MORNING BRIEFING
January 20, 2021

Substantial Further Progress Ahead?

Check out the accompanying chart collection.

(1) Yellen wants US government to "act big." Seriously. (2) Act II of CARES Act could be as stimulative as Act I. (3) Full economic recovery from pandemic recession one year later. (4) Another (bigger) round of government checks with fewer social-distancing restrictions. (5) No double dip so far in credit and debit card shopping or in gasoline usage. (6) Higher inflation and bond yields as the year progresses. (7) Five new voters on FOMC with consensus views. (8) The Fed's new mantra: "substantial further progress." (9) The Fed's new FAITH. (10) Free advice to Powell & Co.: Beware of what you wish for.

T-Fed I: Yellen Thinks Big. Yesterday, Janet Yellen spoke before the Senate Finance Committee at her confirmation to the post of Treasury secretary. President-elect Joe Biden announced her nomination at the beginning of this month. In her prepared remarks, she said, "Neither the President-elect, nor I, propose this relief package without an appreciation for the country's debt burden. But right now, with interest rates at historic lows, the smartest thing we can do is act big."

Everything is coming together for yet another round of fiscal and monetary stimulus that should stimulate more economic growth. As a result, Debbie and I are raising our real GDP outlook for this year. Here are our latest projections for Q4-2020 (7.0%, down from 10.0%), Q1-2021 (7.0%, up from 2.0%), Q2 (4.5%, up from 2.0%), Q3 (4.0%, same), and Q4 (3.0%, same). In this scenario, real GDP would be up 5.8% this year following last year's decline of 3.4%. It would be up 4.6% Q4/Q4 versus -1.8% over the same period last year. (See *YRI Economic Forecasts*.)

In this scenario, real GDP would fully recover from the recession that occurred during the first half of last year by the current quarter (*Fig. 1*). How can this be?

There has been no precedent for the two-month lockdown recession that occurred during March and April of last year. It was followed by an unprecedented V-shaped recovery when lockdown restrictions were lifted in May.

Americans suffered from cabin fever during the recession. They couldn't go shopping at the malls. They couldn't eat out at restaurants. They couldn't travel, go to movies, or attend shows and sporting events. As a result, the personal saving soared of those consumers who remained employed because they could work from home (*Fig. 2*). The government sent support payments of $1,200 per person to lots of Americans, further boosting saving. When the lockdown restrictions were eased, Americans recovered from their cabin fever by going shopping.

Now the Biden administration's plan would send checks of $1,400 per person to many Americans in addition to the $600 coming to them this month. While the pandemic is worse than ever, social-distancing restrictions aren't as stringent as they were during March and April of last year. This is confirmed by weekly series on credit and debit card spending and gasoline usage (*Fig. 3* and *Fig. 4*). Consumers can go shopping and undoubtedly will spend their latest checks from the government.

The economy did start showing signs of slowing late last year as the third wave of the pandemic weighed on the economy (*Fig. 5* and *Fig. 6*). But the latest round of fiscal and monetary stimulus will be like a booster shot after the shot in the arm from the Coronavirus Aid, Relief, and Economic Security (a.k.a. CARES) Act last year. If we can all get access to the vaccine shot during the first half of this year, then the economy should continue to grow at a solid pace during the second half of this year.

All the policy stimulus and the resulting better-than-expected recovery is likely to put some upward pressure on both inflation and bond yields. Here is our current outlook for the core PCED (personal consumption expenditures deflator) inflation rate at a seasonally adjusted annual rate for the four quarters of this year: Q1 (1.8%), Q2 (2.2), Q3 (2.8), and Q4 (2.5). We expect that the Fed will welcome that pickup in inflation and will keep the federal funds rate near zero.

We suspect that the bond market won't welcome it, with our outlook for the 10-year US Treasury bond yield as follows: Q1 (1.10%), Q2 (1.25), Q3 (1.50), and Q4 (2.00). As we've discussed in recent months, the yield would be at 2.00% now but for the intervention of the Fed.

T-Fed II: FOMC Rotates & Keeps the FAITH. It's time for the annual rotation of the members of the Federal Open Market Committee (FOMC). On January 26 and 27, the FOMC will gather for its first monetary policy meeting of the year. Four voting presidents of the 12 regional Fed district banks will be replaced with new ones. New to the voting block for 2021—but not new to their roles as Fed presidents—are Thomas Barkin (Richmond, January 2018), Raphel Bostic (Atlanta, June 2017), Mary Daly (San Francisco, October 2018), and Charles Evans (Chicago, September 2007). Newly appointed Fed Governor Christopher Waller will also be a new voice on the FOMC, as discussed below.

All of them, including Waller, have previously participated in FOMC meetings. But their voices will matter more in 2021 as voters on the committee. For now, they seem to believe that there is no rush to remove monetary accommodation. That strategy is in line with the phrase "substantial further progress" that the FOMC introduced into its statement on December 16 in reference to the improvement it would like to see in its employment and inflation goals before altering its commitment to $120 billion per month in bond purchases.

Even if widespread vaccine distribution ends the Covid-19 health crisis in the second half of 2021, the Fed's voting members will likely hold off on tapering their accommodative stance. Most of the emergency liquidity and lending facilities are being wound down as the need for them abates. But the consensus among all but one FOMC participant during the last meeting in December was that the federal funds rate is likely to remain near zero until at least 2023 and that bond purchases will continue at the current pace, for now. The Fed's commitment to holding interest rates so low for so long was signaled in the December 16 Summary of Economic Projections (SEP), which will next be updated in conjunction with 2021's second FOMC meeting on March 16 and 17.

In the past, the FOMC started to tighten monetary policy when the committee judged that inflationary pressures were starting to heat up. That's unlikely to happen this time around for a couple of reasons: As we discussed in our September 2 *Morning Briefing*, the FOMC updated its overriding "Statement on Longer-Run Goals and Monetary Policy Strategy" to put the employment goal ahead of inflation. Additionally, the Fed has adopted a new approach to targeting inflation, which favors overshooting its long-standing goal of 2.0% annually to make up for previous inflation misses, a strategy dubbed "Flexible Average Inflation Targeting" (FAIT).

Here are some of the latest comments signaling the policy leanings of the newly enfranchised Fed members for 2021:

(1) *Bullard's guy*. The inside circle of permanent voters on the FOMC include Board of Governors Michelle Bowman, Lael Brainard, Richard Clarida, Randal Quarles, Christopher Waller, and John Williams along with Powell. Waller is the newest member of this group, having been confirmed to his seat during December for a term that ends at the end of January 2030. Waller's short bio on the Fed's website reveals that he is an academic. Before heading the research division of the FRB- St. Louis, he headed the University of Notre Dame's economics department.

Appointed by President Donald Trump, Waller received fewer Senate confirmation votes than any Fed governor since at least 1980. This was for reasons related not to his views but to the politics around his appointment, as a December 3 *Wall Street Journal* article discussed. In any event, we have no reason to believe that Waller will do other than stick close to the consensus "substantial further progress" approach. Waller was recommended for his position by his previous boss, FRB-President St. Louis Bullard, who is not a voter this year.

Last Wednesday, Bullard said in a Reuters interview: "Labor markets have improved dramatically but still have a long way to go … you still need unemployment to drop, jobs to come back… certain sectors have really been hard hit and for them to come back we are going to have to get this vaccine rolled out." For the economy as a whole, "it's possible you get a boom ... but let's wait and see if that actually happens." Bullard has also said that the Fed is "not close" to tapering bond purchases.

(2) *Barkin' the mantra*. In a Bloomberg interview last Monday, Barkin said that he thinks that the second half of 2021 will be strong but that the road to recovery will be "bumpy." But he said that fiscal backstops and elevated personal savings should smooth the ride. Nevertheless, Barkin held fast to the Fed's latest mantra, saying: "I do think this notion of 'substantial further progress' is the right way to think about it." He added: "So there are scenarios certainly where we see strong recovery in unemployment and inflation but there are lots of scenarios where we don't."

(3) *Daly laborer*. Mary Daly is a labor economist through and through. So we expect her to vote in favor of staying the course until the unemployment picture improves substantially. At a virtual event on January 7, she said that it would be dangerous to pick one metric for full employment, reported Reuters.

Specifically, she stated: "There's a danger in computing a number and saying, that means we are there." She added that the Fed needs to look at a range of indicators, a "dashboard" of metrics. Last year, the Fed added the word "inclusive" to its maximum employment goal, suggesting that the Fed will give inflation a lot of room to run until employment improves for all.

(4) *Bostic's slow play*. Some took Bostic's comments at a virtual Q&A session last week on Monday as more hawkish than other Fed officials. But we do not see it that way. CNBC quoted Bostic saying that he thinks there's a "possibility that the economy could come back a bit stronger than some are expecting," He added: "If that happens, I'm prepared to support pulling back and recalibrating a bit of our accommodation and then considering moving the policy rate."

But he also said: "I don't see that happening in 2021. A whole lot would have to happen to get us there," he added. "Then we'll see into 2022. Maybe the second half of 2022 or even 2023 where that might be more in play." We will be interested to see how many of the Fed's interest-rate projection "dots" on the March SEP show an increase ahead of 2023; but as of now, Bostic may or may not represent one of those dots.

CNBC observed that in the December 16 SEP, of the "17 FOMC members who submitted policy 'dots' that represent their forecast, none saw a rate hike likely in 2021 and only one indicated an increase in 2022. For the following year, three saw a single 25 basis point increase while one indicated 50 basis points higher and still one more saw a 100 basis point move, translating to a full percentage point or the equivalent of four increases."

(5) *Evans' FAITH*. In our September 22 *Morning Briefing*, we added the letter "H" to the end of the "FAIT" acronym, suggesting that "hope" has become a big part of the Fed's latest strategy. Evans, one of the most dovish Fed members of them all, is hoping that the Fed will eventually reach an inflation target of 2.5%, a full half of a percentage point above the Fed's goal, before it alters the policy path. In a January 4 speech, he said: "It likely will take years to get average inflation up to 2 percent, which means monetary policy will be accommodative for a long time," reported Reuters. "This translates into low-for-long policy rates, and indicates that the Fed likely will be continuing our current asset purchase program for a while as well."

On the monetary front, this means that not much will change until there is "substantial further progress." For dramatic changes, fiscal policy is likely to be where the action will be in 2021.

T-Fed III: Beware of What You Wish For. Ever since the CARES Act was passed last March, Fed officials have been pushing for another round of fiscal stimulus. Their wish has come true, as Biden and Yellen announced in recent days that they are ready to do just that.

In my book *Fed Watching*, I observed that the Fed chairs and their colleagues have tended to communicate their policy intentions by repeating certain keywords, like "gradual," "patient," and "appropriate." We expect to hear the phrase "substantial further progress" more often this year to explain what the Fed is waiting for before starting to tighten monetary policy. The rub is that the latest round of stimulus increases the odds that substantial further progress on the economic and inflation fronts could be made sooner in 2021 rather than later. If so, then Powell and his colleagues may have to start thinking about thinking about raising interest rates.

CALENDARS

US: Wed: Inauguration Day, NAHB Housing Market Index 86, MBA Mortgage Applications, API Crude Oil Inventories. **Thurs:** Housing Starts & Building Permits 1.56mu/1.60mu, Jobless & Continuous Claims 900k/5.5m, Philadelphia Fed Manufacturing Index 12. (DailyFX estimates)

Global: Wed: Eurozone Headline & Core CPI Finals -0.3%/0.2% y/y, UK Headline & Core CPI 0.5%/1.3% y/y, Canada CPI 1.0% y/y, Australia Employment Change & Unemployment Rate 50k/6.7%, BOC Interest Rate Decision, BOJ Interest Rate Decision -0.1%, Bailey. **Thurs:** Eurozone Consumer Confidence Flash Estimate -15, UK Gfk Consumer Confidence -29, France Business Confidence 94, ECB Interest Rate Decision & Deposit Facility Rate 0.0%/-0.5%, European Council Meeting, UK BOE Credit Conditions Survey. (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 during 34 of the past 35 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 31 of the past 33 weeks, and SmallCap's posted its 32nd gain of the past 34 weeks. LargeCap's forward earnings is now up 20.3% from its lowest level since August 2017; MidCap's has risen 45.2% from its lowest level since May 2015; and SmallCap's is up 74.7% 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 5.3% below its record high at the end of January 2000. MidCap's and SmallCap's are 3.5% and 4.3% 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 improved to -4.8% y/y from -5.4%. 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 -0.4% y/y from -2.2% 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 turned positive again, rising to 0.2% y/y from -0.1% 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, 2021, and 2022: LargeCap (-16.6%, 24.0%, 16.5%), MidCap (-24.3, 45.8, 16.4), and SmallCap (-36.2, 76.8, 20.5).

S&P 500/400/600 Valuation (*link*): Two of these three indexes had their valuations fall last week. LargeCap's forward P/E fell 0.5pts to 22.2. That's down from a 19-year high of 22.7 a week earlier, and up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's dropped to 20.2 from a 21-week high of 20.5; its current level is 2.7pts below its record high of 22.9 in early June. SmallCap's rose 0.2pts w/w to a 19-week high of 20.6, which is down 6.1pts 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 22nd week, the longest stretch since May and during 2002-03. 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 premium to MidCap's for the first time in 12 weeks. At the beginning of the year, it had been at the steepest discount to 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 rose 30 cents to $37.22, instead of posting its typical decline during the first week of the earnings season. That $37.22 estimate for Q4-2020 represents a decline of 11.4% y/y on a frozen actual basis and -7.8% 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, five of the 11 sectors are expected to post positive y/y earnings growth. That's up from four a week earlier and three the week before that, but six of the 11 sectors are still 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. A week earlier, Energy had been expected to return to a profit in Q4, but analysts now think the sector will record a third straight quarterly loss. Here are the S&P 500 sectors' latest Q4-2020 earnings growth rates versus their Q3-2020 growth rates: Materials (8.9% in Q4-2020 versus -1.5% in Q3-2020), Financials (6.9, -2.8), Health Care (4.2, 11.8), Information Technology (4.1, 9.9), Consumer Staples (1.0, 6.3), Utilities (-3.8, 0.9), Real Estate (-12.1, -12.8), Communication Services (-12.3, 3.7), Consumer Discretionary (-21.9, -2.3), Industrials (-42.3, -54.7), and Energy (-101.8, -108.2).

GLOBAL ECONOMIC INDICATORS

European Car Sales (*link*): Full-scale lockdowns and other Covid-19-related restrictions caused the biggest yearly drop in car demand on record during 2020. Full-year 2020 EU passenger car registrations (a proxy for sales) fell by 3.0mu (or -23.7%), compared to the comparable 2019 period, to 9.9mu. Double-digit declines were recorded in all 27 EU markets—with Spain (-32.3%) posting the biggest decline, followed closely by Italy (-27.9) and France (-25.5); Germany's (-19.1) contraction was significant, though less pronounced. In December, sales fell 3.3% y/y—with Italy (-14.9% y/y) and France (-11.8) both recording double-digit losses, while Germany (+9.9) recorded a solid gain; Spain's December sales were flat with a year ago.

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