



## MORNING BRIEFING

December 7, 2021

### Taper Tantrum 4.0

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

(1) Taper tantrums now and then. (2) Easier for the Fed to back off during past three tantrums than now. (3) A work in progress. (4) November's CPI won't help. (5) What is the yield curve telling us? (6) Sentiment indexes are bearish on balance, which is bullish. (7) Betting on earnings growth and liquidity. (8) The stock market equation. (9) Peak earnings growth will be followed by less earnings growth. (10) Growth-vs-Value rollercoaster driven by pandemic waves. (11) The death of Growth, Tech, and high-P/E stocks has been exaggerated.

**Replays.** I'm happy to report that I will continue to do the Monday morning webinars because we are getting very good turnouts. We get even more viewers of the replays, which can be found [here](#).

**Strategy I: A Very Brief History of Taper Tantrums.** There have been four taper tantrums in the stock market since 2013 including the latest one. So far, it hasn't been as severe as the previous three, but it has the potential to last well into 2022. The Fed backed off from tightening in response to the previous three tantrums. This time, the Fed may have no choice but to continue tightening monetary policy into next year because inflation is much more troublesome now than it was during the previous three episodes.

The first tantrum was during the spring of 2013, when the index fell 5.8% ([Fig. 1](#)). The second occurred in late 2015 through early 2016, when the index fell 13.3%. The third was during the fall of 2018, when it fell 19.8%.

The latest one is a work in progress. It started last week on Tuesday. Testifying before a Senate committee, Fed Chair Jerome Powell said he thinks reducing the pace of monthly bond buys can move quicker than the \$15 billion-a-month schedule announced earlier this month. "At this point, the economy is very strong and inflationary pressures are higher, and it is therefore appropriate in my view to consider wrapping up the taper of our asset purchases ... perhaps a few months sooner," Powell said. "I expect that we will discuss that at our upcoming meeting."

The financial markets were shocked to hear that Powell is now in the same camp as other hawkish FOMC participants who've been suggesting a faster pace of tapering. The next

FOMC meeting will be held December 14-15. The committee will probably decide to double the pace of tapering from \$15 billion per month to \$30 billion per month, setting the stage for a rate hike before mid-2022.

During the previous three tantrums, Fed officials were spooked by the stock market selloffs. They responded to these tantrums by backing off from their hawkish stance. Their dovish talk calmed the markets, allowing the bull market to continue. This time, Fed officials may be more spooked by the jump in inflation than by any tantrum in the financial markets. Consider the following related developments:

- (1) The FOMC undoubtedly will have a close look at November's CPI report, which will be released on Friday. The index was up 6.2% y/y during October. It is likely to be higher in November, led by rising auto prices and rents ([Fig. 2](#)). While the price of crude oil dropped sharply during November, the retail price of gasoline continued to rise ([Fig. 3](#) and [Fig. 4](#)).
- (2) On Friday, the 2-year US Treasury note yield rose to 0.60%, and the 12-month federal funds futures rose to 0.56% ([Fig. 5](#)). Both are clearly signaling two, and possibly three, 25bps hikes in the federal funds rate next year. Keep in mind that this implies that the federal funds rate should end 2022 at either 0.50% or 0.75%—not exactly levels that would kill the bull market in stocks.
- (3) The yield-curve spread between the 10-year US Treasury and the 2-year US Treasury continues to narrow significantly ([Fig. 6](#)). It is down from a recent peak of 129bps on October 8 to 75bps on Friday.

In our 2019 book [The Yield Curve: What Is It Real Predicting?](#), Melissa and I concluded that narrowing yield-curve spreads tend to predict financial crises, which can morph into credit crises, which cause recessions. So the yield curve is currently suggesting that once the Fed starts to raise interest rates next year, something could break in the credit markets. Presumably, that could be a big threat to the bull market in stocks.

**Strategy II: Mounting Nervousness.** Sentiment seems quite bearish in the stock market. The CBOE Equity Put/Call Ratio jumped to 0.74 on Friday, the highest reading since April 2, 2020, when much of the economy was still in lockdown. It's very unlikely that the government will try that response to the pandemic again.

Sentiment in the stock market is neither overly bullish nor overly bearish according to the Bull/Bear Ratio compiled by Investors Intelligence ([Fig. 7](#)). It was 2.00 during the week of

November 30. Bullish readings tend to be around 3.00 and higher, while bearish ones tend to be around 1.00 and less. Contrarians tend to view overly bullish ratios as sell signals and overly bearish ones as buy signals. They don't have much to work with when the ratio is 2.00.

The recent selloffs in US tech stocks, Chinese stocks, and cryptocurrencies suggest that investors are becoming more risk averse. That's evidenced by the rally in the Treasury bond market too.

From a contrarian perspective, on balance, these sentiment developments are more bullish than bearish for quality stocks, at least over the near term, in our opinion. SMidCaps are especially cheap relative to LargeCaps, as we discussed in yesterday's [Morning Briefing](#).

**Strategy III: Betting on Earnings Growth and Liquidity.** There's mounting chatter about a major correction or even a bear market now that the Fed is likely to tighten monetary policy at a faster pace in 2022. Joe and I are still in the bullish camp. As we noted yesterday, economic growth remains strong, and the outlook for earnings growth remains upbeat. We are concerned that the S&P 500's valuation multiple continues to be elevated; however, it may remain so given that there is so much liquidity in the financial markets. Consider the following:

(1) The stock market equation is simply  $P = P/E \times E$ . The P/E is mostly cyclical and trendless. S&P 500 earnings (E) tends to grow along a 6% long-term trendline within a range of 5%-7% long-term growth ([Fig. 8](#)). That determines the trend growth rate in the S&P 500 stock price index ([Fig. 9](#)).

(2) The yearly percent change in the S&P 500 stock price index, on a monthly basis, is highly correlated with the y/y growth rate in S&P 500 earnings, on a quarterly basis ([Fig. 10](#) and [Fig. 11](#)). The growth rate in earnings undoubtedly peaked during Q2 at 88.5%. It fell to 39.1% during Q3 and should be down to 19.0% during Q4, according to the analysts' consensus. Next year's quarterly growth rates are likely to be in the mid-single digits.

(3) Bear markets are caused by recessions, which tend to be caused by credit crunches and/or soaring oil prices. Debbie and I don't expect a recession in 2022. We do expect that the S&P 500 will rise at rates in the single digits in concert with earnings growth.

**Strategy IV: The Growth vs Value Rollercoaster.** Growth stocks tend to outperform Value stocks during periods of relatively slow growth, when both inflation and interest rates are

relatively low. Value is supposed to outperform when inflation and interest rates are rising. This playbook hasn't been very helpful this year. Consider the following:

(1) *Growth has been the winner so far.* Since the start of the latest bull run—i.e., after the market bottomed during March 23, 2020, through Friday's close—the S&P 500 is up 102.8%, led by a 122.3% increase in Growth; Value has lagged Growth with a gain of 79.7% ([Fig. 12](#)). Since the S&P 500 rose to a record high of 4704.54 on November 18 through Friday's close, the S&P 500 is down 3.5%, with Growth down 4.1% and Value down 2.8% since then.

Since the start of the bull market on March 9, 2009, the S&P 500 is up 570.8% with Growth up 788.2% and Value up 376.9% ([Fig. 13](#)).

(2) *Sources of outperformance.* The outperformance of Growth relative to Value has been fueled by faster forward earnings growth for Growth ([Fig. 14](#)). Without a doubt, even more important has been the spread between the forward P/Es of Growth versus Value. It widened from close to zero at the end of 2008 to 13.4 during the November 25 week this year ([Fig. 15](#) and [Fig. 16](#)). That's the highest since January 2001.

(3) *Rollercoaster ride.* Since the pandemic started, Growth stocks have been viewed as the winners when lockdowns and social-distancing requirements weighed on Value stocks, which have been viewed as "reopening trades." As a result, the waves of the pandemic have caused a rollercoaster ride for investors, which can be seen in the ratio of the stock price indexes for Growth to Value ([Fig. 17](#)).

(4) *Sector performance since the peak.* Since the S&P 500's record peak on November 18 through Friday's close, there has been much chatter about the relative underperformance of Technology and other S&P 500 sectors with relatively high valuation multiples. After all, Growth stocks should underperform at times when inflation is heating up, which typically mean rising oil prices, a weakening dollar, and rising interest rates.

The catch is that these conditions don't currently prevail despite rising inflation. The federal funds rate will probably remain near zero through March, and the bond yield has been falling rather than rising lately. In addition, the price of oil has been weak, and the dollar has been strong lately.

Furthermore, the performance derby of the S&P 500 and its sectors since November 8 through Friday doesn't confirm the conventional chatter. Here it is: Utilities (0.6%),

Consumer Staples (-1.0), Real Estate (-1.4), Health Care (-2.6), Information Technology (-2.9), Energy (-3.1), S&P 500 (-3.5), Financials (-3.6), Materials (-3.8), Industrials (-3.9), Consumer Discretionary (-5.6), and Communication Services (-6.2). (See [table](#).)

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## Calendars

**US: Tues:** Nonfarm Productivity & Unit Labor Costs -4.9%/8.3%; Trade Balance -\$67.0b; Consumer Credit \$26.0b; API Weekly Crude Oil Stocks. **Wed:** JOLTS; Small Business Optimism Index; MBA Mortgage Applications; Crude Oil Inventories. (Bloomberg estimates)

**Global: Tues:** Eurozone GDP 2.2%q/q/3.7%y/y; Germany Industrial Production 0.8%; Germany ZEW Current Conditions & Expectations 5.0/25.3; UK Halifax House Price Index; Japan GDP 0.4%q/q/1.6%y/y. **Wed:** China CPI & PPI 2.5%/12.5% y/y; BOC Rate Decision 0.25%; RBA Bulletin; Lowe. (Bloomberg estimates)

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## Strategy Indicators

**S&P 500/400/600 Forward Earnings** ([link](#)): Among these three indexes, all but MidCap had forward earnings at a record high last week. LargeCap's was at a record high for a 10th 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 three weeks earlier. SmallCap's was at a record for a 13th 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 78 of the past 81 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 75 of the past 79 weeks, and SmallCap's posted 76 gains in the past 80 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 57.0% from its lowest level since August 2017; MidCap's is now up 108.0% from its lowest level since May 2015; and SmallCap's has soared 176.5% 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 ticked down to 32.5% y/y in the latest week from 32.8%; 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 50.5% y/y from 51.3%; 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 dropped to 68.0% y/y from 69.8%; 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 (47.6%, 8.0%), MidCap (78.0, 8.2), and SmallCap (124.4, 13.1).

**S&P 500/400/600 Valuation ([link](#)):** Valuations dropped across the board again for these three indexes last week. LargeCap's forward P/E dropped 0.3pt w/w to 20.5. That's down from a six-month high of 21.5 in early November and compares to an 11-month low of 20.3 in early October. LargeCap's forward P/E also 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 fell 0.5pt to a 20-month low of 15.7 and is down from a 13-week high of 17.1 five weeks ago. That compares to a seven-month high of 20.5 in early March and is 7.2pts below its record high of 22.9 in June 2020. SmallCap's dropped 0.4pt to a 20-month low of 14.4 and is down from a 13-week high of 16.1 five weeks earlier. It's now down 12.3pts from its record high of 26.7 in early June 2020 when forward earnings was depressed. 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 23% discount to LargeCap is its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 68th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 30% reading is its biggest since April 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 25th straight week; SmallCap's current 8% discount to MidCap's is its biggest since July 2001.

**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 just three companies left to report Q3 earnings, the S&P 500's Q3-2021 blended earnings-per-share estimate/actual rose 6 cents w/w to \$53.88. That represents a gain of 39.3% y/y on a frozen actual basis and a 42.3% y/y gain on a pro forma basis. Q3 marks the third straight quarter of double-digit percentage earnings growth, but is down from their respective growth rates of 88.5% and 96.3% in Q1- and Q2-2021. All 11 sectors again posted positive y/y earnings growth during Q3-2021. Here are the S&P 500 sectors' latest earnings growth rates for Q4-2021 versus their blended Q3-2021 growth rates: Energy (over 10,000% in Q4-2021 versus 1,793.1% in Q3-2021), Materials (63.0, 89.2), Industrials (51.4, 86.9), S&P 500 (21.7, 42.3), Health Care (19.3, 28.9), Real Estate (13.3, 34.5), Information Technology (15.0, 37.4), Communication Services (9.3, 35.5), Consumer Discretionary (6.4, 18.9), Financials (2.9, 36.0), Consumer Staples (1.7, 6.9), and Utilities (0.6, 10.3).

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## Global Economic Indicators

**Germany Manufacturing Orders** ([link](#)): "After incoming orders climbed to an all-time high in mid-2021, the index has lost more than 16 points in recent months," the economy ministry noted. Factory orders posted its second big decline in three months, plunging 6.9% during October and 13.5% over the period, led by a decline in foreign orders. Foreign orders from outside the Eurozone recorded the biggest downfall, dropping 18.1% in October and 19.2% over the period, while orders from within the Eurozone sank 3.2% and 8.6% over the comparable periods. Domestic orders recovered 3.4% in October after a two-month plunge of 13.5%; these orders are 12.5% below June's record high. Here's a look at movements in domestic orders, along with orders from inside and outside the Eurozone, respectively, for the main industry groupings in October and during the three months through October: capital goods (+5.9%, -4.0%, -23.6% m/m & -16.2%, -10.2%, -24.4% since July), intermediate goods (+0.6, -3.8, -7.6 & -3.1, -9.0, -7.0), consumer durable goods (+2.4, +2.6, +4.6 & -18.6, +2.3, -19.7), and consumer nondurable goods (+4.8, +3.8, +5.7 & -9.0, +3.4, -0.5).

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