MORNING BRIEFING
July 13, 2021

Yielding to the Central Banks

Check out the accompanying chart collection.

(1) Lots of central banks filling up the punch bowl. (2) PBOC cuts reserve requirement to boost bank lending. (3) Lots of punch for global stock and bond markets. (4) The Fed is TIPSy. (5) Bond yields are unreal, as even junk yields fall below inflation rate. (6) S&P 500 dividend yield falls below 2.00% on the way to 1.00%. (7) Millions more S corporations than S&P 500 corporations. (8) S corporations boosting corporate profits but not corporate taxes. (9) A new study on profits.

Bonds I: Punch Bowl for All. The Fed isn't the only central bank pouring liquidity into the punch bowl to keep the party going. Since the week of March 6, just before the World Health Organization officially declared the Covid-19 pandemic on March 11, through the last week of June of this year, the combined assets of the Fed, the ECB, and the BOJ rose a staggering $8.9 trillion to a record $23.9 trillion (*Fig. 1*). Over this same period, the assets of the three central banks are up as follows: Fed ($3.8 trillion), ECB ($4.1 trillion), and BOJ ($1.0 trillion) (*Fig. 2*).

China's PBOC added some punch on Friday, announcing it would cut its reserve requirement ratio by 0.5ppt on July 15, the first cut since April 2020, when Beijing loosened its monetary policy to stimulate China's pandemic-hit economy (*Fig. 3*). This action will unleash $154 billion worth of liquidity into the domestic banking system.

The PBOC is encouraging lenders to step up loans to the nation's small businesses. In June, China's bank loans, in dollars, rose $369 billion m/m and $5.6 trillion y/y. Chinese bank loans first matched US bank loans at $6.6 trillion during July 2010. Since then through June, US bank loans are up $3.7 billion to $10.3 trillion, while Chinese bank loans are up a whopping $22.3 trillion to a record $28.9 trillion (*Fig. 4*).

Everyone around the world is welcome to drink from the punch bowl. As a result, the All Country World MSCI stock price index continues to closely track the balance sheets of the big three central banks (*Fig. 5*). There has been some chatter about the possibility of central banks tapering their purchases of bonds but no commitment by any of them to actually do so. As a result, the German 10-year government bond yield remains slightly negative, and the comparable Japanese yield remains around zero (*Fig. 6*).

In the US, the 10-year US Treasury bond yield peaked this year at 1.74% on March 31. It was down to 1.37% on Friday of last week. The Fed's $120-billion-per-month purchases of bonds and the gravitational pull of around-zero yields in the Eurozone and Japan seem to be offsetting any concerns about inflation and tapering in the US. The 2-year US Treasury bond yield tends to be a good year-ahead predictor of the federal funds rate (*Fig. 7*). It jumped to this year's high of 0.28% on June 25 but fell as low as 0.19% last Thursday, before ticking up on Friday.

The Fed has also been buying inflation-indexed notes and bonds. Its holdings of TIPS have increased by $222 billion since the March 4, 2020 week to a record $353 billion during the July 7 week (*Fig. 8*). During June, the Fed held 21.4% of outstanding TIPS, up from 8.7% during February of last year (*Fig. 9*). The Fed's purchases may be distorting the signal provided by the widely used proxy for the 10-year expected inflation rate. The yield spread between the 10-year bond and the comparable TIPS peaked this year at 2.54% on May 17 (*Fig. 10*). It was down to 2.28% on Friday.

Bonds II: Unreal Yields. The major central banks have distorted not only nominal bond yields but also real bond yields. The spread between the nominal 10-year US Treasury bond yield and the core PCED inflation rate, on a y/y basis, dropped to -1.77% during May, the lowest since March 1975 (*Fig. 11*). The nominal yield on high-yield corporate bonds fell to just 3.95% on Friday (*Fig. 12*). During May, the PCED headline and core inflation rates were 3.9% and 3.4%, while the CPI headline and core inflation rates were 5.0% and 3.8%.

The July 9 *WSJ* included an *article* titled "Junk-Bond Rally Pulls Yields Below Inflation." The story observed: "A rally in corporate debt rated below investment grade has pushed yields to record lows around 4.57%, according to ICE Bank of America data through Thursday, while consumer prices rose 5% in May compared with a year earlier. That marks the first time on record junk-bond yields have dropped below the rate of inflation, according to Bespoke Investment Group."

Equities I: Falling Dividend Yields. Standard & Poor's released Q2 data for S&P 500 dividends last week. The total edged down to $123.2 billion (*Fig. 13*). But that was up 3.9% y/y. The record high was $127.0 billion during Q1-2020. During Q2-2021, the dividend yield fell to 1.35%, the lowest since Q2-2001 and approaching Q1-2000's record low of 1.12% (*Fig. 14*). The 10-year US Treasury bond yield exceeded the dividend yield, often significantly, from the late 1950s through 2007. Since then, the bond yield has fluctuated around the dividend yield. Consider the following related developments:

(1) *Blue Angels.* Our Blue Angels analytical framework can be used to construct series showing hypothetical values of the S&P 500 stock price index using actual S&P 500 dividends, on a four-quarter trailing sum basis, divided by dividend yields from 1.0% to 6.0% (*Fig. 15*). This approach shows that the S&P 500 has been closely tracking the Blue Angels series based on a 2.00% dividend yield since the start of 2008 through the end of last year. This year, the S&P 500 seems to be heading toward a 1.00% dividend yield, which is currently consistent with the S&P 500 price index at 5787, or 32.4% above Friday's close!

(2) *Trend.* The four-quarter trailing sum of S&P 500 dividends continues to grow between the 5% to 6% compound annual growth rate (CAGR) trends since 1935 (*Fig. 16*). On an inflation-adjusted basis, it is tracking the 2% CAGR trend line.

(3) *Sectors.* Two of the S&P 500's 11 sectors hit record-high dividends during Q2—Information Technology and Materials (*Fig. 17*). Here are the y/y growth rates for the S&P 500 and its sectors: S&P 500 (3.9%), Communication Services (3.3), Consumer Discretionary (19.1), Consumer Staples (3.5), Energy (5.1), Financials (-7.8), Health Care (5.3), Industrials (7.7), Information Technology (4.4), Materials (16.5), Real Estate (13.3), and Utilities (-3.6).

Equities II: S Corporations. By the way, it's interesting to note that S&P 500 dividends currently represent just 35.6% of dividends paid by all corporations (*Fig. 18* and *Fig. 19*). The difference is mostly attributable to S corporations. I am writing a book titled In Praise of Profits that includes a discussion of these entities. Here are some of the highlights:

(1) *S corporations.* On its *website*, the IRS explains that S corporations elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the passthrough of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income.

The IRS rules limit the number of shareholders of an S corporation to no more than 100, who may be individuals, certain trusts, and estates. They may not be partnerships, corporations, or non-resident alien shareholders. The S corporation must be a domestic one, must have only one class of stock, and cannot be an insurance company, a domestic international sales corporation, or certain types of financial institutions.

The IRS estimates that there were 4.7 million S corporation owners in the US in 2017—

three times the number of C corporations and millions more than the 500 corporations in the S&P 500.

(2) *Tax rate.* This helps to explain why the effective corporate tax rate, based on pre-tax and after-tax corporate profits in the National Income and Product Accounts (NIPA), has been well below the statutory rate. S corporations' profits are in the NIPA measure, but their profits are taxed as dividends in personal income. The effective corporate tax rate of the S&P 500 has also been below the statutory rate, but not by as much.

(3) New data. Just by coincidence, as I was researching the available data on S corporations discussed above, the Bureau of Economic Analysis (BEA) was doing the same. On May 17, 2021, the BEA posted a *report* titled "Prototype NIPA Estimates of Profits for S Corporations."

The NIPA report found that S corporations' share of total corporate receipts less deductions rose from 23% in 2012 to 31% in 2017, an increase of 8 percentage points. Their share of total NIPA profits before taxes, with the BEA's capital consumption and inventory valuation adjustments, increased from 27% in 2012 to 35% in 2017, an increase of 8 percentage points.

S corporation dividends as a share of total national dividends has remained close to 39% from 2012 through 2017, according to the report. S corporations have tended to distribute about two-thirds of their pre-tax profits as dividends, while the S&P 500 corporations have tended to distribute about half of their after-tax profits as dividends.

Calendars

US: Tues: NFIB Small Business Optimism Index, Headline & Core CPI 4.9%/4.0% y/y, Federal Budget Balance -$202b, EA Monthly Report. **Wed:** Headline & Core PPI 6.8%/5.1% y/y, MBA Mortgage Applications, EIA Crude Oil Inventories, Beige Book. (Bloomberg estimates)

Global: Tues: Germany CPI 0.4%m/m/2.3%y/y, France CPI 0.2%m/m/1.9%y/y, China Trade Balance $44.2b, EU Finance Ministers Meeting. **Wed:** Eurozone Industrial Production -0.2%m/m/22.2%y/y, Spain CPI 0.4%m/m/2.6%y/y, UK Headline & Core CPI 2.2%/2.0% y/y, Japan Industrial Production & Capacity Utilization, China GDP 1.2%q/q/8.1%y/y, China

Retail Sales 11.0% y/y, China Industrial Production 7.8% y/y, China Unemployment Rate 5.2%, Australia Employment Change & Unemployment Rate 30k/5.0%, BOC Interest Rate Decision 0.25%. (Bloomberg 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 18th week and the first time since October 2018. LargeCap's was at a record high for a 19th straight week; MidCap's was at a record for a 22nd week; and SmallCap's posted its 22nd gain in 24 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 59 of the past 60 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 56 of the past 58 weeks, and SmallCap's posted 56 gains in the past 59 weeks. LargeCap's forward earnings is now up 44.1% from its lowest level since August 2017; MidCap's has risen 84.4% from its lowest level since May 2015; and SmallCap's is up 131.0% 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 edged down 0.3ppt to 39.6% y/y and is down from a record high of 40.4% at the end of May. 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 fell 0.5ppt w/w to 72.0% y/y. That's down from a record high of 78.8% at the end of May and up from record low of -32.7% in May 2020. SmallCap's rate rose 0.2ppt to 119.6%; it's down from a record high of 124.2% in late June and 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 (37.3%, 11.6%), MidCap (61.9, 9.3), and SmallCap (93.5, 16.5).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower last week for these three indexes, but they remain above their multi-month lows from mid-June. LargeCap's forward P/E remained steady w/w at 21.5 and is up from an eight-month low of 20.7 during mid-June. That compares to 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 0.2pt w/w to 17.7 but remains 0.4pt above its 14-month low of 17.3 four weeks ago. Still, that's down from a seven-month high of 20.5 in early March. Its current level is 5.0pts below its record high of 22.9 in June 2020. SmallCap's dropped 0.3pt w/w to 17.5, but remains above its 14-month low of 17.4 in mid-June. It's now down 9.2pts 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 41st week. That's the longest stretch at a discount since last May and during 2002-03. SmallCap's P/E had been mostly below LargeCap from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a discount to MidCap's for a third straight week. It had been at an atypical discount to MidCap around the start of the year 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. Those gains have endured even through the current earnings warnings season, when forecasts typically decline. In the latest week, the S&P 500's Q2-2021 estimate rose 14 cents to $45.21. That $45.21 estimate for Q2-2021 represents a gain of 61.6% y/y on a frozen actual basis and a 65.8% y/y gain on a pro forma basis. That would mark the second straight quarter of double-digit percentage growth and compares to a pro forma 52.8% gain in Q1-2021. Ten of the 11 sectors are expected to post positive y/y earnings growth during Q2-2021, the same as during Q1-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q2-2021 versus their final Q1-2021 growth rates: Industrials (570.7% in Q2-2021 versus 3.0% in Q1-2021), Consumer Discretionary (273.3, 226.1), Energy (223.5, 28.0), Materials (116.0, 62.4), Financials (102.9, 138.0), S&P 500 (65.8, 52.8), Communication Services (40.0, 53.1), Information Technology (31.7, 44.9), Real Estate (25.1, 5.8), Health Care (10.6, 26.7), Consumer Staples (10.2, 11.1), and Utilities (-1.2, -0.9).

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333

Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102