



MORNING BRIEFING

November 17, 2020

The Banks of Last Resort

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

(1) A trillion here, a trillion there adds up to \$21.8 trillion. (2) Whatever it takes to “infinity and beyond.” (3) The Fed is playing by the MMT playbook. (4) Is the Fed trying to peg the bond yield below 1.00%? (5) Record-low interest rates fueling housing boom and record corporate bond issuance. (6) A pile of liquidity waiting for vaccine. (7) ECB and BOJ pumping liquidity as fast as the Fed. (8) A synergistic approach to technical and fundamental analysis. (9) Commodity prices continue to recover. (10) The copper/gold ratio is bearish for bonds, increasing odds that Fed will peg yield below 1.00%. (11) Not much more downside for the dollar. (12) Still favoring Stay Home over Go Global.

Central Banks: Lots More Free Money. While all eyes have been on the elections in the US, the major central banks continue to flood the financial markets with liquidity. Collectively, the assets of the Fed, the European Central Bank (ECB), and the Bank of Japan (BOJ) rose to a record \$21.8 trillion during the first week of November, up \$7.2 trillion since the first week of March ([Fig. 1](#)). Here are the increases over this same period and the latest levels of the three central banks' assets: the Fed (\$3.0 trillion to \$7.1 trillion), ECB (\$2.9 trillion to \$8.0 trillion), and the BOJ (\$1.3 trillion to \$6.7 trillion) ([Fig. 2](#)).

All three are pushing for their countries' fiscal policymakers to provide more stimulus to offset the negative economic consequences of the pandemic. Meanwhile, they continue to do whatever they can on their own. Consider the following:

(1) *Fed.* The Fed's balance sheet has been relatively flat in recent weeks as the Fed's ongoing purchases of securities under QE4ever has been offset by a decline in the loans provided by the Fed's emergency liquidity facilities ([Fig. 3](#) and [Fig. 4](#)). In effect, the Fed has embraced Modern Monetary Theory (MMT) by financing the federal government's spending on pandemic support programs, allowing them to soar without pushing interest rates higher.

Over the past 12 months through October, the 12-month sum of federal government outlays soared 49.7%, while revenues fell 1.2% ([Fig. 5](#)). As a result, the federal budget deficit swelled

to a 12-month record sum of \$3.3 trillion, up from \$1.0 trillion last October ([Fig. 6](#)). Over the same period, the Fed's holdings of US Treasuries jumped \$2.4 trillion. That's MMT on steroids.

To keep the 10-year Treasury bond yield under 1.00%, the Fed has been buying lots of bonds. Since MMT Day on March 23, when the Fed announced QE4ever, the yield has averaged 0.70%, remaining below 1.00% since then ([Fig. 7](#)). From February through October, the supply of US Treasury notes and bonds rose by \$1.0 trillion. However, Treasury notes and bonds held by the public declined by \$613 billion, as the Fed's holdings of these securities jumped \$1,632 billion ([Fig. 8](#)).

The result has been record-low mortgage rates. That has enabled a homebuying boom triggered by pandemic-related deurbanization, with the result that the sum of new and existing single-family home sales jumped to 6.83 million units (saar) during September, the highest since May 2006 ([Fig. 9](#)).

Corporations are refinancing their debts and raising funds at record-low corporate bond yields. Nonfinancial corporate bond issuance totaled a record \$1.4 trillion over the 12 months through September ([Fig. 10](#)).

Also benefiting from the Fed's largess is the stock market, with the S&P 500 hitting a new record high on Friday and again on Monday. There has been a close correlation between the Fed's assets and the forward P/E of the S&P 500 ([Fig. 11](#)). The pandemic initially triggered a mad dash for cash. Although the Fed rushed to provide it to avoid a credit crunch, the precautionary demand for liquidity remains elevated, as evidenced by the record-high \$16 trillion held in liquid assets and the 24% y/y increase in M2 ([Fig. 12](#) and [Fig. 13](#)). A vaccine should reduce liquidity preference pushing asset prices higher, especially those of stocks and homes.

(2) *ECB*. As noted above, the ECB's balance sheet now exceeds those of both the Fed and the BOJ. In euros, the ECB's assets are up €2.1 trillion from the first week of March through the November 6 week, with securities held for monetary purposes up €0.9 trillion and longer-term refinancing operations (LTRO) up €1.2 trillion ([Fig. 14](#)). The LTRO program provides funds to banks to lend to nonfinancial corporations and households. The more loans that participating banks issue, the more attractive the interest rate charged by the ECB on those funds.

The LTRO program did seem to have boosted lending to businesses earlier this year and to households more recently ([Fig. 15](#) and [Fig. 16](#)). Meanwhile, the Eurozone's monetary aggregates rose at double-digit y/y rates during September, as follows: M1 (13.8%), M2 (10.3), and M3 (10.4).

The imposition in recent weeks of another round of tough lockdown restrictions in Europe increases the likelihood of a double-dip in economic growth in the region. Under the leadership of Christine Lagarde, the ECB has essentially pledged to do whatever it takes to cushion the financial and economic blows from the pandemic. That means that the ECB's balance sheet will continue to swell.

(3) *BOJ*. Not to be outdone, the BOJ saw its assets soar 19% since the first week of March through the November 13 week; reserves are up 25%, resulting in a 15% increase in Japan's monetary base using latest available data, through October ([Fig. 17](#)).

(4) *Altogether now*. The three major central banks continue to inject the global financial markets with big shots of liquidity. The hope is that by doing so, they will inoculate the financial markets from a world of troubles, most recently the pandemic. It's working so far, as the All Country World MSCI stock price index (in local currencies) continues to trend higher in record territory along with the assets of the major central banks ([Fig. 18](#)).

Commodities, Bonds & the Dollar: A World of Hope. Our job is to forecast stock, bond, commodity, and currency markets. More often than not, we get important clues from market prices about the trends and inflection points in the fundamentals that drive them. Technicians study the price actions in financial markets but don't bother with what they imply about the underlying fundamentals. For lack of a better term, our approach is a technical-fundamental one. The price action provides us with clues about the fundamentals, which we can use to predict the price action depending on our fundamental analysis of the fundamentals. Here are the latest insights we've gleaned from this approach:

(1) *Commodities*. Debbie and I are big fans of the CRB raw industrials spot price index for assessing the strength or weakness in the global economy. It has rebounded 16% from a low on April 21 through November 13, little changed from the November 9 reading, which was the highest reading since May 8, 2019 ([Fig. 19](#)). Leading the way higher has been its copper component, with the red metal's nearby futures price up 40% over the same period.

The price of copper is especially sensitive to economic developments in China, which led the world into a brief but severe lockdown recession in January and February of this year followed by a remarkable V-shaped recovery since then ([Fig. 20](#)). Similarly, the US economy fell into a severe recession during March and April and has experienced a V-shaped recovery since then. As noted above, Europe's economy may be about to double dip, but so far that's not showing up in weaker commodity prices.

(2) *Bonds*. The US Treasury bond yield has risen from a record low of 0.52% on August 4 to 0.90% on Monday. It remains below 1.00% as a result of QE4ever. Despite the Fed's intervention, the yield has risen on a better-than-expected V-shaped economic recovery and on hopeful vaccine news. On the other hand, the latest waves of the pandemic in Europe and the US are downers for yields. Furthermore, the latest core CPI inflation readings (y/y) remain low for the US (1.7%), Eurozone (0.2), and Japan (-0.3).

The ratio of the nearby future prices of copper to gold is widely followed as an indicator for the "correct" bond yield ([Fig. 21](#)). Its reading on Friday suggested that the yield should be above 1.00%, at 1.68% to be precise. On the other hand, the ratio of the S&P Goldman Sachs Commodity Index (GSCI) to the price of gold suggests that the yield's current price is right ([Fig. 22](#)). The GSCI comprises 24 commodity prices including copper. Energy-related commodities account for roughly 60% of the index.

By the way, the copper/gold ratio works as a bond yield indicator because the copper price is highly correlated with the expected inflation rate in the spread between the 10-year nominal bond yield and the comparable TIPS yield, and the price of gold is inversely highly correlated with the TIPS yield ([Fig. 23](#) and [Fig. 24](#)). In recent weeks, expected inflation has stabilized around 1.7%, while the TIPS yield has edged higher.

(3) *The dollar*. The trade-weighted dollar is inversely correlated with the GSCI ([Fig. 25](#)). When the global economy is weak relative to the US, so are commodity prices and the dollar tends to be strong. When the global economy is outperforming the US, commodity prices tend to be strong and the dollar tends to be weak. A strong/weak dollar tends to be bearish/bullish for the Emerging Markets MSCI stock price index (in local currencies) ([Fig. 26](#)).

(4) *Bottom line*. The current market action points to higher commodity prices, higher bond yields, and a weaker dollar. That suggests that Go Global should outperform Stay Home in global stock portfolios. Nevertheless, we aren't convinced that there is much more upside in

yields since we expect that the Fed will announce a target for the bond yield below 1.00% if it starts moving above that level. That would be bullish for commodities and foreign currencies. It would also be bullish for global stocks, especially in the US. So we are sticking with Stay Home for now.

CALENDARS

US: Tues: Retail Sales Headline & Ex Autos 0.5%/0.6%, Headline & Manufacturing Industrial Production 1.0%/0.9%, Capacity Utilization 72.3%, Business Inventories 0.5%, Import & Export Prices 0.3%/0.3%, NAHB Housing Market 85, API Crude Oil Inventories, Williams, Bostic, Daly. **Wed:** Housing Starts & Building Permits 1.46mu/1.56mu, MBA Mortgage Applications, EIA Crude Oil Inventories, Williams, Bostic, Evans. (DailyFX estimates)

Global: Tues: Lagarde, Guindos, Balz, Bailey, Ramsden, Lowe, Debelle, Macklem. **Wed:** EU Car Registrations, Eurozone Headline & Core CPI -0.3%/0.2% y/y, UK Headline & Core CPI 0.6%/1.3% y/y, Canada CPI 0.2% m/m/0.4% y/y, Australia Employment Change & Unemployment Rate -30k/7.2%, ECB Non-Monetary Policy Meeting, Balz, Haldane, Wilkins. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of these indexes last week. In a typically V-shaped recovery, LargeCap's forward earnings has risen for 26 straight weeks, MidCap's is up in 23 of the past 24 weeks, and SmallCap's posted its 23rd gain of the past 26 weeks. LargeCap's forward earnings is now up 17.0% from its lowest level since August 2017; MidCap's has risen 34.9% from its lowest level since May 2015; and SmallCap's is up 57.2% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. LargeCap's forward earnings is now 7.8% below its record high at the end of January. MidCap's and SmallCap's are 10.4% and 13.9% 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 -6.8% y/y from -7.5%. 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 -5.0% y/y from -6.2% 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 improved to -4.6% y/y from -8.3% 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 improving since July as companies easily beat the consensus Q2 and Q3 forecasts. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-15.9%, 23.1%), MidCap (-25.2, 43.0), and SmallCap (-40.7, 81.7).

S&P 500/400/600 Valuation ([link](#)): Valuations rose for all three indexes last week to their highest levels in nearly a month. LargeCap's forward P/E picked up 0.3pts to 21.7. That compares to a 19-year high of 22.7 at the end of August and is up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's rose to 18.9 from 18.3 the week before; its current level is down 4.0pts from its record high of 22.9 in early June. SmallCap's surged to 18.8 from 18.0, which is down 7.9pts 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, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 12th week, such a long stretch 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. SmallCap's P/E was below MidCap's for a second straight week for the first time since mid-March. Prior to that, it had been below very briefly for three weeks during the Great Financial Crisis.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Since the Q2 earnings season—which came in substantially better than greatly reduced forecasts—analysts have been raising all of their future quarterly forecasts instead of lowering them as is the norm. In the latest week, the S&P 500's Q3 blended EPS estimate/actual rose 57 cents w/w to \$38.65. That \$38.65 estimate represents a decline of 8.3% y/y on a frozen actual basis and -7.4% y/y on a pro forma basis. That compares to a pro forma 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. All 11 sectors had been expected to record negative y/y earnings growth for Q2 when that earnings season began, but three recorded positive y/y earnings growth: Health Care, Tech, and Utilities. That was a big improvement from Q1 when all 11 sectors posted a y/y decline in earnings. For Q3, five sectors are posting a y/y earnings gain so far, a big improvement from the end of September when none were expected to do so. All but Utilities are expected to post less worse growth on a q/q basis, reflecting the reopening of the US economy. Energy is on track 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: Health Care (11.2% in Q3-2020 versus 6.8% in Q2-2020), Information Technology (7.2, 5.6), Consumer Staples (4.1, -4.2), Communication Services (3.8, -16.8), Utilities (0.9, 6.4), Materials (-1.4, -28.6), Financials (-2.8, -46.7), Consumer Discretionary (-5.1, -64.6), Real Estate (-12.6, -15.2), Industrials (-54.2, -85.3), and Energy (-108.2, -168.1).

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): The New York Fed has given us the first glimpse of manufacturing activity in November, showing that growth in its region slowed for the second consecutive month. Activity in November expanded at roughly one-third of September's pace, though firms have remained optimistic that conditions would improve over the next six months. November's composite index slumped to 6.3 this month from 10.5 in October and 17.0 in September—which virtually matched July's 20-month high of 17.2. It was at a record low of -78.2 in April. Growth in both new orders and shipments slowed considerably this month, with the new orders measure falling 8.6 points (to 3.7 from 12.3) this month, while the shipments gauge sank 11.5 points (6.3 from 17.8). Delivery times (to 0.7 from 2.0) were little changed, while unfilled orders (-11.9 from -6.6) and inventories (-8.6 from -14.6) continued to contract—the latter at a slower pace. Meanwhile, the employment measure (to 9.4 from 7.2) reached its highest level in nearly a year, while the average workweek gauge dropped 11.3 points (4.8 from 16.1)—signaling only a small increase in hours worked this month. The future business conditions index held fairly steady, ticking up to 33.9 this month from 32.8 last month; it has averaged 35.8 the past five months, since peaking at 56.5 in June. Measures for both new orders (to 32.9 from 37.7) and shipments (28.2 from 29.8) were slightly lower this month, though considerably below their June peaks of 52.9 and 53.1, respectively. Employment levels (to 22.2 from 23.2) and the average workweek (9.3 from 6.6) are expected to continue to expand up ahead. Looking at prices, both the future prices paid (to 46.4 from 39.1) and prices received (23.2 from 16.6)

measures show an acceleration in prices.

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

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