**MORNING BRIEFING**
**November 2, 2021**

## What's Up with TINA?

*Check out the accompanying chart collection.*

(1) "TINA" isn't the only acronym in town. (2) Big inflows into equity ETFs. (3) Big outflows from equity mutual funds. (4) A couple of extra trillion dollars here and there. (5) Lots of excess saving. (6) Bond funds having more fun. (7) The Fed taketh away. (8) Tapering around the corner. (9) From FAAMGs to GAMMAs. (10) Excluding GAMMAs, S&P 500 forward P/E more reasonable. (11) Smith, Marx, Schumpeter, Keynes, and Samuelson: What they got wrong.

**US Stocks & Bonds I: There Are Alternatives.** TINA has been around the block a few times during the current bull market, which started in 2009. The acronym stands for "There Is No Alternative." The simple concept is that stock prices have advanced mostly because there is no alternative asset class worth buying.

Presumably, TINA made more and more sense as bond yields mostly declined since 2009, falling to record lows since the pandemic. The 10-year US Treasury bond yield was 2.82% during March 2009. It has been below 2.00% since August 1, 2019 (*Fig. 1*). The yield on the high-yield corporate bond composite fell from the low double digits to under 5.00% since November 17, 2020 (*Fig. 2*).

This might explain why equity ETFs have attracted record net inflows of $658.2 billion over the past 12 months through September (*Fig. 3*). But that explanation doesn't jibe with the other relevant flow-of-funds data. Consider the following:

(1) *Equities.* The record inflow into equity ETFs was offset by a significant net outflow of $387.7 billion from equity mutual funds over the 12 months through September. As a result, the net inflow into equity mutual funds plus ETFs was $270.5 billion over the past 12 months through September. That was the best since February 2018. But this series has been in positive territory during only the past four months through September following 23 months of negative readings. This suggests that retail investors have been mostly late to the party, missing much of the dramatic doubling of the S&P 500 from March 2020 through August 2021.

(2) *Liquid assets.* Undoubtedly, many retail and institutional investors have quarantined

themselves in the money markets since the pandemic started. Since the start of the pandemic during February 2020 through September of this year, M2 is up $5.6 trillion to a record $21.0 trillion (*Fig. 4*). Eyeballing the chart, we conclude that M2 is currently about $3.0-$4.0 trillion above the pre-pandemic trend line.

The demand deposits component of M2 is up $2.9 trillion to a record $4.5 trillion since February 2020 (*Fig. 5*). Demand deposits accounted for 21.5% of M2 during September, the highest reading since July 1975 (*Fig. 6*). Over the past 20 months through September, personal saving has totaled a record $2.8 trillion (*Fig. 7*).

(3) *Bonds.* Meanwhile, money has been pouring into bond mutual funds and ETFs (*Fig. 8*). Indeed, the 12-month sum of these net inflows rose to a record high of $1.0 trillion during April of this year. This series remained significant during September at $821.5 billion, with bond mutual funds attracting $617.8 billion and bond ETFs attracting $203.6 billion.

(4) *The Fed.* While the demand for bonds remained surprisingly strong since the start of the pandemic, the Fed has been reducing the supply of bonds. Since the last week of February 2020 through the last week of October, the Fed has purchased $4.2 trillion in US Treasuries and agency bonds (*Fig. 9*).

The Fed's purchases have boosted demand deposits at commercial banks at the same time as loan demand has been flat (*Fig. 10*). As a result, commercial banks have purchased $1.4 trillion in US Treasuries and agencies since the last week of February through the October 20 week.

(5) *Foreigners.* Also reducing the supply of US Treasuries and agencies have been foreign investors. Over the past 12 months through August, they barely purchased any Treasuries, but they did snap up $441.2 billion in agencies (*Fig. 11*). By the way, foreigners' net purchases of US equities totaled $243.8 billion over the past 12 months through August.

(6) *Bottom line.* So there have been alternatives to stocks after all, namely bonds and liquid assets.

**US Stocks & Bonds II: The Valuation Questions.** Our review of the flow of funds above certainly explains why the 10-year US Treasury bond yield has been fluctuating around 1.50% this year rather than rising over 2.00%—as the jump in inflation from February through August of this year suggests it should (*Fig. 12*). Similarly bearish for bonds are the copper/gold prices ratio and the ISM's manufacturing PMI (*Fig. 13* and *Fig. 14*).

The FOMC meets today and tomorrow. The committee is widely expected to announce that the Fed will start tapering its purchases of securities soon, with the aim of ending its QE4ever program by the middle of next year. Both the 12-month futures and the two-year Treasury note yield at their current levels reflect expectations of two 25bps hikes during the second half of next year (*Fig. 15*).

Presumably, this has all been discounted by both the bond and stock markets. Yet the bond yield continues to fluctuate around 1.50% rather than around 2.00%, and the S&P 500 is at a record high. The forward P/E of the S&P 500 has been remarkably stable in a range between roughly 20.0 and 23.0 since mid-2021 (*Fig. 16*). It's been staying so despite the rebound in the bond yield since August 4, 2020, when the yield fell to a record low of 0.52% notwithstanding the upturn in inflation.

Joe and I expect that the S&P 500's forward P/E will remain elevated. As we have previously observed, much of its stability over the past year has been attributable to the forward P/E of the S&P 500 Growth Index (*Fig. 17*). It has been fluctuating around 28.0 since mid-2020. It's also dominated by a handful of large-cap technology stocks. They were formerly known as the "FAAMGs" (for Facebook, Amazon, Apple, Microsoft, and Google/Alphabet). Now they are known as the "GAMMAs," since Facebook was renamed "Meta" last week.

The GAMMAs currently account for about 25% of the market capitalization of the S&P 500. Their collective forward P/E is currently 37.1. Excluding them, the S&P 500 forward P/E has been hovering around 19.0 since mid-2020 (*Fig. 18*). We can live with that.

**New Book: Excerpts.** *In Praise of Profits!* is the sixth in my series of *Predicting the Markets* studies. The paperback is available on Amazon. Subscribers are invited to a free download of the Kindle or pdf version of the book *here*.

My book mostly focuses on what progressives get wrong about entrepreneurial capitalism and profits. Along the way, with all due respect, I take swipes at five of the most famous economists in history. Here are the relevant excerpts:

(1) *Adam Smith.* Sadly, entrepreneurial capitalism has gotten a bad rap ever since 1776. Perversely, that's when Adam Smith, the great proponent of capitalism, published *The Wealth of Nations*. He made a huge mistake when he argued that capitalism is driven by self-interest. Marketing capitalism as a system based on selfishness wasn't smart. Then again, Smith was a professor, with no actual experience as an entrepreneur.

Smith famously wrote: “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities, but of their advantages.”

This oft-quoted statement is totally wrong, with all due respect to the great professor. The butcher, the brewer, and the baker get up early in the morning and work all day long, trying to give their customers the best meat, ale, and bread at the lowest possible prices. They don’t do so because of their self-love, but rather because of their insecurity. If they don’t rise and shine early each day, their competitors will, and put them out of business. Entrepreneurial capitalism is therefore the most moral, honest, altruistic economic system of them all. Among its mottos are: “The customer is always right,” “Everyday low prices,” and “Satisfaction guaranteed or your money back.”

The problems start when the butchers, brewers, and bakers form trade associations to stifle competition, or join existing ones that do so. The associations support politicians and hire lobbyists who promise to regulate their industry—for example, by requiring government inspection and licensing. In this way, they raise anticompetitive barriers to entry into their businesses. In other words, capitalism starts to morph into corrupt crony capitalism when “special interest groups” try to rig the market through political influence. These groups are totally selfish in promoting the interests of their members rather than their members’ customers. At least Smith got that concept right when he also famously wrote, “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”

(2) *Karl Marx. The Communist Manifesto* (1848), which Karl Marx wrote with Friedrich Engels, warns that capitalism is prone to recurring crises because “a great part not only of existing production, but also of previously created productive forces, are periodically destroyed.” This happens because capitalism has “epidemics of over-production,” which are resolved through “enforced destruction of a mass of productive forces,” exploitation at home, and imperialism abroad.

Hey, Karl and Friedrich were only 27- and 25-year-old wannabe revolutionaries when they wrote that nonsense. Even as they got older, though, they never figured out that capitalism’s “process of creative construction” improves the standard of living of the consuming class, i.e., all of us. That’s right, Marx and Engels erroneously focused their analysis on class warfare, pitting industrial workers against their capitalist employers, who were caricatured as greedy, exploitive, and imperialist. They failed to understand that the only class that matters in capitalism is the consumer class, which includes everybody. In a capitalist system, producers, workers, merchants all compete to cater to needs of the consumer class.

Capitalism provides the incentive for entrepreneurs to innovate. Driven by the profit motive, the creators of new or better goods and services at affordable prices get rich by selling their products to consumers who benefit from them. They are the true revolutionaries. They destroy the producers who fail to innovate and to provide consumers with the best goods and services at the lowest prices on a regular basis. Capitalism naturally develops technological innovations that benefit all of society on an ongoing basis.

Capitalism eliminates over-production by putting unprofitable companies out of business. Uncompetitive and unprofitable producers are capitalism's hapless victims.

(3) *Joseph Schumpeter.* Schumpeter's process of creative destruction naturally leads to the "paradox of progress." On balance, society benefits from creative destruction, as this creates new products, better working conditions, and new jobs, thus raising the standard of living. But it also destroys existing jobs, companies, and industries—often permanently. Calling this process "creative destruction," as Schumpeter did, places the focus on the losers, while calling it "creative construction," as I do, focuses on the winners—which, by the way, includes all the consumers who benefit from new or better goods and services at lower prices!

(4) *John Maynard Keynes.* Keynesian macroeconomists tend to focus on the demand side of the economy. Their models are built on a core assumption that economic downturns are caused by insufficient private-sector demand that needs to be offset by government stimulus. Keynesians prefer more government spending over tax cuts, figuring that a portion of people's tax windfalls is likely to be saved rather than spent. They rarely consider the possibility that demand might be weak because government regulations and policies are depressing profits. All they know for sure is that they can help with stimulative fiscal and monetary policies.

(5) *Paul Samuelson.* The latest (19th) edition of *Economics* (2010) by Paul Samuelson and William Nordhaus teaches students that economics "is the study of how societies use scarce resources to produce valuable goods and services and distribute them among different individuals." This definition hasn't changed since the first edition of this classic textbook was published in 1948.

I've learned that economics isn't a zero-sum game as that definition implies. Economics is about using technology to increase everyone's standard of living. Technological innovations are driven by the profits that can be earned by solving the problems posed by scarce resources. Free markets provide the profit incentive to motivate innovators to solve this problem. As they do so, consumers get better products, often at lower prices. The market distributes the resulting benefits to all consumers. From my perspective, economics is about creating and spreading abundance, not about distributing scarcity.

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## Calendars

**US: Tues:** FOMC Meeting. **Wed:** ADP Employment Change 400k, C-PMI & NM-PMI 57.3/58.2, ISM NM-PMI 62.0, Factory Orders 0.1%, Trade Balance -$80.5b, MBA Mortgage Applications, Crude Oil Inventories, Fed Interest Rate Decision. (Bloomberg estimates)

**Global: Tues:** Eurozone, Germany, France, Italy, and Spain M-PMIs 58.5/58.2/53.5/59.7/58.2, Australia Unemployment & Participation Rates 3.9%/70.6%, China Caixin NM-PMI, Debelle. **Wed:** Eurozone Unemployment Rate 7.4%, Italy Unemployment Rate 9.2%, UK C-PMI & NM-PMI 56.8/58.0, UK Nationwide HPI 0.4%m/m/9.3%y/y, Lagarde, Elderson, Mauderer, Gravelle.(Bloomberg estimates)

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## 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 fifth straight week after dropping a hair below in late September due to Match's addition to the index. MidCap's was at a record high for a second week after slipping 0.2% the week before that, and SmallCap's was at a record for an eighth 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 73 of the past 76 weeks, with the down weeks due to Tesla's addition to the index last December, Amazon's earnings shortfall in August, and Match's addition to the index in late September. MidCap's forward earnings is up in 71 of the past 74 weeks, and SmallCap's posted 71 gains in the past 75 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 54.2% from its lowest level since August 2017; MidCap's is now up 100.2% from its lowest level since May 2015; and SmallCap's has soared 160.5% 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 34.2% from 35.1%, 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 53.0% y/y from 56.0%; 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 76.7% y/y from 81.4%; 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 (74.3, 7.0), and SmallCap (112.7, 13.7).

**S&P 500/400/600 Valuation** (*link*): Valuations mostly ticked lower last week for these three indexes, but remained above their recent multi-month lows. LargeCap's forward P/E improved to 21.2 from 20.9 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 dropped 0.1pt to 16.8 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 fell 0.1pt to 15.7, and remains near its 17-month low of 15.4 in mid-September. It's now down 11.0pts 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 20% discount to LargeCap is near its biggest since 2001. SmallCap's P/E was below LargeCap's for a 63rd week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 26% 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 20th 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 rolling in, the S&P 500's Q3-2021 blended earnings-per-share estimate surged $1.81 w/w to $52.38. That $52.38 estimate for Q2-2021 represents a gain of 35.4% y/y on a frozen actual basis and a 39.2% 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 again are expected to post positive y/y earnings growth during Q3-2021. Here are the S&P 500 sectors' latest blended earnings growth rates for Q3-2021 versus their final Q2-2021 growth rates: Energy (1,713.1% in Q3-2021 versus 243.3% in Q2-2021), Materials (91.9, 139.5), Industrials (85.2, 698.4), S&P 500 (39.2, 96.3), Information Technology (35.7, 49.6), Communication Services (35.4, 72.8), Financials (35.3, 158.2), Health Care (23.6, 27.2), Real Estate (21.7, 38.7), Consumer Discretionary (12.8, 380.5), Consumer Staples (6.0, 20.4), and Utilities (0.8, 12.6).

**S&P 500 Q3 Earnings Season Monitor** (*link*): With nearly 56% of S&P 500 companies finished reporting revenues and earnings for Q3-2021, revenues are beating the consensus forecast by a well-above-trend 2.0%, and earnings have exceeded estimates by 11.3%. At the same point during the Q2 season, revenues were a higher 4.3% above forecast and earnings beat by a greater 17.0%. For the 279 companies that have reported Q3 earnings through mid-day Monday, the aggregate y/y revenue and earnings growth rates and the percentage of companies reporting a positive revenue and earnings surprise have slowed considerably from their Q2 measures. The Q3 reporters collectively have a y/y revenue gain of 17.8% and an earnings gain of 42.2%. That compares to y/y growth of 28.0% for revenues and 120.9% for earnings at the same point during Q2. Just over 82% of the Q3 reporters so far has reported a positive earnings surprise, and 76% has beaten revenues forecasts. Fewer companies have reported positive y/y earnings growth in Q3 (82%) than positive y/y revenue growth (89). These figures will change markedly as more Q3-2021 results are reported in the coming weeks. With the US economy largely re-opened compared to a year earlier, the y/y growth rates have slowed considerably in Q3 compared to Q2. The revenue and earnings surprises are moderating as well due to missed deliveries and higher costs.

## US Economic Indicators

**US Manufacturing PMIs** (*link*): Manufacturing activity in October remained robust, though below recent highs, according to both M-PMI measures. Meanwhile, price pressures in the ISM survey are accelerating again after easing a bit, while IHS Markit's survey saw output inflation reach a new record high. October's ISM M-PMI edged down to 60.8 after edging up the prior two months from 59.5 in July to 61.1 in September. It was at 64.7 in March, which was the best reading since 1983. The production (to 59.3 from 59.4) measure has been bouncing in a flat trend around 60.0 the past six months, while the orders measure has dropped from a cyclical high of 68.0 in March to 59.8 in October—still a robust pace. Manufacturers accumulated inventories at their fastest rate since the mid-1980s last month, with the measure jumping from 48.9 in July to 57.0 by October. Meanwhile, the employment (to 52.0 from 50.2) gauge moved further above the breakeven point of 50.0, after slipping below in August (49.0). The supplier deliveries component of the M-PMI moved up for the second month to 75.6, after falling from 78.8 (highest since the mid-1970s) in May to 69.5 in August; the measure continues to reflect the difficulties suppliers experience due to Covid-19 impacts. ISM's price index is accelerating again, climbing to 85.7 in October, after slowing from 92.1 in June—which was the fastest since summer 1979—to 79.4 by August. Looking at IHS Markit's M-PMI, "October saw US manufacturers report yet another near-record lengthening of supply chains, with shortages of components constraining production growth to the lowest since July of last year," according to the report. The M-PMI eased for the third month, from a record-high 63.4 in July to 58.4 last month. While supply restraints have pushed production below the pre-pandemic long-run average, demand remains strong. New order inflows remain well above trend despite easing a bit last month. Inflationary pressures remain intense as firms are passing higher input costs on to their customers at a record pace.

**Construction Spending** (*link*): Total construction spending unexpectedly fell in September, posting only its second decline in 15 months, on widespread weakness. Total construction spending contracted 0.5% in September following a six-month gain of 3.2% to a new record high. Private construction spending fell for the third month since reaching a record high during June, dropping by 0.5% in September and 0.9% over the period. Within private construction, residential spending fell for the second time in three months, by 0.4% in September and 0.9% over the period, after climbing five of the prior six months, by 10.8%, to a new record high. Both single- (-0.6%) and multi-family (-0.3) construction edged lower in September, though the former was only 1.1% below its cyclical high in July, while the latter was fractionally (-0.4%) below its record high during that same month. Home improvement spending fell for the second time since reaching its record high in June, falling

2.5% over the period. Meanwhile, private nonresidential investment dipped 0.6% in September, remaining in a volatile flat trend around recent lows; it's 13.4% below its record high posted at the start of 2020. Public construction spending appears to be finding a bottom after falling 9.6% during the 13 months through June.

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