



MORNING BRIEFING

January 5, 2021

The Punch Bowl

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

(1) New Year's resolution. (2) What's ahead: Sobering correction or intoxicated meltup? (3) Fed chairs no longer party poopers. Now they refill punch bowls at wild parties. (4) Powell, like Greenspan before him, doesn't see irrational exuberance. (5) Georgia's election will be either sobering or intoxicating for stock investors. (6) From dual to sole mandate. (7) The three central banks are the life of the party. (8) No shortage of liquidity at Club Fed. (9) Margin debt amplifies bull and bear markets. (10) Monetary aggregates are dancing up a storm.

Strategy I: Starting the New Year Sober? Monday was the first trading day of 2021.

Yesterday's selloff in the stock market suggests that many investors might have made a New Year's resolution to stay sober, at least for the first day or two of 2021 until we get the results of the elections in Georgia for the state's two Senate seats.

If the Blue Wave scenario prevails, then the Democrats are likely to raise individual income and capital gains taxes. If so, why didn't investors take their profits at the end of last year? They might have been too punch-drunk to do so or else maybe they figured that the tax increases won't be retroactive and will go into effect in 2022. Or else maybe there simply have been too many bulls lately, as we observed during December. So it's time for a sobering correction, which actually would be a healthy start to the new year. Nevertheless, we are more concerned about a liquidity-fueled meltup, as we explain below.

Strategy II: The Party Party. In my forthcoming book on the Federal Reserve's responses to the Great Virus Crisis during 2020, I observe that William McChesney Martin was Fed chair from April 2, 1951 until January 31, 1970, serving under five presidents. He famously said that the Fed's job is to be like a chaperone "who has ordered the punch bowl removed just when the party was really warming up." Joe and I have noted that the meltup in stock prices since their March 23 bottom last year suggests that the stock market may be partying like it's 1999. Back then, former Fed Chair Alan Greenspan kept the punch bowl full. This time, Fed Chair Jerome Powell is doing so.

Recall that in his December 5, 1996 [speech](#), Greenspan famously asked, “But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions ...?” Initially, at the time, the widespread interpretation was that the Fed chair thought that valuations were too high. But it soon became obvious that he was simply asking the question and that he wasn’t convinced that stocks were too expensive. Even in his speech, he supported the bullish case by observing, “Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earnings assets.”

Now Powell is saying that record-low interest rates imply lower risk premiums and higher prices of stocks and other earnings assets. He said so during his December 16, 2020 [press conference](#). When he was asked whether stock prices might be overvalued, he acknowledged that P/Es are “historically high.” But he added that may not be relevant “in a world where we think the 10-year Treasury [yield] is going to be lower than it has been historically...” So stocks are “not overpriced.” He didn’t say that the reason interest rates are low is that the Fed is keeping them that way.

Sooo, it’s party time! Time to cut loose and [boogie on down](#)!

We may get a sense of just how intoxicated the party revelers are Wednesday morning, after Tuesday’s two Georgia Senate elections. Will stock investors have a big hangover? If the Democrats win both seats, they will have unchecked power to enact a very left-leaning agenda, including higher taxes on individuals earning over \$400,000 a year, higher capital-gains taxes and new wealth taxes, increases in the statutory corporate tax rate from 21% to 28%, regulations that inflate the cost of doing business (including lots of pro-union measures), packing the Supreme Court, allowing Washington, DC and Puerto Rico to become states, and possibly enacting a universal basic income. If that doesn’t sober up the revelers, then the party is likely to go on and get even wilder.

The punch-drunk partiers are likely to declare that all these bearish developments for business conditions should be outweighed by lots of spending on infrastructure, including Green New Deal initiatives. Under Democrats unconstrained by checks and balances, government spending is bound to continue to increase faster than revenues (as it has when Republicans have ruled the White House). The partiers will contend that the Fed will fill the punch bowl often enough that there will be plenty of rum punch for everyone.

If the Democrats fail to win both Senate seats, then the Republicans will hold onto their slim majority in the Senate. That means that Mitch McConnell (R-KY) will remain the majority leader in charge of the body rather than Chuck Schumer (D-NY). Chairmanships of all committees will continue to be held by Republicans. That too might incite the stock market party goers to keep the party going.

Perhaps all that will matter on Wednesday morning is that Powell will remain the chaperone who has promised to keep filling up the punch bowl until the economy has achieved “maximum employment.”

Following the Great Depression and World War II, Congress passed the Employment Act of 1946, requiring the federal government “to promote maximum employment, production and purchasing power.” In response to the Great Inflation of the 1970s and ensuing recession, the Full Employment and Balanced Growth Act of 1978 (commonly referred to as the “Humphrey-Hawkins Act”) was introduced, making the federal government responsible for achieving full employment and price stability, among other goals. In 1977, Congress amended the Federal Reserve Act, directing the Fed to “increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates.” The first two—maximum sustainable employment and price stability—are commonly referred to as the Fed’s “dual mandate.”

If inflation remains low, then the dual mandate turns into the sole mandate of achieving maximum employment. Powell has committed to keeping the punch bowl full and spiked until the damage done by the pandemic to the labor market is completely repaired. Before that happens, stock investors could pass out from all the merrymaking.

Strategy III: Punch for All. Late last year, our contrarian instincts turned bearish because everyone seems to be so bullish. However, we are fighting our instincts because the mounting signs of irrational exuberance are irrationally ignoring the rational reason to be bullish, i.e., all the liquidity provided by the Fed’s punch bowl. In effect, that’s what Powell said on December 16 when he said that stocks aren’t overvalued since he is running an open bar. Along with the free drinks comes free money. Consider the following:

(1) *Lots of bartenders.* The Fed isn’t the only monetary chaperone offering all-the-punch-you-can-drink almost for free. So are the bartenders at the European Central Bank (ECB) and the Bank of Japan (BOJ). Since the week before the World Health Organization (WHO) declared

the pandemic on March 11 through the week of December 18, the three of them increased their balance sheets (in dollars) by \$7.8 trillion, or 52% ([Fig. 1](#)). Following the meltdown of Lehman Brothers on September 15, 2008 through the end of that year, their balance sheets increased \$2.5 trillion, or 63%.

The Fed led the way in filling up the punch bowl in 2008. This time, the three central banks collectively have been happy to quench our collective thirst for liquidity. Here are last year's increases in their balance sheets (in levels and percentages, both in dollars) from the week prior to the WHO declaration through the end of 2020 for the Fed (\$3.1 trillion, 74%) and ECB (\$3.3 trillion, 62%) and through the December 18 week for the BOJ (\$1.4 trillion, 25%) ([Fig. 2](#)).

As we noted yesterday, all three of the major central banks have committed to QE-for-longer until the pandemic is over and the economic damage resulting from it has been repaired.

(2) *Lots of liquid assets.* The pandemic of fear triggered by the viral pandemic caused a mad dash for cash by individual investors. They indiscriminately sold their bond mutual funds and exchange-traded funds (ETFs). That caused the freezing of the credit markets. This was all clearly visible in the huge outflows from bond funds during March and the widening of credit-quality yield spreads in the corporate bond market ([Fig. 3](#) and [Fig. 4](#)).

Liquid assets soared \$2.5 trillion to a record \$16.3 trillion from the week before the pandemic declaration through the week of July 6 last year ([Fig. 5](#)). It hovered around that record level through the week of November 16. During the five weeks through the week of December 21, liquid assets fell \$898 billion but remained \$1.5 trillion above the pre-pandemic level.

During the previous two cycles and the most recent one, liquid assets tended to grow fastest during the bear markets in stocks, reflecting the mad dash for cash that tends to occur when everyone wants to get out of stocks ([Fig. 6](#)). This time, investors seemed to be dashing out of bonds even faster than out of stocks.

(3) *Free bar beads at Club Fed.* After the Fed declared QE4ever on March 23, the mad-dash-for-cash trade reversed course and quickly morphed into the reach-for-yield trade once again. As we noted yesterday, investment-grade corporate bond yields dropped to record lows at the end of last year, and their credit-quality yield spreads narrowed to pre-pandemic reach-for-yield levels. The same can be said about yields and credit-quality yield spreads for corporate

junk bonds ([Fig. 7](#)). The 30-year mortgage rate was also down to a record low at the end of last year ([Fig. 8](#)).

With so much relatively free money so readily available, *gross* nonfinancial corporate bond issuance rose to a record high of \$1.4 trillion during the 12 months through November 2020 ([Fig. 9](#)). Based on the Fed's quarterly data on *net* issuance of nonfinancial corporate bonds, we reckon that roughly half of the gross issuance has been allocated to refinancing outstanding bonds at record-low interest rates ([Fig. 10](#)). The rest of the funds have been used to fund the remarkably strong rebound in capital spending, as we discussed yesterday, and to repay lines of credit at the banks that were taken down during the mad dash for cash ([Fig. 11](#)).

Would-be homebuyers have also been enjoying the liquidity provided by the Fed's punch bowl. The four-week moving average of mortgage applications to purchase new and existing homes rose during the December 18 week to the highest pace since October 2008 ([Fig. 12](#)).

As a result, residential construction soared 22.0% from May through November to the highest pace since March 2006 ([Fig. 13](#)). That more than offset the 3.7% drop in nonresidential construction over the same period. Total construction spending rose to a record high of \$1.5 trillion (saar) during November ([Fig. 14](#)).

(4) *Intoxicating margin debt*. Interestingly, stock market margin debt declined during most of 2019 as the S&P 1500 (including LargeCaps and SMidCaps) rose in record-high territory ([Fig. 15](#)). But last year, margin debt bottomed at \$479 billion during March and proceeded to soar along with the stock market, reaching a record \$722 billion during November.

Historically, margin debt has been a coincident indicator of the stock market. It tends to amplify bull markets as investors borrow more money to leverage up their bets. It tends to exacerbate bear markets when investors are piling out of stocks.

(5) *Valuation party*. In my forthcoming book, I characterize the Great Virus Crisis as similar to a world war against the virus. The Fed's allies in the war are the ECB and the BOJ. Their allied campaign to carpet-bomb the global economy and financial markets with cash has led to significant advances against the virus on the economic and financial fronts.

The All Country World MSCI stock price index closed at a record high at the end of 2020. That achievement was mostly attributable to the forward P/E of the index, which fell from 16.8

during the February 20 week to 12.5 during the March 19 week and rebounded to around 20.0 during the second half of 2020. Not surprisingly, there has been a close correlation between the forward P/E of the world stock price index and the collective balance sheets of the Fed, ECB, and BOJ ([Fig. 16](#)).

(6) *Drinking buddies*. Joining the liquidity party have been the US monetary aggregates. On a y/y basis, M2 rose 25.3% last year, while MZM jumped 27.7% ([Fig. 17](#)). Most astonishing has been the recent vertical 64% ascent of M1 from \$4.1 trillion just before the March 11 WHO declaration to \$6.7 trillion during the December 21 week ([Fig. 18](#)).

This is bound to test the monetarist theory that inflation is a monetary phenomenon. If consumer price inflation remains muted, as we expect, that will confirm our view that the four forces of deflation remain powerful. (See our “[Four Deflationary Forces Keeping a Lid on Inflation](#).”) If inflation makes a comeback, it is more likely to apply to asset prices than to consumer prices.

(7) *Corrected monthly bar tab*. Finally, yesterday we wrote: “The [FOMC statement](#) released at the end of the committee’s final meeting of 2020 on December 16 stated that the Fed would ‘continue to increase its holdings of Treasury securities by at least \$80 billion per month and of agency mortgage-backed securities (MBS) by at least \$40 billion per month until substantial further progress has been made toward the Committee’s maximum employment and price stability goals.’ That was the first time since the GVC started that the Fed had specified the likely monthly pace of security purchases. From March through December, the average monthly increases in the Fed’s holdings of Treasuries and MBS were \$221.5 billion and \$66.7 billion, respectively.” (Note that in the advance copy of yesterday’s *Morning Briefing* sent out Sunday afternoon, these last two numbers were misstated.) That’s a lot of punch.

CALENDARS

US: **Tues:** ISM M-PMI 56.5, API Crude Oil Inventories. **Wed:** ADP Employment Change 140k, C-PMI & NM-PMI 55.7/55.3, Factory Orders 0.7%, MBA Mortgage Applications, EIA Crude Oil Inventories, FOMC Minutes. (DailyFX estimates)

Global: **Tues:** Germany Retail Sales -2.0%/m/m/3.9%/y/y, Germany Unemployment Change & Unemployment Rate 10k/6.1%. **Wed:** Eurozone, Germany, and France C-PMIs 49.8/52.5/49.6, Eurozone, Germany, France, Italy, and Spain NM-PMIs 47.3/47.5/49.2/45.3/45.0, UK C-PMI &

NM-PMI 50/7/49.9, Germany CPI 0.6%/m/m/-0.3%/y/y, France CPI 0.5%/m/m/0.2%/y/y, France Consumer Confidence 91, Japan Consumer Confidence, Bailey. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for two of these three indexes last week. In a typically V-shaped recovery, LargeCap's forward earnings has risen during 32 of the past 33 weeks, with the one down week due to Tesla's addition to the index. MidCap's is up in 29 of the past 31 weeks, and SmallCap's posted its 30th gain of the past 32 weeks. LargeCap's forward earnings is now up 18.6% from its lowest level since August 2017; MidCap's has risen 41.2% from its lowest level since May 2015; and SmallCap's is up 72.3% 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 6.6% below its record high at the end of January. MidCap's and SmallCap's are 6.1% and 5.3% 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 edged down to -5.8% y/y from -5.7%. 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 fell w/w to -3.0% y/y from -2.7% 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 dropped to 1.2% y/y from 1.4% 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 still down substantially since early March but have been improving since July as companies easily beat low-balled consensus estimates for Q2 and Q3. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-16.8%, 23.3%), MidCap (-25.3, 44.7), and SmallCap (-37.3, 79.1).

S&P 500/400/600 Valuation ([link](#)): Two of these three indexes had their valuations edge down last week. LargeCap's forward P/E rose 0.3pts to an 18-week high of 22.5 from 22.2. 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 edged down to 19.7 from a 17-week high of 19.8 the week before; its current level is down 3.2pts from its record high of 22.9 in early June.

SmallCap's dropped to 19.2 from 19.3, which is down 7.5pts 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 20th week, the longest stretch since May and during 2002-2003. 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 at a discount to MidCap's for a tenth straight week and the most below that index since January 2006.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Since the Q2 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. In the latest week, the S&P 500's Q4 estimate remained steady at \$36.88. That \$36.88 estimate for Q4-2020 represents a decline of 12.2% y/y on a frozen actual basis and -10.3% y/y on a pro forma basis. That compares to a pro forma 6.5% decline in Q3-2020, a 30.6% decline in Q2-2020, a 12.8% decline in Q1-2020, a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). The last time earnings fell markedly y/y was during the four quarters through Q2-2016. All 11 sectors had been expected to record negative y/y earnings growth for Q2 and Q3 when their respective earnings seasons began. Three sectors recorded positive earnings growth in Q2, and six did so in Q3. That was a big improvement from Q1 when all 11 sectors posted a y/y decline in earnings. For Q4, three of the 11 sectors are expected to post positive y/y earnings growth, but seven of the 11 sectors are expected to post worse growth on a q/q basis. That shortfall likely reflects continued pessimism among the analysts despite the reopening of the US economy. Energy is expected to return to a profit in Q4 following two quarterly losses. Here are the S&P 500 sectors' latest Q4-2020 earnings growth rates versus their Q3-2020 growth rates: Materials (6.0% in Q4-2020 versus -1.5% in Q3-2020), Information Technology (3.7, 9.9), Health Care (3.4, 11.8), Consumer Staples (-0.5, 6.3), Utilities (-3.1, 0.9), Financials (-6.6, -2.8), Real Estate (-11.9, -12.8), Communication Services (-12.5, 3.7), Consumer Discretionary (-22.5, -2.3), Industrials (-41.7, -54.7), and Energy (-98.0, -108.2).

US ECONOMIC INDICATORS

Construction Spending ([link](#)): Construction expenditures in November climbed for the fifth time in six months to a new record high—surpassing February’s pre-Covid record high by 1.3%—driven by private residential building. Total construction spending rose 0.9% in November and 6.6% the past six months, with private construction expenditures climbing 1.2% and 10.0% over the comparable periods; public construction spending fell for the fifth time in six months, sinking 0.2% m/m and 3.1% over the six months through November. Within private construction, residential construction advanced for the sixth successive month, by a total of 22.0%—to a new cyclical high; nonresidential construction spending fell for the ninth time in 10 months, by a total of 8.8%. The rebound in residential construction has been widespread: Single-family (28.2%), home-improvement (16.7%), and multi-family (13.9) construction all posted big upswings during the six months through November—with multi-family construction at a new record high and home-improvement spending just shy of a new record high. Meanwhile, single-family building is at a new cyclical high, surpassing February’s pre-Covid cyclical high by 9.6%.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs ([link](#)): “Global manufacturing growth stays close to decade highs in December, but supply-chain pressures grow,” according to Markit’s December report. The JP Morgan M-PMI in December was unchanged at November’s 33-month high of 53.8 after climbing steadily from April’s 39.6. Since bottoming in April, the M-PMI for the advanced economies rose the final eight months of 2020, climbing 18.1 points (to 54.8 from 36.8) over the period, while the M-PMI for the emerging economies fell for the first time in eight months in December, to 52.8, after advancing 11.2 points (53.9 from 42.7) from April through November. According to the report, both global production and new orders remained among the strongest over the past decade, though world supply chains remained severely stretched, “leading to marked delays and disruption to raw material deliveries, production schedules and distribution timetables.” The global industrial sector finished 2020 strong, as 23 of the 29 countries for which data are available expanded and only five contracted—with Japan breaking even after 23 months of decline. Here’s a country ranking of December M-PMIs from highest to lowest: Brazil (61.5), Taiwan (59.4), Germany (58.3), Netherlands (58.2), Canada (57.9), UK (57.5), Ireland (57.2), US (57.1), Czech Republic (57.0), India (56.4), Australia (55.7), EUROZONE (55.2), WORLD (53.8), Austria (53.5), China (53.0), South Korea (52.9), Italy (52.8), Colombia

(51.8), Poland (51.7), Vietnam (51.7), Indonesia (51.3), France (51.1), Spain (51.0), Thailand (50.8), Turkey (50.8), Japan (50.0), Russia (49.7), Philippines (49.2), Malaysia (49.1), Greece (46.9), and Mexico (42.4).

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