MORNING BRIEFING
April 20, 2021

For Whom the Bull Tolls

Check out the accompanying chart collection.

(1) Happy vs sad theme songs. (2) Old stock market adages. (3) Waiting for the next panic attack. (4) The relevance of Ernest Hemingway. (5) Contrarians say the sun also sets. (6) Too much bullish sentiment? (7) MMT + TINA = MAMU. (8) Margin debt again. (9) Into the weeds of Biden's proposal to increase corporate tax revenues. (10) GILTI as sin. (11) A tax even Europeans don't like.

Strategy I: The Warning Bells Are Tolling. Prince, Bowie, or Metallica? I'm still trying to figure out what will be the theme song for 2021. I'd been thinking "Party Like It's 1999" by Prince until last week, when I suggested that "Space Oddity" by David Bowie might be more relevant if stock prices continue to hurtle into outer space. Either song would be consistent with a continuation of the bull market in stocks. Alternatively, perhaps I need to consider a far more pessimistic theme song like "For Whom the Bell Tolls" by Metallica.

There's an old stock market adage: "They don't ring a bell at the top." My study of financial history suggests that the adage isn't true: Credit crunches serve as bells. More specifically, financial crises that trigger a widespread credit crunch tend to cause bear markets in stocks as investors correctly anticipate that the credit crisis will cause a recession (*Fig. 1*). During credit crunches, the S&P 500 VIX, a measure of stock market volatility, tends to soar along with the yield spread between high-yield bonds and the 10-year Treasury bond (*Fig. 2*).

While the VIX doesn't rise on a predictable schedule as does the sun, its rising can also shed light. In addition to rising during bear markets, it also rises during stock market corrections and minor panic attacks (*Fig. 3* and *Fig. 4*). Since the start of the bull market in 2009, Joe and I have counted 69 panic attacks. The latest one occurred when the Nasdaq fell 10.9% from February 12 through March 8, mostly on jitters over the backup in bond yields. By the way, we count last year's selloff as a panic attack rather than an outright bear market. (See *Table of S&P 500 Panic Attacks Since 2009*.)

The unusual frequency of panic attacks during the current bull market suggests that investors have remained jittery ever since the last bear market during the Great Financial Crisis (GFC) and prone to hear warning bells. Ernest Hemingway, who wrote the novel *For Whom the Bell Tolls* (1940), suffered from tinnitus, a constant ringing in his ears as a result of injuries sustained in World War I. Similarly, investors traumatized by the GFC remain easily convinced that another bear market is imminent.

Yet despite their propensity to panic, stock market investors are reveling in a festive mood with the bulls stampeding. Hemingway's *The Sun Also Rises* (1926) portrays American and British expatriates who travel from Paris to the Festival of San Fermín in Pamplona, Spain, to watch the running of the bulls and the bullfights; merrymaking in the festive atmosphere provides them with an escape from reality, for the time being.

Contrarians aren't indulging in the stock market's revelry; they see too many indicators flashing that stock market sentiment is unduly bullish. For them, the sun will soon set, providing a good reason to take profits before darkness.

On the other hand, there is plenty of liquidity to drive stock prices higher without a significant correction. M2 is up by an unprecedented $4.2 trillion y/y through February (*Fig. 5*). Furthermore, over the past 12 months through February, personal saving totaled a record-shattering $3.1 trillion. All that occurred before the third round of relief checks ($1,400 per eligible person) were sent by the Treasury to over 250 million Americans since mid-March.

MAMU, here we come! In my latest book, *The Fed and the Great Virus Crisis*, I predicted that MMT + TINA = MAMU, where MMT = Modern Monetary Theory, TINA = there is no alternative to stocks, and MAMU = the Mother of All Meltups. (See the relevant excerpt.)

That might turn out to be the new adage for our times. Now let's have a look at the latest running of the bulls:

(1) *Party like it's 1999.* The Nasdaq continues to party like its 1999 (*Fig. 6*). The tech-heavy index is up 104.8% since March 23, 2020 through Friday's close. The Nasdaq bottomed on October 8, 1998 following the Russian debt and LTCM crisis. It was up 113.4% on a comparable temporal basis to the current bull run. If the Nasdaq's bull run is about to turn into a stampede, as happened during the last leg of the 1999/2000 bull market, then it could double in value over the next six to nine months as it did back then. The S&P 500 is up 87.1% since

March 23, 2020 through Friday's close. That's well ahead of 1999, when it was up 33.4% on a comparable temporal basis (*Fig. 7*).

(2) *Stretched valuation.* The S&P 500's forward P/E continues to fluctuate around 22.0, as it has over the past year. That's not far off its record 25.7 valuation multiple during April 1999. On the other hand, the forward price-to-sales ratio of the S&P 500 has been setting new record highs for most of the past year, rising to 27.9 on Friday (*Fig. 8*).

(3) *Bullish sentiment running wild.* The Bull/Bear Ratio compiled by Investors Intelligence was relatively elevated at 3.77 during the week of April 13 (*Fig. 9*). By historical standards, the percentage of bulls was particularly high at 63.4%. Bears are relatively scarce at 16.8%, as are investors expecting a correction at 19.8%.

The running of the bulls is even more discernible in the Bull/Bear ratios based on survey data compiled by the American Association of Individual Investors (*Fig. 10*).

(4) *Fun for almost everyone.* Measures of market breadth show that the bull market has broadened since early last September. The ratio of the equal-weighted to the market-cap weighted S&P 500 stock price indexes has been rising since it bottomed on September 1 (*Fig. 11*). The percentage of S&P 500 stock prices above their 200-day moving averages (dma) rose to 96.2% on April 16, exceeding the 96.0% reached on October 16, 2009 (*Fig. 12*). The S&P 500 was 15.4% above its 200-dma yesterday (*Fig. 13*). That's a relatively high reading. During April 16, the percentage of S&P 500 companies with positive y/y stock prices changes was 93.1%, around previous cyclical highs (*Fig. 14*).

(5) *Another adage.* Here's another old stock market adage: "Sell in May and go away." While doing so might make sense this year since bullish sentiment is so high, I've never been a fan of this adage. It doesn't always work, and even when it does, the investor is left with the problem of determining when to get back into the market. Proponents of the adage say to come back after October, but there have been plenty of times when that advice would have meant missing a summer rebound that followed a selloff in May.

Strategy II: Margin Debt, Again. What about margin debt? It rose to a record high of $822.6 billion during March (*Fig. 15*). Isn't that a contrary indicator? Not really, since contrary indicators are leading indicators of the stock market's direction. Margin debt is a coincident indicator of the stock market since it tends to rise and fall with broad-based measures of the market such as the Wilshire 5000. Joe and I discussed margin debt last week in the April 12 *Morning Briefing* as one of the many measures of liquidity that tends to fuel bull markets and exacerbate bear markets.

Our short analysis prompted a few comments observing that margin debt is very small relative to the market capitalization of the Wilshire 5000 (*Fig. 16*). The former was only 2.0% of the latter during March. That doesn't change our view that margin debt is a positive contributor to bull markets while worsening bear markets.

Fiscal Policy: Taxing Multinationals. Death and taxes are the only two certainties in life, as another adage goes. Most of us will avoid the first outcome for now thanks to the latest Covid-19 vaccines. But many of us are not likely to avoid the forthcoming tax increases that likely will be needed to "pay for" all the latest rounds of fiscal stimulus. I asked Melissa to get into the weeds on this issue. Here are her findings on the impact of Biden's tax proposals on US multinational corporations.

Much of President Joe Biden's tax plan is intended to offset his next big infrastructure package. The federal domestic statutory corporate tax rate was lowered from 35% to 21% as part of the 2017 Tax Cuts and Jobs Act (TCJA). Biden wants to partially reverse these TCJA changes by increasing the corporate tax rate to 28%. US multinational companies could soon be paying more on their foreign tax payments too. Consider the following:

(1) *Competitive disadvantage*. Reversing the TCJA's tax rate cut would give the US one of the highest corporate tax rates globally. Countries have shifted to corporate tax rates below 30% over time, wrote the Tax Foundation in a 2020 analysis, with the US following this trend at the end of 2017. The average corporate tax rate globally stood around 24%. At 21%, the US rate fell competitively among the rounded average for Europe (20%), Asia (20), Oceana (24), North America (26), South America (28), and Africa (29). Most countries' rates range between 20% and 30%, according to the analysis; Biden's 28% rate would be near the top of that range. Increasingly, countries are trending toward further tax reductions in the coming years, according to the Tax Foundation.

(2) *Global minimum tax*. A problem inherent in raising domestic tax rates is that US-based multinationals are equipped with experts who are handy at finding ways of avoiding federal taxes by seeking out tax havens elsewhere. US Secretary of the Treasury Janet Yellen has a plan for that: a global minimum tax. The concept, previously advocated by Yellen's

predecessor Steven Mnuchin, isn't new, but it is gaining momentum. Yellen recently said that she believes she has the support of world leaders to implement it, reported the April 5 *WSJ*.

What's the purpose of the global minimum tax? Yellen said it would allow the US to be more "competitive" on an international tax basis. She also said that it is "about making sure that governments have stable tax systems that raise sufficient revenue to invest in essential public goods and respond to crises, and that all citizens fairly share the burden of financing government."

The Organization for Economic Cooperation and Development and G20 countries aim to reach consensus on a global minimum tax by mid-year, reported Reuters on April 14. Reuters observed: "Since the talks are consensus based, countries are expected to go along with agreement no matter how unpalatable it may be for some low tax countries." The minimum tax, combined with new tax rules on cross-border digital services, is expected to contribute to $50 billion to $80 billion in corporate income tax revenues for governments.

Reuters noted: "The global minimum tax rate would apply to companies' overseas profits. Therefore, if countries agree on a global minimum, governments could still set whatever local corporate tax rate they want. But if companies pay lower rates in a particular country, their home governments could 'top-up' their taxes to the agreed minimum rate, eliminating the advantage of shifting profits to a tax haven." The Biden administration would deny exemptions for taxes paid to countries that don't agree to a minimum rate.

(3) *Taxing the GILTI*. The Biden administration also would seek to double the Global Intangible Low-Taxed Income (GILTI) tax. Created under TCJA, the intent of the GILTI tax was to discourage US-controlled foreign corporations from moving profits related to easily moved assets, like intellectual property rights (copyrights, trademarks, and patents), to regions where local taxes are lower than US rates. Companies with foreign profits mainly derived from intellectual property—e.g., those in the information technology sector—are more likely to have their income taxed as GILTI. But other sectors—like manufacturing—have been caught by GILTI too, as a March 16 Tax Foundation article explained.

To better understand GILTI, it helps first to understand how the current system of international taxation works. A May 2020 Tax Policy Center (TPC) briefing explained: "All countries tax income earned by multinational corporations within their borders. The [US] also imposes a minimum tax on the income US-based multinationals earn in low-tax foreign countries, with a credit" for a portion of foreign income taxes paid. Most other countries exempt the income their multinationals get from foreign sources.

(4) *One of three*. The TCJA-created GILTI is one of the three major current types of taxation on US multinationals' foreign-sourced earnings, the TPC briefing explained. Specifically, the three types are: (i) US companies earning a "normal" return on assets—which is deemed to be 10% per year on the depreciated value of those assets—are exempt from US corporate income tax. (ii) GILTI is the profit over that "normal" return threshold. It is taxed annually at an effective rate of between 10.500% and 13.125%, but it can be higher in certain circumstances. (iii) Income from passive assets is taxed at the full corporate rate with a credit for 100% of foreign income taxes paid on that income.

(5) *Complicating calculations*. In the March 31 *Morning Briefing*, we estimated that the impact of Biden's federal tax increase would reduce S&P 500 earnings per share by about 7%. But figuring out exactly how the international tax changes, if implemented, would impact US-based multinational's earnings is much more complicated for several reasons. First, one needs to dig into the supplementary data of corporate filings to find the domestic and foreign tax break outs. Second, the calculations are complex, particularly for GILTI, as it operates as a minimum tax.

It's also difficult to assess the impact of impending international tax changes because we don't know exactly what other tax rules, perhaps involving exemptions, deductions or credits, might be implemented to offset some of the increased tax burden. We also don't know precisely how a global minimum tax would work for each country, or whether companies might find be able to find a way around paying it.

(6) *Un-European tax*. Further complicating matters, Biden's tax plan would have GILTI calculated on a country-by-country basis as opposed to via a single global calculation under TCJA, as a *WSJ* editorial discussed on April 15. Under the TCJA, profits in some regions offset losses in others—serving to mitigate tax impacts stemming from the absence of loss carrybacks or carryforwards. Without getting too much into the details, the Biden plan's country-by-country approach would sometimes lead to taxing profits that are a recoupment of earlier investments, economically speaking. This approach is also much more difficult and costly to administer. Even "tax-happy Europeans" have avoided this sort of tax calamity, observes the *WSJ*. The authors imply that US Congress would be hard pressed to do what the Europeans wouldn't.

CALENDARS

US: Tues: API Crude Oil Inventories, EIA Crude Oil Inventories. **Wed:** MBA Mortgage Applications. (DailyFX estimates)

Global: Tues: UK Unemployment Rate 5.1%, ECB Bank Lending Survey, Buch. **Wed:** UK Headline & Core CPI 0.8%/1.1% y/y, Canada CPI 0.6%m/m/2.3%y/y, BOC Interest Decision 0.25%, Ramsden, Bailey. (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 a sixth week and the first time since October 2018. LargeCap's was at a record high for a seventh straight week; MidCap's for a tenth week; and SmallCap's for the tenth time in 11 weeks. In what has shaped up to be a typical V-shaped recovery, LargeCap's forward earnings has risen during 47 of the past 48 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 44 of the past 46 weeks, and SmallCap's posted 44 gains in the past 47 weeks. LargeCap's forward earnings is now up 31.4% from its lowest level since August 2017; MidCap's has risen 64.3% from its lowest level since May 2015; and SmallCap's is up 98.0% 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 29-month high of 22.6% y/y from 16.9%. 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 record high of 38.5% y/y from 31.9% 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 record high of 56.9% y/y from 47.3% 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 have been improving since July as companies easily beat low-balled consensus estimates for Q2, Q3, and Q4. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (27.3%, 14.6%), MidCap (45.4, 13.9), and SmallCap (70.4, 20.7).

S&P 500/400/600 Valuation (*link*): Valuations rose for all three of these indexes last week. LargeCap's forward P/E rose 0.2pt to 22.7. That matches its 19-year high from early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's rose 0.2pt to 20.0 but is down from a seven-month high of 20.5 in early March. Its current level is 2.9pts below its record high of 22.9 in early June. SmallCap's ticked up 0.1pt w/w to 20.2. It's now down 6.5pts 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 33rd week. 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 a 14th 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 showed another upside hook as it rose 148 cents to $41.59. That $41.59 estimate for Q1-2021 represents a gain of 25.5% y/y on a frozen actual basis and a 30.9% y/y gain on a pro forma basis. That marks the first quarter of double-digit percentage growth since Q4-2018 and compares to a pro forma 3.8% gain in Q4-2020. Nine sectors are currently expected to post positive y/y earnings growth in Q1-2021, but the final results are likely to be positive y/y for all but the Industrials sector. Here are the S&P 500 sectors' latest expected blended earnings growth rates for Q1-2021 versus their final Q4-2020 growth rates: Financials (116.4% in Q1-2021 versus 20.4% in Q4-2020), Consumer Discretionary (99.0, -5.0), Materials (46.8, 22.7), S&P 500 (30.9, 3.8), Information Technology (24.5, 20.4), Health Care (19.5, 10.6), Communication Services (13.4, 10.1), Consumer Staples (1.5, 5.4), Real Estate (1.1, -10.7), Utilities (0.1, -2.6), Energy (-11.4, -105.0), and Industrials (-16.3, -37.7).

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