



MORNING BRIEFING

March 30, 2021

Alfred Hitchcock & the Dot Plot

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

(1) The dot plot could be the next horror show for the financial markets. (2) Powell says to pay no attention to the forecasts of his colleagues. (3) Monetary policy is backwards looking on purpose. (4) Falling behind the yield curve. (5) Fed's forward guidance pushes tightening into 2023 or later. So it is likely to come much sooner. (6) The regional surveys of business activity and pricing are hot. (7) Delivery times getting longer as unfilled orders pile up. (8) The government is on a spending spree. (9) Taxes are coming.

US Economy I: Killer Birds. In the 1963 movie "The Birds," directed by Alfred Hitchcock, a small town in California is invaded by violent birds that attack the locals, killing some of them. In [one of the horror scenes](#), the main character, played by Tippi Hedren, is sitting on a bench outside a schoolhouse unaware that more and more birds are landing on a jungle gym behind her. The movie is a masterpiece of film editing.

Today, more and more dots in the Fed's dot plot are landing in 2022 and 2023. Every quarter, members of the Federal Open Market Committee (FOMC) forecast where interest rates will go over the short, medium, and long terms. These projections are represented visually in a chart called a "dot plot" that is included in the FOMC's quarterly Summary of Economic Projections (SEP). In the [latest SEP](#), dated March 17, four of the 18 FOMC participants were looking for a rate hike at some point in 2022 (see Figure 2), compared with just one at the December meeting. For 2023, seven members expected a rate increase at last count compared with five in the December forecast. As the chart shows, a strong majority forecasts no hikes until the "longer run."

Investors aren't horrified yet, but they could be if more dots land in 2022 in coming dot plots. Fed Chair Jerome Powell is doing his best to calm us down so that we don't worry about the Fed's raising interest rates just because more FOMC participants have signaled that could happen sooner rather than later. At his March 17 [press conference](#), Powell was asked whether

the latest dot plot suggested that the Fed would start raising interest rates soon. Powell seemed to be horrified by the question, responding:

(1) “I don’t see that at all. We have a range of perspectives on the Committee. I welcome that. We debate things, we discuss things, and we always come together around a solution. But the strong bulk of the Committee is not showing a rate increase during this forecast period. As data improve, as the outlook improves, [as it has] very significantly since the December meeting, you would expect forecasts to move up. It’s probably not a surprise that some people would bring in their estimate of the appropriate time for liftoff. Nonetheless ... the largest part by far of the Committee doesn’t show a rate increase during this period. And again, part of that is wanting to see actual data rather than just a forecast at this point. We do expect that we’ll begin to make faster progress on both ... labor markets and inflation as the year goes on because of the progress with the vaccines, because of the fiscal support that we’re getting. We expect that to happen. But we’ll have to see it first.”

(2) Later during the Q&A, Powell reiterated: “So sometimes with the dots, I have to be sure to point out that they’re not a Committee forecast. ... It’s just compiling these projections of individual people. We think it serves a useful purpose. It’s not meant to actually be a promise or even a prediction of when the Committee will act. That will be very much dependent on economic outcomes, which are highly uncertain.”

(3) He had more to say on this subject in response to another question: “Well, again, I wouldn’t read too much into the March 2021 SEP dot plot. Remember what it is—it’s a compilation of individual projections by individual members. They’re all making different assessments. They have different economic forecasts. Some have more optimistic ones, some less optimistic. And also remember that the SEP doesn’t actually include all the things that go into maximum employment.”

Rather than forward looking, monetary policy will be backward looking. Rather than anticipating that strong economic growth will tighten up the labor market and revive inflation, the Fed will wait until there is a full recovery in the labor market and take a chance that inflation might be higher than expected. As a result, monetary policy will be tightened later than usual in the business cycle ([Fig. 1](#) and [Fig. 2](#)).

Meanwhile, rising bond yields suggest that investors are concerned that the Fed isn’t ready to be more pre-emptive in tightening given the strength of the economy and mounting inflationary

pressures. The Fed is literally behind the yield curve, which has been steepening over the past year, signaling expectations that the Fed will have to tighten sooner rather than later ([Fig. 3](#)). Perversely, the longer the Fed waits to do so, the sooner it might have to act, since maintaining the current stance of unprecedented easy monetary and fiscal policies is overheating the economy.

US Economy II: Getting Hotter. We now have the March results of the regional business surveys conducted by five Federal Reserve Banks. They all showed relatively strong readings for their composite indexes: Dallas (28.9), Kansas City (26.0), New York (17.4), Philadelphia (51.8), and Richmond (17.0) ([Fig. 4](#)). Here's more:

(1) *Regional business activity.* The average of the regional composite indexes was 28.2, the highest in the history of the series going back to mid-2004 ([Fig. 5](#)). That augurs for another strong reading for the national M-PMI during March, which could surpass its record high of 61.4 recorded during May 2004. The regional employment index edged up to 19.5, the highest since August 2018.

Indexes of unfilled orders were especially high in Kansas City (32.0), Dallas (24.5), and Philadelphia (21.8), while Richmond (11.0) and New York (4.0) unfilled orders were relatively weak ([Fig. 6](#)). The Chicago purchasing managers survey also showed a big increase in order backlogs through February ([Fig. 7](#)).

(2) *Regional pricing.* The prices-paid indexes rose in four of the five regional business surveys ([Fig. 8](#)). Their average rose to 66.8, the highest in the history of the series going back to mid-2004 ([Fig. 9](#)). A year ago, it was 4.0. This suggests that the March reading for the national M-PMI price index also rose ([Fig. 10](#)).

The average of the five regional prices-received indexes jumped to 30.9 during March, the highest reading since July 2008. The spread between the averages of the prices-paid and prices-received indexes is highly correlated with the spread between the y/y inflation rates of the Producer Price Index for intermediate goods and the Consumer Price Index for goods ([Fig. 11](#)). Both spreads confirm that cost pressures are mounting.

This development doesn't necessarily have to lead to much higher inflation in prices received, such as consumer prices. Profit margins could be absorbing some of these pressures. More

likely is that a rebound in productivity growth is offsetting inflationary cost pressures, as typically happens during economic recoveries.

US Fiscal Policy I: Spending Galore. It's hard to keep track of the federal government's outlays these days because they are happening at such a fast pace as Congress passes one spending program after another. Our latest attempt was in our March 17 [Morning Briefing](#) in which we had a look at the ingredients in the latest sausage made in Washington, i.e., the \$1.9 trillion [American Rescue Plan Act](#) (ARPA), which was enacted on March 11. We detected some beef, lots of pork, and quite a bit of mystery meat.

Melissa found a handy [crib sheet](#) dated March 15 produced by the Peter G. Peterson Foundation. It shows that the total cost of Covid-19 relief including in the ARPA is \$5.3 trillion, so far. Here are the component amounts by major categories of spending: support for small businesses (\$968 billion), economic stimulus payments (\$856 billion), expanded unemployment compensation (\$764 billion), public health and related spending (\$657 billion), tax incentives (\$566 billion), direct aid to governments (\$512 billion), educational support (\$282 billion), and other (\$730 billion).

A few \$100 billion here, a few \$100 billion there add up to \$5.3 trillion. In coming months, the Biden administration plans to introduce bills for yet more spending amounting to trillions of dollars. The only good news is that the sums will be totals over the next 10 years, unlike the pandemic relief outlays, which are mostly for 2020 and 2021.

US Fiscal Policy II: The Taxman Cometh. Fiscal and monetary policies both are stepping on the accelerator for the second year in a row. They both might start to tap on the brakes next year. The Fed is likely to start raising interest rates sometime next year. Fiscal policy is likely to be raising tax rates.

We reckon that the next round of fiscal packages is likely to include at least \$2 trillion in additional taxes on upper-income taxpayers and on corporations over the next 10 years to pay for \$4 trillion to \$5 trillion in additional spending on infrastructure, green initiatives, education, and income equalization.

The administration's next round of fiscal packages will be made public in coming weeks. For now, let's focus on taxes and review the updated November 6 Tax Policy Center (TPC)

analysis of then-presidential-hopeful Joe Biden's tax proposals as of September 28. It found that they would increase federal revenues by about \$2.1 trillion over the next decade:

(1) *Individual & estate taxes (estimated revenue increase: \$976.3 billion)*. Biden promised no tax increases for Americans earning \$400,000 a year or less. Higher-income earners would see increases while lower-income (and no-income) earners would benefit from expanded tax credits. In terms of the distributional effects of the plan, the top 1.0% of earners is expected to see taxes rise by 15.6% of current-law after-tax income for 2022, while taxpayers in the bottom quintile would receive an average tax cut of 5.2%. The TPC's highlights of Biden's proposals include the following:

(i) Roll back income-tax reductions from the Tax Cuts and Jobs Act of 2017 (TCJA) for taxpayers with annual incomes above \$400,000. The top marginal income tax rate would rise to 39.6% from 37.0%.

(ii) Limit the value of itemized deductions to 28% for taxpayers with annual incomes above \$400,000.

(iii) Tax capital gains and dividends at the same rate as ordinary income for taxpayers with incomes above \$1 million and tax unrealized capital gains at death. Currently, the maximum tax on capital gains is slightly more than 20%.

(iv) Subject earnings over \$400,000 to the Social Security payroll tax.

(v) Lower the estate tax exemption to \$3.5 million (\$7.0 million for married couples) and increase the estate tax rate to 45%.

(vi) Permanently boost the child and dependent care tax credit and make it fully refundable.

(vii) Institute new tax credits for first-time home buyers, family caregivers, and low-income renters.

(viii) Replace a deduction (or income exemption) with a refundable tax credit for contributions to traditional individual retirement accounts (IRAs) and defined-contribution pension plans.

(ix) Temporarily expand the child tax credit to be made fully refundable. This component of Biden's tax plan already has been passed and made effective for the 2021 tax year as a part of the \$1.9 trillion [American Rescue Plan](#). The TPC estimated that this component would amount to a revenue loss of \$240 billion.

(2) *Business taxes (estimated revenue increase: \$1.1 trillion)*. Corporate tax decreases enjoyed courtesy of the TCJA would be abolished. Large corporations would incur incremental tax fees. New tax credits would be established to incentivize businesses to engage in certain activities. The TPC's highlights of Biden's proposals include:

(i) Increase the top corporate income tax rate from 21% to 28%. (The TCJA reduced the statutory rate on all corporate income to a flat 21% from a previous top marginal rate of 35%.)

(ii) Impose a 21% country-by-country foreign minimum tax (from about 13%) and a 15% minimum tax on companies' global book income.

(iii) Establish a financial risk fee on liabilities held by financial institutions with more than \$50 billion in assets.

(iv) Establish a 10% credit for domestic manufacturing.

CALENDARS

US: **Tues:** Consumer Confidence 97.0, S&P Case-Shiller House Price Index 11.0% y/y, API Crude Oil Inventories, Quarles. **Wed:** ADP Employment Change 550k, Chicago PMI 60.7, Pending Home Sales -2.9%, MBA Mortgage Applications, EIA Crude Oil Inventories, Bostic. (DailyFX estimates)

Global: **Tues:** Eurozone Economic & Sentiment & Consumer Confidence 96.0/-10.8, France Consumer Confidence 91, Germany CPI 0.5% m/m/1.7% y/y, Japan Industrial Production -1.2%, China NBS M-PMI 51.0. **Wed:** Eurozone Headline & Core CPI Flash Estimate 1.3%/1.1% y/y, Germany Unemployment Change & Unemployment Rate unchanged/6.0%, France CPI 0.8% m/m/1.1% y/y, Italy CPI 0.8% y/y, UK GDP 1.0% q/q/-7.8% y/y, Canada GDP 0.5% m/m, China Caixin M-PMI 51.3, Japan Tankan Survey, Australia Retail Sales -1.1%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of these indexes last week and were at record highs simultaneously for the first time since October 2018. LargeCap's was at a record high for a fourth straight week; MidCap's for a seventh week; and SmallCap's for the seventh time in eight weeks. In what has shaped up to be a typical V-shaped recovery, LargeCap's forward earnings has risen during 44 of the past 45 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 41 of the past 43 weeks, and SmallCap's posted 41 gains in the past 44 weeks. LargeCap's forward earnings is now up 28.6% from its lowest level since August 2017; MidCap's has risen 62.0% from its lowest level since May 2015; and SmallCap's is up 94.2% 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. 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 a 26-month high of 7.3% y/y from 4.3%. 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 a 27-month high of 17.6% y/y from 10.4% 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 a 27-month high of 26.4% y/y from 19.3% y/y; it 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 (-14.2%, 25.4%, 15.2%), MidCap (-16.9, 44.4, 14.6), and SmallCap (-29.2, 70.4, 20.0).

S&P 500/400/600 Valuation ([link](#)): Valuations dropped for two of these three indexes last week. LargeCap's forward P/E rose 0.3pt to 21.9. That's down from a 19-year high of 22.7 in early January and up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's dropped 0.5pt to 19.6 and is down from a seven-month high of 20.5 several weeks earlier. Its current level is 3.3pts below its record high of 22.9 in early June. SmallCap's fell

0.5pts w/w to 20.4. It's now down 6.3pts from its record high of 26.7 in early June. That compares to MidCap's 10.7 and SmallCap's 11.1 in March 2020, which were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—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 31st week, but by only 0.7pt. That's the longest stretch at a discount 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 an 11th 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 Q2-2020 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 Q1-2021 estimate ticked down 2 cents to \$39.75, instead of declining steeply as typically seen in the week before the quarter's end. That \$39.75 estimate for Q1-2021 represents a gain of 20.0% y/y on a frozen actual basis and a 23.9% y/y gain on a pro forma basis. That would be the first quarter of double-digit percentage growth since Q4-2018 and compares to a pro forma 3.8% gain in Q4-2020. Eight sectors are currently expected to post positive y/y earnings growth in Q1-2021, but the final results are likely to have all 11 sectors higher y/y. Here are the S&P 500 sectors' latest expected earnings growth rates for Q1-2021 versus their final Q4-2020 growth rates: Consumer Discretionary (98.1% in Q1-2021 versus -5.0% in Q4-2020), Financials (66.6, 20.4), Materials (45.8, 22.7), Information Technology (24.2, 20.4), S&P 500 (23.9, 3.8), Health Care (17.9, 10.6), Communication Services (13.8, 10.1), Utilities (2.5, -2.6), Consumer Staples (-0.2, 5.4), Real Estate (0.3, -10.7), Energy (-4.5, -105.0), and Industrials (-13.0, -37.7).

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): Five Fed districts have now reported on manufacturing activity for March (Philadelphia, New York, Richmond, Kansas City, and Dallas) and show the manufacturing sector expanded at a faster pace, led by accelerations in the Philadelphia, Richmond, and Dallas regions. Prices-paid and -received indexes are accelerating in all five

regions. The composite index (to 28.2 from 18.1) expanded at its fastest pace in the history of the series going back to mid-2004, as the Philadelphia (to 51.8 from 23.1) region posted its best performance since 1973, while Richmond's (26.0 from 24.0) reached a new record high (going back to mid-2001), and Dallas' (28.9 from 17.2) was the strongest since August 2018. Meanwhile, the New York (to 17.4 from 12.1) region recorded its strongest growth since last summer, while Richmond's (17.0 from 14.0) has held at a steady pace the past four months. The new orders measure jumped from 14.6 to 27.5 this month, virtually matching its record high of 27.8 during May 2018. Billings in the Philly (to 50.9 from 23.4) region expanded at the fastest pace since 1973, while Kansas City's (37.0 from 16.0) was the best since December 2003's record high of 40.0, and Dallas' (30.5 from 13.0) the strongest since June 2018. New York's (9.1 from 10.8) measure showed orders expanding at a similar pace to that of February this month, while Richmond's (unchanged at 10.0) grew at the same pace as last month. In the meantime, factories (to 19.5 from 18.6) added to payrolls at roughly the same pace as last month—posting its highest reading since August 2018. The Philadelphia (to 30.1 from 25.3) and Dallas (18.8 from 12.7) regions both showed an acceleration in hiring, while Kansas City (17.0 from 21.0) and New York (9.4 from 12.1) manufacturers both hired at a slightly slower pace than last month; Richmond's measure held steady at 22.0.

Regional Prices Paid & Received Measures ([link](#)): We now have prices-paid and -received data for March from the Philadelphia, New York, Kansas City, Richmond, and Dallas regions. The Philadelphia, New York, Kansas City, and Dallas measures are diffusion indexes, while Richmond's measures are yearly percent changes. All five regions are showing a sharp acceleration in prices, though Philadelphia's is exhibiting the steepest rise. Prices-paid measures in the Philadelphia (to 75.9 from 54.4), New York (64.4 from 57.8), and Dallas (66.0 from 57.4) regions accelerated at their fastest paces since March 1980, May 2011, and July 2008, respectively, while Kansas City's (66.0 from 68.0) was close to April 2011's record high of 71.0, and up sharply from its -13.0 reading a year ago. Richmond's prices-paid annual inflation rate rose to 6.2% from 2.1% at the end of last year and 0.8% at the start of 2020. The prices-received indexes in the Philadelphia (to 31.8 from 16.7), Dallas (32.2 from 23.0), Kansas City (31.0 from 27.0), and New York (24.2 from 23.4) regions are also accelerating, though pale in comparison to the regions' input price indexes; that's also the case for Richmond. Richmond's prices-received annual inflation rate climbed to 3.5% from 1.8% in December and 1.3% at the start of last year.

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