



MORNING BRIEFING

October 21, 2020

Financial Stability Could Lead to Instability

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

(1) Slow walking toward the fast-approaching elections. (2) Eight possible outcomes. (3) Gridlock would be bullish. (4) Market needs to mark time to buy time for earnings to catch up. (5) S&P 500 forward revenues and forward earnings remain on recovery paths. (6) The Fed's lending facilities aren't lending much. (7) IMF report says fiscal and monetary policies providing "The Bridge to Recovery." (8) Policies have saved the day, but risk causing too much risk-taking. (9) Are markets disconnected from reality? (10) Some industries remain vulnerable to insolvency. (11) Banks are well capitalized for now. (12) China's vulnerabilities get spotlighted.

Strategy: Electing to Mark Time. While House Speaker Nancy Pelosi (D-CA) and US Treasury Secretary Steve Mnuchin are slow-walking toward another stimulus package, the elections are fast approaching. Since rising to a record high on September 2, the S&P 500 has also been slow-walking toward the elections ([Fig. 1](#)). That's partly as a result of the uncertainty about whether another stimulus package will be passed before Election Day and, more importantly, uncertainty about the outcome of the election. There are eight possible outcomes:

- (1) Trump wins, and the Republicans win both houses of Congress. ("Red Sweep.")
- (2) Trump wins, and the Republicans keep the Senate but lose the House. (Gridlock wins.)
- (3) Trump wins, and the Republicans lose the Senate and the House. (Gridlock wins.)
- (4) Trump wins, and the Republicans lose the Senate but win the House. (Gridlock wins.)
- (5) Biden wins, and the Democrats win both houses of Congress. ("Blue Sweep.")
- (6) Biden wins, and the Democrats keep the House but lose the Senate. (Gridlock wins.)
- (7) Biden wins, and the Democrats lose the Senate and the House. (Gridlock wins.)
- (8) Biden wins, and the Democrats win the Senate but lose the House. (Gridlock wins.)

Joe and I agree with the widely held view that gridlock is bullish for the stock market. In our civics classes in high school, gridlock was called "checks and balances." The Founders created this constitutional system to reduce the risk of political extremism. They designed the system so that more often than not, politicians on either side of the aisle wouldn't have unchecked power. In the past when one party ruled the White House and both houses of

Congress, the electorate had the choice of depriving them of that power every two years, which is what it did on a regular basis, though not necessarily every two years. (Here is a [link](#) to a useful table titled “Party Control of the Presidency and Congress from 1933-2010.”)

In any event, Joe and I expect that the bull market will proceed through 2021 no matter who wins the White House and no matter whether the next president’s party wins both houses of Congress, as we explained in our October 14 [Morning Briefing](#) titled *Que Sera, Sera*. We still have a target of 3800 for the S&P 500. We just aren’t sure whether that happens by mid-2021 or by the end of this year. Our hunch is that the market will get there sooner rather than later under any of the first four scenarios in which Trump wins. In any of the four scenarios in which Biden wins, the market might slow walk to 3800 by the middle of next year.

No matter the election outcome, we prefer a slow walk to new highs for the market to give earnings a chance to catch up. The S&P 500’s forward P/E has been hovering around 22.0 since May 28, up from this year’s low of 12.9 on March 23 ([Fig. 2](#)). Forward revenues bottomed during the May 28 week, rising 4.7% through the October 8 week ([Fig. 3](#)). Forward earnings bottomed during the May 15 week, rising 12.9% through the October 15 week.

S&P 500 operating earnings comparisons won’t turn positive until next year on a y/y basis. The analysts’ consensus estimates currently show Q3 and Q4 declines of 19.3% and 13.4% ([Fig. 4](#)). For 2020, 2021, and 2022, we are forecasting \$125.00 per share (down 23.3%), \$155.00 (up 24.0%), and \$180 (up 16.1%) ([Fig. 5](#)). Industry analysts are currently expecting \$131.13, \$165.83, and \$189.73.

Fed: Not Doing Much Lending. The lender of last resort hasn’t been doing the volume of lending during the pandemic that it had promised. The Fed did respond to the GVC with QE4ever on March 23, purchasing \$2.54 trillion in US Treasuries and mortgage-backed securities since then ([Fig. 6](#)). The Fed also provided several liquidity facilities, which jumped from \$383 billion during the March 11 week to a recent high of \$1.22 trillion during the May 13 week ([Fig. 7](#)). As the financial panic abated, the liquidity facilities loans fell to \$587 billion during the September 30 week. But other lending facilities have barely been used, mostly because QE4ever calmed the financial markets quickly and dramatically.

For example, the Fed [announced](#) on April 9 that it would fund up to \$2.3 trillion in credit market instruments with its SPVs. Of that, the Fed’s Primary and Secondary Corporate Credit Facilities (PMCCF and SMCCF) are set up to purchase up to \$750 billion combined in

corporate debt, including exchange-traded funds (ETFs), as we detailed in our April 15 [Morning Briefing](#). Eligible bonds include investment-grade corporate bonds as well as BBB-rated bonds that recently went over the edge. Any such “fallen angels” that dropped below that rating after March 22 may still be purchased by both facilities, according to the updated term sheets of the PMCCF and the SMCCF.

Compared to the potential size of purchases, the transactions have been limited. But corporate debt purchases have picked up since they began in early May. As of September 30, the PMCCF was operational but had not yet closed any transactions, according to the Fed’s credit facilities [update](#) dated October 7. On May 12, the Fed began purchasing corporate-bond ETFs through the SMCCF. As of May 19, the total outstanding amount of the Fed’s loans under the SMCCF was \$1.3 billion. It was \$12.9 billion as of September 30.

Of all bonds purchased through September 28, according to the detailed spreadsheet disclosure, 41% were rated in the high-investment grade category (AAA/AA/A), while 56% were rated BBB and 3% were rated B, with a combined weighted average maturity of 2.9 years. Consumer (including cyclical and non-cyclical) issues composed 37% of the purchases on a par-value basis. The Fed noted: “The Board continues to expect that the CCFs will not result in losses to the Federal Reserve.”

The Fed’s other major facilities include the following (total outstanding loans as of September 30): Paycheck Protection Program Liquidity Facility (\$67.6 billion), Money Market Mutual Fund Liquidity Facility (\$7.1 billion), Term Asset-Backed Securities Loan Facility (\$3.2 billion), Main Street Lending Program (\$2.2 billion), and Municipal Liquidity Facility (\$1.7 billion). The Primary Dealer Credit Facility totaled \$233.0 million, and the Commercial Paper Funding Facility totaled \$29.9 million.

Of note, according to the related transaction spreadsheets, the Main Street Lending program included loans to about 250 entities, and the Municipal Liquidity facility included loans to two entities: the State of Illinois and the New York Metropolitan Transportation Authority.

Global Financial Stability I: Policymakers Saved Markets. If there is one thing that investors have learned since the start of the Great Virus Crisis (GVC), it is that there’s no such thing as policymakers running out of ammo. Before the GVC, many believed that central bankers held interest rates too close to zero for too long and that fiscal policymakers were

tapped out. Nevertheless, following the onset of the pandemic, global central bankers and governments have unleashed unprecedented monetary and fiscal policy actions to serve as a “Bridge to Recovery.”

That is the title of Chapter 1 of the October 2020 [*Global Financial Stability Report*](#) (*GFSR*) from the International Monetary Fund (IMF). The report’s remaining chapters are expected to be released on Friday. Our short interpretation of the *GFSR*’s Chapter 1 is that policy actions have saved financial markets but have disconnected markets from underlying economic fundamentals, and that has elevated global financial risk.

Global markets have performed well with the US and China outperforming, led by a dominance by technology companies. Globally, weaker performance has been observed in contact-intensive sectors as well as cyclical energy and financial issues. The *GFSR*’s Figure 1.3 shows that swift central bank actions have calmed stock market volatility in spite of the pandemic uncertainty.

Indeed, market performance would likely have been much weaker without the unprecedented policy support. On a ytd basis, the US stock market has outperformed even though that outlook for corporate earnings had deteriorated, says the IMF. Bond spreads have widened, but less so than economic fundamentals would suggest, the report adds. Major factors that could cause renewed problems for the financial markets are the anticipation of decreased policy support and a delayed recovery. Nevertheless, the IMF attributed the containment of near-term global financial risks “for now” to the unprecedented global policy response.

But the report also warns that financial markets are fragile, as the policies that have saved us may lead to excessive risk-taking. In our view, investors seem to believe that “this too shall pass” since many underlying fundamentals already have recovered—suggesting that the markets may not be as disconnected as the IMF contends. Nevertheless, the IMF’s view is important because it has the potential to spark global regulations around excessive risk-taking and/or to cause policymakers to rethink their actions in the context of financial stability.

Here are the latest *GFSR*’s key points:

(1) *Elevated corporate debt & sovereign deficits*. As the pandemic spread and related lockdowns occurred, governments and firms around the world scrambled to raise cash by taking on more debt. In the global sovereign sector, fiscal deficits expanded as fiscal support

was added. With that, six out of 29 systemically important jurisdictions showed elevated vulnerabilities in corporate, banking, and sovereign sectors, according to the IMF. Non-financial corporate (NFC) debt load may lead to greater insolvencies if the recovery stalls. Small and mid-sized enterprises in contact-sensitive industries—like hotels, restaurants, and entertainment venues—are especially vulnerable to insolvency.

(2) *Capitalized banks*. In an analysis of 29 countries (excluding China), banks were found to have enough capital to absorb anticipated losses and maintain sufficient capital buffers in the IMF's baseline scenario. It's only in the IMF's adverse scenario that the "weak tail" of banks experience capital shortfalls that could constrain lending.

(3) *Contained EME flows*. Portfolio outflows for emerging market economies (EMEs) and frontier economies are expected to remain contained. The probability of portfolio outflows over the next three quarters fell from about 60% during late March to 25% during September. EMEs have benefited from global low interest rates and could start to show greater financial instability if external financing becomes increasingly strained.

(4) *Vulnerable entities*. The heart of the IMF's Chapter 1 is found in Figure 1.9.2. on page 11. It presents a heatmap of financial vulnerabilities by sector and region by quintile (denoting the "worst" as red and the "best" as green, with varying shades indicating the directional degree of risk).

The US has mixed results across types of entities evaluated. Sovereigns scored in the worst category and non-bank financial institutions (including NFCs, insurers, asset managers, and others) each independently scored in the second to worst category. But banks and households were both in the green, specifically in the dark green (best) and light green (next to best), respectively.

In the euro area, similar mixed assessments of risk were given across types of entities. Sovereigns, NFCs, and banks all received the worst designation, and asset managers were assessed as next to worst. But households, insurers, and other financial institutions were assessed as next to best.

China's results were less mixed. Significant financial vulnerabilities were detected for households, NFCs, and banks. Sovereigns and asset managers received a next-to-worst designation. Insurers and other financial institutions were assessed at neutral risk levels.

(5) *China debt interlinkages*. In a dedicated box (1.3), the IMF explored China's specific vulnerabilities. It concluded that "[l]inkages between local governments, firms, and banks could pose significant financial stability risks and underscore the urgency of accelerating structural reforms in China, even as authorities seek to support the recovery from COVID-19. Key priorities should be to strengthen the intergovernmental fiscal coordination framework, introduce bank and corporate restructuring frameworks in line with international best practices, and address remaining gaps in financial supervision and regulation."

Global Financial Stability II: Balancing Support & Risk-Taking. The IMF recommends in its latest *GFSR* that monetary policy remain accommodative for as long as it takes to reach a sustainable recovery. But it also recommends financial reform and prudential supervision, particularly for the non-bank financial sector, to ensure that low global returns do not cause excessive risk-taking.

The report states: "As policymakers build a bridge to recovery, policies will have to adjust, depending on the evolution of the pandemic and the pace of the economic rebound." The IMF presents a matrix of policy approaches in the *GFSR*, given policy guidance for each of three phases: i) Gradual Reopening under Uncertainty; ii) Pandemic under Control; and iii) Post-pandemic Financial Reform Agenda.

Here's a recap of the key guidance points:

(1) *Monetary policy, liquidity, and credit*. The IMF recommends continued monetary policy accommodation to remain at least for the first two scenarios. However, liquidity is to be maintained only during the "uncertainty" phase and to be withdrawn as the spread of the virus comes "under control." Credit provisions to support increased bank lending through the use of capital buffers also are recommended only during the earlier phase.

In the "under control" phase, credit provisions are to be removed, but policies to address problem assets and to recapitalize and rebuild as necessary are recommended. In the "post-pandemic" phase, increased regulation is recommended for non-bank financials and globally to prevent risk-taking in a lower-for-longer environment. During each phase of the recovery, policymakers are encouraged to look out for unintended consequences of their actions and to be mindful of future vulnerabilities, especially as bank capital is drawn.

(2) *Adverse scenario*. Support should be scaled up in the event of a worsening spread of the virus and more restrictions to global activity, the IMF suggests. However, added support should be targeted, an approach best achieved through fiscal policy. Central banks should consider further easing, and policies should be developed to support insolvent entities.

(3) *Green & digital shoehorns*. Shoehorned into the IMF's policy suggestions are recommendations for fiscal spending on green infrastructure and digital technologies. Environmental performance has weakened in regions that have suffered economically from the pandemic, and the pandemic has accelerated the digitalization of economies, says the IMF. The crisis "presents an opportunity to engineer a transition to a greener economy," the IMF stated.

CALENDARS

US: **Wed:** MBA Mortgage Applications, EIA Crude Oil Inventories, Beige Book, EIA Crude Oil Inventories, Brainard. **Thurs:** Leading Indicators 0.7%, Initial Jobless & Continuous Claims 860k/9.5m, Existing Home Sales 6.3mu, Kansas City Fed Manufacturing Index, EIA Natural Gas Inventories, Kaplan, Barkin, Presidential Debate, FDA Hearing on COVID-19 Vaccines. (DailyFX estimates)

Global: **Wed:** UK Headline & Core CPI 0.5%/1.3% y/y, Canada CPI -01%/m/m/0.4%/y/y, Lagarde, Guindos, Balz, Lane, Ramsden, Debelle. **Thurs:** Eurozone Consumer Confidence -15, Germany Gfk Consumer Confidence -2.8, France Business Confidence 96, UK Gfk Consumer Confidence -28, Japan Core CPI -0.4% y/y, Panetta, Haldane, Baily. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q3 Earnings Season Monitor ([link](#)): With over 13% of S&P 500 companies finished reporting revenues and earnings for Q3-2020, revenues are beating the consensus forecast by a whopping 3.3%, and earnings have crushed estimates by 19.4%. The large surprises are primarily due to a lack of financial guidance from the companies that analysts follow. At the same point during the Q2 season, revenues were 3.0% above forecast and earnings beat by 13.4%. For the 67 companies that have reported through mid-day Tuesday, aggregate y/y revenue and earnings growth and the percentage of companies reporting a positive revenue and earnings surprise have improved from their Q2 measures. The small sample of Q3 reporters so far has a y/y revenue decline of 2.3%, and earnings are down 13.1%; those

results mark a big recovery from Q2, the worst quarter since Q1-2009 during the financial crisis. Nearly 87% of companies are reporting a positive earnings surprise, and 82% have beaten their revenues forecast. More companies are reporting positive y/y earnings growth in Q3 (55%) than are reporting positive y/y revenue growth (51%). These figures will change markedly as more Q3-2020 results are reported in the coming weeks, but y/y revenue and earnings growth results are expected to remain negative. 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. Few companies are providing guidance about their future financial periods.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): The rapid pace of Covid-19 estimate cuts has turned into a V-shaped recovery as analysts play catch-up from their lowball estimates prior to the better-than-expected Q2 earnings season. Consensus S&P 500 forecasts previously had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues is at its highest level since early April and is now just 3.6% below its record high in mid-February. Forward earnings is also at its highest level since early April and is now 11.0% below its record high in early March. Forward revenues growth remained steady at a 21-month high of 6.2%. That's just 0.1ppt below its seven-year high of 6.3% in February 2018, but is up from 0.2% in April, which was the lowest reading since June 2009. However, forward earnings growth ticked down 0.7ppt to 16.7% and is down from a 10-year high of 17.7% in early October. Forward earnings growth is up 22.3ppts from its record low of -5.6% at the end of April. Analysts expect revenues to decline 4.0% y/y in 2020 and rise 8.1% in 2021 compared to the 4.3% reported in 2019. Analysts expect an earnings decline of 18.4% y/y in 2020 and a 24.6% gain in 2021 compared to a 1.4% rise in 2019. The forward profit margin was unchanged at a six-month high of 11.1%. That's up 0.8ppt from 10.3% during April and May, which was the lowest level since August 2013. It's still down 1.3ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to fall 1.7ppt y/y in 2020 to 9.8%—from 11.5% in 2019—and to improve 1.5ppt y/y to 11.3% in 2021. Valuations rose for a second week to six-week highs. The S&P 500's weekly forward P/E rose 0.4pt w/w to 22.1. That compares to 23.1 in early September, which was the highest level since July 2000 and up from a 77-month low of 14.0 in mid-March. The S&P 500 price-to-sales ratio gained 0.05pt w/w to 2.45. That's down from a record high of 2.53 at the beginning of September and up from the 49-month low of 1.65 in mid-March.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins ([link](#)): Last week saw consensus forward revenues rise w/w for seven of the 11 S&P 500 sectors and five post gains

in their forward earnings. Energy and Industrials had both measure decline w/w. Due to the sharp decrease in forward earnings this year, forward P/E ratios for nearly all sectors now are back above their recent record or cyclical highs prior to the bear market. Tech and Utilities are the only sectors expected to have improved profit margins in 2020, whereas back in early March eight sectors were expected to see margins improve y/y. During 2019, just two sectors' margins improved y/y: Financials and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since 2018, it has moved lower for nearly all the sectors. In the latest week, the forward profit margin moved higher for three sectors and fell for Industrials. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.1%, down from 23.0%), Financials (14.8, down from 19.2), Utilities (14.2, record high), Communication Services (13.7, down from 15.4), Real Estate (13.2, down from 17.0), S&P 500 (11.1, down from 12.4), Health Care (10.6, down from 11.2), Materials (10.1, down from 11.6), Industrials (8.2, down from its record high of 10.5% in mid-December), Consumer Staples (7.4, down from 7.7), Consumer Discretionary (6.2, down from 8.3), and Energy (2.3, down from 8.0).

S&P 500 Sectors Forward Revenues and Earnings Recovery from Covid-19 Trough

[\(link\)](#): The S&P 500's forward revenues and earnings, as well as its implied forward profit margin, bottomed at cyclical lows on May 28 after 14 weeks of Covid-19 declines. Since then, S&P 500 forward revenues has risen 4.8%, forward earnings has gained 13.1%, and the forward profit margin has risen 0.8pt to 11.1%. Seven of the 11 sectors posted new highs last week in either their forward revenues, earnings, or profit margin. Energy's forward revenues remains near a 15-year low, and its forward earnings and profit margin are recovering now from their record lows during April. Real Estate's forward earnings have worsened to a six-year low and its profit margin is at an eight-year low. Financials moved up in the rankings last week while Energy slipped. Here's how the 11 sectors rank by their changes in forward revenues and forward earnings since May 28: Consumer Discretionary (forward revenues up 6.6%, forward earnings up 40.9%), Information Technology (6.2, 8.1), Financials (5.8, 15.8), Industrials (5.7, 18.4), Communication Services (5.6, 8.6), Materials (5.6, 20.6), S&P 500 (4.8, 13.1), Health Care (3.8, 9.6), Consumer Staples (2.4, 5.3), Energy (2.3, 310.6), Real Estate (0.1, -7.2), and Utilities (-1.7, 0.8).

US ECONOMIC INDICATORS

Housing Starts & Building Permits [\(link\)](#): Builders continue to build as their confidence hits

yet another new record high. Both single-family starts and single-family permits (a good leading indicator of housing starts) have rebounded to new cyclical highs—surpassing their pre-pandemic readings by 7.2% and 12.6%, respectively; multi-family measures have not joined the party. Total housing starts advanced for the fourth time in five months, up 1.9% in September and 51.5% over the period to 1.415mu (saar)—but remain 9.7% below its pre-pandemic reading, as multi-family starts tumble. Single-family housing starts continue to soar, jumping 8.5% last month and 63.2% during the five months through September to a cyclical high of 1.108mu (saar), while multi-family starts have plunged 38.0% during the two months ending September to 307,000 units (saar), after a three-month surge of 94.1%. Building permits, in the meantime, have soared to a new cyclical high, jumping 5.2% in September and 45.7% since April to 1.553mu (saar). Single-family permits soared 68.0% from April through September, to 1.119mu (saar), its second reading above 1.00mu since before the Great Recession—August being the first. Multi-family permits are up 8.5% since April, but have dropped 14.2% the past two months to 434,000 units (saar). In the meantime, NAHB's Housing Market Index (HMI) climbed 55 points during the six months through October to a new record high of 85, after plunging a record 42 points in April alone 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 are at their highest levels in the 35-year history of the survey—moving sharply off their April lows: current sales (to 90 from 36 in April), future sales (88 from 36), and traffic of prospective buyers (74 from 13).

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

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).