



MORNING BRIEFING

November 9, 2021

The Bond Conundrum, Again

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

(1) No tapering tantrum in bond market. (2) Tapering isn't tightening. (3) But tapering sets stage for tightening if inflation persists. (4) Are retail investors buying bond funds to rebalance out of stocks? (5) Major central banks in no rush to raise their official lending rates. (6) Bank of England surprises. (7) Chinese trade surplus at record high during October. (8) Large capital outflows from China. (9) Property developers hitting a great wall in China. (10) Investors starting to realize that SMidCaps are cheap.

Bulletin Board. Replays of the Monday, November 8, webinar with Dr. Ed are available [here](#). For a complimentary e-book version of *In Praise of Profits!*, go [here](#).

Bonds: The Conundrum Continues. The 10-year US Treasury bond yield recently peaked at 1.68% on October 21 ([Fig. 1](#)). On November 3, the FOMC announced that the Fed would start tapering its bond purchases of \$120 billion per month by \$15 billion per month, thus setting the stage for possible hikes in the federal funds rate during the second half of next year. Yet the bond yield fell to 1.45% on Friday.

In his November 3 [press conference](#), Fed Chair Jerome Powell stressed: "Our decision today to begin tapering our asset purchases does not imply any direct signal regarding our interest rate policy. We continue to articulate a different and more stringent test for the economic conditions that would need to be met before raising the federal funds rate." He has said the same in previous recent pronouncements on this subject. He has stressed that tapering isn't the same as tightening nor is it necessarily setting the stage for rate hikes. This helps to explain why there hasn't been a taper tantrum in the bond or stock markets.

On the other hand, he provided a mixed message at his latest presser, saying: "We see shortages and bottlenecks persisting into next year, well into next year. We see higher inflation persisting, and we have to be in [a] position to address that risk ... should it create a threat of more persistent, longer-term inflation, and that's what we think our policy is doing now. It's putting us in a position to be able to address the range of plausible outcomes." In other words, tapering is likely to be followed by tightening if inflation remains persistent, which seems more likely now. Yet the bond market chose to focus on Powell's most dovish

pronouncements.

How can we explain the latest conundrum in the bond market? The Fed has started tapering and might be starting to tighten by mid-2022 ([Fig. 2](#)). This year's rise in inflation has turned out to be persistent rather than transitory ([Fig. 3](#)). The Biden administration's spending programs undoubtedly will increase the federal budget deficit and add to upward inflationary pressures ([Fig. 4](#)). Consider the following:

(1) *Fed and banks buying bonds*. Earlier this year, we attributed the conundrum mostly to the Fed's bond purchase program. Since the week of March 24, 2020—a day after the Fed announced its QE4Ever program—the Fed had purchased \$3.9 trillion in US Treasury and agency securities though the week of November 3, 2021, the same day that the FOMC announced its tapering program ([Fig. 5](#)).

Over the same period (through the week of October 27, 2021), commercial banks purchased \$1.3 trillion in such securities. They did so because the Fed's bond purchases boosted commercial bank deposits at the same time that loan demand was weak ([Fig. 6](#)).

Remember, tapering means that the Fed will still be filling up the punchbowl with liquidity, but just at a slower pace in coming months.

(2) *Retail investors buying bond funds*. In the November 2 [Morning Briefing](#) titled "What's Up with TINA?," we observed that money was pouring into bond mutual funds and ETFs ([Fig. 7](#)). Indeed, the 12-month sum of these net inflows rose to a record high of \$1.0 trillion during April of this year. This data series remained significant during September at \$821.5 billion, with bond mutual funds attracting \$617.8 billion and bond ETFs attracting \$203.6 billion.

The question is why would retail investors find bonds attractive at historically low yields? The answer might be that not everyone agrees that there is no alternative to stocks. Furthermore, as stock prices have soared, some investors may be rebalancing their portfolios out of stocks and into bonds.

(3) *Foreigners buying US bonds*. We also observed that foreign investors might very well view US bonds as a good alternative to their domestic bonds. Indeed, the global bond rally at the end of last week seemed to be led by 10-year yields in the UK and Germany ([Fig. 8](#)).

The financial markets were expecting a 15bps rate hike by the Bank of England on

Thursday. That seemed to trigger a drop in global yields, including in the US, as the dollar also strengthened. In addition, officials of the European Central Bank and the Fed have indicated that they are in no rush to raise their official lending rates.

On Friday, the 10-year US Treasury bond yield (1.45%) remained well above those in the UK (0.76), Sweden (0.23), Japan (0.06), France (0.06), and Germany (-0.28).

China: Cracks in the Foundation. China's mounting domestic problems also are bullish for US bonds and the dollar. Exports should continue to boost the country's economy, but not enough to offset the depressing impact of China's struggling property market. These developments could weigh on commodity prices, bolster the US dollar, and keep a lid on US bond yields. Consider the following:

(1) *Exports and imports.* On a seasonally adjusted basis, Chinese exports edged down 0.6% during October from September's record high ([Fig. 9](#)). Imports are down 9.8% from their record high during June through October. As a result, China's trade surplus rose to a record high during October.

By the way, we believe that the 12-month change in the non-gold international reserves held by China less the country's 12-month trade surplus is a good proxy for capital inflows and outflows ([Fig. 10](#) and [Fig. 11](#)). If so, then China's capital outflows have been increasing in recent months; they've totaled \$531 billion over the past 12 months through October, little changed from September's \$536 billion, which was the most since July 2017.

(2) *Property market.* On Friday, BBC News [reported](#) that Kaisa Group has become the latest developer to miss a payment to investors. Kaisa said it was facing unprecedented pressure on its finances due to a challenging property market. This comes as rival developer Evergrande Group is still reeling under the weight of more than \$300 billion of debt.

Evergrande has been the highest-profile example of China's debt crisis, but other companies in China's property sector have similar issues. Their total combined debt is estimated to be more than \$5 trillion, according to Japanese banking giant Nomura. That's almost the size of Japan's economy. Fantasia, Sinic, and China Properties Group all have defaulted on debts in recent months, while Kaisa is the latest developer to have missed a payment.

Strategy: SMidCaps Outperforming, Finally. About a month ago, we observed that the

S&P 400/600 stock price indexes (a.k.a. the SMidCaps) had been moving mostly sideways since early this year, while the S&P 500 stock price index (LargeCaps) was making new highs ([Fig. 12](#)). We also noted that the forward earnings (i.e., the time-weighted average of consensus earnings-per-share estimates for this year and next) of the former were rising faster than that of the latter ([Fig. 13](#)). As a result, the forward P/Es of the SMidCaps were falling both in absolute terms and relative to the valuation multiple of the S&P 500 ([Fig. 14](#) and [Fig. 15](#)). That might have started to change on Friday, as all three forward multiples rebounded.

Dr. Ed's New Book: Excerpt. Finally, I have a simple idea for increasing Americans' appreciation of the importance of corporate profits, which I discuss in my recently released book [In Praise of Profits!](#) The federal government likes to give money away. Why not establish an automatic \$1,000 savings account for all babies born in 2022 and beyond? That would cost a bit less than \$4 billion per year if live births rebound back to the pre-pandemic annual pace of about 3.7 million. The funds would be invested in an S&P 500 exchange-traded fund. Dividends would be automatically reinvested. Beneficiaries would be allowed to have access to the proceeds on a tax-free basis once they turn 65 years old.

Since the end of 1935, the S&P 500 total return index has been rising around 10% per year. Applying this growth rate to a single \$1,000 investment starting next year and compounded annually would provide each beneficiary in 2087 with \$600,000 in current dollars. That would teach Americans born from 2022 onward the power of profits and compounding dividends on a tax-free basis. Capitalism's fans would grow along with their "Birth Right Portfolios."

Calendars

US: Tues: Headline & Core PPI 0.6%/m/m/8.6%/y/y & 0.5%/m/m/6.8%/y/y, NFIB Small Business Optimism, WASDE Report, Weekly Crude Oil Inventories. **Wed:** Headline & Core CPI 0.6%/m/m/5.8%/y/y & 0.4%/m/m/4.3%/y/y, Initial & Continuous Jobless Claims 265k/2.10m, Wholesale Trade Sales 0.4%, MBA Mortgage Applications, Federal Budget Balance -\$179.0b, Crude Oil Inventories, Natural Gas Storage. (Bloomberg estimates)

Global: Tues: Germany ZEW Economic Sentiment 20.0, Germany Trade Balance €13.5b, China New Loans, China CPI & PPI 1.4%/12.0% y/y, Australia Westpac Consumer Sentiment. **Wed:** Germany CPI 0.5%/m/m/4.5%/y/y, Italy Industrial Production -0.1%, Japan

Industrial Production, Japan Core Machinery Orders 1.7%, China Industrial Production 3.1% y/y, China Fixed Asset Investment 6.3% y/y, Australia Employment Change & Unemployment Rate 50k/4.8%, Elderson, Weidmann, Tenreiro. (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 sixth 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 third week after slipping 0.2% the week before that, and SmallCap's was at a record for a ninth 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 74 of the past 77 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 72 of the past 75 weeks, and SmallCap's posted 72 gains in the past 76 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 54.9% from its lowest level since August 2017; MidCap's is now up 105.6% from its lowest level since May 2015; and SmallCap's has soared 171.1% 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 33.2% from 34.2%, 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 rose w/w to 53.7% y/y from 53.0%; but that's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate rose to 77.7% y/y from 76.7%; 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 (47.0%, 7.6%), MidCap (76.3, 8.7), and SmallCap (120.1, 14.2).

S&P 500/400/600 Valuation ([link](#)): Valuations continued to rise last week for these three

indexes, and were back up to multi-month highs from their recent lows in September and October. LargeCap's forward P/E improved to a six-month high of 21.5 from 21.2 a week earlier, and is up from an 11-month low of 20.3 in early October. 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 rose 0.3pt to a 13-week high of 17.1 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 5.8pts below its record high of 22.9 in June 2020. SmallCap's rose 0.4pt to a 13-week high of 16.1, and is up 0.7pt from its 17-month low of 15.4 in mid-September. It's still down 10.6pts 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 21% discount to LargeCap is near its biggest since 2001. SmallCap's P/E was below LargeCap's for a 64th week. That's the longest stretch at a discount since 1999-2002; 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 21st 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 reports nearly 90% complete, the S&P 500's Q3-2021 blended earnings-per-share estimate rose 87 cents w/w to \$53.25. That \$53.25 estimate for Q2-2021 represents a gain of 37.6% y/y on a frozen actual basis and a 41.5% 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 (1,785.6% in Q3-2021 versus 243.3% in Q2-2021), Materials (88.4, 139.5), Industrials (86.8, 698.4), S&P 500 (41.5, 96.3), Information Technology (36.8, 49.6), Financials (36.3, 158.2), Communication Services (36.2, 72.8), Health Care (28.7, 27.2), Real Estate (25.8, 38.7), Consumer Discretionary (13.7, 380.5), Utilities (10.2, 12.6),

and Consumer Staples (6.3, 20.4).

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

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