



MORNING BRIEFING

June 14, 2021

The Greatest Punchbowl on Earth

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

(1) Conundrum in the bond market. (2) Powell's mantra. (3) The future of ZIRP. (4) Japanese yields vs the copper/gold ratio. (5) A second month of base affected CPI gains. (6) Tsunami of liquidity. (7) Banks drowning in deposits, while loan demand is weak. (8) Overnight repos at the Fed. (9) Buddy, can you spare a muni? (10) Tipsy. (11) Taxing jobless benefits. (12) Tug-of-war between the Fed and inflation. (13) Are the Bond Vigilantes dead again already or just taking a siesta? (14) Movie review: "Halston" (+ + +).

YRI Podcast. In our latest, 15-minute video [podcast](#), Dr. Ed discusses the main points of today's *Morning Briefing*.

Bonds I: The Conundrum, Again. In my recent Zoom calls with some of our accounts, everyone seems to be worrying about inflation. In addition, everyone has been amazed by the "bond conundrum"—i.e., the puzzling fact that the 10-year US Treasury bond yield has remained remarkably subdued despite the recent surge in inflation and ballooning federal deficits. The yield rose from 0.93% at the start of this year to peak at 1.74% on March 19 ([Fig. 1](#)). On Friday, it was back down to 1.47% notwithstanding the big jumps in April's CPI (up 4.2% y/y released on May 12) and May's CPI (5.0%, released on June 10).

Melissa and I have been discussing several explanations for the conundrum in recent weeks. Allow us to update our discussion:

(1) *Powell's mantra.* Bond investors may be drinking the spiked Kool-Aid in the punchbowl set out by Fed Chair Jerome Powell. He certainly has been waving them over to it: His mantra has been that the Fed won't even start "talking about talking about" tapering its bond purchases until he sees "substantial further progress" toward "broad-based and inclusive maximum employment." And he repeatedly has said that the federal funds rate won't be raised for a long period after tapering is completed.

(2) *ZIRP forever?* The yield curve spread between the bond yield and the federal funds rate has widened to 135bps currently from last year's low of -61bps on March 3. During past

economic expansions, it has tended to widen to about 300bps. It may not widen further for the time being since bond investors anticipate no hikes in the federal funds rate over the foreseeable future ([Fig. 2](#)). That is, they may be assuming that zero interest-rate policy (ZIRP) is here to stay, for now.

(3) *Near-zero foreign yields.* While the copper/gold price ratio continues to signal that the yield should be closer to 2.50% than to 1.50%, the gravitational pull of near-zero government bond yields in Germany and Japan may also be keeping the US yield from rising ([Fig. 3](#) and [Fig. 4](#)).

By the way, the reason that the copper/gold price ratio has tracked the bond yield so closely in the past is that the price of copper is very highly correlated with a proxy for expected inflation: the yield spread between the 10-year nominal bond and the comparable TIPS ([Fig. 5](#)). Meanwhile, the price of gold is highly correlated with the inverse of the 10-year TIPS yield. We like to think of it as a risk-on versus risk-off indicator. ([Fig. 6](#)). Notwithstanding the recent jump in inflation, the expected-inflation proxy edged down from a recent peak of 2.54% on May 17 to 2.32% on Friday.

(4) *The base effect.* It was widely noted that May's higher-than-expected CPI report, like April's, mainly reflected "base-effect" increases—from unusually depressed prices a year ago owing to the pandemic—in some CPI components, including used car prices, car rental fees, hotel and motel charges, and airline fares. That's true; but over the next few months, Debbie and I expect to see signs that inflationary pressures are broader based, reflecting rapidly rising labor costs. Furthermore, the recent jobless claims data suggest to us that payroll employment will be rising at a faster pace in coming months. Nevertheless, the bond market's surprisingly benign reaction to both CPI numbers suggests that investors are content to keep sipping Powell's punch for now.

Bonds II: Tsunami of Liquidity. In our opinion, the most likely explanation of the bond conundrum is that the Fed continues to flood the financial system with a tsunami of liquidity. Consider the following:

(1) *Massive cash flow into deposits.* The Fed's \$3.0 trillion in bond purchases last year and \$120 billion per month so far this year have been drowning commercial banks with deposits ([Fig. 7](#)). Since the March 23 week of 2020 through the June 2 week of this year, the Fed has purchased \$3.4 trillion in securities. That—along with the three rounds of pandemic relief checks that the Treasury sent to most Americans and the large infusion of cash it supplied to support the airline industry and municipalities—caused commercial bank

deposits to increase \$3.3 trillion over the same period ([Fig. 8](#)).

(2) *Weak loan demand*. However, business loan demand is weak because corporations raised a record \$1.4 trillion in the bond market last year during the pandemic when the Fed backstopped the corporate bond market and corporate bond yields fell to record lows ([Fig. 9](#)). We previously estimated that half the funds were used to refinance outstanding debt and that a good chunk of the rest has financed a capital spending boom, leaving enough left over to pay down bank loans. Over the past 52 weeks through the June 2 week, US commercial banks' commercial and industrial loans collectively is down \$450 billion, while their holdings of US Treasury and agency securities is up \$895 billion ([Fig. 10](#)). The banks have had no choice but to put much of their deposit inflows into securities rather than loans.

(3) *Treasury writing checks*. The Treasury's general account balance at the Fed has dropped by \$940 billion since the start of this year, from \$1,670 billion to \$730 billion, as deficit-financed (and Fed monetized) funds for pandemic relief have been dispersed ([Fig. 11](#)).

(4) *Overnight at the Fed*. To avoid earning negative returns in money market instruments, money market funds have been forced to invest in the zero yield they can get on overnight reverse repurchase agreements offered by the Fed ([Fig. 12](#)).

The June 9 *WSJ* [reported](#) that "some banks, awash in deposits, are encouraging corporate clients to spend the cash on their businesses or move it elsewhere." Banks have focused on moving clients from deposits into money-market funds. "The money-market funds, in turn, need new places to park all that new cash and earn some interest. But rock-bottom interest rates have pushed them into storing it back at the Federal Reserve overnight, in a facility that pays them zero return and had been largely ignored for the past three years."

Bloomberg [reported](#) on June 9 that demand "for a key Federal Reserve facility used to help control short-term rates surged to more than half a trillion dollars for the first time ever, accommodating a barrage of cash in search of a home. ... Even though the offering rate on the Fed facility is 0%, demand has been increasing as a flood of cash overwhelms U.S. dollar funding markets. That's in part a result of central-bank asset purchases and drawdowns of the Treasury General Account, which is pushing reserves into the system. At the same time, regulatory constraints are also spurring banks to turn away deposits and direct that cash to money-market funds."

(5) *Muni shortage*. On June 10, Bloomberg [reported](#) that the supply of municipal securities

has dried up. “The amount of debt changing hands in the secondary market has become unusually thin, with investors holding on to their bonds ... Tax-exempt bonds have been heavily in demand this year, in part because of President Joe Biden’s push to raise income taxes on the wealthiest Americans.” The AAA-rated muni bond yield composite is back down near last year’s record lows of around 1.00%.

(6) *Foreigners and pension funds.* The June 11 *WSJ* [reported](#) “recent Treasury bond auctions have seen an uptick in demand from foreign investors. A 5-year debt sale on May 26 received the most bids from overseas investors since August at over 64%. A 7-year issuance in the same week saw the most since January.” The latest data from the US Treasury department show that major foreign investors upped their holdings of longer-maturity US government bonds in March ([Fig. 13](#)).

Furthermore, the *WSJ* reported: “Another source of money flowing into Treasuries has been pension funds. Strong rallies in riskier assets, like stocks, in recent months helped to close the shortfall many funds have between the value of their assets and their liabilities, allowing them to move cash into safer assets, like bonds.”

(7) *Bottom line.* The Fed has flooded the financial system and economy with liquidity, contributing to a demand shock and inflationary pressures while pushing the bond yield down from its recent peak of 1.69% on May 12 to 1.47% on Friday.

Bonds III: Fed Is Getting Mighty Tipsy. The Treasury securities that the Fed has purchased in connection with its unconventional quantitative easing programs—from QE1, QE2, and QE3 to QE4ever—have distorted the pricing mechanism in the fixed-income markets. That’s been especially true since March 23, 2020, when the Fed implemented QE4ever and aggressively purchased Treasury notes and bonds. Let’s say all that was necessary to get us through the pandemic. Why then, the question becomes, has the Fed also been buying TIPS aggressively since the pandemic began?

Since February 2020 through May of this year, the Treasury has issued \$79 billion in TIPS ([Fig. 14](#)). Over the same period, the Fed purchased \$210 in these securities. As a result, the Fed’s holdings increased from 8.7% of total TIPS outstanding to 21.4% over this period ([Fig. 15](#)).

The Treasury first issued TIPS to allow individual and institution investors to be protected against inflation. By buying up TIPS itself, the Fed not only is distorting the pricing mechanism in this segment of the fixed-income bond market but also is depriving investors

of a significant portion of the TIPS outstanding available for purchase. The yield on the 10-year TIPS fell from 0.15% at the start of 2020 to -0.85% on Friday ([Fig. 16](#)). The Fed's purchases clearly contributed to that decline and probably also boosted the expected-inflation proxy in TIPS market ([Fig. 17](#)).

Bonds IV: Good News on the Fiscal Front, Sort of. The Treasury released its May budget report last Thursday. Hip, hip, hooray: The 12-month budget deficit narrowed from a record \$4.09 trillion through March to \$3.32 trillion through May ([Fig. 18](#)). The big surprise was the big increase in individual income tax receipts from a 12-month sum of \$1.66 trillion through March to \$2.04 trillion through May ([Fig. 19](#)). That's a new record high and \$279 billion above the pre-pandemic record high last March!

How is that possible when 9.3 million Americans are still unemployed and payroll employment is still 7.6 million below its pre-pandemic record high? The only explanation we can come up with is that individual income tax receipts were boosted by the pandemic-related spike in unemployment insurance benefits, which are taxable. In other words, the federal government giveth and taketh some back.

Bonds V: Tug-of-War. So where does the bond market—stuck in the middle of a fierce tug-of-war between the Fed's inflation outlook and what inflation is doing—go from here? The Fed will win if inflation moderates in coming months as the base effect wears off. If that happens, then its tapering of asset purchases will start later and be slower and its hiking of the federal funds rate will be even later and even slower than that. That seems to be the scenario the bond market is telegraphing. However, be warned: The bond market's pricing mechanism is broken, because it isn't really a free market given the Fed's ongoing and heavy-handed intervention.

While we agree with the Fed's party line on the likely transitory nature of inflation, we think it might run hotter and last longer than Fed officials seem to expect. That's because they believe that the recent flare-up in inflation is mostly caused by the base effect as prices this year rebound from pandemic-depressed year-ago levels. They also dismiss widespread shortages as temporary and likely to end once supplies catch up with the surge in demand attributable to the reopening of the economy. Furthermore, as the pent-up demand is met, demand and supply will come back into balance, they maintain, such that price inflation should cool off quickly.

Kind of makes sense. However, there are countervailing factors at play too. As we noted above, we expect that inflationary pressures could be more widespread in coming months,

reflecting rising labor costs and persistent order backlogs related to the shortage of labor. Also, as we've recently discussed, we see more upward pressure building on food and energy prices and on rents. But in coming years, we still expect that current inflationary pressures will dissipate as productivity growth continues to improve during the Roaring 2020s.

Now let's review some of the latest developments on the inflation front and the Fed's likely response to them:

(1) *Barber of Locust Valley*. The most important recent development on the inflation front is that my local barber just raised his price for a haircut by 30% from \$20 to \$26. The increase isn't a base effect, since he didn't lower his prices during the lockdowns last year. The CPI index for haircuts and other personal services rose 5.1% y/y through May ([Fig. 20](#)). That's up from 3.3% at the start of 2020, just before the pandemic. By the way, this inflation index is highly correlated with the yearly percent change in average hourly earnings (AHE), which has been distorted by the pandemic. However, AHE is up 4.4% (saar) over the past three months and going higher.

(2) *CPI base-effect categories*. The 3-month percent change in the CPI at an annual rate through May was 8.2%. A year ago, it was -4.5%. The jump was dominated by categories that probably tended to have a big base effect. Here are the major outliers' latest 3-month annualized increases through May of this year and last year: gasoline (27.4%, -122.2%), lodging away from home (48.9, -49.6), airfares (73.5, -116.2), car & truck rentals (182.2, -90.4), used cars & trucks (74.8, 0.0), and household furniture & bedding (23.7, -7.6).

(3) *CPI rent*. Rent has a big weight in the CPI. It was depressed a year ago, as many urban renters rushed to become suburban homeowners. But home prices have soared 20% over the past year, likely causing many of the renting would-be homeowners to keep renting. Rent inflation is also highly correlated with wage inflation, which is picking up. Here are the 3-month annualized inflation rates now and a year ago for tenant rent (2.4%, 2.9%) and owners' equivalent rent (3.0%, 2.7%) ([Fig. 21](#)).

(4) *Dot plot*. The dot plot in December's FOMC's quarterly Summary of Economic Projections (SEP) showed that only one Fed official thought a rate increase would be appropriate for 2022. But the latest SEP, for March, showed that four Fed officials thought so. We expect to see continued drifting of the dots to 2022 at the next update, for the June 15-16 meeting. Keep in mind, however, that the SEP does not include a prediction about tapering bond purchases. For that, we need to listen to Powell's post-meeting press

conference. We expect him to say that the FOMC has started to talk about tapering.

Bonds VI: Vigilantes RIP—Again? It's a fun and funny business we are in. When the bond yield was rising earlier this year, I was often asked if the Bond Vigilantes are back from the dead. I said "yes." Now that the yield has declined in recent weeks despite the surge in the CPI, I am often asked if they are dead again. I say "no." Rather than fight the Fed, I think they are taking a siesta. The adage "Don't fight the Fed" applies to the bond market as much as the stock market. They are likely to be back once the Fed starts tapering.

Movie. "Halston" (+ + +) ([link](#)) is a Netflix biopic series about the American fashion designer who rose to international fame in the 1970s. His first big hit was the pillbox hat he designed for Jacqueline Kennedy, who wore it to the inauguration of her husband, President John F. Kennedy, in 1961. His designs were usually simple--minimalist yet sophisticated, glamorous, and comfortable at the same time. During the 1980s, his lifestyle was much more complex, full of s*x, dr*gs, and rock & roll. He was a regular at Studio 54 with his BFFs Liza Minnelli, Bianca Jagger, Joe Eula, and Andy Warhol. The script is very well written. And the cast is superb, with an outstanding performance by Ewan McGregor as Halston.

Calendars

US: Mon: None. **Tues:** Retail Sales Total, Ex Autos & Gas, and Control Group -0.8%/0.3%, Headline & Core PPI 6.3%/4.8% y/y, Empire State Manufacturing Index 22.0, Headline & Manufacturing Industrial Production 0.6%/0.5%, Capacity Utilization 75.0%, Business Inventories -0.1%, NAHB Housing Market Index 83, API Oil Inventories. (Bloomberg estimates)

Global: Mon: Eurozone Industrial Production 0.4%/m/m/37.4%/y/y, Japan Industrial Production, RBA Meeting Minutes. **Tues:** Eurozone Trade Balance Germany CPI 0.5%/m/m/2.5%/y/y, France CPI 0.1%/m/m/1.4%/y/y, Italy CPI 0.0%/m/m/1.3%/y/y, UK Employment Change & Unemployment Rate 150k3m/3m/4.7%, Japan Headline & Core Machinery Orders 8.0%/2.7%China FDI, Bailey. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance ([link](#)): Last week saw the US MSCI index rise 0.6% for its third straight weekly gain. The US ranked 22nd of the 49 global stock markets that we follow in a week when 26 of the 49 countries rose in US dollar terms, and the AC World ex-US index rose 0.2% as most regions moved higher for a fourth week. EM Eastern Europe was the best-performing region last week with a gain of 1.2%, ahead of EMEA (0.9%), EMU (0.6), and EAFE (0.3). EM Latin America was the biggest underperformer with a drop of 0.7%, followed by BRIC (-0.3) and EM Asia (0.1). Turkey was the best-performing country last week, with a 6.3% gain, followed by Jordan (3.3), Israel (3.1), Thailand (2.5), and Greece (2.4). Peru was the worst performer with a decline of 12.4%, followed by Egypt (-4.6), South Africa (-2.5), Poland (-2.3), and Austria (-1.6). EM Eastern Europe is the top-performing region so far in 2021 with a gain of 18.4%, ahead of EMEA (17.4), EMU (14.0), the US (12.4), EAFE (10.2), and the AC-World ex-US (9.9). The following regions are lagging, albeit with gains: BRIC (4.2), EM Asia (5.4), and EM Latin America (7.9). The top-performing countries ytd: Austria (27.9), Jordan (26.1), the Czech Republic (25.0), Hungary (22.7), and Canada (21.3). The biggest laggards of 2021 so far: Colombia (-16.5), Turkey (-16.4), Egypt (-16.0), New Zealand (-15.5), and Peru (-14.5).

S&P 1500/500/400/600 Performance ([link](#)): All three of these indexes rose for a third week. LargeCap gained 0.4% for the week, behind the increases for SmallCap (0.9%) and MidCap (0.9). LargeCap ended the week at a record high for the first time in five weeks. MidCap and SmallCap ended the week 0.7% and 1.3% below their respective record highs on May 7 and March 12. Twenty-one of the 33 sectors were higher for the week, down from 24 a week earlier. SmallCap Real Estate rose 3.9% in the best performance for the week, followed by SmallCap Health Care (3.4), MidCap Health Care (3.4), MidCap Real Estate (3.3), and SmallCap Utilities (2.7). LargeCap Financials (-2.4) was the worst performer, followed by LargeCap Materials (-2.0), LargeCap Industrials (-1.7), and MidCap Financials (-1.3). SmallCap continues to lead so far in 2021 with a gain of 24.8%, ahead of both MidCap (19.3) and LargeCap (13.1). All 33 sectors are higher ytd, paced by these best sector performers: SmallCap Energy (83.9), MidCap Energy (58.2), SmallCap Consumer Discretionary (47.4), LargeCap Energy (44.5), and MidCap Materials (32.8). The biggest laggards so far in 2021, albeit with gains: MidCap Communication Services (3.5), LargeCap Consumer Staples (4.5), LargeCap Utilities (4.7), LargeCap Consumer Discretionary (6.6), and MidCap Tech (7.2).

S&P 500 Sectors and Industries Performance ([link](#)): Six of the 11 S&P 500 sectors rose last week, and six outperformed the composite index's 0.4% gain. That compares to a 0.6%

rise for the S&P 500 a week earlier, when nine sectors rose and five outperformed the index. Real Estate rose 2.0% for the biggest gain of the week, ahead of Health Care (1.9%), Consumer Discretionary (1.6), Tech (1.4), Utilities (1.1), and Communication Services (0.8). The worst performers this week: Financials (-2.4), Materials (-2.0), Industrials (-1.7), Consumer Staples (-0.7), and Energy (-0.6). With respect to 2021's performance, the S&P 500 has risen 13.1% so far, with all 11 sectors higher ytd and six beating the broader index. The leading sectors so far in 2021: Energy (44.5), Financials (26.9), Real Estate (24.4), Materials (18.4), Communication Services (17.6), and Industrials (16.5). This year's laggards to date, albeit with gains: Consumer Staples (4.5), Utilities (4.7), Consumer Discretionary (6.6), Tech (8.7), and Health Care (9.4).

S&P 500 Technical Indicators ([link](#)): The S&P 500 rose 0.4% last week, but weakened slightly relative to its 50-day (50-dma) and 200-day moving averages (200-dma). It was above its 50-dma for a 15th week after dropping below for a week at the end of February for only the second time since early November. It was above its 200-dma for a 50th straight week last week after being below for 13 weeks through late May. The S&P 500's 50-dma rose last week for a 32nd week after falling for a week at the end of October for the first time in six months. However, the price index ticked down to 1.9% above its rising 50-dma from 2.0% a week earlier and is down from its 19-week high of 5.8% during mid-April. That compares to 0.1% below its rising 50-dma around the end of February and is down from a 13-week high of 6.0% above its rising 50-dma in mid-November. The index mostly has been trading above its 50-dma since late April 2020; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index was above its 200-dma for a 50th week, but down less than 0.1ppt to 12.0% above its rising 200-dma. That compares to a 14-week high of 15.4% in mid-April and a 17-week low of 9.7% above at the end of February. It's down from 17.0% above in early December, which was the highest since November 2009 and up from the 26.6% below registered on March 23—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008.

S&P 500 Sectors Technical Indicators ([link](#)): Ten S&P 500 sectors traded above their 50-dmas last week, up from nine a week earlier. Utilities moved above its 50-dma after two weeks below, and Consumer Discretionary was below its for a fifth straight week. That's down from all 11 sectors above at the beginning of May and compares to just four above at the end of January. All 11 sectors had a rising 50-dma for a third straight week. Energy's 50-dma turned back up several weeks earlier after dropping below for one week and for the

first time since early November. That compares to just six sectors with a rising 50-dma in mid-March, which had been the lowest count since early November. Looking at the longer-term 200-dmas, all 11 sectors traded above them for a 14th week. During April 2020, just one sector (Health Care) was above its 200-dma. All 11 sectors have had rising 200-dmas for the past 14 weeks. Energy's 200-dma finally turned higher in mid-December after mostly falling since October 2018.

US Economic Indicators

Consumer Sentiment Index ([link](#)): Consumer sentiment rebounded in mid-June, recouping two-thirds of May's decline, driven by a jump in expectations—with middle- and upper-income households leading the gain. The Consumer Sentiment Index climbed to 86.4, back near April's 13-month high of 88.3. The expectations component leaped 5.0 points to a 16-month high of 83.8, as an all-time record number of consumers expect a net decline in unemployment; it was at 92.1 just before the pandemic hit. The present situation component was little changed at 90.6 in mid-June after dropping 7.8 points in May from June's 13-month high of 97.2. Meanwhile, inflation remained a concern, though both the one-year (to 4.0% from 4.6%) and five-year expected inflation (2.8 from 3.0) rates eased a bit this month after reaching decade highs in May. According to the report, "Spontaneous references to market prices for homes, vehicles, and household durables fell to their worst level since the all-time record in November 1974." However, it notes that consumers are temporarily less sensitive to prices due to pent-up demand, record savings, and improved job and income prospects.

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