



## MORNING BRIEFING

January 26, 2021

### Act Big

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

(1) Yellen talks softly and carries a big act. (2) Government continues to spew out checks. (3) American Rescue Plan is fourth congressional pandemic response. (4) Bernie Sanders is all for reconciliation if Republicans won't reconcile. (5) Rahm's Rule again. (6) The Mag-5 underperforming despite their new record-high market cap. (7) Market breadth has improved thanks to vaccines. (8) V-shaped recovery in forward revenues, earnings, and margins. (9) In January, US PMIs remained remarkably robust. (10) Pandemic is mutating. (11) Stock market valuation multiples in outer space.

**Fiscal Policy: Big Act.** A week ago, on Tuesday, January 19, Janet Yellen, President Joe Biden's nominee for Treasury secretary, urged congressional lawmakers to "act big" on coronavirus relief spending, arguing that the economic benefits far outweigh the risks of a higher debt burden. She said so in her prepared statement during her nomination hearing. In yesterday's *Morning Briefing*, I observed that the federal government has already been acting very big during the pandemic.

Three congressional acts passed last year aimed at dealing with the adverse consequences of the pandemic totaled \$3.6 trillion: Enacted on March 27, the Coronavirus Aid, Relief, and Economic Security (CARES) Act had a price tag of \$2.2 trillion, including \$1,200 checks for eligible persons. The Paycheck Protection Program and Health Care Enhancement Act on April 24 cost \$483 billion. On December 27, the Coronavirus Response and Relief Supplemental Appropriations Act totaled \$900 billion in relief payments, including \$600 checks. Biden's proposed [American Rescue Plan](#) (ARP) amounts to \$1.9 trillion of support. There are lots of "act big" provisions in the plan. For example:

(1) *\$1 trillion for struggling families.* ARP would supplement the \$600-per-person checks sent in January with another round of \$1,400 checks. It expands eligibility to adult dependents who have been left out of previous rounds of relief. The plan includes a \$400-per-week unemployment insurance supplement through September. It would "automatically adjust the length and amount of relief depending on health and economic conditions so future legislative delay doesn't undermine the recovery and families' access to benefits they need." It would cover self-employed workers "like ride-share drivers and many grocery delivery workers."

(2) *\$440 billion for struggling communities plus \$170 billion for schools.* ARP calls on “Congress to send a lifeline to small businesses; protect educators, public transit workers, and first responders from lay-offs; and keep critical services running at full strength. Altogether, his plan would provide approximately \$440 billion in critical support to struggling communities. This is in addition to funds that President-elect Biden is requesting for safely reopening schools throughout the country.” ARP allocates \$170 billion for K-12 schools and institutions of higher education.

(3) *\$350 billion for essential workers.* ARP calls on Congress to provide \$350 billion “in emergency funding for state, local, and territorial governments to ensure that they are in a position to keep front line public workers on the job and paid, while also effectively distributing the vaccine, scaling testing, reopening schools, and maintaining other vital services.”

(4) *\$160 billion for healthcare response to the pandemic.* ARP “calls on Congress to provide the \$160 billion in funding necessary to save American lives and execute on his plan to mount a national vaccination program, expand testing, mobilize a public health jobs program, and take other necessary steps to build capacity to fight the virus.”

(5) *Supporting workers.* Biden’s ARP calls on Congress to raise the minimum wage to \$15 per hour. The plan proposes to “provide emergency paid leave to 106 million Americans to reduce the spread of the virus.” (Keep in mind that payroll employment totaled 143 million during December!) It would “provide a maximum paid leave benefit of \$1,400 per-week for eligible workers. This will provide full wage replacement to workers earning up to \$73,000 annually, more than three-quarters of all workers.”

(6) *A serious crisis.* These ARP proposals are certainly all consistent with Yellen’s “act big” approach to the pandemic. The odds of this plan passing the Senate with bipartisan support are slim to none, since all 50 Democratic senators plus 10 Republican ones would have to sign on.

Bernie Sanders is ready to act big. On Sunday, the Vermont senator—who is the incoming chairman of the Senate Budget Committee—said that Democrats would use a rare procedural tactic to pass major parts of a Covid-19 relief package if Republicans refuse to move on the measure. Sanders, an Independent who caucuses with the Democrats, told CNN’s Dana Bash on “State of the Union” that Democrats will use the move—known as “reconciliation”—“as soon

as we possibly can” to pass the package by 51 votes in the Senate, rather than 60, if Republicans don’t move the legislation. “What we cannot do is wait weeks and weeks and months and months to go forward. We have got to act now,” he said.

As Rahm Emanuel, chief of staff in the Obama administration, famously said, “You never want a serious crisis to go to waste. And what I mean by that is an opportunity to do things that you think you could not do before.” The Democrats can be expected to follow Rahm’s Rule to the letter during this serious pandemic crisis. Yellen’s advice to act big is advice that won’t be wasted by them under the circumstances.

**Strategy I: Big Act for Small Stocks.** Washington’s willingness to act big this year after acting big last year, combined with the availability of vaccines since late last year, has led to a broadening of the bull market in stocks. Consider the following:

(1) *The Mag-5.* Since 2017 until late last year, the Magnificent Five stocks have dominated the three major investment styles, causing LargeCaps to outperform SMidCaps, Growth to beat Value, and Stay Home to lead Go Global The Mag-5 are the S&P 500 component stocks with the five largest market capitalizations in the index.

They have been truly magnificent relative to the S&P 495 since the start of 2017 through August 28, 2020 ([Fig. 1](#)). They’ve underperformed since then, even though their combined market cap rose to a record high of \$7.8 trillion on Friday ([Fig. 2](#)). Their market cap is up 3.5% since then through Friday, while the S&P 495’s market cap is up 11.8% over the same period. (Tesla replaced Facebook in this group on January 7.)

(2) *Market-cap vs equal-weighted S&P 500.* The Mag-5’s reversal of fortune is also visible in the ratio of the S&P 500 equal-weighted to market-cap-weighted indexes ([Fig. 3](#)). It fell from 2017’s high of 1.57 on January 4 to last year’s low of 1.29 on September 1. It was back up to 1.39 on Friday. A similar story is told by the ratio of the S&P 500 to the S&P 100 ([Fig. 4](#)).

(3) *LargeCaps vs SMidCaps.* The meltup in stock prices since the March 23 bottom was led by the S&P 500, which rose 51.5% to a new high on August 18, exceeding the previous February 19 record high. Over that same period, the S&P 400 MidCaps and S&P 600 SmallCaps rose 58.9% and 52.3% ([Fig. 5](#)). Both remained below their record highs. They went on to surpass their previous record highs during November and December, respectively. Now, since March 23 through Friday’s close, here’s their performance derby: S&P 500 (71.7%), S&P 400

(102.1%), and S&P 600 (106.8%). The latter two indexes have significantly outperformed the former since September 2020 ([Fig. 6](#)).

(4) *Fundamentals*. The forward revenues of the S&P 500/400/600 have had shorter and shallower recessions during the Great Virus Crisis (GVC) than during the Great Financial Crisis (GFC) ([Fig. 7](#)). They haven't fully recovered yet. As of the January 14 week, the forward revenues of the S&P 500/400/600 were below their record highs before the start of the GVC-by 1.9%, 5.1%, and 3.2%.

The recession/recovery cycles of the S&P 500/400/600 forward earnings have been more V-shaped this time compared the U-shaped patterns during the GFC ([Fig. 8](#)). Here are their peak-to-trough and trough-to-peak performances this time around and their current percentages below their record highs: S&P 500 (-21.2%, 21.5%, and -4.3%), S&P 400 (-33.6%, 46.0%, and -3.0%), and S&P 600 (-45.2%, 75.8%, and -3.7%).

It's all very impressive and consistent with the unprecedented nature of recent events. We had an unprecedented two-month lockdown recession. The resulting credit crunch was cut short by unprecedented massively stimulative monetary and fiscal policy. The initial mad dash for cash during February and early March turned into an unprecedented flood of liquidity.

(5) *Profit margins*. The rebound in forward earnings has been led by the remarkable V-shaped recoveries in forward profit margins ([Fig. 9](#)). Here is where they were at the start of 2020, at their troughs of last year, and during the week of January 14 for the S&P 500 (12.0%, 10.3%, 11.6%), S&P 400 (7.2%, 5.2%, 7.5%), and S&P 600 (5.1%, 2.9%, 5.2%). They all augur well for the recovery in the actual profit margins of these three indexes.

(6) *Purchasing managers*. The underlying fundamentals for US stocks remain strong, as evidenced by January's flash M-PMI (59.1) and NM-PMI (57.5) ([Fig. 10](#)). The resilience of the NM-PMI may seem surprising, but keep in mind that it isn't limited to services industries. It includes construction-related businesses, which are booming.

(7) *The pandemic*. The broadening of the stock market started last September on expectations that vaccines would soon be available. Measures of market breadth exploded to the upside last November on news that Pfizer and Moderna would soon receive emergency-use authorization from the Food & Drug Administration for their vaccines.

There certainly remain plenty of challenges on the health front in the world war against the virus. In the US, the third wave of the pandemic has been the worst ([Fig. 11](#)). However, it has been showing signs of cresting in recent days. The process of distributing the vaccines has been poorly executed so far. Mutant strains of Covid-19 are spreading more rapidly than the original version and may be more deadly. However, the current versions of the vaccines are expected to work against them.

One concern is that if the virus remains active in other parts of the world where vaccines may not be readily available, there could be more mutations of the virus that come back to infect those of us who have been inoculated but remain vulnerable to the mutants. It ain't over until it's over, notwithstanding the stock market's euphoria about better times ahead.

**Strategy II: Big Valuation Multiples.** The stock market is certainly expecting a happy outcome on the health front without any major setbacks. Joe and I calculate a daily proxy for the quarterly Buffett Ratio, which is equal to the total market cap of the US stock market divided by nominal GDP. Our proxy is the ratio of the S&P 500 stock price index divided by S&P 500 forward revenues (P/S).

Our ratio is highly correlated with the daily forward P/E of the S&P 500. Our ratio continues to soar into record-high territory, while the forward P/E is getting closer to its record high ([Fig. 12](#)).

Asset prices are getting increasingly frothy and may be experiencing “MAMU,” i.e., the Mother of All Meltups. If that continues during the first half of this year, we will be on the lookout for a second-half “MAMD” (Mother of All Meltdowns) or at least a severe correction.

## CALENDARS

**US: Tues:** Consumer Confidence 89, Richmond Fed Manufacturing Index, S&P Case-Shiller Home Price Index 8.6% y/y, API Crude Oil Inventories, IMF World Economic Outlook.

**Wed:** Durable Goods Orders Total & Ex Transportation 0.9%/0.5%, MBA Mortgage Applications, EIA Crude Oil Inventories, Fed Interest Rate Decision 0.25%. (DailyFX estimates)

**Global: Tues:** UK Employment Change & Unemployment Rate -100k/5.1%, UK Average Earning Including & Excluding Bonus 2.9%/3.1% y/y, Australia CPI 0.7% y/y, World Economic

Forum Annual Meeting. **Wed:** Germany Gfk Consumer Confidence -7.9, France Consumer Confidence 94, Japan Retail Sales -0.4%, Japan Leading & Coincident Indicators 96.6/89.1, World Economic Forum Annual Meeting, Lane. (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 35 of the past 36 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 32 of the past 34 weeks, and SmallCap's posted its 33rd gain of the past 35 weeks. LargeCap's forward earnings is now up 21.5% from its lowest level since August 2017; MidCap's has risen 46.0% from its lowest level since May 2015; and SmallCap's is up 75.8% 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 4.3% below its record high at the end of January 2000. MidCap's and SmallCap's are 3.0% and 3.7% 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 -4.0% y/y from -4.8%. 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 0.0% y/y from -0.4% 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 higher too, rising to 0.7% y/y from 0.2% 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 (-15.9%, 23.8%, 16.1%), MidCap (-24.5, 46.4, 16.5), and SmallCap (-35.9, 76.2, 20.3).

**S&P 500/400/600 Valuation** ([link](#)): All three of these indexes had their valuations rise last week. LargeCap's forward P/E rose 0.2pts to 22.4. That's down from a 19-year high of 22.7 the week before that, and up from 13.3 in mid-March, which was the lowest since March 2013.

MidCap's rose to 20.4 from 20.2, which compares to 21-week high of 20.5 several weeks earlier. Its current level is 2.5pts below its record high of 22.9 in early June. SmallCap's rose 0.2pts w/w to a 20-week high of 20.8, which is down 5.9pts from its record high of 26.7 in early June. That compares to MidCap's 10.7 and SmallCap's 11.1 in mid-March, which were their lowest readings since March 2009. LargeCap's forward P/E in mid-February—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 23rd 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 a second week after 11 weeks at a discount. 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 soared 123 cents to \$38.45, better than the typical positive surprise boost usually seen during the second week of the earnings season. That \$38.45 estimate for Q4-2020 represents a decline of 8.4% y/y on a frozen actual basis and -5.7% 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 three just before the end of Q4, 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. 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: Financials (15.1 in Q4-2020 versus -2.8% in Q3-2020), Materials (8.9, -1.5), Information Technology (6.8, 9.9), Health Care (4.8, 11.8), Consumer Staples (2.8, 6.3), Utilities (-3.4, 0.9), Real Estate (-12.0, -12.8), Communication Services (-12.3, 3.7), Consumer Discretionary (-22.2, -2.3), Industrials (-42.7, -54.7), and Energy (-105.7, -108.2).

## US ECONOMIC INDICATORS

**Regional M-PMIs**([link](#)): Three Fed districts have now reported on manufacturing activity for January (Philadelphia, New York, and Dallas) and show the manufacturing sector expanded at a faster pace, thanks to a sharp acceleration in the Philadelphia region. The composite index climbed to 12.3 this month, after slipping from 18.8 in October to 8.2 by year-end, as the Philadelphia (to 26.5 from 9.1) region posted its best performance in a year; Dallas' (to 7.0 to 10.5) measure eased for the third month since reaching 21.2 in October, while New York's (3.5 from 4.9) continued to show limited growth. The new orders gauge improved from 8.3 to 14.3—as billings in the Philly (to 30.0 from 1.9) region expanded at the fastest pace since October, while orders in the New York (6.6 from 3.4) and Dallas (6.3 from 19.6) regions grew at roughly the same pace, though the former showed an acceleration in growth while the latter showed a deceleration. In the meantime, factories added to payrolls at the best pace since August 2018, with the employment measure climbing from 13.6 to 16.8 this month and with the Philadelphia (to 22.5 from 5.6) region once again driving growth; hirings in both the Dallas (16.6 from 20.9) and New York (11.2 from 14.2) regions slowed from December's pace, though remained solid.

## GLOBAL ECONOMIC INDICATORS

**Germany Ifo Business Climate Index**([link](#)): German business confidence dropped more than expected this month, as “the second wave of coronavirus has brought the recovery of the German economy to a halt for now,” according to Ifo. Its Business Climate Index fell for the third time in four months from a seven-month high of 93.3 in September to 90.1 by January. The expectations (to 91.1 from 97.5 in September) component took the biggest hit, dropping 6.4 points over the four-month period, while the present situation was unchanged at 89.2—though it did dip 2.1 points this month, erasing the 2.1-point rise during the three months through December. (The total, expectations, and present situation components were at 95.8, 92.9, and 98.8 before the pandemic hit.) In early November, Germany had shut down restaurants, bars, and sports & leisure facilities to halt a rise in Covid-19 infections. It

succeeded for a while, but the case numbers didn't fall. On December 16, schools and nonessential shops were added to the list—with all restrictions extended through February 14 last week. By sector, sentiment among manufacturing companies was little changed this month at +8.8, after rising steadily from -44.8 in April to +9.1 in December—its fourth positive reading since June 2019—October's (+1.3) being the first. Flash estimates for January's M-PMI (to 57.0 from 58.3) showed growth in Germany's manufacturing sector was close to December's pace—which was the strongest since February 2018. However, there were delays on deliveries to manufacturers stemming from growing pressure on supply chains and widespread freight disruptions. In the meantime, sentiment in the service sector deteriorated to a seven-month low of -4.4—its third negative reading since July. The flash estimate for the NM-PMI (to 46.8 from 47.0) revealed Germany's service sector was in contractionary territory for the fourth successive month in January; the reading is considerably below July's 13-month high of 55.6. Sentiment among construction companies (to -5.10) deteriorated for the fourth month, posing its third negative reading this month; it had climbed steadily from -17.0 in April to +3.1 by September.

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