MORNING BRIEFING
January 27, 2022

The Fed, Stocks & CBDC

Check out the accompanying chart collection.

(1) Fed Chair Powell fails to calm investors' nerves. (2) Bracing for higher interest rates and balance-sheet reductions. (3) The cloud, 5G, and consumer spending boost earnings of Microsoft, Corning, and AmEx. (4) The average stock not down as much as index performance would suggest. (5) The MegaCap-8 stocks take their toll. (6) Athletes can try China's digital currency—the e-CNY—at the Olympics. (7) The Fed is STILL studying a digital dollar. (8) Assessing the digital dollar's impact on banks, monetary policy, privacy, and money laundering.

Strategy I: Earnings Cut Through the Gloom. Since early this month, the stock market has been having a taper tantrum. Federal Reserve Chair Jerome Powell wasn't very comforting at his *press conference* yesterday following the end of the latest meeting of the FOMC.

Investors had been hoping that Powell would get their message and give them some love, or at least some dovish talk. At first, when the FOMC *statement* didn't mention reducing the balance sheet, investors took that as a dovish response to their tantrum. But Powell squelched that impression when he said that the labor market is very strong and that the Fed's balance sheet is too large. He made it clear that the Fed was proceeding with tightening monetary policy by ending bond purchases in March and starting to raise the federal funds rate at the same time. Then he indicated that the Fed will proceed with balance-sheet reductions. Much as we all may have to learn to live with Covid, we will have to deal with the Fed's pivot from easy to tight monetary policy.

Despite the specter of higher interest rates fueled by Powell's press conference, stocks received some support yesterday from better-than-expected earnings news from a handful of companies. Let's have a look at three of these—Microsoft, Corning, and American Express:

(1) *Microsoft: Big but getting bigger.* Microsoft's December-quarter earnings assuaged a lot of nerves. The giant tech company grew its top line by 20% to $51.7 billion, and its net income jumped 21% to $18.8 billion. That's amazing growth for such a large company. Results beat analysts' estimates, and management raised its sales forecast for the current

quarter. Microsoft's revenue from Azure and other cloud services rose 46% last quarter, down slightly from 48% growth in the September quarter; but with growth that strong, complaining about the slippage seems like splitting hairs.

Microsoft shares trade at 32.4 times consensus earnings estimates for the fiscal year ending June 2022, almost twice the 15.6% earnings growth rate analysts are forecasting for fiscal 2022. But those earnings estimates have been increasing—from $9.11 per share three months ago to $9.30 today. Microsoft shares rose 2.9% on Wednesday.

(2) *Corning reignites tech optimism.* Corning's pricing power managed to offset higher costs last quarter and resulted in earnings that beat Wall Street's expectations. The company's adjusted Q4 sales rose 11.6% to $3.7 billion, and its adjusted earnings jumped 3.8% to 54 cents a share, above the Street's forecast of 52 cents. Management also surprised analysts by raising its 2022 revenue forecast to $15.0 billion, representing 6.4% growth, versus analysts' consensus expectation of $14.7 billion.

Corning's optical communications division benefitted last quarter from the 5G rollout as well as the growth in cloud computing. That unit's Q4 sales grew 23.6% y/y to $1.2 billion, but its net income gained only 9.9% y/y to $141 million, hurt by increased raw materials prices and higher shipping costs in H2-2021, the company's *press release* stated.

Revenue in Corning's display technologies business also jumped, by 12.0% y/y to $841 million, and net income rose 16.1% y/y to $252 million, helped by a favorable pricing environment and volume growth.

While margins took a hit from increased freight, logistics, and raw material costs and lower automotive sales, the company has renegotiated customer contracts to share the greater cost burden, said CFO Tony Tripeny. "The revised pricing terms take effect throughout 2022, and we expect gross margin to expand accordingly." Corning shares jumped 11.2% Wednesday.

(3) *Amex attracts the youngsters.* American Express management presented an optimistic outlook on Tuesday that sent its shares higher. The company benefitted from increased spending on goods last year and is expected to benefit from the pickup in spending on consumer and corporate travel this year—assuming that Covid-19 cases recede. The company expects revenue will increase 18%-20% in 2022 after climbing by 29.9% y/y in Q4-2021 as net income improved by 19.5% y/y. Results in Q4-2020 were hurt by a provision for credit losses that wasn't repeated in Q4-2021.

“AmEx said trip bookings were up 24% in the fourth quarter over 2019 and up 44% through the first couple of weeks of January,” a January 25 *WSJ* article reported. The company also noted that Millennials and Gen Z customers represented about 60% of new accounts added last year, which bodes well if the company can retain those accounts. AmEx shares climbed 10.3% over Tuesday and Wednesday.

Strategy II: Average Never Looked So Good. Technology stocks once again are having an outsized impact on the S&P 500’s performance. Last year, the rally in big tech helped the S&P 500 perform much better than the average stock. This year, the reverse is true. The huge drop in large-technology stocks has caused the S&P 500 to perform much worse than the average stock. Don’t get us wrong—the performance this year is still negative for most S&P 500 stocks. It’s just not as terrible as headlines and the performance of tech stocks might suggest. Let’s take a look:

(1) *Tech’s impact on sectors.* Eight of the S&P 500’s 11 sectors are outperforming the broader index. The exceptions are those that have exposure to stocks that we call the “MegaCap-8”: Alphabet (the former Google), Amazon, Apple, Meta (the former Facebook), Microsoft, Netflix, Nvidia, and Tesla. Here’s the performance derby for the S&P 500 and its sectors from its peak on January 3 through Tuesday’s close: Energy (14.4%), Financials (-2.8), Consumer Staples (-3.0), Industrials (-4.0), Utilities (-5.3), Materials (-6.8), Health Care (-8.2), Real Estate (-8.7), S&P 500 (-9.2), Communication Services (-11.2), Information Technology (-14.0), and Consumer Discretionary (-15.1).

The MegaCap-8 stocks kick in from 45% to 52% of the market capitalization of the three underperforming sectors, according to Joe’s calculations. Consumer Discretionary is home to Amazon and Tesla; Information Technology holds Apple, Microsoft, and Nvidia; and Communication Services includes Alphabet, Meta, and Netflix (*Fig. 1*, *Fig. 2*, and *Fig. 3*).

Each of the MegaCap-8 stocks has fallen more sharply than the S&P 500. Here are their performances from January 3 through Tuesday’s close: Alphabet (-12.5%), Amazon (-17.9), Apple (-12.2), Meta (-11.3), Microsoft (-13.8), Netflix (-38.7), Nvidia (-25.9), and Tesla (-23.5). The MegaCap-8 is down 15.8%, the S&P 500 is down 9.2%, and the S&P 500 excluding the MegaCap-8 stocks is down 6.9% (*Fig. 4*).

The impact is even more dramatic if the clock starts when the MegaCap-8 shares collectively peaked on December 27; here are those stats through Tuesday’s close: Alphabet (-14.2%), Amazon (-17.5), Apple (-11.4), Meta (-13.3), Microsoft (-15.8), Netflix (-40.2), Nvidia (-27.9), and Tesla (-16.0). The MegaCap-8 is down -15.9%, the S&P 500 (-

9.1), and the S&P 500 excluding MegaCap-8 (-6.7).

(2) *A look at industries.* This bodes well for the average portfolio manager, who is bound to keep individual stock positions to 2%-3% of total assets under management. S&P 500 industries that performed in the top quartile are either in positive territory since January 3 or they've loss less than 2%. These overachievers include many Energy sector industries and an odd mix of industries in the Industrials, Financials, and Materials sectors.

Here are the top-performing S&P 500 industries from January 3 through Tuesday's close: Oil & Gas Equipment & Services (20.9%), Oil & Gas Exploration & Production (15.9), Integrated Oil & Gas (15.0), Oil & Gas Refining & Marketing (9.2), Brewers (6.1), Tobacco (5.8), Oil & Gas Storage & Transportation (5.6), Housewares & Specialties (5.6), Agricultural & Farm Machinery (5.2), and Interactive Home Entertainment (5.1).

The S&P 500 industries with the biggest losses are chock full of tech names, but industries in other areas—particularly those with lofty P/Es—have hit the skids too. For example, the performance of Estee Lauder shares is weighing down the performance of the S&P 500 Personal Products industry index, and that of Align Technology, maker of Invisalign braces, has hurt the performance of Health Care Supplies.

Here are the worst-performing S&P 500 industries since January 3: Movies & Entertainment (-24.9%), Automobile Manufacturers (-21.7), Personal Products (-20.5), Health Care Supplies (-19.4), Semiconductor Equipment (-18.5), Semiconductors (-18.4), Internet & Direct Marketing Retail (-17.9), Steel (-16.7), Electronic Equipment & Instruments (-16.2), and Application Software (-15.7).

(3) *Deflating multiples.* The selloff has taken a large toll on the MegaCap-8 stocks' forward P/Es (i.e., the P/E multiples based on forward earnings, which is the time-weighted average of analysts' consensus estimates for this year and next). Here's a look at where the forward P/Es were last Friday and where they stood just before the MegaCap-8's market capitalization peak: Tesla (99.6, 129.3), Amazon (53.7, 66.3), Nvidia (44.9, 57.7), Netflix (33.5, 46.9), Microsoft (29.6, 33.9), Apple (27.5, 30.1), Alphabet (22.9, 30.1), and Meta (21.0, 23.6) (*Fig. 5*).

The MegaCap-8 stocks are boosting the S&P 500's forward P/E multiple by 2.0 points. Were the MegaCap-8 excluded, the S&P 500's multiple would drop to 18.3 (*Fig. 6*). At its peak in late August 2020, the MegaCap-8's multiple reached 38.5, it was down to 29.8 last Friday. The valuations of Amazon, Meta, Netflix, and Tesla have all fallen by more than

30% since then.

Disruptive Technologies: Digital Currencies at Home & Abroad. When visitors arrive at the Winter Olympics next week, they'll be able to use China's digital yuan—also called the "e-CNY"—to make purchases in the Olympic Village and surrounding area such as on buses and subways, in supermarkets, and at tourist spots like the Forbidden City, reported a January 19 *South China Morning Post* (*SCMP*) *article*.

While China rolled out the digital yuan in 10 regions last year, the Federal Reserve is still studying the possibility of creating a digital dollar. The Fed put out a study last week and asked for comments on the subject. After comments are received, there will be public hearings on the matter and Congress may need to jump in with legislation. In other words, we'll be lucky to see a digital dollar in 2023.

Here's a look at what the Chinese are doing with their digital currency and what the Fed is studying:

(1) *The Chinese rollout.* China started testing the e-yuan in April 2020 and has rolled it out to 10 cities/areas so far. By the end of last year, the e-CNY had been used in 87.6 billion yuan ($13 billion) of transactions, 261 million digital wallets had been opened, and the digital currency was accepted by more than 8 million merchants.

To drum up interest in the digital currency, the Chinese government has given out vouchers with free money through merchants and banks, and local governments have held lotteries that give away the e-CNY. The government has not announced when it will roll out the e-CNY to the rest of the country.

(2) *e-CNY at the Olympics.* Visitors to the Olympic Village can use the e-CNY by downloading a phone app, getting a physical card, or using self-service machines that convert foreign bank notes into e-CNY, a January 10 Bloomberg *article* reported. Athletes and coaches can swipe wristbands that act as e-wallets to pay for goods and services.

Alipay and WeChat Pay, which control over 90% of China's mobile payments market, also support digital yuan payments. But surprisingly, their payment services cannot be used in the Olympic Village, the Bloomberg article reported. Only the e-CNY, renminbi cash, and Visa cards will be honored. Perhaps that's the latest indication that China's government aims to take its Internet giants down a peg.

(3) *Sidestepping SWIFT.* Officials in Beijing, Hong Kong, Thailand, and the United Arab Emirates reportedly have "been collaborating" about the use of digital currency in international markets, a January 22 *article* in the *SCMP* reported. Doing so would likely allow these nations to bypass the SWIFT (Society for Worldwide Interbank Financial Telecommunications) network used by financial institutions to transfer funds and securities internationally. Threatening to take away access to SWIFT or actually doing it has been one way the US and other western nations have punished international bad actors. Iran was kicked off the network in 2012, and Russia may be next if it invades the Ukraine.

(4) *Fed still studying.* Meanwhile, the Fed is moving at a glacial pace. The *paper* it introduced last week examines the pros and cons of a digital dollar. While the Fed is asking for comments on the matter, it did have an opinion on the subject: "The Federal Reserve's initial analysis suggests that a potential U.S. CBDC, if one were created, would best serve the needs of the United States by being privacy-protected, intermediated, widely transferable, and identity-verified." The Fed will move forward only if it determines that a digital currency is superior to the existing system and only with the support of the executive and legislative branches of government, ideally through authorizing law.

A CBDC would need to offer consumers privacy but enough transparency to deter criminal activity. Banks and nonbank financial service providers would offer accounts or digital wallets to manage CBDC holdings and payments, even though the CBDC would be a liability on the books of the Federal Reserve. CBDC providers would have to comply with existing rules to combat money laundering and the financing of terrorism, including the verification of the identity of persons accessing CBDC. Banks have existing systems to do the necessary due diligence, recordkeeping, and reporting.

The Fed hopes the digital dollar will be more inclusive than our current currency system and reduce related expenses, which is particularly important for underserved and lower-income households. More than 5% of US households are unbanked, and another 20% with bank accounts use expensive financial services like money orders, check-cashing services, and payday loans. Cross-border payments are slow, have high fees, and have limited access, sometimes because of the institutions in the overseas country.

That should improve next year. "The Clearing House has developed the RTP network, which is a real-time interbank payment system for lower-value payments. The Federal Reserve is also building a new interbank settlement service for instant payments, the FedNow Service, scheduled to debut in 2023," the report states. But it still falls short of the convenience, cost savings, and liquidity a digital dollar might offer.

(5) *Weighing the pros and cons.* A CBDC would give the public access to digital money free from credit and liquidity risk. It would give small, private-sector financial innovators the ability to invent new services and distribution methods without worrying about the need to develop a currency. It could be used in micropayments and to make payments at certain times. With the right international coordination, a digital dollar could make international transfers easier. And it might preserve the international role of the dollar, allowing the US to compete with other countries that are issuing digital currencies.

There are risks, however. If consumers were paid interest on their CBDC, they might no longer hold cash in bank accounts, requiring banks to find alternative funding sources. These new sources possibly might increase their costs and reduce their capital availability. The same might hold true for money market mutual funds, Treasury bills, and other short-term instruments. Another issue: If consumers could quickly convert bank deposits into essentially risk-free CBDC, bank runs could become more likely during times of financial stress. These problems might be dodged by making CBDC non-interest-bearing, limiting the amount of digital dollars that any end user could hold, and/or limiting the amount of digital dollars that could be acquired over short periods.

The Fed also needs to study how a CBDC will affect monetary policy. A CBDC might result in the Fed increasing the size of its balance sheet and holding more reserves and/or securities to ensure ample liquidity in the system. A CBDC would have more of an impact on the overall system if it pays interest.

Any system using a CBDC would have to be extremely resilient to operational disruptions and cybersecurity risks. Again, existing banks—which already have the necessary infrastructure—would likely have an advantage. The Fed is researching whether offline CBDC payments would be feasible, as that feature could help protect against the collapse of the entire payment system during times of natural disasters or other large disruptions.

Calendars

US: Thurs: Real GDP & GDP Price Index 5.5%/6.0%; Core PCED 4.9%; Durable Goods Orders, Total, Core, and Core Nondefense Capital Goods Orders -0.5%/0.4%/0.4%; Initial & Continuous Jobless Claims 260k/1.65m; Kansas City Fed Manufacturing Index; Pending Home Sales -0.2%; Natural Gas Storage. **Fri:** Personal Income & Consumption 0.5%/-0.6%; Core PCED 0.5%m/m/4.8%y/y; Consumer Sentiment Index Headline, Current

Conditions, and Expectations 68.7/73.2/65.8; Employment Cost Index 1.2%; Baker-Hughes Rig Count. (Bloomberg estimates)

Global: Thurs: Germany Gfk Consumer Climate -7.8; Spain Unemployment Rate 14.2%. **Fri:** Eurozone Economic Sentiment 114.5; Germany GDP -0.3%/1.8%y/y; France GDP 0.5%; Spain GDP 1.4%q/q4.5%y/y; Italy Business & Consumer Confidence 115.3/116.5. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) slipped further below 2.00 again this week after moving above 2.00 three weeks ago for the first time since late November. The BBR sank for the third week to 1.31 this week—the lowest since mid-April 2020—after climbing three of the prior four weeks from 1.57 to 2.15. Bullish sentiment fell 15.7ppts the past three weeks to 34.9% after climbing 10.8ppts (to 50.6% from 39.8%) the prior three weeks—with the 50.6% reading three weeks ago the first percentage above 50.0% since late November. The latest three-week drop in bullish sentiment reflects a 12.5ppts (38.4% from 25.9%) jump in the correction count to its highest percentage since March 2020—with the largest group of respondents now projecting a correction. Bearish sentiment climbed for the second week to 26.7% this week after slipping 2.3ppts (to 23.0 from 25.3) the previous four weeks. The AAII Ratio dropped for the third week last week to 31.0%—the lowest since late July 2020—after rebounding the prior two weeks from 39.1% to 55.2%, as bullish sentiment dropped from 37.7% to 21.0% over the three-week period while bearish sentiment rose from 30.5% to 46.7%.

S&P 500 Q4 Earnings Season Monitor (*link*): With nearly 20% of S&P 500 companies finished reporting revenues and earnings for Q4-2021, revenues have beat the consensus forecast by 1.7% and earnings by 3.0%. These surprises are substantially weaker than the pace seen since Q1-2020. At the same point during the Q3 season, revenues were 2.2% above forecast and earnings beat by 12.8%. For the 100 companies that have reported Q4 earnings through mid-day Wednesday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings during Q2 and Q3. The small sample of Q4 reporters so far collectively has a y/y revenue gain of 10.3% and an earnings gain of 21.3%. Just 81% of the Q4 reporters so far has reported a positive earnings surprise, not much higher than the 79% that has beaten revenues forecasts. However, fewer companies have reported positive y/y earnings growth in Q4 (78%) than positive y/y revenue growth

(87). These figures will change markedly as more Q4-2021 results are reported in the coming weeks, but the early read on earnings is disappointing compared to the previous six quarters. We expect the y/y growth rates to continue easing in Q4 compared to Q2 and Q3. We also think the revenue and earnings surprises will moderate q/q as well due to missed deliveries, higher costs, and increased company guidance ahead of the earnings season.

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI improved m/m in January for the first time since July, rising to a three-month high of 8.0% from 7.0% in December. It was positive for an 18th month following 13 straight negative readings but down from a record-high 23.1% in July. January's reading compares to an 11-year low of -37.4% in May 2020 and the prior tax-cut-induced record high of 22.1% in March 2018, when the index's NERI was positive for 18 straight months through October 2018. Nine of the 11 S&P 500 sectors had positive NERI in January, unchanged from December's reading. All 11 sectors had a positive reading in September and October. Four sectors had NERI improve m/m in January, up from three sectors rising m/m in December and just one in November. Only three sectors had NERIs in the double digits during the month, down from nine sectors meeting that criterion in October. Here are the January NERIs for the S&P 500 and its sectors compared with their December readings: Energy (23.7% in January [12-month low], down from 32.0% in December), Financials (21.0, 13.1), Information Technology (10.2 [17-month low], 11.5), Consumer Discretionary (8.7, 7.7 [16-month low]), S&P 500 (8.0, 7.0 [17-month low]), Real Estate (5.2 [nine-month low], 6.8), Health Care (4.7, 3.3 [17-month low]), Materials (4.2, 5.1), Industrials (4.1, -1.9 [17-month low]), Consumer Staples (1.3, 2.7), Utilities (-1.0, 0.4), and Communication Services (-4.1 [18-month low], -2.0).

US Economic Indicators

New Home Sales (*link*): New home sales (counted at the signing of a contract) soared to a nine-month high at the end of 2021, boosted by a shortage of previously owned homes on the market. New home sales recorded back-to-back double digit gains, jumping 11.9% in December and 25.0% over the period to 811,000 units (saar). Still, sales were 18.3% below January 2021's 993,000 units—which was the highest since the end of 2006. Of the 811,000 homes sold last month, construction had yet to be started on 231,000, while 393,000 were under construction—which were the highest levels in seven and 11 months, respectively. Meanwhile, only 23% were completed (187,000). Regionally, sales were strong in the Midwest (56.4%) and South (14.9) during the month, while sales in the Northeast tumbled (-15.6) and sales in the West (0.4) were flat. There were 403,000 new homes on the market in December, up from 299,000 units a year ago and the highest since August 2008—representing a 6.0 months' supply, compared with 3.8 months a year ago. Meanwhile, the median home price in December was 3.4% above a year ago, slowing dramatically from August's 24.2% y/y—which nearly matched its record 24.5% in the late 1980s.

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