same point during the Q1 season, revenues were 0.5% above forecast, but earnings missed by 3.4%. For the 130 companies that have reported through mid-day Monday, aggregate y/y revenue and earnings growth are below the similar Q1 measures, but the percentages of companies reporting positive revenue and earnings surprises actually improved. The Q2 reporters so far have a y/y revenue decline of 6.7%, and earnings are down 41.2% in the worst quarter since Q1-2009. The percentage of companies reporting a positive revenue surprise (69) is well below those reporting a positive earnings surprise (79). However, more companies are reporting positive y/y revenue growth in Q2 (38) than are reporting positive y/y earnings growth (29). That's the lowest rate for earnings growth since Q2-2009. These figures will change markedly as more Q2-2020 results are reported in the coming weeks, but the y/y revenue and earnings growth results are expected to remain dismal. Now more than ever, what companies say about the state of their business and their plans to ride out the COVID-19 crisis will be investors' main focus. However, many companies still are not providing guidance about their future financial periods.

US ECONOMIC INDICATORS

Durable Goods Orders & Shipments ([link](#)): Durable goods orders in June rose sharply for the second month, with core capital goods orders and shipments also recovering; however, somewhat tighter government restrictions due to a rise in coronavirus cases in some states could curb momentum. Orders for durable goods jumped a larger-than-expected 7.3% in June following a 15.1% surge in May; orders had plunged an unprecedented 32.0% during the two months ending April. Record gains in orders for new cars and trucks in both June (85.7%) and May (28.9) drove the big gains in durable goods orders recently. Excluding transportation, orders climbed 3.3% and 3.6% in June and May, respectively. In the meantime, both core capital goods orders and shipments recovered a bit in May and June following steep declines. Nondefense capital goods orders ex aircraft (a proxy for future business investment) accelerated 3.3% in June, following a downwardly revised 1.6% (vs 2.3%) increase in May, after sliding 6.6% in April and 8.3% during the three months through April. Meanwhile, core capital goods shipments (used in calculating GDP) jumped 3.4% in June, double May's 1.6% gain, which followed declines of 6.4% and 8.2%, respectively, over the comparable April periods.

Regional M-PMIs ([link](#)): The manufacturing sector continued to expand this month, with impressive gains posted by the Philadelphia and New York Fed districts—two of the four, along with Kansas City and Dallas, that so far have reported on manufacturing activity for July. The composite index improved for the third month since plunging to a record low of -59.7 April, climbing to +10.3 this month—with activity in the Philly (to 24.1 from -56.6 in April) region continuing to grow at a solid pace and New York's (17.2 from -78.2) expanding for the first time in five months. The recovery in the Kansas City (3.0 from -30.0) region pales in comparison to those of Philly and New York; the Dallas (-3.0 from -74.0) region continued to contract. Meanwhile, July's new orders measure climbed from a record-low -67.5 in April to 13.2 this month as Philadelphia (to 23.0 from -70.9 in April), Kansas City (9.0 from -64.0), and Dallas (6.9 from -68.7) billings expanded for the second month and New York's (13.9 from -66.3) moved into the plus column for the first time since February. In the meantime, factories added to payrolls for the first time since February, with the employment measure climbing to 6.7 this month from April's record low of -39.5. Manufacturers in the Philly (+20.1 from -46.7 in April) region boosted payrolls for the first time since March—and at the region's fastest pace since October—while Kansas City (3.0 from -34.0) and Dallas (3.1 from -22.0) began hiring for the first time since the start of the year, though barely; New York (0.4 from -55.3) manufacturers

cut no jobs for the first time since before the pandemic.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): “The German economy is recovering step by step,” Ifo Chief Clemens Fuest said in a statement as business expectations continued to soar. Germany’s Ifo Business Climate Index rose for the third month in July, by 4.2 points to 90.5—building on the back-to-back record monthly gains in May (+5.4 points) and June (+6.6). The index had plummeted 21.5 points during the two months through April to a record-low 74.3. The rebound is being driven by a 27.4-point surge in the expectations component during the three months ending July to a 20-month high of 97.0, after a two-month plunge of 23.3 points to a record-low 69.6. The present situation component increased for the second month, by a total of 5.6 points to 84.5 in July, after falling from 99.1 in January to 78.9 in May—which was the lowest since July 2009. By sector, the services’ business climate index advanced for the third month, by a total of 36.1 points to +2.0—its first reading in positive territory since before the pandemic. Sentiment in the construction (to -2.4 from -18.0 in April), trade (-5.2 from -48.4), and manufacturing (-12.0 from -44.4) sectors all improved for the third month, but remain in negative territory—though construction and trade could soon swing from negative to positive.

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