## MORNING BRIEFING
**October 26, 2021**

### Less Worrisome Worry List, For Now

*Check out the accompanying chart collection.*

(1) Monday webinars. (2) Hooray for profits! (3) Bobby McFerrin's happy tune. (4) Halloween came early for stock investors. Xmas might have started early too. (5) Bull/Bear Ratio isn't bullish, which is bullish. (6) Ex-FAAMGs, stocks are fairly valued. (7) Earnings picture remains bright. (8) Lots of very liquid liquidity sitting in demand deposits. (9) No fiscal cliff ahead. (10) Beijing says "Forget CO2, burn coal baby!" (11) Nord Stream 2 likely to be full of gas for Europe soon. (12) Evergrande is still in business. (13) Inflation remains the main worry on the worry list.

**YRI Monday Webinar.** Instead of my regular Sunday video podcast, I've started doing webinars on Mondays at 11 a.m. EST as a better way to interact with you. You will receive an email with the link to the webinar one hour before showtime. I aim to keep them relatively short, say about half an hour. Replays are available *here*. As always, we welcome your feedback.

**Dr. Ed's New Book.** *In Praise of Profits!* is available on Amazon. Subscribers are invited to a free download of the Kindle or pdf version of my new book *here*. You can see key excerpts *here* as well.

**Strategy: Be Happy.** The first paragraph of my 2018 book *Predicting the Markets* observes: "Books don't usually come with theme songs. But if I had to pick one for my professional autobiography, it would be "*Don't Worry, Be Happy*" (1988), written and sung by Bobby McFerrin. During the 40 years that I have spent on Wall Street as an economist and investment strategist, investors benefited from great bull markets in both stocks and bonds. Yet instead of being happy, it seemed to me that most investors were worried for most of that time."

There were lots of worried investors during September. In our September 13 *Morning Briefing*, we observed that a "long worry list is traditional this time of year." The S&P 500 fell 5.2% from its record high of 4536.95 on September 2 to 4300.46 on October 4 (*Fig. 1*). By last Thursday, October 21, it was back up by 5.8% to a new record high of 4549.78. Joe and I are still shooting for the index to hit 4800 by the end of this year and 5200 sometime next year.

Investors may still be worried, but the stock market is happy. Let's review why the worry list might have lightened up recently:

(1) *Sectors.* During September's swoon, S&P 500 Energy and Financials outperformed the other nine S&P 500 sectors and the broader index as follows: Energy (13.6%), Financials (-0.8), Consumer Discretionary (-3.0), S&P 500 (-5.2), Consumer Staples (-5.4), Industrials (-6.0), Materials (-6.7), Information Technology (-6.7), Communication Services (-6.8), Utilities (-7.1), Real Estate (-7.6), and Health Care (-8.0). (See *Table 1*.)

The rebound from October 4 through October 21 was led by the Consumer Discretionary and Information Technology sectors: Consumer Discretionary (7.9), Information Technology (7.4), Materials (6.2), Industrials (5.9), S&P 500 (5.8), Financials (5.8), Real Estate (5.2), Energy (4.8), Health Care (4.5), Utilities (3.4), Communication Services (3.3), and Consumer Staples (3.0). (See *Table 2*.)

(2) *Technicals.* The percent of S&P 500 companies showing positive y/y price comparisons on October 22 was 89.5%, solidly in bullish territory (*Fig. 2*). Likewise bullish was the percent of S&P 500 companies trading above their 200-day moving averages (dma) that day, which was 73.3% (*Fig. 3*).

During September's selloff, the S&P 500 remained above its 200-dma (*Fig. 4*). The S&P 500 Transportation Index briefly dipped below its 200-dma but is back above that indicator of past momentum now (*Fig. 5*). The Nasdaq rebounded off its 200-dma in early October (*Fig. 6*).

(3) *Sentiment.* The Investors Intelligence Bull/Bear Ratio dropped below 2.00 to around 1.85 during the first three weeks of October as the percentage of bears rose to nearly a quarter of respondents to the sentiment survey, and the correction camp rose to about a third (*Fig. 7*). For contrarians, these relatively high readings of investor caution are bullish. The S&P 500 VIX, a measure of stock market volatility that tends to confirm extreme readings in the Investors Intelligence bearish percentage, was relatively calm at 15.4 on Friday (*Fig. 8*).

(4) *Valuation.* The S&P 500's forward P/E (i.e., based on the weighted average of this year's and next year's consensus earnings-per-share estimates) remained relatively high at 20.9 on Friday (*Fig. 9*). The forward P/E of S&P 500 Value was relatively cheap at 16.5 compared to Growth's 28.1. Growth's valuation multiple has been mostly boosted by the forward P/E of the Magnificent Five FAAMG (i.e., Facebook, Amazon, Apple, Microsoft and Alphabet/Google) stocks collectively, which was 35.4 on Friday (*Fig. 10*). The forward P/E

of the S&P 500 excluding them was 17.8 on October 15.

(5) *Earnings.* During the current Q3 earnings reporting season, company managements have been saying that their costs are rising and that they are experiencing shortages of parts and labor. But despite managements' cautious guidance, analysts' consensus earnings estimates have remained stable for Q4 and have continued to rise for the four quarters of 2022 (*Fig. 11*). As a result, S&P 500 forward earnings rose to yet another record high of $217.03 per share during the week of October 21 (*Fig. 12*).

The S&P 500 Net Earnings Revisions Index has remained solidly in positive territory—at around 15.0 during October so far—as it has for the previous 10 months (*Fig. 13*).

(6) *Liquidity.* It is widely expected that the Fed will start tapering its purchases of bonds following the November 2-3 meeting of the FOMC and stop doing so by mid-2022. Melissa and I agree with that assessment. The 10-year bond yield has reflected this outlook, rising from a recent low of 1.19% on August 4 to 1.63% on Monday.

Nevertheless, there is ample liquidity in the Fed's punch bowl to keep the party going in the stock market. The ratio of M2 to nominal GDP has been hovering around a record 90% in recent quarters through Q2 (*Fig. 14*). Demand deposits in M2 have soared by $2.9 trillion to a record $4.5 trillion during the 19 months of the pandemic through August (*Fig. 15*).

(7) *Fiscal policy.* The Democrats in Congress are likely to cut back on their fiscal spending plans to get the votes needed to enact them through the reconciliation process. The plans will still be huge and stimulative. The debt ceiling is likely to be raised with the reconciliation process. On Sunday, House Speaker Nancy Pelosi (D-CA) was asked about using reconciliation to do so on CNN's State of the Union. She responded, "That's one path, but we're still hoping to get bipartisanship."

(8) *Energy crisis in China.* China is the world's top coal miner and consumer, and top emitter of CO2. The Chinese government has pledged to slash its carbon intensity—i.e., CO2 emissions per unit of GDP—by 2030, to become carbon neutral by 2060, and to halt its construction of coal power plants abroad.

For now, however, the country has more immediate energy concerns. Winter is coming, and China is already having a below-average cold snap. Its winter heating needs are about to soar. The government is desperately scrambling to get more coal to generate more electricity after the country's recent power crisis, which sparked energy rationing and an economic growth slowdown. Coal-fired power accounts for roughly 60% of China's total electricity generation.

On Friday, President Xi Jinping said China will make efforts to ensure the stable supply of coal and electricity for economic and social use. He also called for more exploration and development of oil and gas, state media reported. China's thermal coal futures plunged on Friday following Beijing's strongest intervention in years to boost supply of the commodity—and thereby slow runaway prices for it—amid a widespread power crunch.

The most actively traded futures price for thermal coal in China plunged 30% below a record high hit on Tuesday. That brought it down nearly 15% for the week, the biggest weekly drop since May, *reported* Reuters.

(9) *Energy crisis in Europe.* In an excellent October 24 Bloomberg Opinion *article* on the climate-change policymaking, Stanford University professor Niall Ferguson observes that the European and British decisions not to invest in hydraulic fracturing ("fracking") and the German decision to renounce nuclear power after the 2011 disaster in Fukushima, Japan, have left Europe dangerously dependent on gas imported from Russia.

The Nord Stream 2 pipeline is completed and ready to pump Russian gas to Europe, but nothing is flowing yet because the project is still awaiting clearance from Germany's energy regulator. On Friday, the regulator suggested clearance will be coming soon.

(10) *Property bubble in China.* Evergrande is still in business. The Chinese property developer surprised international investors and dodged a default by making $83.5 million in overdue interest payments on around $2 billion of outstanding dollar bonds, the *WSJ* *reported* yesterday. It also said construction is progressing at some of its residential projects in southern China.

(11) *Pandemic.* Of course, the pandemic isn't over. However, the latest wave of the pandemic in the US peaked on September 8 based on the 10-day moving average of hospitalizations, which since has fallen by 46% through October 22 (*Fig. 16*). The percent of Americans who have received at least one dose of the vaccine is up to 84%.

(12) *Inflation and supply disruptions.* Inflation is the one item on the worry list that has gotten worse lately. No one views it as a transitory problem related to the base effect any longer. Instead, the consensus view is that it's a more persistent problem owing to global supply-chain disruptions and ongoing shortages of labor.

An argument can be made that inflation will prove to be a long-lived problem if a wage-price spiral unfolds. Workers have been getting bigger wage increases recently, but they are also seeing the prices they pay go up just as fast.

September data show that the percentage of small business owners planning to increase workers compensation in the next three months rose to a record high 30.0% (*Fig. 17*). This series is highly correlated with the y/y growth rate of wages and salaries in the Employment Cost Index. The same survey found that 46.0% of them are both raising average selling prices and planning to do so (*Fig. 18*).

## Calendars

**US: Tues:** Consumer Confidence 108.8, New Home Sales 755k, Richmond Fed Manufacturing Index, S&P/CS HPI Composite 20 City 1.4%m/m/20.1%y/y, Crude Oil Inventories. **Wed:** Durable Goods Total & Core Capital Goods Orders -1.1%/0.5%, Advanced Goods Trade Balance, Wholesale Inventories, Crude Oil Inventories, MBA Mortgage Applications. (Bloomberg estimates)

**Global: Tues:** Australia CPI 0.8%m/m/3.1%y/y, China Industrial Profits. **Wed:** Germany Gfk Consumer Climate -0.5, BOC, Japan Retail Sales -2.3%, Interest Rate Decision 0.25%, BOJ Interest Rate Decision -0.10%, Beermann, Debelle. (Bloomberg estimates)

## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): All three of these indexes had forward earnings at a record high last week. LargeCap's was at a record high for a fourth straight week after dropping a hair below in late September due to Match's addition to the index. MidCap's was back at a record high after slipping 0.2% from its prior record in early October, and SmallCap's was at a record for a seventh 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 72 of the past 75 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 70 of the past 73 weeks, and SmallCap's posted 70 gains in the past 74 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 53.9% from its lowest level since August 2017; MidCap's is now up 99.8% from its lowest level since May 2015; and SmallCap's has soared 160.2% 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 dropped to 35.1% from 36.1%, and is 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 56.0% y/y from 57.3%; 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 81.4% y/y from 83.8%; 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 (113.1, 13.6).

**S&P 500/400/600 Valuation** (*link*): Valuations continued to edge higher last week for these three indexes from their recent multi-month lows. LargeCap's forward P/E improved to 20.9 from 20.6 a week earlier, and is up from an 11-month low of 20.3 the week before that. 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 16.9 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 rose 0.2pt to 15.8, and remains near its 17-month low of 15.4 in mid-September. It's now down 10.9pts 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 55th week. That's the longest stretch at a discount since 2002-03; SmallCap's current 25% 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 a 19th straight week; SmallCap's current 7% 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 reports starting to roll in, the S&P 500's Q3-2021 blended earnings-per-share estimate surged $1.24 w/w to $50.57. That $50.57 estimate for Q2-2021 represents a gain of 30.7% y/y on a frozen actual basis and a 34.8% 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 (1,544.4% in Q3-2021 versus 243.3% in Q2-2021), Materials (94.7, 139.5), Industrials (78.3, 698.4), S&P 500 (34.8, 96.3), Financials (33.0, 158.2), Information Technology (32.6, 49.6), Communication Services (27.2, 72.8), Health Care (18.8, 27.2), Real Estate (17.4, 38.7), Consumer Discretionary (9.6, 380.5), Consumer Staples (4.4, 20.4), and Utilities (1.0, 12.6).

## US Economic Indicators

**Regional M-PMIs** (*link*): Three Fed districts (New York, Philadelphia, and Dallas) now have reported on manufacturing activity for October and show the manufacturing sector expanded at a slower, though still robust pace. The composite index slipped to 19.4 this month after rebounding from 15.6 to 23.2 in September, as activity in the Dallas (to 14.6 from 4.6) region accelerated this month, while both the Philadelphia (23.8 from 30.7) and New York (to 19.9 from 34.3) measures showed slower, though still elevated growth—outpacing the Dallas region. Meanwhile, new orders accelerated for the second month, from 17.7 in August to 23.3 this month, as billings in the Philadelphia (to 30.8 from 15.9) and Dallas (14.9 from 9.5) regions showed stronger growth, while New York's (24.3 from 33.7) slowed, though was better than Dallas'. Job gains remained solid, with the employment (to 25.4 from 24.4) measure showing job growth holding around this rate for the seventh month—more than double last October's rate. Philadelphia (to 30.7 from 26.3) and Dallas (28.3 from 26.3) factories are hiring at a faster pace than New York's (17.1 from 20.5), though the latter is holding around recent highs. Inflationary pressures remain elevated, with

Dallas' prices-received measure accelerating to a record-high 49.8 this month and the prices-paid measure (76.3) near June's record-high 80.8. Meanwhile, Philadelphia's prices-received (51.1) measure has been holding near August's rate of 53.9, which was the highest since 1974, while the prices-paid measure (70.3) has been fluctuating in a flat trend just below June's 80.7, which was the highest since the end of 1979. New York's prices-received measure eased to 43.5 after accelerating to a record-high 47.8 in September, while the prices-paid measure rose to 78.7 this month after slowing steadily from May's record high of 83.5 to 75.7 by September.

## Global Economic Indicators

**US PMI Flash Estimates** (*link*): Private-sector growth accelerated this month despite supply bottlenecks, as the service sector has begun to recover from the Delta wave. Prices have continued to increase at a record pace. The C-PMI increased in October for the first time in five months, to 57.3, after sliding from May's record high of 68.7 to 55.0 by September. The NM-PMI recovered to 58.2 this month after sliding the prior four months from a record-high 70.4 to 54.9 last month—which was linked in part to the Delta variant spread. Meanwhile, the M-PMI fell for the third month from 63.4 in July to a seven-month low of 59.3 this month—still a very strong reading. According to the report, "October saw resurgent service sector activity as Covid-19 case numbers continued to fall, marking an encouraging strong start to the fourth quarter for the economy." Additionally, manufacturers have continued to report strong growth despite some strong headwinds.

**Eurozone PMI Flash Estimates** (*link*): "Supply bottlenecks curb economic growth to a six-month low in October, while pushing prices higher at a record pace," was the headline of IHS Markit's October report. The C-PMI eased for the third month to 54.3, after accelerating steadily the prior six months, from 47.8 at the start of the year to 60.2 by July. The service sector has seen some of its summer rebound fade: The NM-PMI has dropped noticeably the past two months to 54.7 this month from 56.4 in September and 59.0 in August, as "resurgent virus case numbers bring renewed concerns, notably in Germany," the report noted. Supply-chain delays have pushed the M-PMI down 4.9 points over the past four months, from 63.4 in June to 58.5 this month. Supply-chain delays remain a major concern, with average selling prices for both goods and services rising at rates not seen in over two decades.

**Japan PMI Flash Estimates** (*link*): The Japanese private-sector economy expanded in

October for the first time since April, as the dominant service sector experienced growth for the first time since January 2020. The manufacturing sector picked up a bit, making its eighth successive month of expansion. October's C-PMI climbed to 50.7, up from a recent low of 45.5 in August, as the NM-PMI accelerated from 42.9 in August to 50.7 this month. The M-PMI advanced to 53.0 this month after slowing during four of the prior five months from 53.6 in April to 51.5 in September. Shortages have caused input prices to accelerate at their fastest pace in over 13 years—contributing to the sharpest rise in output prices since summer 2018.

**Germany Ifo Business Climate Index** (*link*): "Sand in the wheels of the German economy is hampering recovery," noted Clemens Fuest. German business confidence sank to a six-month low as supply bottlenecks, soaring energy prices, and Covid-19 are impacting businesses. Ifo's business climate index fell for the fourth month, by 1.2 points in October and 4.3 points over the period, to 97.7. The decline was nearly entirely in expectations, with the measure sinking 8.6 points the past four months to an eight-month low of 95.4; it was at 104.0 in June, which was the highest since the end of 2010. In the meantime, the present situation component dipped 1.4 points during the two months ending October to 100.1, after rising steadily from 89.5 in January to 101.5 in August—which was the highest since May 2019. The manufacturing index moved lower for the fourth month, from 29.1 to 17.2 over the period, with the expectations component sinking for the seventh month from 23.8 in March to a 17-month low of 2.8 this month. Meanwhile, the service sector business climate index dipped to 16.5 this month after increasing from 17.8 to 19.1 last month, as the expectations component sank from 12.1 to 6.4 this month. The construction index has continued to head straight up, as strong housing demand pushed the index up eight of the past nine months by 18.2 points to a 20-month high of 12.9—led by a 24.1-point rebound in the expectations component to -3.5, which continues to climb toward positive territory. According to Ifo economist Klaus Wohlrabe, supply problems will slow growth to about 0.5% during the current quarter, from 1.6% during Q3.

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