



MORNING BRIEFING

December 2, 2020

The Carrie Trade

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

(1) Stephen King's first horror novel. (2) Bond Vigilantes have something in common with Carrie. (3) Bond, Dow, and Dollar Vigilantes. (4) The CRB index is bullish for Emerging Markets, commodity currencies, and materials stocks. (5) Red metal is bullish on Red China. (6) Copper/gold price ratio is bearish for bonds. (7) The Fed's Carrie trade is keeping bond yield under 1.00%. (8) Public pension funds are significantly underfunded according to Fed data. (9) A political problem that may require a political solution.

Credit: The Bond Zombies. *Carrie* is a horror novel by Stephen King. It was his first published novel, released on April 5, 1974. It was turned into a movie in 1976 starring Sissy Spacek and John Travolta. Carrie is a misfit bullied in her high school and dealing with an abusive, religious fanatic mother at home. She finds that she can channel her angst into telekinetic powers, which she uses to exact revenge on her tormenters. Much blood is spilt along the way, including Carrie's. In the final scene, she seems to rise from the dead but that's just a bad dream.

The Bond Vigilantes have been buried by the Fed. However, in our nightmare scenario, they could rise from the dead like Carrie. It isn't likely to happen if inflation also remains buried, as Debbie and I expect.

Meanwhile, there are other vigilantes in the financial markets. The Dow Vigilantes sent out a blood-curdling scream when the S&P 500 plunged 33.9% in 33 days earlier this year ([Fig. 1](#)). The Fed responded with QE4ever on March 23. The Dollar Vigilantes are threatening a crash in the currency if US fiscal and monetary policies continue to placate the Dow Vigilantes by swelling the federal budget deficit and the money supply ([Fig. 2](#), [Fig. 3](#), and [Fig. 4](#)). A plunge in the dollar could revive inflation and unleash a plague of Bond Zombies.

It's hard to get a clear signal from the financial markets since their price mechanisms have been so distorted by the Fed and the other major central banks. The one clear signal may be coming from the commodity markets. Consider the following:

(1) *CRB raw industrials*. The CRB raw industrials spot price index continues to signal rebounding global economic activity ([Fig. 5](#)). It is highly inversely correlated with the trade-weighted dollar. The rising CRB index is bullish for the Emerging Markets MSCI stock price index, the Australian and Canadian dollars, and the S&P 500 Materials sector. (See our [Market Correlations: CRB Raw Industrials Spot Price Index](#).)

The CRB index is also highly correlated with expected inflation as measured by the yield spread between the 10-year nominal Treasury bond and the comparable TIPS ([Fig. 6](#)). This spread has rebounded from this year's low of 0.50% on March 19 to a range of 1.6%-1.8% in recent weeks.

(2) *Copper*. The price of copper is one of the 13 components of the CRB raw industrials spot price index ([Fig. 7](#)). (Petroleum and lumber products are not included in the index.) The copper price has been leading the overall CRB index higher since this year's bottom. On Monday, copper closed at the highest price since January 2, 2014. Driving the price of the red metal higher has been China's M-PMI, which has recovered solidly over the past six months through November ([Fig. 8](#)).

(3) *Copper/gold ratio*. When we multiply the ratio of the nearby futures prices of copper to gold by 10, the resulting series has shown a remarkably close fit with the 10-year Treasury bond yield since 2004 ([Fig. 9](#)). The ratio currently suggests that the bond yield should be closer to 2.00% than to 1.00%. As we discussed on Monday, the yield has remained under 1.00% since March 20, as the Fed has been buying Treasury notes and bonds faster than the Treasury has been issuing them.

That's the "Carrie trade." As long as it continues, the Bond Vigilantes will remain buried.

US Economy: The Public Pension Crisis. Only about half of the \$9 trillion in state and local public pension entitlements is funded, according to the Fed's [Financial Accounts of the United States](#) ([Fig. 10](#)). That means that states and municipalities do not have enough funds set aside to pay for all of the benefits accrued to public workers when they retire.

The problem is not new. During Q2-2020, 48.3% of public pension liabilities were unfunded ([Fig. 11](#)). This percentage has been quite stable around 50.0% since 2009. However, the

Covid-19 pandemic has significantly stressed state and local finances, which is likely to exacerbate the underfunding problem for public pension funds.

How big is the problem? The Fed's data seem to answer that question quite well. However, the exact level of US public pensions' collective underfunding is hard to gauge but might be anywhere from \$1.6 trillion to \$6.0 trillion, observed a 2019 Reason Foundation [article](#). That's because the gap between the present value of plans' liabilities (measured as the benefits promised to retirees) and plans' assets (including stocks, bonds, and other investments) depends on various complex actuarial assumptions. Those include the discount rate used to calculate the liabilities and the rate of return used to project growth in assets, among others.

The Pew Research Center [estimates](#) that the aggregate funding gap for just the state pension plans will be about \$1.4 trillion for 2020. The latest [analysis](#) of the most recently available full-fiscal-year data from Pew found a pension funding gap for the 50 states during 2018 of \$1.2 trillion. Such a big gap may not be quite as scary as it looks, observed a 2019 *Brookings* [report](#). The gap need not be reduced to zero for funds to remain viable, just to a level that can be sustained by municipal cash flows.

If the funds are not available to meet beneficiaries' entitlements, then either catch-up employer contributions or reduced employee benefits would be necessary in the absence of external sources of funding. However, higher contributions or reduced benefits is not really an either/or decision. In many states, paying out public pension obligations is regarded as "sacrosanct," as an [article](#) in the April 2 *New York Times* put it. So to meet higher contribution targets while staying on budget, states must either raise taxes or cut government programs. The only other solution is for the federal government to bail out the states, a highly politically charged concept, as we discuss below.

Fortunately, the deeply underfunded status of many public pension plans could be manageable and even avoidable if financially sound funding policies are implemented. Unfortunately, many states got into the public pension mess because they have mismanaged their plans due to political pressures. Consider the following:

(1) *Funding status varies by state*. State and local government pension plans support more than 21 million participants in more than 5,500 plans, according to data cited in an [article](#) from The Urban Institute. State and local government pensions account for 19% of total retirement

saving assets. About 90% of members and 82% of assets are in state-administered plans, partly because many local government employees are covered by state plans.

Pew's analysis of 2018 data linked above measured whether state plans are making enough contributions to reduce debt if plan assumptions are met (see Pew's table [here](#)). The researchers found that if state plans achieve their average 7.2% annual investment return targets, only half of them would continue to reduce pension debt and improve funding levels. Pew observes that just seven states are at least 90% funded (ID, NE, NY, SD, TN, WA, and WI), while nine states are less than 60% funded (CO, CT, HI, IL, KY, NJ, PA, RI, and SC). South Dakota is in the top position at 100% funded, followed by New York at 98.0%. New Jersey is the worst on the list, with a funded ratio of just 38.4%. Illinois is not far behind at 39.0%.

(2) *Those managed well manage well.* The plans that have adhered to consistently sound funding policies are the most fully funded, according to Pew. Best-practice funding policies include the following: lowering investment return assumptions to allow for a better determination of future potential funding shortfalls, adopting employee cost-sharing policies to lower cost variability, and implementing pension stress-testing to assess potential shortfalls.

Plan designs also make a big difference to funding status. These are different across states, but most states provide some form of defined benefit plan that promises a lifetime annuity for retirees, observed the Tax Foundation in an April 15 [note](#). That means that every new teacher, firefighter, and other public worker hired adds to public pension liabilities for a lifetime! Some states have recently transitioned to a defined contribution plan for new employees whereby employees control their investments and the upfront employer contributions are funded by the state, while others have shifted to a hybrid plan, wrote the Tax Foundation.

(3) *How we got here.* Unions often have pushed for increased pension benefits, explained an [article](#) on The Conversation website written by a public policy professor at the University of Virginia. Constrained by budgets, state lawmakers often have failed to contribute enough funds to meet future obligations, favoring other spending programs. Often, the first item cut from budgets has been the state pension contribution because doing so has few political consequences. To justify the inadequate contributions, pension plan sponsors often have bumped up their return targets to unrealistically high levels, the article observed. Other key assumptions—like the longevity of retirees and future costs of living—also have been adjusted unrealistically to justify lower contributions.

Risky return targets have led pension plans to acquire riskier investment classes, the Urban Institute article highlighted. Corporate equities have increased as a share of pension assets to roughly 60% of total investments, on average, since the mid-1990s. Recent years have seen pension plans' holdings of alternative investments—such as private equity, hedge funds, real estate, commodities, and other potentially risky asset classes—increase too.

States' pandemic-related revenue declines and expenditure increases will likely make meeting their expected annual contributions to pension programs even more difficult. Moody's Investors Service estimated as of early April that US public pension plans were on pace for an average investment loss of about 21% for the fiscal year ending June 30, [according](#) to Pensions & Investments. Plans' investment performance mostly recovered by the end of June, according to an August 2020 Pew [analysis](#). It found, however, that the typical pension fund still fell short of expected market returns for the 2020 fiscal year.

(4) *Federal bailout up for discussion.* If pensions can't meet their return targets, can't reduce future benefits owed because they are "sacrosanct," and are unwilling to meet the appropriate level of contributions due to budgets, then only external funding can save the day. But whether it does is a matter of politics. In late April, President Trump [tweeted](#): "Why should the people and taxpayers of America be bailing out poorly run states (like Illinois, as example) ...? ... I am open to discussing." Five GOP senators agreed with the President's suggestion that the federal government should not provide aid to the states hard-hit by the pandemic in April 30 [letter](#). "We believe additional money sent to the states ... will be used to bail out unfunded pensions, reward decades of state mismanagement, and incentivize states to become more reliant on federal taxpayers," they said.

Those comments came on the heels of Senate Majority Leader Mitch McConnell's April 22 comment that struggling municipalities should "use the bankruptcy route." Later in the day, McConnell told Fox News that the federal government is "not interested in solving [state] pension problems for them," [according](#) to Politico. In response, New Jersey's democratic Governor Phil Murphy [told](#) CNBC: "The alternative is we will gut the living daylights out of the very services that our folks now are desperately relying upon."

(5) *Who is entitled to have a pension?* The Great Virus Crisis will not be the last challenge to public pension funding status. That's especially true given that the aging population will

pressure plans' cash flows. Less active workers will contribute to plans to support the increased share of retirees on the public pension payroll.

The Federal Reserve's Distributional Financial Accounts (DFAs) show that the Baby Boomer generation holds the largest share of private and public pension entitlements (54.1%), followed by Gen X (28.9), the Silent Generation (9.6), and Millennials (7.4) ([Fig. 12](#)). We wonder whether Millennials are less interested in pension-providing state jobs than Boomers have been or whether plan sponsors are offering less attractive entitlement packages to more recently hired workers.

By the way, public and private pensions are largely held by middle-income groups in the 50th to 99th percentile. This cohort currently holds about 90.0% of pension entitlements, according to the latest data from the Fed's DFAs ([Fig. 13](#)). That makes sense, since the folks who tend to earn pension entitlements (e.g., teachers, police officers, and municipal workers) also tend to fall in the middle to upper income groups. They tend to be college educated too ([Fig. 14](#)).

Experienced and educated working middle-to-upper class pension beneficiaries are unlikely to relent on demands for the future entitlements owed to them, so something will have to give. And that just might be Uncle Sam—or rather Uncle Joe. Forthcoming proposals from the incoming Biden administration, according to Biden's website, include issues related to pensions, starting with passing the Butch Lewis Act. It would provide federally backed loans to underfunded multi-employer defined benefit pension plans, [according](#) to SHRM.

CALENDARS

US: **Wed:** ADP Employment Change 420k, MBA Mortgage Applications, EIA Crude Oil Inventories, Beige Book, Powell, Williams, Harker, Quarles. **Thurs:** Initial & Continuous Jobless Claims 775k/5.92m, ISM NM-PMI 60.9, IHS Markit C-PMI & NM-PMI 57.9/57.7, EIA Natural Gas Storage. (DailyFX estimates)

Global: **Wed:** Germany Retail Sales 1.0%/m/m/5.9%/y/y, Japan Consumer Confidence, China M-PMIs, ECB Non-Monetary Policy Meeting, BOE FPB Meeting, Land. **Thurs:** Eurozone Retail Sales 0.8%/m/m/2.7%/y/y, Eurozone, Germany, and France C-PMIs 45.152.0/39.9, Eurozone, Germany, and France NM-PMIs 41.3/46.2/38.0, UK C-PI & NM-PMI 4. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI improved in November for a sixth straight month and was positive for a fourth month following 13 straight negative readings. NERI rose to a 32-month high of 15.2% from 15.1% in October and is up from an 11-year low of -37.4% in May. That compares to a tax-cut-induced record high of 22.1% in March 2018. NERI was positive for 10 sectors for a third month in November, the most since September 2018. That compares to negative NERI readings for all 11 sectors from April to July. Seven of the 11 sectors improved m/m in November, down from eight improving in October and all 11 from June to September. All 11 had been worsening on a m/m basis from March to May. Real Estate has the worst track record among the sectors, with 12 months of negative NERI. Here are the sectors' November NERIs compared with their October readings: Financials (32-month high of 21.3% in November, up from 13.7% in October), Consumer Staples (21.0 [32-month high], 20.3), Industrials (20.4, 22.8 [31-month high]), Materials (19.2 [32-month high], 19.1), Consumer Discretionary (18.1 [32-month high], 17.2), Communication Services (15.5 [25-month high], 14.1), S&P 500 (15.2 [32-month high], 15.1), Information Technology (12.3, 12.6), Health Care (10.7, 15.3), Energy (8.0, 11.6), Utilities (5.9 [26-month high], 5.9), and Real Estate (-1.9 [10-month high], -6.3).

MSCI World & Region Net Earnings Revisions ([link](#)): Analysts' recent earnings revisions through November continue to suggest greater optimism about profits across the world. The US's NERI was positive in November for a fourth straight month after 14 negative readings, rising to a 32-month high of 15.6% from 15.5%, which is up from an 11-year low of -36.9% in May. It remains well below its corporate-tax-rate-cut-boosted record high of 21.8% in March 2018. The AC World ex-US MSCI's NERI was positive for a second month after 30 straight negative readings, rising to a 42-month high of 2.3% from 0.6%, which compares to an 11-year low of -23.9% in May. All regions improved m/m, and with the exception of the EMU, all have positive NERIs now. Here are November's scores among the regional MSCIs: US (15.6% in November [32-month high], up from 15.5% in October), AC World (5.7 [32-month high], 4.4), EM Latin America (3.9 [highest since November 2009], 0.1), EM Asia (3.1 [highest since January 2011], 2.3), Emerging Markets (3.1 [highest since January 2011], 2.1), EM Eastern Europe (2.4 [24-month high], 1.0), AC World ex-US (2.3 [42-month high], 0.6), Europe (1.2 [40-month high], -0.6), EAFE (0.7 [32-month high], -2.4), Europe ex-UK (0.7 [26-month high], -2.4), and EMU (-1.8 [26-month high], -3.2).

MSCI Countries Net Earnings Revisions ([link](#)): NERI was positive for 26/44 MSCI countries

in November, up from 22/44 in October and compared to zero from April to June. November's count is the highest since 29/44 countries were positive in June 2017. NERI improved m/m in November for 28/44 countries, up from 27/44 in October; this compares to a record-high 42/44 countries improving in August. Among the countries with improving NERI in November; Brazil was at a record high, Ireland was the highest since April 2007 (163 months), South Africa since June 2007 (161), India since August 2009 (135), Korea since July 2010 (124), and Sweden since September 2010 (122). Fifteen countries had NERIs drop m/m; Argentina's fell to a record low, New Zealand's dropped to a 14-month low, Israel's was at a nine-month low, and the remaining 12 had NERIs at two- to five-month lows. Among the 26 countries with positive NERI, seven have been positive for four months. Mexico's NERI turned positive for the first time in 49 months and Singapore's for the first time in 31 months. Those of Indonesia, Malaysia, and Thailand have been negative for 32 months. The highest NERI readings in November: Ireland (16.6%), the US (15.6), Sweden (14.1), India (12.4), Pakistan (10.1), and Korea (9.1). The weakest NERIs occurred this month in Argentina (-21.1), Portugal (-16.3), Spain (-11.1), New Zealand (-11.1), and Hong Kong (-9.7).

US ECONOMIC INDICATORS

Construction Spending ([link](#)): Construction expenditures in October climbed for the fourth time in five months to within 0.2% of February's record high, with private construction spending at a new record high and public construction spending 4.3% below its record reading in March. Total construction spending rose 1.3% in October and 5.1% the past five months, with private construction expenditures climbing 1.4% and 8.2% over the comparable periods; public construction spending increased 1.0% in October—its first increase in five months—after a four-month slide of 4.8%. Within private construction, residential construction advanced for the fifth month, by a total of 18.1%—to a new cyclical high; nonresidential construction spending fell for the eighth time in nine months, by a total of 8.2%. The rebound in residential construction has been widespread: Single-family (21.6%), home-improvement (14.9%), and multi-family (14.1) construction all posted big upswings during the five months through October, with multi-family construction at a new record high and single-family construction surpassing its pre-pandemic level by 4.0% to a new cyclical high. Meanwhile, home-improvement spending has weakened a bit after reaching a new record high in August.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs ([link](#)): Global manufacturing activity in November expanded at its

fastest pace since January 2018—and one of the best rates in nearly a decade. According to the report, manufacturing output expanded for the fifth consecutive month in November, with growth registered across the three sub-industries covered by the survey. The strongest increase was posted by investment goods producers, where output rose to the greatest extent in almost a decade. Stronger growth was also recorded in the consumer goods category, while the rate of increase in the investment goods sector stayed close to October's 33-month record. The JP Morgan Global M-PMI advanced for the seventh month in November, jumping 14.1 points to 53.7 after hitting bottom in April at 39.6. Over the seven-month period, the M-PMI for the advanced economies climbed 17.0 points (to 53.8 from 36.8), while the M-PMI for the emerging economies advanced 11.2 points (53.9 from 42.7). Of the 30 countries for which data are available for November, 19 expanded while 11 contracted. Growth was led by strong and accelerated increases in output in the US and China, while the upturn in the Eurozone slowed; Japan's manufacturing sector contracted for the 23rd consecutive month. Here's a country ranking of November M-PMIs from highest to lowest: Brazil (64.0), Germany (57.8), Taiwan (56.9), US (56.7), India (56.3), Australia (55.8), Canada (55.8), UK (55.6), China (54.9), Netherlands (54.4), Czech Republic (53.9), EUROZONE (53.8), WORLD (53.7), South Korea (52.9), Ireland (52.2), Colombia (52.1), Austria (51.7), Italy (51.5), Turkey (51.4), Poland (50.8), Indonesia (50.6), Thailand (50.4), Philippines (49.9), Vietnam (49.9), Spain (49.8), France (49.6), Japan (49.0), Malaysia (48.4), Russia (46.3), Mexico (43.7), Myanmar (43.2), and Greece (42.3).

US Manufacturing PMIs ([link](#)): Manufacturing activity is still flying based on both the ISM and IHS Markit measures—more than recouping their Covid-19-related losses. ISM's M-PMI dipped slightly in November, to 57.5, not far from October's 59.3—which was 8.4 points above its pre-pandemic level, and the highest since September 2018; it was at an 11-year low of 41.5 in April. Both the new orders (to 65.1 from 67.9) and production (60.8 from 63.0) measures remained above 60.0; they were at 27.1 and 27.5, respectively, in April. The employment (to 48.4 from 53.2) gauge shows factories reduced payrolls again in November, though not by much, after boosting them for the first time in a year in October; the reading was at 27.5 in April. Meanwhile, the supplier deliveries component of the M-PMI moved up for the fourth month to 61.7, after falling from 76.0 in April to 55.8 in July. The inventory measure indicated inventories (to 51.2 from 51.9) expanded for the second month in November, after contracting the prior three months. In the meantime, IHS Markit's M-PMI advanced for the seventh month in November to 56.7 (the highest since September 2014), after tumbling to an all-time low of 36.1 in April. The rise in production was the steepest in over six years, amid stronger new

order inflows. While demand for consumer goods remained subdued, reflecting rising virus infection rates, demand for investment goods, rose sharply. According to the report, “The rise in investment spending sends a welcome signal that companies have become more optimistic about longer term prospects, something that was reinforced by a surge in firms’ expectations about production in the year ahead—even in consumer-facing sectors—to the highest since early-2015.” Encouraging vaccine news also helped lift expectations.

Eurozone CPI Flash Estimate ([link](#)): November’s CPI headline rate is expected to be negative for the fourth month, after moving into negative territory in August for the first time since May 2016. November’s rate is predicted to be unchanged at -0.3% for the second month, after rising from 0.1% in May (which at the time was the lowest rate since June 2016) to 0.4% in July; the rate was at 1.4% in January. The core rate is expected to remain at its record low of 0.2% y/y again in November; it had dropped from 1.2% in July to 0.2% y/y in September, where it since has levelled out. Looking at the main components, food, alcohol & tobacco once again is forecast to post the highest rate, at 1.9% y/y, after climbing from 1.7% in August to 2.0% by October; it was as at 3.6% in April—which was the highest since November 2008. Energy is expected to have the lowest rate once again, at -8.4% y/y (the 10th consecutive negative reading); the decline had narrowed from -11.9% in May—which was the steepest since July 2009—to -7.8% by August. The rate for non-energy industrial goods is predicted to be -0.3% y/y in November; the rate has bounced between -0.1% and -0.3% since August. Of the top four Eurozone economies, only France (0.2% y/y) is predicted to be above the Eurozone’s headline rate of -0.3%, while rates for Spain (-0.9) and Germany (-0.7) are expected to be below; Italy’s is forecast to match the headline rate.

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