MORNING BRIEFING
November 18, 2020

The Fed's Third Mandate

Check out the accompanying chart collection.

(1) Tesla is in the fast lane. (2) Back to the Future. (3) T-Fed congratulates the Fed and the Treasury for a job well done. (4) Strong recovery should support valuations, says the Fed. (5) Corporate debt bomb has been detonated, says the Fed. (6) Households are stable, and banks are in good shape too. (7) Non-banks are on regulators' radar screen. (8) The meaning of "backstop." (9) Record equity in homes. (10) Millennials have a lot of catching up to do with Baby Boomers and GenXers in homeownership derby.

Strategy: Tesla Gets The Green Light From S&P. Standard & Poor's announced after Monday's close that Tesla (TSLA) will be added to the S&P 500 index in the Consumer Discretionary sector before the opening of trading on December 21. The stock soared 8.2% on the news to close at $441.61 on Tuesday. The company's shares are up 428% ytd. Its market capitalization of $412 billion makes Tesla the largest-ever addition to the index and ninth biggest company in the index today.

The last exciting index addition occurred in 1999, when Yahoo soared 64% in the five trading days between its announcement and inclusion in the index. A similar drag race for Tesla would propel it to the sixth spot in the S&P 500, ahead of Berkshire Hathaway and behind the FAAMG (Facebook, Amazon, Apple, Microsoft, and Google) stocks. However, it would represent only about 1% of the S&P 500 index by size. Here are a few other relevant consequences:

(1) *MegaCap.* Tesla's size eclipses fellow Consumer Discretionary sector constituents and automakers Ford and GM, which are worth about $95 billion combined. Given Tesla's heft, its addition will have an Amazon-lite effect on the sector. Amazon accounted for 47% of the sector's market capitalization at Friday's close. Its share would fall to 42% after Tesla's addition. However, both companies would account for more than half, or 52% of the sector's market cap.

(2) *Impact on valuation, etc.* The addition of Tesla to the S&P 500 won't affect the index price on the day it is included because S&P's divisor adjusts for index changes. However, the divisor is not used to adjust the S&P 500's revenues and earnings, and subsequently its valuation ratios. When an incoming company's valuation is higher than those of the index and the company it is replacing, then the index's valuation rises. This is also true for the profit margin.

While Tesla's large size and relatively high valuation makes the addition to the index a big deal, it actually will have little impact on the S&P 500 index's revenue, earnings, and profit margin. Our back-of-the-envelope calculation suggests that Tesla will account for 1.3% of the S&P 500's market cap but just 0.2% of its total forward earnings and 0.4% of its total forward revenues. Based on Monday's close, this would cause the S&P 500's P/E to rise 0.2pts to 22.2 and its price-sales ratio to rise 0.02pts to 2.51. Tesla's relatively low forward profit margin of 6.6% reflects its roots as an auto manufacturer rather than a technology firm. That will cause the S&P 500's profit margin to dip slightly, but so slightly that rounded to the tenth place it remains the current 11.3%.

(3) *Prequel to the Roaring 2020s.* S&P has not announced which company will be removed from the index. However, it traditionally has removed companies from the index due to market-cap size considerations. At present, there are four S&P 500 Energy firms in the five lowest market-cap companies in the index, each worth around $4 billion. The removal of one of them, particularly from the Oil & Gas Exploration & Production sub-industry (which has 10 companies in the index), would further alter the new-age versus old-economy makeup of the S&P 500 index—keying us up for a Hollywood-style movie ending, with Tesla's addition just the prequel. In other words, with more fast-growing tech firms filing to go public, Tesla's addition may herald more exciting changes to the index in the new Roaring 2020s.

Fed I: Fed Says Fed Doing a Good Job. The pandemic could have triggered a financial meltdown and a depression. Thankfully, the monetary policy averted these calamities. Fiscal policy helped too. That's the central message of the Fed's November *Financial Stability Report* (*FSR*).

The Fed lowered the federal funds rate to zero on March 15 and announced QE4ever on March 23. When the President signed the CARES Act into law on March 27, the Federal Reserve and the US Treasury effectively became the "Bank of the United States," or "T-Fed," as Melissa and I call the duo. The CARES Act enabled the US Treasury to supply equity of up to $450 billion to special purpose vehicles to be established by the Fed and leveraged into up to $4.0 trillion in credit.

On April 9, the Fed announced emergency lending facilities to help pandemic-ridden corporations, municipalities, Wall Street, and Main Street with up to $2.3 trillion in credit. Let's review how the Fed perceives that it saved the day, according to the latest *FSR*:

(1) *Floating (mostly) all boats*. The purpose of the *FSR* is to create transparency around and accountability for the resilience of the US financial system to shocks. The Fed notes in the *FSR* that financial stability is crucial to achieving its dual mandate of maximum employment and stable inflation. "In an unstable financial system, adverse events are more likely to result in severe financial stress and disrupt the flow of credit, leading to high unemployment and great financial hardship," the report states. In other words, financial stability is really the Fed's third mandate, though it's not explicitly set by law as is the dual mandate.

The report is broken down into four key sections: the risk of outsized drops in asset prices (i.e., valuation), the risk of businesses and households cutting back on spending due to previously excessive borrowing (i.e., debt), the ability of the financial sector to absorb losses from the business and household sector (i.e., financial sector leverage), and the risk of runs and fire sales (i.e., funding, or liquidity, risks). While the pandemic put a major strain on each of these areas, the Fed says that it avoided or mitigated stability risks from materializing in nearly all of them.

(2) *Fear not elevated asset prices*. "Given the high level of uncertainty associated with the pandemic, assessing valuation pressures is particularly challenging, and asset prices remain vulnerable to significant declines should investor risk sentiment fall or the economic recovery weaken," said the Fed (*Fig. 1*). Especially vulnerable sectors emphasized in the report include energy, travel and hospitality, and commercial real estate. (See our discussions of corporate bankruptcies and default risk, particularly in these sectors, here and here. Also see this recent Covid-19 bankruptcy list from AlphaSense.)

Nevertheless, asset prices should be supported by "a stronger than-expected economic recovery" thanks to "[p]rompt and forceful policy responses—including fiscal stimulus, lower interest rates, and various asset purchase and emergency lending programs," the report added. Go, T-Fed! You rock!

(3) *Corporate debt bomb avoided*. Corporations took on more debt in a mad dash for cash as the pandemic spread to offset weakening cash flow, the report explained (*Fig. 2*). Even before the pandemic, business debt ran historically high, it observed. Declines in revenues weakened the ability of businesses to service their debts.

Not to worry, said the Fed: “So far, strains in the business and household sectors have been mitigated by significant government lending and relief programs and by low interest rates.” For example, spreads in corporate debt markets returned to historical norms as market functioning improved, and issuance resumed following the Fed’s bold actions. The *FSR* stated: “The announcement of a range of measures to support market functioning and the flow of credit in late March, particularly the corporate credit facilities, led to significant improvement in corporate bond market functioning and provided a backstop to support borrowing by corporations.”

(4) *Household sector risk mitigated*. Vulnerabilities arising from household debt had been modest before the pandemic (*Fig. 3*). While the risk of household delinquencies and defaults grew as jobs and incomes were lost, fiscal policies helped to avoid them. Household risk may increase as fiscal stimulus expires, affecting lenders throughout the financial system, warned the *FSR*.

Nevertheless, supported by low interest rates, housing prices have increased over the course of the pandemic. Mortgage debt accounts for roughly two-thirds of total household credit. Some risk remains in the household sector, such as for auto and credit card loans; but for now, lenders have provided Covid-19 related accommodations preventing delinquency and default status (*Fig. 4* and *Fig. 5*).

(5) *Banks relatively stress free*. The pandemic pressured banks, but US banks remain well capitalized. Some non-bank financial institutions, however, “felt significant strains amid the acute period of extreme market volatility, declining asset prices, and worsening market liquidity earlier this year.” But the Fed eased these pressures with policy actions, said the report. Bank and broker-dealer leverage remains low, the *FSR* observed. In contrast, it found that measures of leverage at life insurance companies and hedge funds remain elevated.

Bank funding risk remained low throughout the pandemic, said the report. But “the large redemptions from money funds and fixed-income mutual funds, as well as the need for extraordinary support from emergency lending facilities, highlighted vulnerabilities in these sectors. While in place, those facilities substantially mitigate these vulnerabilities."

(6) *External vulnerabilities abound*. Near-term risks associated with the virus and its effects on the global economy remain high, the report noted. It added that there "is potential for stresses to interact with preexisting vulnerabilities in dollar funding markets or those stemming from financial systems or fiscal weaknesses in Europe, China, and emerging market economies," posing additional risks to the US financial system.

Fed II: Regulators Focus on Non-Banks. Increased global regulations around non-bank financials are coming, as we discussed in our October 21 *Morning Briefing*, which covered the International Monetary Fund's *Global Financial Stability Report*. Banks may be well capitalized, but non-bank financials remain vulnerable to risks according to the *FSR* as noted above.

In her statement, Brainard said: "The resurgence of fragility and funding stress in the same nonbank financial sectors in the COVID-19 crisis and the Global Financial Crisis highlights the importance of a renewed commitment to financial reform. We saw runs on prime money market funds—which had grown rapidly in the preceding couple of years—as large or larger than those in 2008. We also saw record outflows from open-ended funds that offer daily redemptions against less liquid underlying assets, such as the $1.7 trillion in corporate bonds held by mutual funds in the second quarter."

A November 16 Reuters article titled "Regulators target money market funds after COVID-19 turmoil" reported that the Financial Stability Board (FSB), which coordinates financial rules for the Group of 20 Economies (G20), said in a Tuesday report that the Covid-19 turmoil in markets exposed vulnerabilities throughout the financial sector. "But further investigation is warranted into money market and open-ended funds, into how derivatives clearing houses vary margin or cash calls to cover trading positions, and into the structure of bond markets, the FSB said," according to the article.

Chair of the FSB and Vice Chair of the Fed Randal Quarles told reporters that action needs to be taken on these issues. The FSB said that sectors like money market funds would have fared much worse in the "dash for cash" if it were not for "central banks doling out liquidity to maintain stability," wrote Reuters. The FSB wants to avoid a "moral hazard" or an expectation that central banks would act again as a safety net for struggling funds in the next crisis.

Fed III: The Implications of Providing a 'Backstop.' On numerous occasions, Fed officials have characterized the Fed's large lending facilities as "backstops" to the financial system. Because they are only backstops, the facilities have gone largely unused (as we detailed in Monday's *Morning Briefing*), explained an August 17 *Chicago Fed Insights* note. As a backstop, the primary purpose of the facilities is to restore the confidence of the private markets rather than to incentivize lending through the facilities.

Specifically, backstops influence financial conditions "by providing a safety net and by influencing bargaining in private transactions," wrote the Chicago Fed. It explained: "By regulation, lending facilities created under the Fed's emergency powers are 'backstops,' charging a penalty interest rate that encourages borrowers to obtain funds in the market when possible." As a result, "many of the Fed facilities have seen little borrowing, and total use has leveled off as financial stresses have diminished," it said.

The Fed's *FSR* indicated that its corporate credit facility purchases to date totaled just slightly more than 0.2% of the $5.5 trillion of outstanding non-financial corporate bonds. Its municipal facility has purchased only two issues totaling just more than $1.6 billion. It noted: "[S]ince the announcement of the backstop facilities and funding market stabilization measures, more than $1 trillion in new nonfinancial corporate bonds and more than $250 billion in municipal debt have been issued, purchased almost entirely by the private sector."

Wealth Distribution: Who Owns Houses? Perhaps the biggest difference between the Great Financial Crisis (GFC) and the Great Virus Crisis (GVC) is that homeowners suffered substantial capital losses during and after the GFC but benefitted from substantial capital gains before, during, and after the GVC (so far). This time, homeowners have lots of equity in their homes, which can be used to cushion the shock of any economic and financial losses resulting from the pandemic.

Last week, Melissa and I started our examination of wealth distribution in America with a focus on corporate equities and mutual fund shares. Today, we continue it with a focus on real estate. Consider the following:

(1) *The big picture.* Table B.101 in the Fed's Financial Accounts of the United States is titled "Balance Sheet of Households and Nonprofit Organizations." It shows that the value of real estate held by households dropped 26% from Q4-2006 through Q1-2012 (*Fig. 6*). Over this

same period, the 12-month average of the median existing single-family home price fell 22%. Owners' equity dropped 42% over this period.

The recovery since the lows has been impressive, with all three series at new record highs during Q2-2020 as follows: residential real estate value ($30.8 trillion), median home price ($288,540 during the 12 months through September), and owners' equity ($20.2 trillion). The level of outstanding mortgages has been remarkably flat around $10.5 trillion for the past few years, while real estate value has been rising to new highs since Q3-2016, resulting in more equity for homeowners (*Fig. 7*). Collectively, owners' equity as a percentage of home values has recovered from a recent low of 45.8% during Q1-2012 to 65.6% currently (*Fig. 8*).

No wonder that the Fed's latest *Financial Stability Report* views residential real estate and finance as among the most stable sectors in the economy.

(2) *Residential wealth distribution by percentile groups.* Here are the values and percentage shares of the $30.8 trillion in real estate value during Q2-2020 by household wealth percentile groups: top 1% ($4.5 trillion, 14.6%), 90%-99% ($9.3 trillion, 30.2%), 50%-90% ($13.3 trillion, 43.4%), bottom 50% ($3.6 trillion, 11.8%) (*Fig. 9* and *Fig. 10*). The percentage shares have been relatively stable in recent years. The data suggest that lots of middle-class homeowners continue to benefit from rising real estate values.

Currently, roughly 80 million US households own their own home. This implies that the average home represents about $385,000 in real estate value, with owners sitting on an average of $252,500 in equity and holding an average mortgage of $132,500.

(3) *The impact of age.* Here are the real estate values and percentage shares owned by the major generations as of Q2-2020: Silent ($4.6 trillion, 14.9%), Baby Boomer ($13.4 trillion, 43.7%), GenX ($9.4 trillion, 30.4%), and Millennials ($3.4 trillion, 11.0%) (*Fig. 11* and *Fig. 12*).

The share of the Silent Generation has declined steadily from around 65% during the early 1990s to about 15% now. Gaining the most market share during the 1990s were Baby Boomers and GenXers. The former peaked at 49% during 2010 and is down to 44%, while the latter remains on an uptrend. Coming from behind, with lots of catching up to do, is the Millennials.

CALENDARS

US: **Wed:** Housing Starts & Building Permits 1.46mu/1.56mu, MBA Mortgage Applications, EIA Crude Oil Inventories, Williams, Bostic, Evans. **Thurs:** Leading Indicators 0.7%, Initial & Continuous Jobless Claims 707k/6.47m, Existing Home Sales -1.2%, Philadelphia Fed Manufacturing Index 22, Kansas City Fed Manufacturing Index. EIA Natural Gas Storage, Mester. (DailyFX estimates)

Global: **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. **Thurs:** UK Gfk Consumer Confidence -34, Japan Headline & Core CPI Australia Retail Sales 0.3%, Lagarde, Mauderer, Buch, Wuermeling. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q3 Earnings Season Monitor (*link*): With over 93% of S&P 500 companies finished reporting revenues and earnings for Q3-2020, revenues are beating the consensus forecast by a record-high 3.7%. Earnings have similarly crushed estimates, by 19.7%, which is the second highest since Q1-2009 and below Q2-2020's record high of 23.4%. 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 2.9% above forecast and earnings beat by 23.4%. For the 467 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 Q3 reporters so far collectively have a surprisingly small y/y revenue decline of 1.2%, and their collective earnings drop is just 8.7%; those results mark a huge recovery from Q2, the worst quarter since Q1-2009 during the financial crisis. A tad under 84% of companies are reporting a positive earnings surprise, and nearly 79% have beaten their revenues forecast. Slightly fewer companies are reporting positive y/y earnings growth in Q3 (50%) than are reporting positive y/y revenue growth (51), but those readings are up sharply from their respective Q2 readings of 37% and 33%. Taking a look at the Q3 shares outstanding tallied so far, companies outside of the Tech sector have put the brakes on share buybacks and are letting their share counts stabilize or edge higher. The basic shares outstanding count has risen 0.1% q/q and is unchanged y/y. At the same point during the Q2 season, the share count was unchanged q/q and down just 0.5% y/y. We don't expect the Q3-2020 figures to change much as the remaining companies report in the coming weeks. With more companies providing guidance about their future financial periods during the Covid-19 crisis, the revenue and earnings surprises should become smaller in future reporting periods.

US ECONOMIC INDICATORS

Retail Sales (*link*): Both headline and core retail sales lost momentum in October, but each continued to reach new record highs; they were 4.5% and 9.2%, respectively, above their record highs posted before the pandemic hit. Headline sales rose a smaller-than-expected 0.3% in October, following a slight downward revision to September's (to 1.6% from 1.9%) gain but a big upward revision to August's (+1.4 from 0.6). Overall sales increased 34.1% during the six months through October, while core retail sales (which excludes autos, gasoline, building materials, and food services) edged up 0.1% in October and 20.8% since bottoming in April. Adjusted for inflation, we estimate retail sales climbed 0.3% last month and 30.4% during the six months ending October, while core retail sales rose 0.2% and 17.5% over the comparable periods. Last month, five of the 13 nominal retail sales categories were in the plus column, led by nonstore retailers (+3.1%), while eight were in the minus column, with clothing and sporting goods & hobby stores posting the largest declines—each falling 4.2% last month. Here's a snapshot of each categories' performance since their April lows and where they stand relative to their pre-COVID levels: i) clothing & accessory stores (542.6% & -14.0%); ii) furniture & home furnishing stores (158.0 & 2.7); iii) sporting goods & hobby stores (107.0 & 13.1); iv) electronics & appliance stores (106.4 & -5.0); v) food services & drinking places (85.3 & -15.1); vi) auto dealers (67.8 & 8.8); vii) miscellaneous store retailers (54.5 & -2.2); viii) gasoline service stations (39.1 & -14.9); ix) health & personal care stores (16.6 & 4.7); x) building materials & gardening equipment (16.2 & 12.4); xi) nonstore retailers (11.4 & 27.9); xii) general merchandise stores (9.1 & 2.1); and xiii) food & beverage stores (-0.5 & 9.9).

Business Sales & Inventories (*link*): Nominal business sales continued to recover in September from Covid-19-related declines, and was only fractionally below January's record high, while real sales—reported with a lag—reached another new record high in August. The increase in September business sales slowed again to 0.6% from 0.9% in August. These sales had averaged monthly gains of 6.8% the prior three months; they rebounded 23.6% during the five months through September. Real sales ticked up only 0.1% in August, though was 18.1% above its April bottom. Real sales of retailers has more than recouped its pandemic-related decline—and was 5.0% above pre-pandemic readings, though remained stalled around July's record high for the second month. Meanwhile, real wholesale and manufacturing sales have rebounded 16.4% and 15.1%, respectively, during the four months through August—leaving them within 0.5% and 1.8% of February levels. September's nominal inventories-to-sales ratio remained at 1.32; it had shot up from 1.38 in February to 1.67 in April. Similarly, the real inventories-to-sales ratio for August was unchanged at 1.37; it had soared to a record high of 1.66 in April from 1.43 in February.

Industrial Production (*link*): Industrial output resumed its climb in October after a brief dip in September. Production advanced for the fifth time in five months, rebounding 1.1% in October and 13.0% since bottoming in April, with manufacturing output up 1.0% and 19.1% over the comparable period. Headline production is 5.6% below its pre-pandemic level, manufacturing 4.8% below. Output by market group returned to the plus column in all categories during October, resuming their recent upswing. Here's a snapshot of each category's (and their components) performances since their April lows and where they stand relative to their February levels: Business equipment (31.0% & -7.4%), led by transit equipment (260.9 & -8.9), followed by industrial equipment (19.1 & -8.4), and information procession equipment (1.7 & -4.0)—with the latter showing little volatility during the pandemic shutdown despite dropping 6.2% the past two months. The same exercise shows the rebound in consumer goods production (18.6% & -1.7%) is being driven by durable goods (98.7 & -2.1)—mostly automotive products (345.8 & -1.3)—while the gain in consumer nondurable goods (5.8 & -1.5) production paled in comparison.

Capacity Utilization (*link*): The headline capacity utilization rate climbed for the fifth time in six months since falling to a record low of 64.2% in April, advancing to 72.8% in October; it was at a cyclical high of 79.6% during November 2018. October's rate was 7.0ppts below its long-run (1972-2019) average but 8.6ppts above April's low. Manufacturing's capacity utilization rate has increased steadily since reaching bottom in April at 60.1%, rising to 71.7% by October—11.6ppts higher than its trough in April but still 6.5ppts below its long-run average. The utilization rate for mining fell from 78.2% to 77.9% last month, remaining below its long-run average of 87.2%, while the rate for utilities rose from 70.2% to 72.7%—12.5ppts below its long-run average.

Import Prices (*link*): Import prices fell for the first time in six months as petroleum prices posted their second decline. Import prices ticked down 0.1% last month, following a five-month increase of 4.3%; as petroleum prices fell 1.0% last month and nonpetroleum prices were flat after a 2.0% increase during the five months through September. Petroleum prices are down 7.7% the past two months, following a four-month spike of 67.6%. The yearly rate for import prices rose to -1.0% y/y, narrowing steadily from April's -6.8% bottom. Petroleum prices were 29.1% below last October, with the rate holding around -30.0% the past four months; it bottomed at -58.5% in April. Meanwhile, the yearly rate for nonpetroleum prices accelerated to a 29-month high of 1.8%, up from -1.1% y/y in April; the rate was negative from the start of 2019 through June of this year. The rate for capital goods imports (0.8% y/y) was positive for only the third month since August 2018, the first month being August of this year. Meanwhile, the decline in the rate for industrial supplies & materials (-7.2% y/y) has narrowed from April's 26.5%—which was the lowest reading since November 2015. Rates for consumer goods ex autos (0.1% y/y) remained around zero, while the rate for autos (1.2) was little changed from September's 1.3% rate—which was the highest since February 2013. Food prices were 1.9% above a year ago, the second positive reading since February and the highest since April 2018. Import prices are showing signs of picking up among some of our trading partners, with import prices for goods from the EU at a two-year high of 2.1% y/y and China's (0.1% y/y) above zero, though slightly, for the first time since October 2018. The rate for the NICs (-1.5% y/y) remains negative, though has narrowed steadily from -4.0% in April, while the rate for Japan remains around zero.

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