MORNING BRIEFING
January 11, 2022

Is the Party Ending or Just Moving?

Check out the accompanying chart collection.

(1) Drinking the Fed's punch. (2) Party getting out of hand. (3) Fed will soon stop filling up the punch bowl, but there will be lots of liquidity left in there. (4) Inflation spiked by spiked punch. (5) FOMC minutes' talk about paring Fed's balance sheet shocks investors. (6) Bond Vigilantes no longer punch drunk? (7) Expected inflation is up, but prices-paid index is down. (8) Are rising bond yields so bearish for Growth? (9) No, but they are bullish for Financials. (10) Mag-8 accounts for almost 50% of Growth's market cap. (11) When in doubt, diversify with Energy, Financials, and the Mag-8.

Strategy I: The Punch Bowl. Fed Chair Jerome Powell has been a party animal since the start of the pandemic, continually filling the Fed's punch bowl with lots of high-octane liquidity. During 2020, all that rum punch fueled a V-shaped economic recovery, i.e., a fast rebound from a severe but short recession. It lasted only two months, i.e., March and April, according to the Index of Coincident Indicators (*Fig. 1*).

On a quarterly basis, the recession spanned two quarters, i.e., Q1-2020 and Q2-2020 (*Fig. 2*). Real GDP fully recovered and rose to a new record high during Q2-2021. The party started to get out of hand last March, when the CPI inflation rate breached the Fed's 2.0% target, rising to 2.6% y/y (*Fig. 3*). It got as high as 6.8% y/y during November. December's number—to be released on Wednesday—is expected to exceed 7.0% y/y.

The Fed kept filling the punch bowl nonetheless, because Powell and other Fed officials believed that the spike in inflation was transitory notwithstanding the spiked punch. They changed their minds late last year. Consider the following:

(1) During the November 2-3 FOMC meeting, members voted to start tapering their bond purchases of $120 billion per month by $15 billion per month so that they would stop by July. (See the November FOMC *statement*.) During their December 14-15 meeting, the committee decided to taper by $30 billion per month starting in January, thus ending their bond purchases by April.

At his post-meeting *press conference* at the end of last year. Powell suggested that the Fed could start raising the federal funds rate soon after tapering was done. He mentioned that there was a discussion about reducing the Fed's balance sheet without "the need for another long delay" after the first rate hike. However, he also said, "we'll make this decision in coming meetings, and it's not—it's not a decision that the Committee has really focused on yet."

(2) But then the actual *minutes* of the December meeting was released on January 5 and investors were shocked to learn that there was a new section titled "Discussion of Policy Normalization Considerations." It turns out that there was significant discussion about reducing the Fed's balance sheet.

As Melissa and I observed in yesterday's *Morning Briefing*, "The big surprise that unnerved investors is that the minutes noted that participants discussed 'the appropriate conditions and timing for starting balance sheet runoff relative to raising the federal funds rate.' Furthermore, '[a]lmost all participants agreed that it would likely be appropriate to initiate balance sheet runoff at some point after the first increase in the target range for the federal funds rate.' The word 'runoff' was mentioned 10 times in the minutes. It wasn't mentioned at all in the previous minutes."

(3) So the FOMC is set to stop filling the punch bowl. However, we aren't convinced that doing so would end the party for the stock market. Through Monday's close, the S&P 500 is down only 2.6% from its record high of 4796.56 on January 3. On the other hand, the party has already ended for some stocks, such as those in Cathie Wood's ARK funds. Lots of Nasdaq stocks are in bear markets. The Nasdaq is down 6.9% from its record high on November 19, with the Nasdaq 100 down 5.8%, also from its November 19 record high.

Meanwhile, as we've discussed often recently, there is plenty of liquidity left in the punch bowl as a result of the excessively stimulative fiscal and monetary policies of the past two years. We reckon that M2 currently exceeds its pre-pandemic uptrend by $3 trillion to $4 trillion (*Fig. 4*). It is up $6.0 trillion from February 2020 through November 2021, led by a $3.1 trillion increase in demand deposits.

Strategy II: Bond Vigilantes Sobering Up. The 10-year US Treasury bond yield jumped from 1.514% at the end of last year to 1.63% on January 3, the first trading day of the new year (*Fig. 5*). It did so on expectations of a faster pace of Fed tapering and an earlier start to Fed rate-hiking this year. The "run-off" minutes released on January 5 pushed the yield higher. It closed at 1.767% yesterday.

The 2-year US Treasury note yield tends to be a good year-ahead leading indicator for the federal funds rate. It started the year at 0.774%, implying three 25bps rate hikes this year. Yesterday, it closed at 0.902%, implying possibly four rate hikes (*Fig. 6*).

In the January 4 *Morning Briefing*, we discussed whether the bond market might act more normally in 2022 than it did in 2021. We observed that despite the surge in inflation last year, the bond yield mostly hovered around 1.50%. Around mid-year, we moved our 2.00% target for the yield from the end of last year to the end of this year. Now it appears we will get to 2.00% soon, so we are raising our year-end target to 2.75%. It could go still higher in 2023, but for now we are predicting that inflation will moderate by the second half of this year. Consider the following related developments:

(1) The most bearish indicators for the bond market have been all the uniformly ugly inflation statistics since last March, noted above. As a result, the median one-year-ahead expected inflation rate was 6.0% during November according to a survey of consumers conducted by the NY Fed (*Fig. 7*). The only bit of good news, so far, was 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. 8*).

(2) The copper-to-gold price ratio has been hovering around a level consistent with a bond yield of 2.50% since late April of last year (*Fig. 9*). This ratio has been closely tracking the yield since 2004, but they diverged last year. The V-shaped recovery in the M-PMI since summer 2020 should have been more bearish for bonds as well last year (*Fig. 10*).

Strategy III: Is the Party Moving from Growth to Value? Computer trading algorithms and portfolio managers seem to have something in common these days: They rotate out of Growth and into Value stocks when bond yields are rising. They've certainly been doing that so far this year. Since the end of last year through Friday's close, the S&P 500 Growth index is down 4.5%, while the Value index is up 1.0%. Much of the rotation seems to be out of the S&P 500 Information Technology sector and into Energy and Financials. Let's have a closer look at the dynamics of this rotation:

(1) *Bond-yield correlations.* There has been some correlation between the 10-year bond yield and the ratio of the S&P 500 Financials to the S&P 500 Information Technology stock market indexes (*Fig. 11*). Both variables have been in downward trends since the early 1990s. On a short-term basis over several weeks and even months, they have diverged. Eyeballing the two, we are convinced that even a computer algorithm could not make money trading the relationship of the two.

A better correlation is between the bond yield and the ratio of the S&P 500 Financials to the market capitalization of the S&P 500. The fit between the two has been especially tight since the start of the pandemic (*Fig. 12*).

(2) *Growth and Mag-8 market cap*. Growth tends to account for about 50%-55% of the market cap of the S&P 500 (*Fig. 13*). The Magnificent Eight (the eight biggest-cap stocks in the index) currently account for almost 50% of the market cap of Growth, up from around 13% during 2013 (*Fig. 14*). The Mag-8 account for about 25% of the market cap of the S&P 500 (*Fig. 15*).

(3) *Market cap winners and losers.* Last year, the S&P 500 rose 26.9%. The Mag-8's market cap rose 37.5%. Excluding them, the S&P 500 was up 23.7% (*Fig. 16*).

Last year, the S&P 500 Growth index increased 31.0%. Excluding the Mag-8, S&P 500 Growth increased 20.9% (*Fig. 17*).

(4) *Relative forward earnings.* The forward earnings of the S&P 500 Growth has been outpacing the forward earnings of the S&P 500 Value for many years (*Fig. 18*). ("Forward earnings" is the time-weighted average of analysts' consensus earnings estimates for this year and next.) The outperformance was accelerated by the pandemic, as the former rose 39.8% and the latter rose 6.3% from the last week of 2019 through the last week of 2020.

(5) *Mag-8 earnings growth rates.* I asked Joe to calculate STRG and STEG for the Mag-8. The former is analysts' consensus expectation for forward revenues growth over the short term (i.e., one year ahead), while the latter is their consensus expectation for short-term forward earnings growth (*Fig. 19*).

During the January 6 week, STRG was 14.9%, while STEG was 9.7%. Here are the STRG and STEG readings as of January 7 for each of the Mag-8 stocks: Alphabet (16.6%, 4.7%), Amazon (17.7, 27.5), Apple (4.5, 4.3), Meta (18.9, 3.6), Microsoft (15.8, 15.9), Netflix (14.6, 22.4), Nvidia (19.0, 19.9), and Tesla (39.7, 38.4). (See our *The Magnificent Eight* chart book.)

(6) *Valuation.* Investors certainly aren't worrying about the Mag-8's growth potential. What has them on edge is the group's high forward P/E. It was 32.2 during the January 7 week. That's why the forward P/E of the S&P 500 Growth is at 27.0 (*Fig. 20*).

While the ratio of the S&P 500 Financials sector's stock price index to the S&P 500

Information Technology sector's stock price index displays some correlation with the bond yield, the same cannot be said about the ratio of Growth's to Value's stock price indexes.

(7) *Don't sell Growth short.* Our conclusion is that the bond yield is just one of many variables involved in the valuation of Growth. The most important variable is probably earnings growth itself, which still looks solid for the Mag-8. Another valuation booster is all the liquidity that remains in the Fed's punch bowl.

So we would stick with the Mag-8. Of course, it's hard to market-weight them, let alone to overweight them, since most portfolio managers are limited in the percentage of their portfolio that can be in any individual stock. Own them, and own stocks in the S&P 500 Energy and Financials sectors too.

Calendars

US: Tues: NFIB Small Business Optimism Index 98.6; MBA Mortgage Applications; EIA Short-Term Energy Outlook; Powell; Mester; George. **Wed:** Headline & Core CPI 0.4%m/m/7.0%y/y & 0.5%m/m/5.4%y/y; Fed Budget Balance -$25.0b; Crude Oil Inventories & Gasoline Production; Cleveland CPI; Beige Book. (Bloomberg estimates)

Global: Tues: Italy Retail Sales 0.6%; Spain Industrial Production 0.6%; Japan Leading & Coincident Indicators; China CPI & PPI 1.8%/11.1% y/y; Lagarde; Weidmann; Kuroda. **Wed:** Eurozone Industrial Production 0.5%m/m/0.6%y/y; Enria; Cunliffe. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three indexes had forward earnings at a record high last week. LargeCap's was at a record high for a second week after dropping a week earlier due to index changes. MidCap's was at a record high for a fifth straight week after dropping 0.1% below at the end of November. SmallCap's was out of record-high territory for a third week due to index changes, but improved to 0.2% below its peak. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 81 of the past 85 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 79 of the past 83 weeks, and SmallCap's posted 79 gains in the past 84 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 58.7% 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 177.4% 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 down to 33.1% y/y in the latest week from 33.4%; 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 fell w/w to 51.0% y/y from 52.2%; 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 59.8% y/y from 59.9%; 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%, 8.5%), MidCap (83.0, 7.9), and SmallCap (121.3, 13.7).

S&P 500/400/600 Valuation (*link*): Valuations fell across the board for these three indexes last week. LargeCap's forward P/E dropped 0.5pt w/w to 20.9 from 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 fell 0.3pt to a 21-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 slipped 0.3pt to 14.8 from a six-week high of 15.1, but remains above 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 11.9pts 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 25% discount to LargeCap is its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 72nd 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 29th straight week; SmallCap's current 5% 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 up 1 cent w/w to $51.16, and is up from $51.08 at the beginning of the quarter. That $51.16 estimate represents a gain of 20.1% y/y on a frozen actual basis and a 22.4% 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 growth is slowing. 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 (10,527.1% in Q4-2021 versus 1,798.0% in Q3-2021), Materials (64.2, 89.1), Industrials (51.5, 88.4), S&P 500 (22.4, 42.6), Health Care (19.4, 29.0), Real Estate (13.9, 34.4), Information Technology (15.9, 38.2), Communication Services (9.6, 35.6), Consumer Discretionary (8.1, 19.4), Financials (2.2, 35.9), Consumer Staples (3.3, 7.4), and Utilities (0.8, 10.3).

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