MORNING BRIEFING
October 19, 2021

The Fed's Squid Game

Check out the accompanying chart collection.

(1) Fed's green light enabled the V-shaped recovery. (2) Light was still green when inflation was deemed to be transitory. (3) More persistent inflation forces Fed to turn on flashing orange light. (4) Will a wage-price spiral force Fed to turn on the red light? (5) Powell is frustrated. (6) Will supply bottlenecks also be less transitory than Fed expects? (7) Lots of liquid assets. (8) Parts shortages depressing output in US and Eurozone. (9) Mixed readings in September's CPI. (10) Stock market bulls likely to charge through flashing orange light. (11) It's still a green light for banks. (12) China's faulty light switch. (13) Movie review: "Squid Game" (+).

US Economy: Green Light, Red Light. The Fed's ultra-easy monetary response to the pandemic has provided a very bright green light for the demand side of the economy. It has allowed fiscal policy to provide lots of relief checks that caused the federal budget deficit to balloon. But the checks also fueled a V-shaped economic recovery without pushing up interest rates, so far, even though inflation has certainly rebounded.

The Fed's pandemic response has also given a very bullish green light to the stock and commodity markets, by lowering the federal funds rate down to zero on March 15, 2020 and following that up just one week later with QE4ever on March 23.

When inflation started to soar earlier this year, Fed officials didn't waver but kept the bright green light steadily shining. They did so by claiming that y/y price comparisons were boosted mostly by the "base effect," causing a transitory increase in inflation. But now, they've replaced the steady green light with a flashing orange one.

In other words, Fed officials have acknowledged just recently that inflation is turning out to be more persistent and that the base effect no longer applies as it did from March through August. Their explanation now is that supply bottlenecks are lifting inflation. The bottlenecks too should be transitory, they say. But just in case, they are hedging their bets: Fed officials now are signaling that tapering will start soon and end around mid-2022, just in case the bottlenecks persist and they have to start raising interest rates to battle a far more persistent wage-price spiral than expected. In other words, we should all be ready for the Fed to turn on at least a flashing red light during the second half of next year.

Consider the following:

(1) *Powell is frustrated.* In our October 4 *Morning Briefing* titled "A Spell of Stagflation," Melissa and I wrote: "[T]he recent heightened levels of inflation have proven to be more persistent and less transitory than Fed officials had predicted. Last Wednesday [September 29], Fed Chair Jerome Powell said, 'It's also frustrating to see the bottlenecks and supply chain problems not getting better—in fact at the margins apparently getting a little bit worse. We see that continuing into next year probably, and holding up inflation longer than we had thought.'' He said so during a *panel discussion* hosted by the European Central Bank.

He was no longer talking about the temporary base effect but about a more persistent problem with global supply chains. He didn't mention that ultra-easy monetary and fiscal policies have been overheating demand, thus contributing to the supply bottlenecks and resulting in higher inflation.

(2) *Word count*. The *Minutes* of the September 21-22 meeting of the FOMC, released on October 13, mentioned the words "bottlenecks" and "shortages" nine times each. The word "taper" was mentioned eight times. For example, the Minutes noted: "With respect to the business sector, participants observed that firms in a number of industries were facing challenges keeping up with strong demand due to wide-spread supply chain bottlenecks as well as labor shortages."

(3) *Lots of liquidity.* Since the week of March 18, 2020 through the October 6 week of this year, the Fed's holdings of US Treasury and agency securities increased by $4.0 trillion (*Fig. 1*). All those purchases boosted commercial bank deposits and caused the banks to increase their holdings of the same type of securities by $1.3 trillion over the same period because loan demand has been weak.

Demand deposits in M2 soared by $2.9 trillion from February 2020 to a record $4.5 trillion through August of this year (*Fig. 2*). They are up 100% on a y/y basis (*Fig. 3*). The ratio of M2 to nominal GDP has been hovering around a record 90% for the past five quarters through Q2 (*Fig. 4*). In other words, M2 is equivalent to almost a year's worth of nominal GDP. The Fed's punch bowl remains full, brimming with rum punch.

(4) *Bottlenecks and shortages.* The demand shock resulting from the end of last year's lockdowns and the massive fiscal and monetary stimulus triggered a supply shock resulting in bottlenecks, shortages, and rapidly rising prices. Industrial production in the US declined

1.3% m/m in September, as supply-chain disruptions and lingering effects of Hurricane Ida weighed on manufacturing and mining output during the month. This decline is the sharpest since February, when severe winter weather in the South and central region of the country disrupted factory activity. In August, industrial output fell by a revised 0.1% versus a 0.4% rise previously estimated.

Manufacturing output—the biggest component of industrial production—fell by 0.7% m/m in September. Motor vehicle and parts production decreased by 7.2% amid the shortage of semiconductors (*Fig. 5*). The good news was that output of industrial equipment and information processing equipment rose 1.2% m/m and 0.1% m/m—with the latter at a new record high (*Fig. 6*).

The supply-chain problems are global. Industrial production fell 1.6% m/m during August in the Eurozone. One of the steepest declines was in Germany, where manufacturing output dropped 4.1% (*Fig. 7*). However, industrial output rose 1.0% in France and 0.1% in Spain.

In Germany, factory orders remain on a rising trend, despite August's dip, while production has been declining in recent months (*Fig. 8*). Germany's large auto industry has been forced to idle production and put thousands of workers back on furlough due to shortages of materials, particularly semiconductors (*Fig. 9*).

In the US, *survey readings* on regional business conditions in October are available only from the New York Federal Reserve Bank so far. Unfilled orders and slow delivery times remained elevated, and so did prices-paid and prices-received indexes.

(5) *Inflation.* So in recent weeks, the consensus outlook for inflation has evolved in the same way as the Fed's outlook has. Instead of transitory, inflation is looking more persistent as a result of the supply bottlenecks that are widely expected to persist through the first half of next year. If so, then economic growth should get a boost in the second half of 2022 and inflationary pressures should abate at the same time.

Meanwhile, Debbie and I should note that both the headline and core CPI inflation rates, on a three-month annualized basis, have diminished, to 4.7% through September from a recent peak of 9.3% during June and to 2.7% during September from a recent peak of 10.2%, respectively (*Fig. 10*).

Most of this improvement in fact is attributable to the moderation of prices most affected by the base effect: used cars and trucks (-8.1% down from a recent high of 121.8%), gasoline

(26.4, 98.8), apparel (-2.8, 9.0), lodging away from home (9.3, 62.4), airfares (-60.3, 84.3), and truck & car rental (-61.1, 182.2).

On the other hand, here are some September CPI readings that remain disturbingly high or have been moving higher: new vehicles (17.2%), motor vehicle parts & equipment (14.6), household furniture & bedding (16.4), household appliances (12.3), food (8.2), rent of primary residence (3.7), and owners' equivalent rent (3.9). (See our *CPI Inflation Components (3-month basis)*.

Strategy I: Red Light for Stock Bulls? The Fed's flashing orange light isn't going to stop the stock markets bulls from charging higher through at least mid-2022, when the Fed might finally start raising the federal funds rate. Both the 12-month forward futures for the federal funds rate and the two-year Treasury yield suggest that the markets expect one or two rate hikes during the second half of 2022 (*Fig. 11*). For now, there's plenty of cash on the sidelines to buy stocks, as noted above. Consider the following:

(1) *Revenues, earnings, and profit margins.* The outlook for S&P 500 revenues growth remains positive. S&P 500 aggregate revenues is highly correlated with business sales, which rose 15.3% y/y through August (*Fig. 12*).

The forward revenues of the S&P 500/400/600 (i.e., the time-weighted average of consensus revenues estimates for this year and next for the three indexes) are still rising in record-high territory (*Fig. 13*). The forward earnings of the S&P 500/400/600 are doing the same (*Fig. 14*). Forward profit margins remain in record-high territory as well.

(2) *Blue Angels.* Our Blue Angels framework shows that the forward earnings of the S&P 500/400/600 continue to fly into the wild blue yonder (*Fig. 15*). The forward P/E of the S&P 500 has been hovering north of 20.0 recently, while the forward P/Es of the S&P 400/600 have been closer to 16.0.

Strategy II: Green Light for Banks? Among the best-performing S&P 500 industry groups this year to date are Diversified Banks and Regional Banks. The big banks provided lots of good news last week about their Q3 earnings results even though loan demand has been weak (*Fig. 16*).

Many of the banks set aside billions of dollars last year to prepare for the likelihood that consumer and business loans would go bad as a result of the pandemic-driven recession (*Fig. 17*). But that didn't happen thanks to the massive intervention by the Fed. So this year, banks are reducing their reserves for loan losses, which has boosted their earnings. They are likely to continue doing so over the next couple of quarters.

Wall Street firms are also benefiting from the Fed's ultra-easy monetary policy, which has fueled a boom in M&A activity and a surge in investment banking fees (*Fig. 18*). In other words, Fed policy has benefitted the banks a great deal. By the way, the widespread notion that banks do best when bond yields are rising may not apply to investment banks. Low bond yields fuel M&A deal-making and fees.

China: Running Out of Juice. Last Wednesday, Jackie and I observed that China is in the midst of a serious energy crisis. The country's utilities are having a tough time keeping up with the demand for electricity, which has been booming as producers have been scrambling to fill export orders, especially from the US. Chinese exports rose 20% y/y during September to a new record high. There has been a remarkably close correlation between Chinese exports and electricity demand (*Fig. 19*). The shortage of electricity depressed China's Q3 real GDP growth rate to 4.9% y/y and only 1.6% q/q (saar).

Movie. "Squid Game" (+) (*link*) is a dystopian television series produced in South Korea and distributed worldwide by Netflix. I've watched only the first two episodes, but I thought that the show might be a cautionary tale about the Fed. While the Fed hasn't forced investors to buy stocks and bonds, lots of them have felt compelled to play the game because the alternative yields available in the money markets are close to zero thanks to the Fed's zero-interest-rate policy. Meanwhile, the gains in stocks and bonds since last March have been spectacular—all the more reason to keep playing. The Fed has provided a bright green light for investors. So the bulls continue to charge ahead, especially in the stock market, knowing that at some point the Fed will say "Red light!" Nevertheless, a lot investors could get killed when that happens.

Calendars

US: Tues: Housing Starts & Building Permits 1.62mu/1.68mu, API Weekly Crude Oil Inventories Daly, Bostic. **Wed:** MBA Mortgage Applications, Crude Oil Inventories, Beige Book, Quarles. (Bloomberg estimates)

Global: Tues: Japan Trade Balance -¥519.2b, Japan Exports & Imports 11.0%/34.4% y/y, PBOC Loan Prime Rate, Bailey. **Wed:** Eurozone Headline & Core CPI 0.5%m/m/3.4%y/y &

0.5%m/m/1.9%y/y, Eurozone Current Account, Germany PPI 1.0%m/m/12.7%y/y, UK Headline & Core CPI 0.4%m/m/3.2%y/y & 0.5%m/m/3.0%y/y, UK PPI Input & Output 1.0%m/m/11.6%y/y & 0.5%m/m/6.8%y/y, Canada CPI 0.1%m/m/4.3%y/y, Elderson. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings at a record high last week. LargeCap's was at a record high for a third straight week after dropping a hair below in late September due to Match's addition to the index. MidCap's improved to less than 0.1% below its record high in early October, and SmallCap's was at a record for a sixth week after dropping in early September for the first time in six months. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 71 of the past 74 weeks, with the two other down weeks due to Tesla's addition to the index last December and Amazon's earnings shortfall in August. MidCap's is up in 69 of the past 72 weeks, and SmallCap's posted 69 gains in the past 73 weeks. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 53.7% from its lowest level since August 2017; MidCap's is now up 99.6% from its lowest level since May 2015; and SmallCap's has soared 159.7% from its lowest point since August 2013. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act 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 was 36.1%, down from a record-high 42.2% at the end of July. 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 w/w to 57.3% y/y from 59.0%; that's down from a record high of 78.8% at the end of May and up from a record low of -32.7% in May 2020. SmallCap's rate dropped to 83.8% y/y from 87.3%; 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 beating consensus estimates quite handily 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 (44.2%, 9.6%), MidCap (74.2, 7.0), and SmallCap (113.2, 13.6).

S&P 500/400/600 Valuation (*link*): Valuations mostly rose from multi-month lows for these three indexes. LargeCap's forward P/E improved to 20.6 from an 11-month low of 20.3. LargeCap's forward P/E 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 gained 0.3pt to 16.6 and is up from a 17-month low of 16.2 in early October. That compares to a seven-month high of 20.5 in early March and is 6.3pts below its record high of 22.9 in June 2020. SmallCap's remained steady at 15.6, and remains near its 17-month low of 15.4 in mid-September. It's now down 11.1pts from its record high of 26.7 in early June 2020. During March 2020, MidCap's 10.7 and SmallCap's 11.1 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; MidCap's current 19% discount to LargeCap is near its biggest since 2001. SmallCap's P/E was below LargeCap's for a 54th week. That's the longest stretch at a discount since 2002-03; SmallCap's current 24% reading is near its biggest since 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for an 18th straight week; SmallCap's current 6% discount to MidCap's is near its biggest since 2003.

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 endured even through the Q3 earnings warnings season, when forecasts typically decline. With the Q3 earnings just beginning to roll in, the S&P 500's Q3-2021 blended earnings-per-share estimate rose 37 cents w/w to $49.33. That $49.33 estimate for Q2-2021 represents a gain of 27.5% y/y on a frozen actual basis and a 31.9% y/y gain on a pro forma basis. That would mark a third straight quarter of double-digit percentage growth and compares to a pro forma gain of 96.3% in Q2-2021. All 11 sectors are again expected to post positive y/y earnings growth during Q3-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q3-2021 versus their final Q2-2021 growth rates: Energy (1,519.4% in Q3-2021 versus 243.3% in Q2-2021), Materials (92.0, 139.5), Industrials (75.5, 698.4), S&P 500 (31.9, 96.3), Information Technology (28.9, 49.6), Communication Services (23.3, 72.8), Financials (30.6, 158.2), Real Estate (17.5, 38.7), Health Care (15.3, 27.2), Consumer Discretionary (7.5, 380.5), Consumer Staples (3.8, 20.4), and Utilities (0.4, 12.6).

US Economic Indicators

Industrial Production (*link*): Continued supply constraints pushed industrial production down sharply in September, with the auto sector the hardest hit "as shortages of semiconductors continued to hobble operations," the Fed reported. Headline production tumbled an unexpected 1.3% last month, while August's 0.4% gain was revised to a 0.1% loss. Manufacturing output sank 0.7% in September and 1.1% during the two months through September, as motor vehicle production plunged 7.2% and 10.1% over the comparable periods to its lowest level since mid-2020. By market group, consumer goods production contracted 1.9%, with both consumer durable (-3.7%) and nondurable (-1.4) goods production in the red—with the decline in the former led by motor vehicles (-7.0) and the latter by energy (-3.7) output. Meanwhile, production of business equipment increased 0.4% as a decline in transit equipment (-1.1) was more than offset by a 1.2% expansion in industrial equipment and a 0.1% uptick in information processing and related equipment to a new record high. Here's a snapshot of September production by market group (and their components) since last April and where they stand relative to their pre-Covid levels: business equipment (48.1% & +3.1%), led by transit equipment (267.9 & -0.3), followed by industrial equipment (30.9 & +2.2) and information processing equipment (15.1 & +8.7). The gain in consumer goods (18.4 & -0.6) production was led by a surge in consumer durable goods (82.0 & -3.9), while nondurable goods (7.4 & +0.2) output was more subdued.

Capacity Utilization (*link*): The headline capacity utilization rate fell in September for the second month, to 75.2%, after climbing steadily from 74.8% in April to 76.3% by July—which was the highest since February 2020. The rate is 11.8ppts above last April's low of 63.4% and is currently 4.4ppts below its long-run average. Meanwhile, manufacturing's capacity utilization rate sank to 75.9% after rising from 75.1% in April to a 30-month high of 76.8% in July. The rate for mining fell from 76.2% in July to a seven-month low of 73.9% in September, while the rate for utilities continued its up-and-down-pattern, falling to 73.0% last month after rising from 74.0% in July to 75.8% in August. The rate for all three sectors remained below their long-run averages in September.

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