Yardeni Research

MORNING BRIEFING
January 5, 2022

Covid-19, Mag-8, and FOMC-19

Check out the accompanying chart collection.

(1) Powell's pivot on inflation puts contrarians on alert. (2) Alternative bets. (3) M-PMI prices-paid index recedes. (4) Omicron and done? (5) The fastest-spreading virus on record. (6) The wild brushfire analogy for optimists. (7) Milder symptoms. (8) Herd immunity, here we come? (9) Cases soaring in US and Europe. (10) The Magnificent 8 were magnificent again in 2021. They might be again in 2022. (11) Growth isn't cheap. (12) Rearranging the deck chairs on the USS FOMC. (13) Biden likely to choose more progressives to fill Fed vacancies. (14) Meet Sarah Raskin.

US Economy: Is Inflation Peaking Already? Last year, during his *November 3* and *December 15* press conferences, Fed Chair Jerome Powell conceded that inflation was more persistent and less transitory than he had expected. Some contrarians immediately concluded that inflation might turn out to be even more persistent and problematic than Powell acknowledged. The alternative contrarian bet is that inflation will turn out to be relatively transitory after all. Debbie and I are taking this bet.

Needless to say, we were pleased to see that the prices-paid index in December's M-PMI survey fell to 68.2 from the cyclical high reading of 92.1 during June (*Fig. 1*). Nevertheless, this is the 16th month in a row that the index has been above 60%. The survey's *press release* stated: "Aluminum; corrugate and packaging materials; electrical and electronic components; energy; lumber; freight; and some steels continue to remain at elevated prices due to product scarcity amongst high demand. A [prices-paid] Index above 52.7 percent, over time, is generally consistent with an increase in the Bureau of Labor Statistics (BLS) Producer Price Index for Intermediate Materials."

Pandemic: Is Covid Peaking Already? Will the rapidly spreading Omicron variant of Covid mark the end of the pandemic? Stock investors certainly seem to think so given that the S&P 500 rose to yet another new record high on Monday, the first trading day of the new year. We agree with them. In any event, while the pandemic may not be over as soon as many of us hope, we certainly are learning to live with it. Consider the following:

(1) Omicron is the fastest-spreading virus known to humankind. Barely a month after its detection in southern Africa, it was already dominant in countries around the world, and

there have been more cases than ever before. According to an infectious disease expert at Massachusetts General Hospital quoted in a January 3 *El País* article, one case of measles would cause 15 cases within 12 days. One case of Omicron would give rise to another six in four days, 36 in eight days, and 216 in 12 days. With current conditions, a simple exponential growth model would show 14 million people infected in 60 days from a single case, compared to 760,000 with measles in a population with no specific defenses, according to the epidemiologist.

(2) Omicron is capable of infecting people who've been inoculated with Covid vaccines, but the vaccines still prevent serious disease, as confirmed by a recent study by two Dutch virologists mentioned in the *El País* article. By one estimate, the new variant is 25% less severe than the Delta variant, identified in India a year ago, in people who have not been vaccinated or previously infected.

Six preliminary studies suggest that Omicron is able to invade the upper respiratory tract more easily than Delta but is less effective at infecting the lungs. That would explain its higher contagiousness and lower mortality. One very small study, published on December 27, suggests that Omicron infection protects against Delta infection.

(3) Investors are clearly hoping that Omicron will set the stage for the pandemic to turn endemic. In combination with vaccinations, it might lead to enough herd immunity so that the pandemic ends the way wild brushfires stop spreading. Some immunologists expect that the human immune systems will continue to get better at recognizing and fighting back. The hope is that Covid becomes more like the common cold or the seasonal flu.

(4) Meanwhile, the wildfire is raging. In the US, the number of new cases rose to a new record high at the end of last year, slightly exceeding last year's peak (*Fig. 2*). Hospitalizations remain below the peaks of the previous two waves, but they are rising.

In Europe, new cases are off the charts, well surpassing previous peaks (*Fig. 3* and *Fig. 4*). Hospitalizations remain well below previous peaks, but are also rising (*Fig. 5* and *Fig. 6*).

The Mag-8: Will They Remain Magnificent in 2022? On Monday, Apple became the first company to cross the $3.0 trillion market capitalization mark, even if for only a moment. Bloomberg reported that the tech giant will be launching lots of new products in 2022. Also on Monday, Tesla shares soared 13.5% on news that the company delivered 308,600 cars during Q4, as compared to analysts' expectations of 263,000 units. The market capitalization of Apple and Tesla rose to $2,986 billion and $1,205 billion, respectively, on

Monday.

The two companies are in our Magnificent 8 composite of the MegaCap stocks in the S&P 500. The Mag-8 are Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Netflix, NVIDIA, and Tesla. For quite some time, Joe and I have been chronicling the dramatic impact that they have had on the S&P 500. Here's an update:

(1) The Mag-8's market capitalization rose to a record $12.1 trillion at the end of last year, up from $1.2 trillion at the start of 2013 (*Fig. 7*). They accounted for 25.7% of the market cap of the S&P 500 at the end of last year, up from 7.3% at the start of 2013 (*Fig. 8*).

(2) The market cap of the S&P 500 was up 222.1% from the start of 2013 through the end of 2021 (*Fig. 9*). Over this same period, the market cap of the S&P 500 excluding the Mag-8 was up 158.2%. In other words, these eight stocks have accounted for 29% of the market cap gain in the S&P 500 since the start of 2013.

(3) The Mag-8 are all in the S&P 500 Growth index. However, they are not all in the S&P 500 Information Technology sector. Only Apple, Microsoft, and Nvidia are in this sector, and they accounted for 52% of its market cap at the end of last year. Alphabet, Meta, and Netflix are in the Communication Services sector and accounted for 47% of its market cap at the end of last year. Amazon and Tesla are in the Consumer Discretionary sector and accounted for 44% of the sector's market cap at the end of last year.

(4) Here were the market capitalizations of the individual Mag-8 stocks at the end of last year: Apple ($2,913 billion), Microsoft ($2,525 billion), Alphabet ($1,921 billion), Amazon ($1,691 billion), Tesla ($1,061 billion), Facebook ($936 billion), and Nvidia ($735 billion).

(5) At the end of last year, the industry analysts who follow these stocks projected that their revenues and earnings will increase 14.8% and 9.7% over the next 12 months. Those are relatively high growth rates, but they are realistic (*Fig. 10*).

The Mag-8's forward profit margin at the end of last year was 20.4% with Amazon and 27.8% without Amazon (*Fig. 11*). The forward profit margin of the S&P 500 was 13.2% with the Mag-8 and 12.5% without them.

(6) Needless to say, the Mag-8 stocks aren't cheap. Their collective forward P/E was 33.8 at the end of last year compared to 21.3 and 18.6 for the S&P 500 with and without them (*Fig. 12*).

FOMC: Which Fed Heads Rotate? It's time for the annual member rotation of the 19-seat Federal Open Market Committee (FOMC). On January 25 and 26, the FOMC will gather for its first monetary policy meeting of the new year. The presiding Fed governors and the president of the New York Federal Reserve Bank (FRB) will retain their permanent voting status on the FOMC. However, as is annual tradition, the four rotating regional FRB presidents with FOMC voting rights will be replaced with new ones, though all 12 of the regional FRB presidents will continue to participate in the FOMC meetings.

In the past, the FOMC started to tighten monetary policy when the committee judged that inflationary pressures were starting to heat up. Such anticipatory moves didn't happen at the Fed this time around for a couple of reasons. As we've often discussed, the August 2020 update of the FOMC's overriding "*Statement on Longer-Run Goals and Monetary Policy Strategy*" put the employment goal ahead of inflation. Additionally, the Fed has adopted a new approach to targeting inflation, which favors overshooting its long-standing goal of 2.0% annually to make up for previous inflation misses, a strategy dubbed "Flexible Average Inflation Targeting" (FAIT). We call it "FAITH," tacking on an "H" for "hope" at the end.

The Fed had "hoped" that they could bring inflation back under control after letting it run wild, but that strategy hasn't been working out so well. As a result, most current Fed officials, including those FRB presidents who are rotating in as voters, have shifted to the hawkish view that policy needs to tighten to curb inflation now. However, the hawks may be muted if US President Joe Biden nominates more "dovish" progressive-leaning counterparts to the open Fed governors' seats, as we expect he'll do at some point. The President has expressed his commitment "to improving the diversity in the Board's composition," but failed to make nominations in early December as previously intended.

Biden did make good on his word to nominate a Fed chair by the end of last year, renominating incumbent Fed Chair Jerome Powell. Under Powell's continued leadership, tightening likely will remain the course of policy for 2022. The rapid spread of the Omicron variant could slow things down a bit, but the latest Fed consensus is that it's time to end the Fed's period of easy monetary policy and raise interest rates. Consider the following:

(1) *New voting Fed heads.* New to the voting block for 2021—but not new to their roles as FRB presidents—are James Bullard (St. Louis, 2008), Esther George (Kansas City, 2011), Loretta Mester (Cleveland, 2014), and whomever is appointed to the open president's post in Boston. Kenneth Montgomery is the Boston FRB's interim president, succeeding former Boston FRB President Eric Rosengren. "According to Fed practice, Philadelphia Fed

President Patrick Harker, generally viewed as a centrist on monetary policy, will likely substitute for the Boston leader as an FOMC voter until the Boston Fed has a new president," *reported* the *WSJ*.

(2) *Vacant Fed heads.* In addition, US President Joe Biden likely will have three out of seven Fed board governors to appoint. Those include the open seat left by Randal Quarles during 2021 and the one that Richard Clarida, vice chair of the FRB, is expected to vacate when his term ends at the end of January. The Fed board has operated with at least one open slot for the past *eight years*. Quarles' seat is particularly important because it includes the double duty of Fed governor and the lead bank supervisory role at the Fed. Rosengren's and Quarles' resignations were announced in 2021 amid controversy over their trading activities at the height of the pandemic. Clarida was also accused of misconduct. Dallas FRB President Robert S. Kaplan also left his position as a result of the controversy, but the Dallas president doesn't vote during 2022 anyway.

(3) *Hawkish Fed heads*. During a December 3 *speech*, Bullard noted: "The FOMC at upcoming meetings may want to consider removing accommodation at a faster pace." In a November 5 *speech*, George stated: "It is also clear that the risk of a prolonged period of elevated inflation has increased. The argument for patience in the face of these inflation pressures has diminished." In a December 1 Bloomberg *interview*, Mester said: "I do think that we have to be in a position that if we need to raise rates a couple of times next year, we're able to do that." This hawkish chorus of voters rotating in is likely to be joined by Fed Governor Christopher Waller, who turned heads when he said in a December 17 *speech*: "Turning to inflation, it is alarmingly high, persistent, and has broadened to affect more categories of goods and services, compared with earlier this year."

(4) *Dovish Fed head candidates.* Nevertheless, the pack of hawks could be muted if, as we expect, Biden nominates more dovish counterparts into the open governor seats. The *WSJ* reported on Friday that Biden could appoint former Fed Governor Sarah Bloom Raskin to the supervisory role and Michigan State University Professor Lisa Cook and Davidson College Professor Philip Jefferson to the other two Fed governor positions.

Treasury Secretary Janet Yellen reportedly had considered Raskin to head the US Treasury's new climate hub. In Raskin's former role as deputy Treasury secretary in the Obama administration, following when she worked alongside Yellen as a Fed governor, Raskin warned in interviews and speeches that US regulators must do more to strengthen the financial system's resilience to climate risks.

(5) *Fed-head-in-chief.* Controversially, Biden *announced* his intent to nominate Fed Chair Powell for an additional four-year term November 22 as well as to nominate Fed Governor Lael Brainard as vice chair. That followed accusations of the previously mentioned ethics violations, which didn't involve Powell personally but did occur on his watch.

Senator Elizabeth Warren (D-MA) blasted the Fed chair at a hearing in October, calling him a "dangerous man to head up the Fed." Warren has opposed Powell's perceived relaxed view on bank supervision. Biden said that he picked Powell because he "provided steady leadership during an unprecedently challenging period," communicating respect for the Fed's political independence. Brainard reportedly had been considered as a replacement to Powell but ended up with the nod as vice chair. Biden's expected pick for the supervisory role, Raskin, is expected to appease Warren.

In any event, the leader of the Fed heads is heading toward tightening. In a December 15, *press conference*, Powell said: "We're in a position where we're ending our taper by March, in two meetings, and we'll be in a position to raise interest rates as and when we think it's appropriate." The Fed also signaled that it likely will raise interest rates by about 75 basis points before the end of 2022 in its latest *Summary of Economic Projections*. Each of the 18 officials submitting expectations saw rates rising in 2022, and most of them saw three 0.25ppt increases.

Calendars

US: Wed: ADP Employment 390k; MBA Mortgage Applications; FOMC Minutes. **Thurs:** Initial & Continuous Jobless Claims 200k/1.72m; ISM NM-PMI 71.0; Factory Orders 1.4%; Trade Balance -$74.8b; Natural Gas Storage. (Bloomberg estimates)

Global: 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. **Thurs:** Germany Factory Orders 2.1%; Germany CPI 0.4%m/m/5.1%y/y; UK C-PMI & NM-PMI 53.2/53.2; Japan Household Spending -0.6%; Schnabel. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q4 Earnings Trend vs. Past Quarters (*link*): With the December-quarter books closed, the current Q4-2021 earnings forecast of $51.15 per share has risen 0.1% since the quarter's start. While that's a slowdown from the 3.3%, 7.2%, and 5.7% gains over comparable weeks during Q3-2021, Q2-2021, and Q1-2021, respectively, the increase indicates there will be another strong earnings surprise hook. The gain in the Q4 forecast marks a record-high sixth straight quarter that consensus forecasts rose throughout the quarter and is well above the average three-month decline of 4.2% for all quarters since Q1-2000. Analysts expect Q4 earnings will rise 20.1% y/y, but we think y/y growth will be 29.1% to earnings of about $55.00 per share. That's above the $53.89 reported for Q3, but the y/y growth rate will slow markedly from 39.3% during Q3. Q4-2021 should mark the sixth straight positive surprise for the S&P 500 and its 50th in the past 51 quarters. The Q4 earnings forecast rose during the quarter for five of the 11 S&P 500 sectors, down from eight of the 11 sectors improving before the Q3 earnings season. Here's how much the Q4 earnings forecast changed for the sectors over the course of Q4: Energy (43.1%), Real Estate (2.9), Financials (2.8), Materials (0.8), Information Technology (0.5), S&P 500 (0.1), Utilities (-1.5), Communication Services (-1.6), Consumer Staples (-1.9), Health Care (-2.7), Industrials (-10.5), and Consumer Discretionary (-14.4).

US Economic Indicators

Construction Spending (*link*): Total construction spending reached yet another record high in November, posting only one decline since June 2020. Total spending edged up 0.4%, matching October's gain, slowing from gains of 1.0% in each of the prior two months. It has increased a whopping 13.3% since bottoming in mid-2020. Private construction spending led the recovery, also reaching a new record high, as residential investment spending made the record books. Meanwhile, nonresidential spending remains on an upward trend, climbing to within 9.4% of its record high recorded in January 2020, just before the pandemic hit. Within residential investment, single-family (1.2%) and home-improvement (0.9) spending continued to climb in November, with the former at a new cyclical high and the latter at a new record high. Multi-family (-0.3) spending dipped a bit, but was only fractionally below its record high reached during July. In the meantime, public construction spending slipped 0.2% in November, after a 4.3% rebound during the four months through October, and is 6.0% below its record high recorded during March 2020.

Global Economic Indicators

Global Manufacturing PMIs (*link*): Global manufacturing activity ended 2021 on an up note, with growth in output, new orders, and employment all accelerating, while business confidence remained optimistic. The report notes that while the manufacturing sector continued to be troubled by price inflation and supply-chain pressures, there were at least tentative signs that these were beginning to ease. The JP Morgan Global M-PMI posted a reading of 54.2 for the third month in December, as the M-PMI for emerging economies (to 51.7 from 51.2) accelerated a bit last month and the M-PMI for developed economies (56.6 from 56.9) eased a bit. Of the 30 countries for which data are available for December, growth expanded in 26 countries—with 14 of those nations showing slower growth than in November, while China returned to growth. Meanwhile, four countries (Brazil, Thailand, Mexico, and Myanmar) contracted during the month. Here's a country ranking of December M-PMIs from highest to lowest: Italy (62.0), Czech Republic (59.1), Greece (59.0), Netherlands (58.7), Austria (58.7), Ireland (58.3), EUROZONE (58.0), UK (57.9), US (57.7), Australia (57.7), Germany (57.4), Canada (56.5), Spain (56.2), Poland (56.1), France (55.6), India (55.5), Taiwan (55.5), Japan (54.3), WORLD (54.2), Indonesia (53.5), Colombia (53.1), Malaysia (52.8), Vietnam (52.5), Turkey (52.1), South Korea (51.9), Philippines (51.7), Russia (51.6), China (50.9), Brazil (49.8), Thailand (49.5), Mexico (49.4), and Myanmar (49.0).

US Manufacturing PMIs (*link*): Manufacturing activity in December remained robust, though below recent highs, according to both M-PMI measures, while price pressures also eased in both surveys. December's ISM M-PMI edged down to 58.7 from 61.1 during November; it was at 64.7 in March, which was the best reading since 1983. The new orders (to 60.4 from 61.5) measure remained slightly above 60.0, while the production (59.2 from 61.5) measure slipped just below 60.0. The orders and production gauges were at cyclical highs of 68.0 and 68.1, respectively, during March. Meanwhile, the employment (54.2 from 53.3) gauge moved further above the breakeven point of 50.0, after slipping below in August (49.0), recording the fastest pace of hiring since April. The supplier deliveries (64.9 from 72.2) component of the M-PMI dropped below 70.0 after three months above, as supply constraints are starting to ease, while the inventories (54.7 from 56.8) measure shows inventories continued to accumulate at a fairly steady pace. ISM's price (68.2 from 82.4) index eased noticeably in December, slowing further from June's 92.1—which was the fastest since summer 1979. Looking at IHS Markit's M-PMI, it slowed for the fifth month since reaching a record-high 63.4 in July, slumping to a 12-month low of 57.7 in December, as material shortages and supplier delays dragged on. While shortages remained, the end of 2021 saw some signs that cost pressures have eased, with the rate of input price inflation slowing to a six-month low from November’s record high.

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