



MORNING BRIEFING

May 25, 2021

More Tapering Talk

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

(1) How many is “a number” of participants? (2) Tapering sooner rather than later? (3) Two hawks and three doves. (4) More states are cutting jobless benefits. (5) Plenty of job openings. (6) Camps and schools are reopening. (7) Will Powell pivot again? (8) Fed’s word games. (9) Bond market conundrum 2.0. (10) Few signs of tapering tantrum in the bond market or in stock market forward P/Es. (11) Valuation multiples down for Mag-5 and overseas stocks.

Tapering I: Talking Fed Heads. Drip. Drip. We now have two Fed officials talking about the need to talk about tapering the Fed’s asset purchases program. We know that there must be more of them who think it’s time to start that conversation. On May 16, the Fed released the [minutes](#) of the April 27-28 FOMC meeting, which stated that “a number” of the committee’s participants wanted to talk about tapering sooner rather than later. Melissa and I reckon that “a number” is more than two or even three. It might be four or even more.

More specifically, the minutes stated: “A number of participants suggested that if the economy continued to make rapid progress toward the Committee’s goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases.”

Consider the following:

(1) *Kaplan*. First out of the gate was Dallas Federal Reserve Bank (FRB) President Robert Kaplan. On April 30, he said that he thinks the FOMC should begin discussions on slowing down, or tapering, its \$120 billion of monthly asset purchases. “At the earliest opportunity, I think it will be appropriate for us to start talking about adjusting those purchases.” He added that he thought the economy was improving and would soon reach the Fed’s prerequisite of ‘substantial further progress.’ I think we’re going to reach that benchmark sooner than I would have expected in January.”

Kaplan could be right now that at least 22 states are [responding](#) to severe labor shortages around the country by no longer paying \$300 per week in enhanced federal unemployment benefits. That’s even though the program expires in September, which will affect more than 3.6 million people. This

might encourage more of the unemployed to get back to work. After all, during March, there was a record 8.1 million job openings, not far below the 9.8 million number of unemployed workers ([Fig. 1](#) and [Fig. 2](#)).

As we reported in our May 11 [Morning Briefing](#), Powell noted during his last press conference that the federal unemployment benefit could be keeping people from seeking jobs. On a positive note, he said that the fact that schools are reopening should boost labor force participation. The mayor of New York City just announced that all NYC schools will be in person this fall, with no remote-learning options! The reopening of schools could bring back into the labor force lots of the parents who had to stay home to care for their kids throughout remote learning. It's possible that more of them could reenter the labor force this summer if summer camps and other forms of childcare services reopen too and parents feel comfortable sending their kids, as we expect they will.

(By the way, when we first wrote that the fall would be a likely timeframe for talking about tapering in the *Morning Briefing* cited above, only two states had opted out of federal benefits, and the decision on NYC schools was still pending. And we noted that these developments could cause Powell to pivot on policy at an earlier time.)

(2) *Harker*. Philadelphia FRB President Patrick Harker on Friday, May 21, became the second Fed official, along with Kaplan, to urge a faster start to discussions about when and how quickly to reduce the central bank's monthly bond purchases. "It is something that, in my mind, we should start to have a conversation about sooner rather than later," Harker said at a virtual event organized by the Washington Post.

(3) *Bostic*. Atlanta FRB President Raphael Bostic and Richmond FRB President Thomas Barkin, speaking at the same event as Kaplan, both stuck to their positions that more hiring needs to take place before they would be ready to discuss a bond purchase taper. "Right now, we are not in a position where that's in play for moves," Bostic said, a view that currently is the consensus at the Fed.

(4) *Powell*. Uber-dove Fed Chairman Jerome Powell has been saying that he doesn't want the central bank to begin "talking about talking about" tapering yet. He reiterated that doing so is premature at his [press conference](#) on April 28 and stuck to his guns when asked about it:

"So, no, it is not time yet. We've said that we would let the public know when it is time to have that conversation, and we said we'd do that well in advance of any actual decision to taper our asset purchases, and we will do so. In the meantime, we'll be monitoring progress toward our goals. We first articulated this 'substantial further progress' test at our December meeting. Economic activity

and hiring have just recently picked up after slowing over the winter. And it will take some time before we see substantial further progress.”

Yet the minutes of the April 27-28 FOMC meeting that Powell led just before making that statement indicated that talking about talking about tapering was discussed, with a number of participants ready to talk about it sooner rather than later!

(By the way, for a guide for understanding “Fed speak,” see Chapter 9 of my 2020 book, [*Fed Watching for Fun & Profit*](#). It’s all about the Fed’s word games.)

Tapering II: Bond Market Conundrum 2.0. The bond market seems to be drinking the Kool-Aid that Powell is serving in the Fed’s punchbowl. Despite April’s higher-than-expected CPI and PPI inflation reports, released on May 12 and 13, the 10-year Treasury bond yield remains around 1.666% ([*Fig. 3*](#)). It’s been trading around that level since March 12. Even the latest tapering chatter hasn’t unnerved the bond market!

This reminds us of “Greenspan’s conundrum,” which I also discussed in my 2020 book about the Fed. The federal funds rate was increased by 25 basis points to 1.25% at the June 29–30, 2004 meeting of the FOMC. That was followed by increases of 25 basis points at every one of the next 16 meetings, putting the rate at 5.25% after the June 29, 2006 meeting. It remained at that level through August 2007.

However, yields didn’t rise. Instead, the 10-year US Treasury bond yield fluctuated around 4.50% from 2001 to 2007. That was a big surprise given that short-term rates were almost certainly going to go up at every FOMC meeting, albeit at an incremental pace, once the Fed commenced its measured rate hikes.

Then Fed Chair Alan Greenspan was puzzled. In his February 16, 2005 semiannual testimony to Congress on monetary policy, he said globalization might be expanding productive capacity around the world and moderating inflation. Then Fed Governor Ben Bernanke tried to solve the conundrum in a March 10, 2005 speech. He argued that the US bond market during the 2000s was increasingly driven by countries outside of the US. In his narrative, there was a “global savings glut.”

Now consider the following recent developments in the bond market:

(1) *Bearish indicators.* In addition to the latest inflation news, there have been other bearish indicators for the bond market recently. In the past, the bond yield was highly correlated with the

national ISM M-PMI, which has been soaring in recent months through April; recent data show Markit's M-PMI flash estimate jumped to a new series high in May ([Fig. 4](#)). The copper-to-gold price ratio currently suggests the yield should be closer to 2.40% ([Fig. 5](#)).

(2) *Global saving glut, again?* Perhaps it's the gravitational pull from the 10-year Japanese and German government bond yields, at 0.09% and -0.13%, that are keeping the US yield from rising ([Fig. 6](#)). Japanese and German investors may be getting better yields on US bonds even after paying to hedge the currency risk.

(3) *The Fed's latest QE.* Of course, the Fed's purchases of \$80 billion per month in US Treasury securities since late last year are also helping to keep yields from rising. Over the past 12 months through April, the Fed's holdings of these securities were up \$1.0 trillion, to \$5.0 trillion ([Fig. 7](#)). Over that same period, the Fed's holdings of Treasury notes and bonds increased by \$0.8 trillion, to \$4.0 trillion ([Fig. 8](#)).

(4) *Beware the dot plot.* Notwithstanding the above, we are puzzled that the US bond yield has remained so subdued. Perhaps we might have jumped the gun last Thursday after we read the latest FOMC minutes. We wrote: "We conclude that the Fed's talking heads are likely to start talking publicly about tapering their asset purchases before they meet again at the June 15-16 FOMC session. At that meeting, we expect that they will discuss doing so at length and start doing so after the July 27-28 meeting of the FOMC. They should announce that they will finish tapering by the end of this year, setting the stage for hiking the federal funds rate before the middle of next year, well ahead of the 'dot plot' schedule in the March 1 [Summary of Economic Projections](#)."

Let's see how many more talking Fed heads start talking about tapering between now and the next FOMC meeting on June 15-16. Then, let's see what the dot plot shows following that meeting. During the March meeting, only four of the 18 participants projected at least one rate hike next year. We expect more will be doing so at the June meeting. Tapering is likely to start three to six months before the first rate hike.

The suspense has us on the edge of our seats. For now, we continue to predict that the bond yield will rise to 2.00% before the end of this year and to 2.50%-3.00% next year.

Tapering III: The Valuation Question. The stock market also doesn't seem worried about tapering anytime soon. In fact, even though the bond yield is up by about 100bps since last August, the forward P/E of the S&P 500 has been hovering around 22.0. It was down to 21.0 on Friday ([Fig. 9](#) and [Fig. 10](#)). As of the May 21 week, 52.2% of the S&P 500 had forward P/Es of 20 or more, while only 6.3% were trading at forward P/Es of 10 or less ([Fig. 11](#)).

Let's drill down some more to see whether valuation multiples seem to be reacting negatively to the prospects of the Fed tapering sooner rather than later:

(1) *S&P 500 Growth vs Value*. Neither the rise in the bond yield since last summer nor last week's tapering chatter have unsettled the valuation multiples of either S&P 500 Growth or S&P 500 Value ([Fig. 12](#)). The former has been trading in a range between roughly 25.0 and 30.0 since mid-2020. It is currently 26.6. The latter's 17.6 is near the bull market's recent highs.

(2) *Magnificent 5*. Hardest hit has been the collective forward P/E of the Magnificent 5 ([Fig. 13](#)). But that has more to do with the previous outperformance of those five stocks, i.e., the S&P 500's top five in terms of market capitalization—Apple, Microsoft, Amazon, Alphabet (Google), Facebook—during the worst of the pandemic, when the market's breadth was very narrowly focused on them as the major beneficiaries of the calamity. They've been underperforming since September of last year as the bull market broadened with the outperformance of stocks representing reopening plays. The forward P/E of the Mag-5 ended the week of May 21 at 33.5, the lowest reading since April 17, 2020 and down 29% from 46.9 back on February 12.

(3) *Stay Home vs Go Global*. Joe and I have previously observed that the forward P/E of the All Country World MSCI stock price index excluding the US closely tracks the forward P/E of the S&P 500 Value stock price index ([Fig. 14](#)). They started to diverge in recent weeks, with the former falling more (to 15.5) than the latter (to 17.6). That's not surprising, since overseas stock markets, especially those in emerging economies, tend to be very sensitive to talk about Fed tapering.

Calendars

US: Tues: Consumer Confidence 119.0, New Home Sales 975k, Richmond Fed Manufacturing Index, S&P Case-Shiller Home Price Index 12.3%/y/y, Quarles. **Wed:** MBA Mortgage Applications, EIA Crude Oil Inventories. (DailyFX estimates)

Global: Tues: Germany GDP -1.7%q/q/-3.3%/y/y, Germany Ifo Business Climate Headline, Current Conditions, and Expectations 98.1/95.5/101.0, Japan CPI, Tenreyro. **Wed:** France Consumer & Business Confidence 97/106, Japan Leading & Coincident Indicators, China Industrial Profits. (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 an 11th week and the first time since October 2018. LargeCap's was at a record high for a 12th straight week; MidCap's was at a record for a 15th week; and SmallCap's soared 6.2% w/w for its 15th gain in 16 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 52 of the past 53 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 49 of the past 51 weeks, and SmallCap's posted 49 gains in the past 52 weeks. LargeCap's forward earnings is now up 40.3% from its lowest level since August 2017; MidCap's has risen 77.3% from its lowest level since May 2015; and SmallCap's is up 121.1% 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 record high of 40.0% y/y from 39.6%. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings rose w/w to a record high of 76.2% y/y from 73.7% y/y and is up from a record low of -32.7% in May 2020. SmallCap's rate turned higher too, rising to a record high of 118.9% y/y from 98.4% y/y; it is up from a record low of -41.5% in June 2020. Companies have been easily beating consensus estimates since the Q2-2020 earnings season, causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (35.4%, 12.0%), MidCap (57.1, 10.2), and SmallCap (88.9, 16.6).

S&P 500/400/600 Valuation ([link](#)): Valuations were down for these three indexes last week. LargeCap's forward P/E dropped 0.2pt to a 29-week low of 21.0. That's down from a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's dropped 0.3pt to a 28-week low of 18.3, and is down from a seven-month high of 20.5 in early March. Its current level is 4.6pts below its record high of 22.9 in early June. SmallCap's tumbled 1.2pts w/w to a 28-week low of 18.1. It's now down 8.6pts from its record high of 26.7 in early June 2020. 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 37th week. That's the longest stretch at a discount since last 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 discount to MidCap's for the first time since early January, when it had been at a discount for 10 straight weeks.

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 Q1 earnings from the retailers boosted it another 50 cents to \$48.84. That \$48.84 estimate for Q1-2021 represents a gain of 47.4% y/y on a frozen actual basis and a 52.0% 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. Ten of the 11 sectors posted positive y/y earnings growth in Q1-2021. Here are the S&P 500 sectors' latest expected blended earnings growth rates for Q1-2021 versus their final Q4-2020 growth rates: Consumer Discretionary (216.6% in Q1-2021 versus -5.0% in Q4-2020), Financials (137.4, 20.4), Materials (62.3, 22.7), Communication Services (53.4, 10.1), S&P 500 (52.0, 3.8), Information Technology (43.9, 20.4), Health Care (26.4, 10.6), Energy (25.4, -105.0), Consumer Staples (10.4, 5.4), Real Estate (5.7, -10.7), Industrials (3.1, -37.7), and Utilities (-0.9, -2.6).

S&P 500 Q1 Earnings Season Monitor ([link](#)): With 95% of S&P 500 companies finished reporting revenues and earnings for Q1-2021, revenues are beating the consensus forecast by a record-high 3.8%, and earnings have crushed estimates by a record-high 23.4%, aided by loan loss reversals at the banks and stellar results from the Mag-5 stocks. At the same point during the Q4 season, revenues were 2.8% above forecast and earnings beat by 17.1%. The S&P 500's Q1 earnings surprise excluding Financials drops to 20.3% from 23.4%. For the 475 companies that have reported through mid-day Monday, aggregate y/y revenue and earnings growth and the percentage of companies reporting a positive revenue and earnings surprise have improved from their Q4 measures. The Q1 reporters so far have a y/y revenue gain of 10.2% and an earnings gain of 51.7%, which rises to 10.3% and drops to 36.3%, respectively, when Financials are excluded. A record-high 87% of the Q1 reporters has reported a positive earnings surprise, and a record-high 78% has beaten revenues forecasts. Slightly more companies have reported positive y/y earnings growth in Q1 (77.3%) than positive y/y revenue growth (76.6%). These Q1-2021 results are not expected to change markedly as the remaining 25 companies, primarily retailers, report in the coming weeks.

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