MORNING BRIEFING
September 22, 2020

Fed Fully Embraces MMT

Check out the accompanying chart collection.

(1) September is the worst month for stocks. (2) Stocks weighed down by known unknowns, and too much bullishness. (3) Powell before and during the pandemic. (4) Another pivot: Powell on MMT before and after Covid. (5) A trillion dollars here, a trillion dollars there. (6) Waiting for another round of fiscal stimulus, which might be derailed by fight over SCOTUS. (7) A straight line of dots near zero. (8) FOMC inflation projection undershoots 2% through 2023. (9) Should we have faith in FAITH? (10) Maximum employment exceeds full employment. (11) Powel paints dark picture without more fiscal stimulus. (12) Inflation expectations remain relatively subdued. (13) A couple of dissenters.

Strategy: Update on Panic Attack #67. The S&P 500 peaked at a record high on September 2. It is down 8.4% since then through Monday's close. September does have a history of being the worst month of the year for the stock market. Since 1928, the month's average loss has been 1.0% (*Fig. 1*). Only two other months have been down on average over this period, but by only 0.1% each. The bad news is that the S&P 500 lost 4.6% on average during the 49 months it was down of the 91 Septembers since 1928. The good news is that Septembers have a tendency to create buying opportunities for the remainder of the year with average gains for October (0.4%), November (0.8), and December (1.3). Oh, and January's have had an average gain of 1.2%. However, during the 38 down months for October, the S&P 500 was down 4.7%.

Past performance is no guarantee of future returns, as we often say in our business. Joe and I have viewed the selloff since September 2 as a "healthy correction." We would have been more concerned if the market meltup continued. We felt that the market needs to consolidate its gains since March 23 to give earnings some time to catch up. Besides, there are still important issues that need to be resolved such as the course of the pandemic, its ongoing impact on the economy, and the outcome of the upcoming election.

The uncertainty around all three known unknowns is currently weighing on the market. The virus is still out there, and spreading more rapidly again in Europe, where government officials are considering targeted lockdowns. The V-shaped economic recovery from May through

August in the US is showing signs of slowing. Yesterday's stock market selloff might have been triggered by fears that the imminent partisan fight over a new justice for the Supreme Court reduces the chances of getting agreement in Congress on another stimulus bill. These issues won't go away in October, and the November 3 election is fast approaching.

Joe and I are sticking with our S&P 500 targets of 3500 by year-end and 3800 next year.

Fed I: Teaming Up With the Treasury. What a difference a pandemic makes. Fed Chair Jerome Powell was asked about Modern Monetary Theory (MMT) during congressional testimony on February 26, 2019. He hated it back then. "The idea that deficits don't matter for countries that can borrow in their own currency I think is just wrong," the Fed chair said in response to a question about MMT. The "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."

Powell rejected the notion that the Fed should enable fiscal spending: "And to the extent that people are talking about using the Fed—our role is not to provide support for particular policies," he said. "Decisions about spending, and controlling spending and paying for it, are really for you." In effect, he told Congress, "Fiscal policy is your domain. Leave us out of it."

MMT's proponents contend that since the American government borrows in its own currency, it can always print more dollars to cover its obligations. As a result, the US can run sustained budget deficits and rack up an ever-increasing debt burden. Along the way, the Fed can help by keeping interest rates low. The only reason to stop this free flow of money would be a significant rise in inflation.

Again: What a difference a pandemic makes! Consider the following:

(1) On March 23, the Fed adopted QE4ever committing to an open-ended program of bond purchases. On March 27, President Donald Trump signed the CARES Act. The result has been a huge increase in the federal budget deficit financed by a huge increase in the Fed's holdings of US Treasury securities. Over the past 12 months through August, the budget deficit totaled a record $2.92 trillion, while the Fed's portfolio of Treasuries has swelled $2.30 trillion y/y through the September 16 week (*Fig. 2* and *Fig. 3*).

(2) Despite the swelling budget deficit, the 10-year US Treasury bond yield has remained under 1.00% since March 23, averaging just 0.67% since then through Friday (*Fig. 4*). It's been held down by the federal funds rate, which was lowered by 100bps to zero on March 15, when plain-vanilla QE4 was also introduced. QE4ever pushed the bond yield below 1.00% since March 23.

(3) The Fed also purchased $603 billion in mortgage-backed securities (MBS) since March 23 through the September 16 week. In addition, US commercial banks have been big buyers of Treasuries and MBS. Together, the Fed and the banks have purchased $2.5 trillion in Treasuries and MBS since March 23 through the September 9 week (*Fig. 5*). No wonder bond yields and mortgage rates remain near record lows.

Fed II: Waiting for More Fiscal Stimulus. In other words, Covid's knock-on effects have not only grounded airplanes, but also interest rates. Last Wednesday, the Fed confirmed that the Federal Open Market Committee (FOMC) expects to keep the federal funds rate close to zero through at least the end of 2023, as Melissa and I predicted in our September 2 *Morning Briefing* titled "The Fed Is in Control." We recalled that Fed Chair Jerome Powell famously said in his June press conference that the Fed isn't "even thinking about thinking about raising rates." We concluded: "[T]hat thought may remain out of mind for many years to come!"

During his September 16 FOMC press conference, Powell stated: "[T]he outlook for the economy is extraordinarily uncertain and will depend in large part on our success in keeping the virus in check … A full economic recovery is unlikely until people are confident that it is safe to reengage in a broad range of activities."

While monetary policy officials are thinking that the US economy will require lower interest rates for longer to sustain the recovery, they are also calling for more fiscal stimulus. Apparently, their economic projections assume that more of such support is on the way, according to Powell. Now let's focus on the FOMC's latest projections:

(1) *Dots lined up in a row*. The Fed's latest quarterly "dot plot" anonymously shows the projections of the federal funds rate of each of the 17 FOMC participants for each year from the current one through 2023. Not one of these forecasters expects an increase in the federal funds rate during 2020, or 2021, according to the September 16 *Summary of Economic Projections*. Only one participant forecasts a rate increase for 2022. Only four expected so for 2023, with the highest forecasted rate at just 1.25%. Both their median and central tendency

forecasts are stuck at 0.1% from 2020 to 2023. That's notwithstanding that their "longer-run" forecast for the federal funds rate is 2.5%. (See our *FOMC Summary of Economic Projections*. The latest dot plot reminds us of ducks lined up in a row.)

(2) *Inflation projections undershoot.* Notwithstanding the Fed's latest round of ultra-easy monetary policies—including ZIRP, QE4Ever, and NALB, i.e., No Asset Left Behind—the FOMC's median forecast for PCE inflation does not rise up to the committee's 2.0% target until 2023. In other words, inflation isn't expected to be an obstacle to MMT.

The slow projected ascent to 2.0% is especially significant because the Fed's recently adopted "flexible average inflation targeting" hope (FAITH) is intended to "make up" for past inflation misses, allowing inflation to "moderately" overshoot the Fed's long-standing 2.0% target for inflation. But that target has only been reached during 15 months out of 102 months since the Fed set the goal on January 25, 2012 (*Fig. 6*). Indeed, the PCE inflation rate has been trending along a 1.3% growing trend line since then (*Fig. 7*). And the FOMC currently doesn't expect to be overshooting it, at least through 2023. That certainly doesn't boost our faith in the Fed's ability to overshoot 2.0%. (Hat tip to Vineer Bhansali for "FAITH.")

CNBC's Steve Liesman asked Powell during the press conference if the inflation projections are to be interpreted as a lack of confidence by the FOMC that "not only can it not hit" its 2.0% goal "but that now it can't hit its goal of being above 2.0%." Powell stammered in his initial response. Then, he blurted out that "this very strong, very powerful guidance shows both our confidence and our determination. It shows our confidence that we can reach this goal, and our determination to do so." He certainly didn't boost our faith in FAITH.

When Liesman asked Powell to clarify his response, Powell answered: "The economy will be below maximum employment, below full demand. And that will tend to wear, to put downward pressure on inflation. So we think that once we get up closer to maximum employment, we think that inflation will come back generally. … It's a slow process, but there is a process there."

We guess that means that the Fed hasn't completely given up on the inverse relationship between the unemployment and inflation rates as posited by the Phillips curve model. The FOMC projections show unemployment is expected to drop from 7.6% during 2020 down to 4.0% by 2023.

(3) *Bolder employment mandate.* The Fed is now more committed than ever to "maximum employment." It was prioritized ahead of inflation in the Fed's September 16 FOMC Statement. That was widely expected following the release of the Fed's August 27 "Longer-Run Goals and Policy Strategy," which we previously discussed in our September 2 *Morning Briefing* linked above. Powell reiterated during his press conference that maximum employment would not be defined by a rule but a "whole range of things," including labor force participation and wage growth. Nevertheless, Powell said that there is "a lot to like about" 3.5% unemployment. He followed that up by saying: "But the good news is we think we can have quite low unemployment without raising troubling inflation."

(4) *Desperately seeking fiscal assistance*. In other words, the FOMC expects that it will take a long time to generate higher inflation, even with the powerful monetary stimulus and added fiscal stimulus combined. Powell said that FOMC participants generally were assuming further fiscal action in their projections. For all the stimulus, the FOMC's projections arrive at a "longer-run" growth rate in real GDP of just 1.9%. Yet, here are their latest projections for this year and over the coming three years along with their comparable projections at their June meeting: 2020 (-3.7% vs -6.5%), 2021 (4.0, 5.0), 2022 (3.0, 3.5), and 2023 (2.5).

In his opening remarks, Powell noted: "The path forward will also depend on the policy actions taken across all parts of the government to provide relief and to support the recovery for as long as needed." During the Q&A, Powell elaborated: "As I have emphasized before, these are lending powers, not spending powers. The Fed cannot grant money to particular beneficiaries. We can only create programs or facilities with broad-based eligibility to make loans to solvent entities with the expectation that the loans will be repaid. Many borrowers are benefiting from these programs, as is the overall economy. But for many others, getting a loan that may be difficult to repay may not be the answer. In these cases, direct fiscal support may be needed."

Later, he observed that "as the months pass … if there isn't additional support and there isn't a job for some of those people who are from industries where it's going to be very hard to find new work, then that will start to show up in economic activity. It will also show up in things like evictions and foreclosures and, you know, things that will scar and damage the economy."

(5) *Market inflation expectations easing*. Bond investors remain doubtful about a swifter pace of inflation too. A widely used proxy for the 10-year expected inflation rate is the nominal 10-year US Treasury bond yield minus the 10-year TIPS yield. It has remained below 2.0% since year-end 2018 (*Fig. 8*). Following the release of the Fed's latest strategic policy update and

Powell's speech on August 27, the proxy rose to 1.73% and then hit a recent peak of 1.80% on August 31, but it fell back to 1.65% on September 11 and has remained around that rate to date (*Fig. 9*).

(6) *A couple of dissenters.* Dissenting votes are not all that common on the FOMC. But two Fed officials, FRB Governor Robert Kaplan and FRB Minneapolis President Neel Kashkari, voted against the Fed's latest action. Nevertheless, their viewpoints were rather nuanced. Regarding the dissenting views, Powell said during his press conference that they were "sort of on two sides of the discussion" around the Fed's new framework.

Kaplan preferred to "retain greater policy rate flexibility" beyond when "the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals as articulated in its new policy strategy statement." Yesterday, he explained that he is concerned about too-low rates for too long creating financial imbalances and instabilities. Kashkari preferred that the FOMC wait to consider raising rates until core inflation, which typically runs at a slower pace than the headline, has reached 2.0% on a "sustained basis."

Powell said that he welcomed the discussion and that "this is all about credibility. And we understand perfectly that we have to earn credibility." We certainly agree with that!

CALENDARS

US: Tues: Existing Home Sales 5.98mu, Richmond Fed Manufacturing Index, API Crude Oil Inventories, Powell. **Wed:** M-PMI & NM-PMI Flash Estimates 53.1/54.7, MBA Mortgage Applications, EIA Crude Oil Inventories, Powell, Mester, Quarles, Evans. (DailyFX estimates)

Global: Tues: Lane, Panetta. **Wed:** Eurozone, Germany, and France C-PMI Flash Estimates 51.7/54.1/51.9, Eurozone, Germany, and France M-PMI Flash Estimates 51.9/52.5/50.5, Eurozone, Germany, and France NM-PMI Flash Estimates 50.5/53.0/51.5, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 56.3/54.1/56.0, Germany Gfk Consumer Confidence -1, Spain GDP -18.5%q/q/-22.1%y/y, Kuroda. (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 18 straight weeks, MidCap's is up in 15 of the past 16 weeks, and SmallCap's posted its 15th gain of the past 18 weeks.

LargeCap's forward earnings is now up 11.3% from its lowest level since August 2017; MidCap's has risen 20.0% from its lowest level since May 2015; and SmallCap's is up 30.3% 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 forward earnings is now 12.4% below its record high at the end of January. MidCap's and SmallCap's are 20.3% and 28.6% below their October 2018 highs. 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 -11.7% y/y from -12.2%. That's up from mid-May's -19.3%, 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 -18.6% y/y from -19.2% 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 -20.2% y/y from -21.1% 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. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-19.9%, 27.7%), MidCap (-32.3, 48.6), and SmallCap (-52.5, 107.5).

S&P 500/400/600 Valuation (*link*): Valuations dropped across the board last week and slipped further below their recent cyclical and record highs. LargeCap's forward P/E fell to a 12-week low of 21.2 from 21.4 a week earlier and a 19-year high of 22.7 at the end of August. That's up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's was unchanged at an 18-week low of 18.8, which is down 4.1pts from its record high of 22.9 in early June. SmallCap's was steady too, at a 20-week low of 19.9 and is down 6.8pts from its record high of 26.7 in early June. 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 yet 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 was below LargeCap's for a fifth week and for the first time since May. SmallCap's P/E 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 adjusting their estimates slightly higher for Q3 as the quarter begins to wind down, which is not the typical pattern before an earnings season begins. During the Q2 earnings season, which came in substantially better than greatly reduced forecasts, they adjusted their future forecasts higher instead of lower as is the norm. In the latest week, the S&P 500's Q2 blended EPS estimate/actual rose 2 cents w/w to $28.13. That $28.13 actual represents a decline of 31.9% y/y on a frozen actual basis and -30.6% y/y on a pro forma basis. For Q3, the estimate jumped 20 cents w/w to $32.69, which represents an earnings decline of 22.4%, or 22.1% on a pro forma basis. That compares to a 30.6% decline in Q2-2020, 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. Just three of the sectors have recorded positive y/y earnings growth during Q2: Health Care, Tech, and Utilities. That's a big improvement from Q1 when all 11 sectors posted a y/y decline in earnings. Looking ahead to Q3, six of the 11 sectors are expected to post less worse growth on a q/q basis, reflecting the reopening of the US economy. Energy is expected to report a second straight quarterly loss during Q3. Here are the S&P 500 sectors' latest Q3-2020 earnings growth rates versus their Q2-2020 growth rates: Information Technology (-1.0% in Q3-2020 versus 5.6% in Q2-2020), Health Care (-2.2, 6.8), Utilities (-4.0, 6.4), Consumer Staples (-6.1, -5.2), Real Estate (-14.4, -15.1), Materials (-18.5, -28.6), Communication Services (-20.7, -16.7), Financials (-23.2, -45.6), Consumer Discretionary (-37.6, -64.9), Industrials (-65.8, -82.5), and Energy (-107.5, -168.5).

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