MORNING BRIEFING
May 27, 2021

Tapering, Crypto & the Drought

The next *Morning Briefing* will be on Tuesday, June 1.

Check out the accompanying chart collection.

(1) Clarida's just the latest Fed head to talk about talking about tapering. (2) Treasury market takes tapering talk in stride. (3) What's in Fed's inflation tool kit? (4) Western drought forcing tough decisions on the farm. (5) Keeping an eye on fruit and veggie prices. (6) With strong FQ-2, Deere says farmers doing great and buying equipment. (7) Fed studies digital dollar, while crypto financial ecosystem flourishes. (8) China's regulators cracking down on crypto trading and mining. (9) Lots of crypto banking services outside of the banking system. (10) DeFi even trickier for regulators to control. (11) Mark Cuban sees a future filled with smart contracts on the blockchain.

The Fed I: Tiptoeing to Tapering. Drip. Drip. Drip. Drip. Now we have four Fed officials talking about talking about tapering.

In Tuesday's *Morning Briefing*, Melissa and I observed that Dallas Federal Reserve Bank (FRB) President Robert Kaplan did so on April 30 and Philadelphia FRB President Patrick Harker did so on Friday, May 21. We can now add Fed Vice Chair Richard Clarida to the list: He told Yahoo! Finance in a Tuesday, May 25, morning *interview*, "[T]here will come a time in upcoming meetings we'll be at the point where we can begin to discuss scaling back the pace of asset purchases … I think it's going to depend on the flow of data that we get."

Clarida's comments were similar to those of FRB San Francisco President Mary Daly, who during a CNBC *interview* Tuesday afternoon said that the central bank's policymakers are "talking about talking about tapering" its bond-buying program. She said tapering planning was "not about doing anything now. … We need to be patient … data dependent … but very patient to let the volatility of the data come through."

One would think such comments would roil the bond market, but its recent action has surprised us. The 10-year Treasury bond yield has dropped 7bps since the last FOMC meeting on April 27-28 despite mounting talk about tapering. We discussed why this might be happening on Tuesday. Nevertheless, we continue to expect higher yields ahead.

The Fed II: Talking About Inflation. Fed officials mostly believe that the recent jump in inflation is transitory. They claim they have "tools" for bringing inflation down gently if necessary to avoid causing a recession. The only tool we can think of is raising the federal funds rate once they've finished tapering. In the past, monetary tightening has always led to a credit crunch and a recession. Their assurances aren't reassuring. Consider the following:

(1) *Clarida.* On Wednesday, May 12, Clarida *acknowledged* that he was surprised by April's jump in consumer prices but argued that the rise in inflation was likely to prove largely transitory. "Readings on inflation on a year-over-year basis have recently increased and are likely to rise somewhat further before moderating later this year," he told a meeting of the National Association for Business Economics. However, "I expect inflation to return to—or perhaps run somewhat above—our 2% longer-run goal in 2022 and 2023."

In his May 25 interview with Yahoo! Finance linked above, Clarida said, "And if in the risk case, the upward pressure on inflation were to prove to be more persistent and to put upward pressure on inflation expectations we have the tools and I'm convinced that we would act to counteract and bring inflation down to our long-run goal of 2%."

(2) *Brainard.* Federal Reserve Governor Lael Brainard on Monday, May 24, *said*, "I would expect those price pressures associated with reopening and bottlenecks to subside over time." She added, "An important part is that longer term inflation expectations have been extremely well anchored."

"If we did see inflation above our goals persistently … we have tools and experience to gently guide inflation back down to target," Brainard said. "No one should doubt our commitment to do so."

(3) *George.* But not all are completely convinced. Speaking late Monday, FRB Kansas City Esther George *noted* the "tremendous" amount of fiscal stimulus that has been pumped into the economy and said she is "not inclined to dismiss today's pricing signals or to be overly reliant on historical relationships and dynamics in judging the outlook for inflation."

Industrials: The Intensifying Western Drought. We discussed the West's megadrought and new water-saving technologies being used on the farm in the May 6 *Morning Briefing*. Since then, tales of farmers and ranchers making snap economic decisions to cope with the lack of water have made headlines. Here's a quick update:

(1) *Anecdotes from the farm.* The drought is forcing farmers to change their plans. A California

farmer bulldozed his older almond trees to save water to support his younger ones. In Southwest Colorado, a farmer planted only 130 acres of alfalfa instead of his usual 900 acres when water is plentiful. And Arizona water officials plan “painful” water cutbacks, outlined in an online *meeting* in April.

With no end in sight, the drought could start affecting prices at the grocery store. “California supplies two-thirds of the nation’s fruits and one-third of its vegetables,” a May 24 *Mercury News* *article* reported. Debbie reports that vegetable and fruit prices, up just over 3% y/y at both the consumer and producer levels, aren’t yet rising faster than the broader consumer or producer price indexes (*Fig. 1* and *Fig. 2*).

(2) *Fed is watching.* The impact of the drought even got a shout-out in a March 10 *report* by the San Francisco FRB. “According to the U.S. Drought Monitor, as of February 23, drought covered most of the land area in [the FRB’s district]. Drought was far less pronounced at the same time last year. Drier climate contributed to significant fire activity in the West during 2020. … Wildfire, as well as other climate-related shifts, pose ongoing financial and operational risks for bank offices, employees, and customers.”

The drought could also affect employment on the farm. “In 2014-2015, during the depths of the last drought, total farm-related losses in California totaled $5 billion and 20,000 farm hands lost their jobs, according to estimates by the Center for Watershed Sciences at the University of California, Davis,” a May 21 *WSJ* *article* reported.

(3) *Farmers elsewhere doing great.* Interestingly, Deere executives made no mention of the drought’s impact on farmers’ businesses or their machine purchasing decisions in the May 21 fiscal Q2 earnings *conference call*. Conversely, the company’s report was solidly bullish about the demand for Deere equipment. For the Q2 ending May 2, sales rose 30%, margins expanded, and adjusted net income jumped to $1.8 billion from $666 million a year earlier.

The company beat analysts’ consensus earnings estimate and raised its full-year earnings target. Analysts now forecast earnings will grow 84.2% this year and 16.5% in 2022 (*Fig. 3*).

Deere expects grain and oilseed consumption to outpace supply for a second consecutive year in 2021. US principal crop cash receipts are forecast to increase 30%, with higher commodity prices more than offsetting less government aid. US farmers are also benefitting from better market access and elevated exports to China. So they’re buying new equipment, leading the company to expect a multiyear cycle for agricultural equipment.

Deere is the only member of the S&P 500 Agricultural & Farm Machinery stock price index, which is up 156.3% y/y through Tuesday's close, making it the second best performing S&P 500 industry index that we follow, trailing only Copper (*Fig. 4*).

Disruptive Technologies: Regulators vs DeFi. Fed Governor Lael Brainard's May 24 *speech* about cryptocurrencies and the Fed's approach to developing a digital dollar made two things very clear.

First, regulators, as they are wont to do, are thoroughly studying the risks and benefits of developing a digital dollar. And while they study, the private market is leaving them in the dust. A huge ecosystem of private companies—located in the US and abroad—is facilitating cryptocurrency transactions worth billions of dollars outside the banking system, and the ecosystem is growing by leaps and bounds. In addition to trading cryptocurrencies, many companies facilitate international payments and lending against cryptocurrencies.

So it's not surprising that the large selloff in cryptocurrencies last week was partially attributed to margin calls that resulted in forced crypto sales. Bitcoin fell to a recent low of $36,922 on May 21 from the record high of $63,347 on April 15, a 42% drop compared with the S&P 500's 0.3% decline over the same time period (*Fig. 5*). Investors in Blue Chip stocks may not consider this their problem until investors in crypto currencies facing a margin call need to sell their Blue Chip stocks to raise cash. The Fed needs to get a move on.

Second, Brainard was clear that the Fed intends for the banking system to retain its central role even after a digital dollar is created. That approach runs completely counter to the goal of distributed finance, or "DeFi." The aim of DeFi networks is to eliminate the banking system, getting rid of the friction created by intermediaries. DeFi networks connect lenders directly to borrowers using a software-driven, rules-based system. Whether a Fed-designed system with banks at its core can co-exist or compete with a DeFi ecosystem is unclear. But the longer the Fed waits to roll out the digital dollar, the more competition it will face from the growing DeFi and cryptocurrency world.

Let's look at crypto DeFi markets and responses by US and Chinese regulators:

(1) *Introducing the crypto traders.* The world of crypto finance is much, much bigger than just the actual cryptocurrencies. As we wrote in the April 22 *Morning Briefing*, there's a whole world of small companies being created to provide banking services without the banking system. There are companies that use crypto in trading, lending, payments, and other financial services. Some look like traditional financial companies, but others use "dApps," which is short for "distributed

applications."

Because all these companies offer services over the Internet, they can be located anywhere. While some choose to adhere to know-your-customer rules, they are largely unregulated. Basic information about their ownership or financial standing isn't available on their websites. Yet billions of dollars in transactions occur on these systems. Many offer trading on margin or outright lending using cryptocurrencies as collateral.

The many larger companies include Singapore-based Bityard; BitMEX and Poloniex, headquartered in the Seychelles; and US-based Kraken. Binance Holdings is incorporated in the Cayman Islands and has an office in Singapore, but its CEO Changpeng Zhao tap dances around the question of where his company's headquarters is located in this May 8, 2020 Coindesk *interview*.

One exception is Coinbase Global. This US-based crypto trader is more transparent because it listed its shares on the Nasdaq in April. We can now see just how fast the company is growing. Its revenue jumped to $1.8 billion in Q1 from $585 million in Q4, while its net profit soared to $771 million in Q1 from $177 million in Q4.

(2) *DeFi trading eliminates the exchange.* When an investor trades on a crypto exchange like Coinbase, the cryptocurrency is typically held in a wallet over which Coinbase has control. Coinbase acts as a middleman. This goes against the decentralized ideals of cryptofinance. Enter DeFi—or peer-to-peer—trading. Decentralized exchanges allow traders to remain anonymous and control their cryptocurrency until they enter a trade using a smart contract based on blockchain technology.

An excellent May 24 *WSJ* *article* explained that DeFi exchange Uniswap doesn't have a central set of servers, making it impossible for regulators to shut down. And DeFi exchanges are growing fast. Monthly volume on decentralized exchanges jumped to $122.3 billion in April, up from $82.3 billion in March and only $1.1 billion in March 2020.

Entrepreneur/investor Mark Cuban sees smart contracts extending beyond crypto assets. A *WSJ* May 23 Opinion *column* quotes him saying, "Most people think they own the stock. They own the right to the stock. It's held in street name. It gets lent out to shorts and they don't collect the vig on the borrow. And then of course there is front running and payment for order flow and the fact that a share of stock doesn't truly convey the holder any real ownership rights. If every share or block of shares was an NFT [non-fungible token] then it all would be transparent." Using smart contracts, investors could directly control their shares and earn the income from stock lending. He predicts that smart contracts on blockchains, particularly Ethereum, are “an enormous game changer that every company will use.”

(3) *Crypto lending exists too.* Most of the crypto exchanges offer loans on crypto in trading accounts. There are also companies that offer loans based on crypto assets. And once again, there are DeFi lenders—like Aave, Compound, and Maker—that have created smart contracts for peer-to-peer lending using cryptocurrencies as collateral. Lenders are earning interest rates ranging 5%-10% or more.

Lenders on these DeFi systems don’t know who is borrowing, and they don’t care because the loan is collateralized by the cryptocurrency and managed according to the rules in the smart contract. Transactions happen in minutes.

The recent downdraft in bitcoin and other cryptocurrencies was accentuated by margin calls. “Bitcoin traders liquidated roughly $12 billion in levered positions last week as the price of the cryptocurrency spiraled, according to bybt.com. This mass exodus wiped out about 800,000 crypto accounts,” a May 25 CNBC *article* reported.

(4) *Chinese regulators clamp down.* All of these new cryptocurrency organizations provide regulators around the world with thorny problems. How can a US regulator track and punish platforms that can be located anywhere in the world and have a global reach? With all of these little firms providing margin and loans, how can regulators know how much leverage is in the system? If the crypto system replaces banking, how would central bankers boost or restrain the economy? Would monetary policies become toothless?

China’s response has been to shut down crypto trading. The regulators don’t like cryptocurrencies’ volatility, and they want to end cryptocurrency mining because it uses too much electricity. Left unsaid is the fact that cryptocurrencies erode the Chinese government’s control over its citizens and the financial system. Most recently, Chinese financial institutions were warned that they “shouldn’t accept virtual currencies for payment or provide services using them,” a May 19 *WSJ* *article* reported. That was followed by the government’s pledge to crack down on bitcoin mining and trading following a meeting led by Vice Premier Liu He. So far, however, citizens haven’t been prohibited from owning cryptocurrencies.

How successful Chinese regulators will be is unclear. “Cryptocurrency exchanges that operate offshore can be accessed by people in China using virtual private networks that bypass the country’s internet restrictions,” a May 24 *WSJ* *article* explained. Particularly tough to track are peer-to-peer transactions on DeFi systems because the transactions involve direct fund transfers between individuals who might be looking to buy or sell bitcoin using the yuan.

(5) *US regulators moving slowly.* In the US, the Biden administration's tax-enforcement plan released last week requires businesses receiving more than $10,000 in cryptocurrency to report the transactions, a May 21 *WSJ* *article* reported. Meanwhile, the US Federal Reserve is studying how to develop a central bank digital currency (CBDC). In her speech this week, Brainard noted that a CBDC "should complement and not replace currency and bank accounts. … CBDC would need to include safeguards to protect against disintermediation of banks and to preserve monetary policy transmission more broadly." The existence of an intermediary runs counter to the ideals of the DeFi crypto world.

Brainard noted that a first step toward creation of a CBDC is rolling out FedNow Service, which would allow all US banks to provide instant payment services around the clock every day of the year. But it's not scheduled to go into production for TWO years. That's insanely slow given the pace of financial innovation and growth in crypto transactions occurring in the private markets.

Brainard concluded by saying: "In light of the growing role of digital private money in the broader migration to digital payments, the potential use of foreign CBDCs in cross-border payments, and the importance of financial inclusion, the Federal Reserve is stepping up its research and public engagement on a digital version of the U.S. dollar." May we suggest they up the urgency?

Calendars

US: **Thurs:** GDP & GDP Price Deflator 6.5%/4.1%, Corporate Profits, Initial & Continuous Jobless Claims 425k/3.75m, Durable Goods Orders 0.9%, Pending Home Sales 0.8%, Quarles. **Fri:** Personal Income & Spending -14.0%/0.5%, PCED Core Inflation 2.9% y/y, Consumer Sentiment 82.9, Merchandise Trade Balance Advance Estimate Chicago PMI 68.0, Baker-Hughes Rig Count. (DailyFX estimates)

Global: **Thurs:** Eurozone Business Climate Index, Germany Gfk Consumer Confidence -5.2, Italy Consumer & Business Confidence 104.4/106.4, Japan Unemployment Rate 2.7%, Weidmann, Schnabel, Guindos, Vlieghe. **Fri:** Eurozone Economic Sentiment 112.1, Eurozone Consumer & Economic Sentiment -5.1/11.3, France GDP 0.4%, France CPI 1.4% y/y. (DailyFX estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) fell this week for the fourth time in five weeks, to 3.07 from 3.81 five weeks ago, as bullish sentiment fell 12.2ppts (to 51.5% from 63.7%) over the period. There was a stampede of bulls to the correction camp, which rose 12.1ppts (to 31.7% from 19.6%) over the period. Meanwhile, bearish sentiment slipped to 16.8% this week from 17.2% in each of the prior two weeks; it's been fluctuating in a narrow band between 16.5% and 17.2% the past eight weeks. The AAII Ratio continued its up-and-down pattern (prevalent since early March), rising to 58.5% last week after falling the prior week from 65.7% to 57.5%. Bullish sentiment climbed to 37.0% last week, while bearish sentiment slipped to 26.3%.

MSCI World & Region Net Earnings Revisions (*link*): Analysts' recent earnings revisions through May continue to suggest substantially greater optimism about profits in the US than the rest of the world. Most regions, with the exceptions of EM Asia and EM, are at multi-year or record highs now. The US's NERI was positive in May for a tenth straight month after 14 negative readings, and surged to a 13-year high of 19.0% from 12.7%. May's monthly reading is the third highest on record dating back to 1988, and just below the corporate tax-cut boosted record high of 21.8% during March 2018. That compares to an 11-year low of -36.9% in May 2020. The AC World ex-US MSCI's NERI was positive for a seventh month after 30 straight negative readings and at its highest level since November 2009 as it improved to 6.1% from 5.5%. That compares to an 11-year low of -23.9% in May 2020. With the exception of the EMU, which had NERI turn positive in January, much of the world's regions have had positive NERI readings since September and October. Here are May's scores among the regional MSCIs: US (19.0% in May [38-month high], up from 12.7% in April), Europe ex-UK (13.0 [record high], 6.5), Europe (12.1 [record high], 6.0), EMU (11.3 [15-year high], 4.4), EM Eastern Europe (10.3 [16-year high], 6.7), EAFE (10.0 [record high], 7.0), AC World (9.5 [record high], 7.4), EM Latin America (7.8 [record high], 3.3), AC World ex-US (6.1 [12-year high], 5.5), Emerging Markets (3.1, 4.4), and EM Asia (2.6, 4.1).

MSCI Countries Net Earnings Revisions (*link*): NERI was positive for 38/44 MSCI countries in May. That matches the record high count from November 2009 and is up from 33 during March and April. That also compares to zero countries with positive NERI from April to June 2020. NERI improved m/m in May for 33/44 countries, up from 29/44 countries improving in April. Among the countries with improving NERI in May, six were at record highs: Argentina, Canada, Hungary, Ireland, Switzerland, and Taiwan. Nineteen other countries were at multi-year highs dating back to 1996. The US and the following five countries has had positive NERI for ten straight months: Canada, Korea, Norway, Sweden, and Taiwan. The Philippines and Portugal have the worst negative-NERI streaks at 16 months. Spain's NERI turned positive for the first time in 34 months and Israel's for the first time in 16 months. China's turned negative in May for the first time in 10 months. The highest NERI readings in May: Argentina (29.7%), Hungary (28.0), Austria (26.8), Sweden (23.9), and Ireland (23.2). The weakest NERIs occurred this month in New Zealand (-23.9), Portugal (-5.7), the Philippines (-4.9), Indonesia (-2.8), China (-0.3), and Greece (-0.2).

AC World ex-US MSCI (*link*): This index has risen 2.0% in dollar terms so far in May and is up 7.9% ytd. In local-currency terms, the index is up a lesser 0.9% in May to a higher 8.2% gain for 2021 to date. Local-currency forward revenues has risen 3.8% since it bottomed in late January, but remains 9.3% below its record high of May 2019. Local-currency forward earnings has jumped 31.4% since it bottomed in late July, but remains 3.8% below its record high of October 2018. Revenues are expected to rise 11.6% in 2021 and 5.6% in 2022 following a decline of 6.3% in 2020, and earnings are expected to increase 40.4% (2021) and 10.2% (2022) after falling 13.8% (2020). The industry analysts' sales forecasts imply short-term 12-month forward revenue growth (STRG) of 9.1% and short-term 12-month forward earnings growth (STEG) of 24.3%, compared to 4.1% and 10.0% before Covid-19 hit the news. These measures bottomed at -0.1% and -0.3%, respectively, during May 2020. The profit margin implied by analysts' earnings and revenue estimates calls for a gain to 8.5% in 2021 from 6.7% in 2020, and an increase to 8.9% in 2022. The forward profit margin forecast of 8.6% is up from a 10-year low of 6.6% at the end of May but remains below its 9.0% record high in September 2007. The Net Earnings Revision Index (NERI) for the AC World ex-US MSCI was positive in May for an eighth straight month following 30 negative readings. It improved to a 12-year high of 6.1% from 5.5% in April, which compares to an 11-year low of -23.9% in May 2020. The forward P/E of 15.5 remains close to its 12-month low of 15.4 a week earlier and is down from an 18-year high of 17.1 in mid-February. The forward P/E drops to 14.8 using normalized forward earnings. Those readings are up from their March 2020 lows of 10.8 and 10.2, respectively. The index's current 16% discount to the World MSCI P/E remains near a record low.

Emerging Markets MSCI (*link*): The EM MSCI price index has dropped 0.2% in US dollar terms so far in May to a gain of 4.2% ytd. In local-currency terms, EM is down a tad more 0.7% in May but is up a greater 4.5% ytd. Local-currency forward revenues has risen 4.4% since its bottom in late January but is still down 10.4% from its record high in May 2019. Local-currency forward earnings is up 32.30% since its bottom in mid-June and now exceeds it prior record high from October 2018 by 2.3%. Revenues are expected to rise 15.6% in 2021 and 8.2% in 2022 after falling 1.4% in 2020. That's expected to lead to an earnings gain of 46.8% in 2021 and 10.9% in 2022, following a 3.8% drop in 2020. Forecasted STRG pf 12.4% is near an 11-year high, up from a five-year low of 3.6% at the end of April 2020. STEG has dropped to 27.7% from a record high of 33.7% in December, but that's up from a 14-month low of 7.5% in April 2020. The implied profit margin is expected to rise from 6.2% in 2020 to 7.9% in 2021 and 8.1% in 2022. The forward profit margin of 8.0% is up from a four-year low of 6.1% at the end of May 2020 and compares to its 10.3% record high in December 2007. NERI was positive in May for a ninth month after 30 straight negative readings, but is down to a six-month low of 3.1% now from an 11-year high of 6.0% in February. That compares to an 11-year low of -18.7% in May 2020. Emerging Markets' forward P/E of 13.8 is up a tad from a 12-month low of 13.7 a week earlier, but is down from a record high of 16.3 in mid-February. The P/E drops to 13.1 using normalized forward earnings. That's up sharply from those figures' March 2020 lows of 10.1 and 9.3, respectively. The index is trading at a 25% discount to the World MSCI P/E, which is in line with its discount since 2013.

China MSCI (*link*): The China MSCI price index has dropped 1.2% in US dollar terms so far in May to a decline of 0.4% ytd. In local-currency terms, China is down a tad greater 1.4% in May and 0.5% ytd. Local-currency forward revenues has risen 3.0% since its bottom in early April but is still down 35.3% from its record high in October 2014. Local-currency forward earnings is up 11.4% since its bottom in June 2020, but remains 8.4% below its record high in June 2018. Revenues are expected to rise 15.7% in 2021 and 10.0% in 2022 after zero growth in 2020. That's expected to lead to an earnings gain of 16.4% in 2021 and 17.1% in 2022, following a surprising 3.8% gain in 2020. Forecasted STRG of 13.2% remains near an 11-year high, up from a five-year low of 5.0% at the end of April 2020. STEG has dropped to 16.0% from a 10-year high of 18.6% during December, but that's up from a four-year low of 8.0% in April 2020. The implied profit margin ranks as one of the lowest in the world, is expected to remain unchanged y/y at 5.1% in 2021 and to rise to 5.3% in 2022. The forward profit margin of 5.1% is down a tad from its record high 5.2% in early March, but that's up from a pandemic-low of 4.5% in May 2020. NERI dropped to -0.3% in May from 0.5%. That was its first negative reading in 10 months and ranked fifth worst among the 44 MSCI countries that we follow. China's forward P/E of 15.2 drops to 14.1 using normalized forward earnings. That's up sharply from those figures' March 2020 lows of 10.5 and 9.8, respectively. The index is trading at a 17% discount to the World MSCI P/E, which is in line with its discount since 2013.

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