MORNING BRIEFING
January 4, 2022

Bonds Have More Fun with Old People

Check out the accompanying chart collection.

(1) Enlightening students about "entrepreneurial capitalism." (2) Will bond market conundrum persist in 2022? (3) Two-year Treasury note anticipating three rate hikes this year. (4) Gravitational pull of near-zero yields in Germany and Japan. (5) Bearish indicators for bonds remain bearish. (6) Age Wave remains bullish for bonds. (7) Chronic labor shortages should stimulate productivity. (8) Bond funds had record inflows in 2021! (9) Will the worst S&P 500 industries in 2021 be among the best in 2022? (10) Last year was another good year for Stay Home investors. So should be 2022.

Bulletin Board. Don't forget to listen to *replays* of Dr. Ed's Monday webinars if you miss the live events. A few of our accounts who are influential alumni of their alma maters have joined my effort to promote my latest book *In Praise of Profits!* among college and business students to enlighten them about entrepreneurial capitalism. Let me know if you would like to join our campaign. You can download a complimentary copy of the book *here*.

Bonds I: Back to Normal In 2022? Among the biggest surprises in 2021 was the bond market. Lots of the traditional drivers of the 10-year US Treasury bond yield strongly suggested that the yield should rise to at least 2.00%, if not 2.50%. Yet last year's high was 1.74% on March 31 (*Fig. 1*). It's been mostly hovering around 1.50% since then even though inflation has turned out to be higher and more persistent than widely expected (*Fig. 2*).

The Fed has responded to that inflation surprise by moving faster to taper its bond-purchasing program, setting the stage for as many as three rate hikes this year and sooner rather than later. Reflecting these rising expectations for rate hikes, the spread between the 2-year Treasury note yield and the federal funds target rate has widened from near zero during the first half of 2021 to 61bps at the end of last year (*Fig. 3* and *Fig. 4*).

At the beginning of last year, Debbie and I predicted that the bond yield would rise to 2.00% by the end of the year. That forecast seemed to be on track during the first three months of the year. But then the yield fell and fluctuated around 1.50% the rest of last year. In mid-2021, we reeled in our year-end target to 1.50%. Now 2.00% is our year-end 2022 target. We won't rule out 2.50%, which is still quite low relative to our 3%-4% inflation forecast for

the second half of this year, as we discussed on Monday.

When the bond yield went off track over the second half of 2021, we posited that massive bond purchases by the Fed and commercial banks might explain why bond yields remained low (*Fig. 5*). However, the yield remained around 1.50% through the end of 2021 even after the Fed announced its tapering program on November 3 and accelerated the tapering schedule on December 15. Then again, the yield started the new year off by rising to 1.64%.

Another possibility is that near-zero 10-year government bond yields in Germany and Japan are providing some gravitational pull on US bond yields (*Fig. 6*). We are coming around to believe that perhaps the best explanation for the abnormal behavior of the bond market might be the Age Wave. Consider the following:

(1) *Bearish economic indicators.* The most bearish indicators for the bond market have been all the uniformly ugly inflation statistics. For example, last year, the y/y CPI inflation rate rose above 2.0% during March. By November, it was up to 6.8%. The copper-to-gold price ratio has been hovering around 2.50% since late April of last year (*Fig. 7*). The V-shaped recovery in the M-PMI since summer 2020 should have been more bearish for bonds as well last year (*Fig. 8*).

(2) *Bullish geriatric demographics.* In my book *Predicting the Markets* (2018), I recounted explaining during the 1980s why a strong correlation might exist between the “Age Wave” and both inflation and the bond yield. The Age Wave is the percentage of 16- to 34-year-old people in the labor force (16 and older). It rose from 37% during 1962, when the oldest Baby Boomers turned 16, to peak at 51% during 1980, when the youngest ones turned 16. The oldest of them turned 65 during 2011, and the youngest will do so in 2029. The Age Wave percentage fell to a low of 35%–36% from 2011 through 2021 (*Fig. 9*).

Currently, the Age Wave explains why the bond yield has remained so subdued (*Fig. 10*). It also suggests that the recent flare up in the inflation rate should subside (*Fig. 11*).

The growth rate in the civilian noninstitutional working-age population (based on the y/y percent change in the 12-month average) fell to 0.4% during November—the lowest since the early 1950s (*Fig. 12*). The labor force was flat on the same basis. We expect that business managers will continue to respond to chronic labor shortages by boosting their spending on productivity-enhancing capital equipment and technologies. That should help to moderate inflation and keep a lid on bond yields.

Bonds II: More Bullish Demographic Trends. From an Age Wave perspective, the most bullish demographic trends in the world for bonds have been unfolding in Japan for several years. The country's population has been falling over the past 10 years (*Fig. 13*). Deaths have exceeded live births since July 2007 (*Fig. 14*). Over the past 12 months through July, deaths in Japan exceeded births by 504,000. The population of people 14 years old or younger has dropped from 24.7 million at the end of 1988 to 15.5 million at the end of 2021. The labor force there has been essentially flat since the late 1990s. The 10-year Japanese government bond yield has been hovering around zero since late 2016.

The US seems to be following Japan down the same demographic path:

(1) As noted above, US population growth is close to zero. Live births still exceed deaths, though barely owing to Covid (*Fig. 15*). Deaths should decline as the pandemic abates. But births have been in a downtrend since they peaked at a record 4.33 million, on a 12-month basis, during February 2008. They were down to 3.58 million during June 2021.

(2) One of the reasons that Americans are having fewer babies is that they are getting married later in life. The median age at first marriage during 2020 was 30.5 years old for men and 28.1 years old for women (*Fig. 16*). Both are record highs. The median age of the population rose to a record high of 38.3 years during 2020 (*Fig. 17*).

(3) As a result, the percent of the working-age population that is single, was 51.3% in November, holding near September's record 51.5%, with never married people at 32.3% and 19.1% accounting for all other singles (*Fig. 18*).

And what do older folks like to do with their spare change? Some invest in stocks and real estate. The big surprise is that even though bond yields are historically low, they like to invest in bonds. How else to explain the record inflows into bond mutual funds and ETFs during 2021 (*Fig. 19*)?

Stocks I: Best and Worst S&P 500 Industries in 2021. We start every year by singing "Auld Lang Syne," which is Scottish for "days gone by." As we start 2022, let's review which sectors and industries led and especially lagged the S&P 500 in 2021, as some of the latter might make good possible contrarian bets for this year.

Here is the performance derby of the 11 sectors of the S&P 500 during 2021: Energy (47.7%), Real Estate (42.5), Information Technology (33.4), Financials (32.5), S&P 500 (26.9), Materials (25.0), Health Care (24.2), Consumer Discretionary (23.7), Communication

Services (20.5), Industrials (19.4), Consumer Staples (15.6), and Utilities (14.0). Now here are the best- and worst-performing industries in each sector (see our 2021 performance derby *tables* for the S&P 500 and its sectors and industries):

(1) *Consumer Discretionary:* Automotive Retail (58.4%) & Casinos & Gaming (-11.7%)
(2) *Consumer Staples:* Food Retail (42.5) & Brewers (2.6)
(3) *Energy:* Exploration & Production (81.4) & Equipment & Services (25.4)
(4) *Communication Services:* Interactive Media & Services (46.8) & Interactive Home Entertainment (-19.9)
(5) *Financials:* Investment Banking & Brokerage (48.9) & Property & Casualty Insurance (15.6)
(6) *Health Care:* Health Care Facilities (43.9) & Biotechnology (9.3)
(7) *Industrials:* Human Resource & Employment Services (78.5) & Airlines (-1.8)
(8) *Information Technology:* Semiconductor Equipment (56.6) & Data Processing & Outsourced Services (-4.7)
(9) *Materials:* Steel (114.6) & Commodity Chemicals (1.6)
(10) *Real Estate:* Real Estate Services (73.0), Hotel & Resort REITs (18.9)
(11) *Utilities:* Water Utilities (23.1) & Independent Power Producers & Energy Traders (3.4)

Will the first come in last and the last come in first during 2022? Plausible arguments can be made for this to happen in some of the sectors.

Stocks II: The Best in the World in 2021. Joe and I have been recommending overweighting the US in global equity portfolios almost since the start of the bull market in 2009. So far, so good. Here is the performance derby of the major MSCI stock price indexes in local currencies and in US dollars since March 9, 2009 through the end of last year: US (611.8%), Japan (182.8, 142.8), Emerging Markets (179.5, 153.9), EMU (177.9, 150.0), and UK (98.8, 95.8) (*Fig. 20* and *Fig. 21*).

Here is the comparable performance derby for 2021: US (25.2), EMU (20.1, 11.7), UK (15.0, 13.9), Japan (11.4, -0.1), and Emerging Markets (-2.3, -4.6). (See our 2021 performance derby *tables* for the MSCI global market indexes.)

The outperformance of the US is attributable to several of the S&P 500 sectors. Here is the performance derby for the 11 sectors of the S&P 500 from March 9, 2009 through the end of last year: Information Technology (1,430.6%), Consumer Discretionary (1,181.2), Financials (676.0), Real Estate (631.1), S&P 500 (604.5), Industrials (573.8), Health Care (549.1), Materials (423.5), Utilities (219.6), Communication Services (203.6), and Energy

(36.0) (*Fig. 22* and *Fig. 23*).

During 2021, in local currency, the global winner among the 56 MSCI stock price indexes we monitor was the Czech Republic with a 52.0% gain, while the biggest global loser was China (-22.7%). Contrarians are recommending overweighting China this year. At the risk of never going to China again, I think it's clear that the Chinese Communist Party has been turning increasingly totalitarian, which is extremely bad news for China's people and for foreign investors.

Calendars

US: Tues: ISM M-PMI & Price Index 60.2/85.5; Job Openings; Motor Vehicle Sales; OPEC Meeting. **Wed:** ADP Employment 390k; MBA Mortgage Applications; FOMC Minutes. (Bloomberg estimates)

Global: Tues: Germany Retail Sales -0/5%m/m/-2.0%y/y; Germany Unemployment Change & Unemployment Rate -15k/5.3%; France CPI 2.8% y/y; UK M-PMI 57.6. **Wed:** Eurozone, Germany & France C-PMIs 53.4/50.0/55.6; Eurozone, Germany, France, Italy, and Spain NM-PMIs 53.3/48.4/57.1/53.7/57.5; France Consumer Confidence 98; Italy CPI; Japan Household Confidence. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings at record highs last week. LargeCap's was back up to a record high after dropping a week earlier due to index changes. MidCap's was at a record high for a fourth straight week after dropping 0.1% below at the end of November. SmallCap's was out of record-high territory for a second week, but remains just 0.6% below due to index changes. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 80 of the past 84 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings shortfall in August, and index changes in late December and September. MidCap's forward earnings is up in 78 of the past 82 weeks, and SmallCap's posted 78 gains in the past 83 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 58.2% from its lowest level since August 2017; MidCap's is now up 115.0% from its lowest level since May 2015; and SmallCap's has soared 176.4% 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 up to 33.4% y/y in the latest week from 33.2%; but that's 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 52.2% y/y from 51.0%; 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 59.9% y/y from 60.0%; 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 (47.4%, 8.4%), MidCap (83.8, 7.7), and SmallCap (120.5, 14.0).

S&P 500/400/600 Valuation (*link*): Valuations ticked up across the board for these three indexes last week. LargeCap's forward P/E rose 0.1pt w/w to an eight-week high of 21.4. 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 rose 0.2pt to 16.0, but remains near mid-December's 20-month low of 15.7 and is down from a 13-week high of 17.1 in early November. 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 increased 0.2pt to a six-week high of 15.1, but also remains near mid-December's 20-month low of 14.4 and is down from a 13-week high of 16.1 in early November. It's now down 11.6pts 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 24% discount to LargeCap is its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 71st week. That's the longest stretch at

a discount since 1999-2002; SmallCap's current 29% reading is near 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 28th straight week; SmallCap's current 6% discount to MidCap's is near 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 are enduring even through the current Q4 earnings warnings season, when forecasts typically decline. The S&P 500's Q4-2021 earnings-per-share estimate ticked down 1 cent w/w to $51.15, but is up from $51.08 at the beginning of the quarter. That $51.15 estimate represents a gain of 20.1% y/y on a frozen actual basis and a 42.6% y/y gain on a pro forma basis. Q4 is on pace to mark the fourth straight quarter of double-digit percentage earnings growth, but is down from its respective growth rates of 39.3% in Q3, 88.5% in Q2, and 96.3% in Q1. All 11 sectors are expected to post positive y/y earnings growth for a third straight quarter during Q4-2021, but double-digit growth is expected for only six sectors; that's down from 10 sectors doing so during Q3. 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 1,798.0% in Q3-2021), Materials (64.1, 89.1), Industrials (51.4, 88.4), S&P 500 (22.3, 42.6), Health Care (19.1, 29.0), Real Estate (13.8, 34.4), Information Technology (15.9, 38.2), Communication Services (9.6, 35.6), Consumer Discretionary (7.2, 19.4), Financials (2.9, 35.9), Consumer Staples (2.3, 7.4), and Utilities (0.7, 10.3).

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