



## MORNING BRIEFING

August 30, 2021

### Some Thoughts on Valuation

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

(1) Tapering before the end of the year. (2) Rate hikes not for a while. (3) Commercial banks facing big deposit inflows and weak loan demand buying bonds. (4) S&P 500 tracking Dividend Yield Model. (5) Are SMidCaps cheap or not? (6) Closer looks at S&P 500 vs Russell 1000 and S&P 600 vs Russell 2000. (7) Powell declares mission accomplished on inflation front. (8) July's PCED inflation data still not confirming inflation is transitory. (9) Four regional business surveys showing possible peaks in prices-paid indexes, while prices-received indexes hit new highs in August. (10) Movie review: "Respect" (+ +).

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

**Strategy I: Tracking Dividend Yield.** In his [speech](#) on Friday at the virtual Jackson Hole conference, Fed Chair Jerome Powell acknowledged that enough progress has been made on the inflation and employment fronts that the Fed is likely to start tapering its bond purchasing before the end of this year. However, he also said that it could be a while longer before the Fed will be raising interest rates:

"The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test. We have said that we will continue to hold the target range for the federal funds rate at its current level until the economy reaches conditions consistent with maximum employment, and inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time. We have much ground to cover to reach maximum employment, and time will tell whether we have reached 2 percent inflation on a sustainable basis."

Not surprisingly, the major stock market indexes proceeded to rise to fresh record highs on Friday, with the S&P 500 rising above 4500 to close at 4509.37. The 10-year bond yield edged lower, closing at 1.31%, notwithstanding Powell's assertion that tapering would start this year, not next year.

Until tapering actually begins, the Fed is committed to purchase \$120 billion per month in the bond market, as it has been doing since December of last year. That has resulted in

significant increases in bank deposits at a time when loan demand is weak ([Fig. 1](#)). Especially weak is the demand for business loans because funding is so readily and cheaply available in the corporate bond market ([Fig. 2](#)). So the banks have joined the Fed in purchasing bonds that have yields north of zero, unlike most money market instruments, which have interest rates close to zero. Since March 23, 2020, when the Fed implemented QE4ever, through the August 11 week of this year, banks purchased \$1.1 trillion in US Treasury and agency bonds, while the Fed purchased \$3.8 trillion of these securities ([Fig. 3](#)).

The dividend yield of the S&P 500 was down to 1.35% during Q2, the lowest since Q2-2001. That's almost identical to the current bond yield. The Dividend Yield Model shows that the S&P 500 is currently appropriately valuing the index's dividends given the current bond yield ([Fig. 4](#)).

**Strategy II: SMidCaps Again.** Last week, in the August 24 [Morning Briefing](#), Joe and I observed that the S&P 500 LargeCaps stock price index has been outperforming the S&P 400 and 600 indexes, collectively the "SMidCaps," since March 15 ([Fig. 5](#) and [Fig. 6](#)). Here are the performances since March 15 through this past Friday's close of the three S&P 500/400/600 indexes: 13.6%, 3.1%, and -1.6%.

The S&P 500's outperformance relative to its smaller-cap counterparts has lacked apparent earnings justification: That is, the V-shaped recoveries in the forward earnings of the S&P 400/600 SMidCaps have been even more impressive than the impressive rebound in the S&P 500's forward earnings since they all bottomed last year during May and June ([Fig. 7](#)). Over that same period, the forward profit margins of the S&P 500/400/600 have soared ([Fig. 8](#)). Here are the increases in their forward earnings and forward profit margins from their lows of last year through August 19: S&P 500 (51.2%, 28.2%), S&P 400 (95.2, 69.2), and S&P 600 (152.3, 124.1).

The outperformance of SMidCaps' fundamentals has been more than offset by the drop in their forward P/Es from 20.8 and 21.6 on March 15 to 17.1 and 16.2 on Friday ([Fig. 9](#)). The forward P/E of the S&P 500 is down from 22.0 to 21.1 over this same period.

So last week, we concluded that "SMidCaps are cheap relative to LargeCaps."

It was subsequently brought to our attention by a few of our readers that the *WSJ* posted an August 22 [story](#) titled "Small-Cap Stocks May Be Pricier Than They Appear." It focused on the valuation of the Russell 2000 SmallCaps versus the Russell 1000 LargeCaps. Here is

our analysis of the *Journal's* polar-opposite conclusion relative to ours on the relative valuations of these indexes:

(1) *Leaving out losers*. For starters, the *WSJ* article observes: “[W]hen calculating the price-to-earnings ratio, analysts sometimes ... cut out the companies that don’t turn a profit. This can have a dramatic effect on how pricey a broad swath of the market appears, especially since the share of the small-cap index without profits, high to begin with, surged in the aftermath of the pandemic-induced recession.” That makes sense, though we’ve never done so. That’s because most of our analytical work is based on the S&P 500/400/600.

(2) *S&P 500 vs Russell 1000*. There’s no controversy about the S&P 500 and the Russell 1000. Their forward P/Es have been almost identical since the start of the Russell series during 2002 ([Fig. 10](#)). The forward earnings ratio of the former to the latter has been stable since 2006 at roughly 0.97 ([Fig. 11](#)).

(3) *S&P 600 vs Russell 2000*. There has been a significant spread between the forward P/Es of the Russell 2000 and the S&P 600, with the former consistently exceeding the latter by a wide margin ([Fig. 12](#)). The spread between the two has averaged 5.6 pts since 2002, but has jumped since the pandemic to well over 10 pts ([Fig. 13](#)). The obvious explanation is the one offered by the *WSJ* article: There are many more unprofitable companies in the Russell 2000 than in the S&P 600. The forward earnings ratio of the S&P 600 to the Russell 2000 has risen from roughly 0.35 before the pandemic to 0.42 currently ([Fig. 14](#)).

(4) *MidCaps*. In years past, the forward P/Es of the Russell and S&P 400 MidCaps tended to be fairly close ([Fig. 15](#)). They’ve diverged significantly since the start of the pandemic, with the former’s current reading at 21.2 and the latter at 16.5. The forward earnings ratio of the S&P 400 to the Russell MidCap is 0.42 now, up from 0.38 prior to the pandemic ([Fig. 16](#)). By the way, the Russell MidCaps consists of the Russell 1000 less the 200 companies with the biggest market capitalization.

(5) *Biotech*. The *WSJ* article observes: “A factor contributing to the upward drift in the Russell 2000’s share of negative earners has been the growing presence of biotechnology stocks. The group makes up about 10% of the Russell 2000, up from 3% in January 2012, according to FTSE Russell. ...

“Many Russell 2000 companies that reported losses in the second quarter are in biotech, according to Institutional Brokers Estimate System data from Refinitiv.

“Analysts note that investors in biotech companies aren’t usually basing their decision on past or even near-term earnings. They are betting instead on the likelihood that the companies will achieve breakthroughs in research that could lead to outsize future gains.”

(6) *Bottom line.* Our conclusion remains the same: the S&P 400/600 are cheap relative to the S&P 500.

**Inflation: Mission Accomplished.** In his [speech](#) on Friday, Powell stated: “We have said that we would continue our asset purchases at the current pace until we see substantial further progress toward our maximum employment and price stability goals, measured since last December, when we first articulated this guidance.” Then he declared: “My view is that the ‘substantial further progress’ test has been met for inflation.” That’s great, unless you are a consumer!

The Fed has been trying to get inflation above its 2.0% target since January 2012, when the Fed adopted this inflation target. It has finally done so decisively as a result of the massive amount of monetary and fiscal stimulus aimed at offsetting the initial adverse economic and financial consequences of the pandemic. Let’s review the latest inflation data to assess whether there is any evidence so far that the pickup in inflation is likely to be transitory, as Powell reiterated once again in his speech:

(1) *Blast off.* The PCED measure of inflation, on a y/y basis, first rose above 2.0% during March ([Fig. 17](#)). By July, the headline rate was up 4.2%, while the core rate was 3.6%. These were the highest readings since January and May 1991, respectively.

(2) *Three-month view.* A better way to track whether inflationary pressures are mounting or easing is to calculate the latest three-month percentage changes at annual rates in the various components of inflation through July and to compare them to June’s numbers.

The results are mixed. The core PCED inflation rate edged down from 6.7% during June to 5.6% during July ([Fig. 18](#)). The PCED categories with downticks included: used motor vehicles (66.9%), gasoline (16.9), sports & recreational vehicles (8.5) clothing & footwear (8.4), furniture and home furnishings (6.4), motor vehicle parts (6.2), tenant rent (2.5), physician services (0.2), personal care products (-2.2), and prescription drugs (-2.4).

The following categories showed upticks: new motor vehicles (up to 21.2% annualized), household appliances (12.5), food services & accommodations (12.2), food & beverages (7.3), alcoholic beverages (4.8), owner-occupied rent (3.7), and education services (2.3).

(3) *Bottom line*. The jury is still out on Powell's assessment of the transitory nature of the recent jump in inflation. Four of the five regional business surveys conducted by the Fed's district banks are available through August ([Fig. 19](#)). All four registered readings for their prices-paid indexes slightly below their highs of a month or two ago. However, prices-received indexes for three of the four regions (New York, Richmond, and Kansas City) rose to new record highs, while Philadelphia's was the highest since the mid-1970s.

**Movie.** "Respect" (+ +) ([link](#)) is a biopic about the life and times of Aretha Franklin, the Queen of Soul. It really doesn't do justice to either. Instead, the movie focuses on Aretha's soulful songs, which clearly reflected the challenges she faced in her life. She was haunted by "demons" and bad relationships with various men, including her father. She contributed greatly to Martin Luther King's civil rights movement by appearing at fundraisers for his organization. Jennifer Hudson does a great job playing Aretha and belting out her songs.

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## Calendars

**US: Mon:** Pending Home Sales 0.4%, Dallas Fed Manufacturing Index. **Tues:** Consumer Confidence 124.0, S&P Case-Shiller HPI 20-City 1.7%*m/m*/18.6%*y/y*, Chicago PMI 68.0, API Crude Oil Inventories. (Bloomberg estimates)

**Global: Mon:** Eurozone Business & Consumer Survey 117.9, Germany CPI 0.1%*m/m*/3.9%*y/y*, Spain 2.9% *y/y*, Japan Unemployment Rate 2.9%, Japan Industrial Production -2.5%, China IHS Markit M-PMI 50.2. **Tues:** Eurozone CPI 2.8% *y/y*, Germany Unemployment Change & Unemployment Rate -34k/5.6%, France GDP 0.9%, France Consumer Spending 1.4%, France CPI, Italy GDP 2.7%*q/q*/17.3%*y/y*, Italy CPI 0.2%*m/m*/1.7%*y/y*, Canada GDP 2.5%, Australia GDP 0.5%*q/q*/9.2%*y/y*, China Caixin M-PMI 50.2. (Bloomberg estimates)

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## Strategy Indicators

**Global Stock Markets Performance** ([link](#)): Last week saw the US MSCI index rise 1.6%—its biggest gain in five weeks—and end the week at a record high. The US ranked 34th of the 49 global stock markets that we follow in a week when 44 of the 49 countries rose in US

dollar terms. The AC World ex-US index outperformed with a gain of 2.6%, reaching 3.3% below its June 15 record high, as all regions rose. EM Latin America was the best-performing region last week with a gain of 5.2%, ahead of EM Asia (4.4%) and BRIC (4.3). EMEA was the biggest underperformer, albeit with a gain of 1.3%, followed by EAFE (1.8) and EMU (1.9). Peru was the best-performing country last week with a gain of 9.0%, followed by Argentina (8.1), South Africa (7.2), Norway (6.8), and Thailand (6.7). Pakistan was the worst performer, with a decline of 3.3%, followed by Portugal (-1.9), Denmark (-1.4), and Indonesia (-0.9). EMEA is tied with the US in the race for the top-performing regions so far in 2021 with a ytd gain of 19.6%. Other regions ahead of the 6.6% ytd gain for the AC World ex-US: EM Eastern Europe (17.4), EMU (13.7), and EAFE (9.4). The following regions are lagging: BRIC (-7.0), EM Asia (-4.3), and EM Latin America (1.5). The top-performing countries ytd: Argentina (36.8), the Netherlands (31.1), Austria (28.7), the Czech Republic (28.0), and Hungary (23.9). The biggest laggards of 2021 so far: Peru (-27.1), Colombia (-16.3), China (-16.0), Pakistan (-15.2), and New Zealand (-14.4).

**S&P 1500/500/400/600 Performance** ([link](#)): LargeCap rose 1.5% last week, but trailed 4.1% and 3.4% gains for SmallCap and MidCap, respectively. LargeCap ended the week at a new record high, while MidCap and SmallCap finished 0.1% and 2.8% below their respective record highs on May 7 and June 8. Twenty-seven of the 33 sectors were higher for the week, up from just six sectors rising a week earlier. SmallCap Energy soared 16.0% for the best performance of the week, followed by MidCap Energy (10.6%), LargeCap Energy (7.3), SmallCap Tech (5.8), and MidCap Tech (4.8). LargeCap Utilities was the worst performer with a decline of 2.1%, followed by SmallCap Utilities (-1.4), MidCap Utilities (-1.4), LargeCap Consumer Staples (-1.4), and LargeCap Health Care (-1.2). SmallCap regained the lead in the 2021 derby this week with a gain of 22.9% ytd, ahead of LargeCap (20.1), and MidCap (20.0). All 33 sectors are higher ytd, paced by these best sector performers: SmallCap Energy (50.2), MidCap Energy (45.7), SmallCap Consumer Discretionary (42.3), LargeCap Financials (32.0), and MidCap Consumer Discretionary (30.3). The biggest laggards so far in 2021: MidCap Communication Services (3.5), LargeCap Consumer Staples (6.7), MidCap Consumer Staples (7.1), LargeCap Utilities (8.6), and MidCap Tech (9.7).

**S&P 500 Sectors and Industries Performance** ([link](#)): Seven of the 11 S&P 500 sectors rose last week and six outperformed the composite index's 1.5% gain. That compares to a 0.6% decline for the S&P 500 a week earlier, when five sectors rose and six outperformed the index. Energy rose 7.3% for the biggest gain of the week, ahead of Financials (3.5%), Communication Services (2.8), Consumer Discretionary (2.6), Materials (2.6), and Industrials (2.2). The worst performers this week: Utilities (-2.1), Consumer Staples (-1.4),



Health Care (-1.2), Real Estate (-0.3), and Tech (1.4). With respect to 2021's performance, the S&P 500 has risen 20.1% so far, with all 11 sectors higher ytd and five beating the broader index. Financials is now the leading sector with a gain of 32.0% ytd, followed by Energy (29.0), Real Estate (29.4), Communication Services (28.0), and Tech (21.0). This year's laggards to date, albeit with gains: Consumer Staples (6.7), Utilities (8.6), Consumer Discretionary (11.3), Industrials (18.1), Health Care (18.3), and Materials (18.3).

**S&P 500 Technical Indicators** ([link](#)): The S&P 500 rose 1.5% last week and improved relative to its 50-day moving average (50-dma) and 200-day moving average (200-dma). It was above its 50-dma for a tenth week after dropping below a week earlier for the first time since February. It was above its 200-dma for a 61st straight week last week after being below for 13 weeks through late May of 2020. The S&P 500's 50-dma rose last week for a 42nd straight week as the price index improved to 2.9% above its rising 50-dma from 2.0% a week earlier. That compares to an eight-month low of 0.4% below its rising 50-dma during mid-June; the index is still down from its 19-week high of 5.8% above during mid-April. 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 61st week last week, and improved to 11.2% above its rising 200-dma from 10.2% a week earlier. It had been at an eight-month low of 9.2% during mid-June. That compares to 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 of the 11 S&P 500 sectors traded above their 50-dmas last week, up from eight a week earlier. Consumer Discretionary and Industrials moved back above their 50-dmas last week. The sole laggard, Energy, was below for an eighth straight week. That compares to all 11 sectors above at the beginning of May and just four above at the end of January. Ten sectors have a rising 50-dma, up from nine a week earlier as Industrials turned up w/w. Energy is the only sector remaining in the falling 50-dma doghouse. Looking at the more stable longer-term 200-dmas, all 11 sectors are above again as Energy reversed course in the latest week. A week earlier, Energy had ended a 23-week period when all 11 sectors had been above. However, all 11 sectors have had rising 200-dmas for 24 straight weeks. For perspective, back in April 2020, just one sector (Health Care) was trading above its 200-dma. Energy's 200-dma finally turned higher in mid-December after mostly falling since October 2018.

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## US Economic Indicators

**Personal Income & Consumption ([link](#)):** Personal income in July posted its biggest gain in four months, while consumer spending growth slowed as supply shortages sent motor vehicle purchases south for the third successive month. Adjusted for inflation, consumer spending dipped 0.1%, though remained above the Q2 average. Personal income climbed 1.1% last month, boosted by the initial payments from the expanded Child Care Tax Credit along with strong employment gains. Wages & salaries rose for the 14th month since bottoming last April, expanding 1.0% in July and 17.4% over the period to yet another record high. Personal consumption expenditures increased 0.3%, slowing from 1.1% in June, as a 2.8% drop in motor vehicle expenditures sent goods consumption down 1.1%; goods consumption has dropped 1.9% since reaching a new record high in April. Meanwhile, services consumption continued to post solid gains, rising 1.0% in June to a new record high after averaging monthly gains of 1.5% over the past five months. The jump in income and the slowing in spending last month boosted personal saving by \$152.6 billion to \$1.7 trillion, with the saving rate at 9.6%; these two measures were at \$1.4 trillion and 8.3% pre-Covid. The personal consumption deflator rose 0.4% in July (and 4.2% y/y), pushing real consumer spending down 0.1% last month, with real goods consumption falling 1.6% and real services spending rising 0.6%. The core PCED rose 0.3% m/m and 3.6% y/y in July.

**Consumer Sentiment Index ([link](#)):** Consumer sentiment collapsed in August to its lowest level since December 2011, with losses widespread across all demographic groups and regions. Richard Curtin, the survey director, noted, “Consumers’ extreme reactions were due to the surging Delta variant, higher inflation, slower wage growth, and smaller declines in unemployment. The extraordinary falloff in sentiment also reflects an emotional response, from dashed hopes that the pandemic would soon end and lives could return to normal.” The Consumer Sentiment Index (CSI) tumbled 10.9 points (to 70.3 from 81.2) in August—with the only larger declines occurring during last April’s shutdown (-17.3 points) and during the depths of the Great Recession in October 2008 (-12.7 points). The expectations (to 65.1 from 79.0) and present situation (78.5 from 84.5) components sank 13.9 points and 6.0 points, respectively, to their lowest readings since October 2013 and April 2020. (The headline and expectations measures were little changed from their mid-month readings of 70.2 and 65.2, respectively, while the present situation component was up slightly from 77.9.) Meanwhile, August’s expected one-year inflation rate (to 4.6% from 4.7%) was just a tick below June’s—which was the highest since August 2008—while the expected five-year



rate (2.9 from 2.8) ticked up, though was down from May's 3.0%, which was the highest since September 2013.

**Regional M-PMIs** ([link](#)): Four Fed districts have now reported on manufacturing activity for August (New York, Philadelphia, Richmond, and Kansas City) and show the manufacturing sector expanded at roughly half the pace of July, as growth in the both the New York and Richmond regions slowed noticeably. The composite index fell to 18.9 this month after accelerating from 25.3 to 30.5 last month, as growth in Richmond's (to 9.0 from 27.0) manufacturing sector was the weakest in 13 months, while the New York's (to 18.3 from 43.0) grew at less than half July's record rate; Philadelphia's (19.4 from 21.9) basically matched July's pace, while Kansas City's (to 29.0 from 30.0) held around April's record high of 31.0. New orders (to 19.2 from 25.3) expanded at the slowest rate since February, though remained at a respectable pace. Richmond (5.0 from 25.0) and New York (14.8 from 33.2) billings slowed appreciably, though both the Kansas City (34.0 from 26.0) and Philadelphia (22.8 to 17.0) regions showed an acceleration in growth. Meanwhile, employment (to 22.9 from 28.2) growth slowed a bit from July's record rate, as factories in the New York (12.8 from 20.6) and Richmond (18.0 from 36.0) regions hired at a slower pace, as Philadelphia's (32.6 from 29.2) hired at a new record rate and Kansas City's (28.0 from 27.0) climbed back toward April's record 29.0.

**Regional Prices Paid & Received Measures** ([link](#)): We now have prices-paid and -received data for August from the Philadelphia, New York, Richmond, and Kansas City regions, and all show inflationary pressures have remained intense. Prices-received measures continued to accelerate into record-high territory, though prices-paid measures showed signs of peaking in some regions. (The Philadelphia, New York, and Kansas City measures are diffusion indexes, while Richmond's measures are average annualized inflation rates, which we multiply by 10 for easier comparison to the other regional measures.) Inflationary pressures remain elevated, with Richmond's prices-paid (to 11.1% from 11.2%) measure virtually matching July's record rate, while the Kansas City (80.0 from 78.0) and Philadelphia (71.2 from 69.7) measures accelerated slightly, with the former just below May's record high of 86.0, while the latter held below June's 80.7—which was the highest since the end of 1979. New York's prices-paid measure eased for the third month from May's record high of 83.5 to 76.1 this month. Meanwhile, prices-received measures accelerated to new record highs in the New York (46.0 from 39.4), Richmond (92.5 from 69.3), and Kansas City (61.0 from 52.) regions, while Philadelphia's (53.9 from 46.8) was the highest since the mid-1970s.

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