MORNING BRIEFING
March 29, 2022

Three Related Delusions

Check out the accompanying chart collection.

Executive Summary: The ripple effects of three delusions held in high places have triggered a host of interrelated global problems. Putin's delusion about Ukraine's sovereignty has led to war and related supply shortages of crucial commodities, which are exacerbating runaway inflation. … Powell's delusion that the inflation outlook is more benign than it really is has misled bond investors. … But the bond market is finally shedding its delusions and acting more predictably. … How high might the 10-year Treasury bond yield go during this year of rising interest rates and stagflation? We project 3.00% by year-end.

Geopolitics I: Putin's Delusion. Russian President Vladimir Putin first outlined the historical basis for his claims against Ukraine in a controversial 5,000-word essay titled "*On the Historical Unity of Russians and Ukrainians*." It was published on July 12, 2021 and featured many of his talking points since the start of his undeclared war against Ukraine since 2014, when Russia invaded and annexed Crimea.

In his essay, Putin reiterated his frequently stated conviction that Russians and Ukrainians are "one people." He openly questioned the legitimacy of Ukraine's borders and argued that much of modern-day Ukraine occupies historically Russian lands. He concluded that "Russia was robbed." He signaled his intention to acquire eastern Ukraine by saying, "I am becoming more and more convinced of this: Kyiv simply does not need Donbas." He questioned the legitimacy of Ukrainian statehood, declaring, "I am confident that true sovereignty of Ukraine is possible only in partnership with Russia."

Russia and Ukraine have been engaged in armed conflict over the industrial Donbas region in eastern Ukraine since 2014. In effect, the essay was Putin's formal declaration of war against Ukraine. Indeed, Moscow had already started amassing over 100,000 troops close to the border with Ukraine when he wrote the essay last July.

In his essay, Putin claimed that Russia and Ukraine share "spiritual, human, and civilizational ties formed for centuries." He might actually have believed that Ukrainians would welcome his invading army as liberators. Apparently, he shared that delusion by sending the essay to his troops, who reportedly were shocked to be met by locals shouting

at them to go back home and tossing Molotov cocktails at their tanks.

The Ukrainians have many grievances against the Russians. Until their recent invasions, the major calamity inflicted on them by their big brother was the Holodomor, a.k.a. the Great Famine, from 1932 to 1933. Ukraine has some of the most fertile soil in the world, yet 3 million to 5 million people died from starvation those years as household food was confiscated and population movement restricted. Ukrainians viewed it as a genocide against them carried out by the Soviet government under Stalin to eliminate an independence movement.

No doubt, Putin's war will continue to poison the relationship between Ukraine and Russia for years after the war is over.

For now, ceasefire is the hope. Russian President Vladimir Putin and Turkish President Tayyip Erdogan agreed in a telephone call on Sunday for Istanbul to host talks today, which hopefully will lead to a ceasefire in Ukraine. Putin seems to have backed off from seizing Kyiv and is regrouping his forces to consolidate Russia's hold on eastern Ukraine. Ukrainian President Volodymyr Zelensky recently signaled that he might agree to keeping his country neutral but rejected any suggestion that he would cede any territory in eastern Ukraine.

Geopolitics II: Wheat Shortages. A prolongation of the war in Ukraine could weigh on the global economy and boost global inflation by depressing supplies of key commodities.

Many countries are very dependent on Ukraine for their grain exports. President Joe Biden said that the world will experience food shortages as a result of Russia's invasion of Ukraine. "It's going to be real," Biden said at a news conference in Brussels last week. "The price of the sanctions is not just imposed upon Russia. It's imposed upon an awful lot of countries as well, including European countries and our country as well." Ukraine and Russia are both major producers of wheat in particular, and Kyiv's government has already warned that the country's planting and harvest have been severely disrupted by the war.

The two nations account for about 28% of the world's wheat exports, according to the Food and Agriculture Organization (FAO) of the United Nations. An *ING analysis* suggests that about three-quarters of Ukraine's harvest from last year has already been shipped. With ports closed, the remaining quarter will likely remain in the country, and the export of Ukraine's spring harvest is in question. Similar uncertainties about the export and sale of Russia's wheat also remain.

The FAO, in a recent *analysis* of the fallout from the Russia-Ukraine conflict, argued that the fighting, should it lead to a "sudden and prolonged reduction in food exports," could cause the undernourishment of between 8 million and 13 million people in economically vulnerable countries around the globe.

According to a *National Post* *analysis*, US crop consultant Sarah Taber says that the world as a whole doesn't actually have a wheat shortage, since warehouses hold millions of tons of wheat. "The amount of wheat that is missing due to this conflict is like one thousandth of one per cent of all supply," she says. But places dependent on wheat from the Black Sea region are experiencing shortages, and those shortages may be exacerbated by panicked hoarding in the West because the war is causing excessive speculation in wheat markets. Black Sea wheat goes mainly to the Middle East, North Africa, and underdeveloped countries that rely heavily on food imports. Nearly 50 countries around the world source more than 30% of their wheat imports from Russia and Ukraine.

The S&P GSCI indexes for grain, soybeans, wheat, and corn are all at or near record highs (*Fig. 1*, *Fig. 2*, *Fig. 3*, and *Fig. 4*).

Geopolitics III: Turning Off the (Neon) Lights. Ukraine supplies about half of the neon used globally in the manufacture of semiconductor chips. But Ukraine's two leading neon suppliers, Ingas and Cryoin, have halted operations as a result of the war, a March 11 Reuters *article* reported. Together, the two companies produce "45% to 54% of the world's semiconductor-grade neon, critical for the lasers used to make chips."

Ingas is based in Mariupol, which has been under siege by Russian forces. It exported neon gas to customers in Taiwan, Korea, China, the US, and Germany, with about 75% going to the chip industry. Cryoin is located in Odessa and halted operations on February 24, when the invasion started.

So far, there are no reports that a shortage of neon is exacerbating the shortage of chips, particularly to the global auto industry. That's because the major semiconductor manufacturers have inventories that may cover them for a few months. However, neon prices are soaring as a result of hoarding-motivated demand.

The CRB raw industrials spot price index soared to yet another record high at the end of last week (*Fig. 5*). Leading this index higher is its metals component (*Fig. 6*).

Inflation: The Fed's Delusion. While we are on the topic of delusions, Melissa and I were

surprised to see that Fed Chair Jerome Powell still believes that inflationary expectations are “well anchored.” He said so in his March 21 *speech* last week:

“Our monetary policy framework, as embodied in our Statement on Longer-Run Goals and Monetary Policy Strategy, emphasizes that having longer-term inflation expectations anchored at our longer-run objective of 2 percent helps us achieve both our dual-mandate objectives. While we cannot measure longer-term expectations directly, we monitor a variety of survey- and market-based indicators. In the recent period, short-term inflation expectations have, of course, risen with inflation, but longer-run expectations remain well anchored in their historical ranges.”

To prove his point, Powell’s *Figure 7* showed medians of responses about average inflation during the next 5-10 years compiled by the University of Michigan Surveys of Consumers. They’ve been fluctuating between 2.0% and 3.5% since the early 1990s. They were at 3.0% in March of this year. But if inflation continues to be less transitory and more persistent than Powell and his colleagues have been expecting, at what point do rising short-term inflationary expectations unmoor those “well anchored” long-term expectations? Consider the following:

(1) Just by coincidence, at the end of last week, the widely used proxy for the 10-year expected inflation rate jumped to a record high of 2.95% (*Fig. 7*). The proxy is simply the yield spread between the 10-year Treasury bond and the comparable TIPS (*Fig. 8*).

(2) February’s survey of consumers’ inflation expectations, conducted by the Federal Reserve Bank of NY, showed that the year-ahead number was 6.0%, while the three-years-ahead result was 3.8% (*Fig. 9*). Given that both were as low as 2.5% at the end of 2019, we aren’t convinced that describing long-term inflationary expectations as “well anchored” is justified.

(3) The regional business surveys conducted by five of the Federal Reserve district banks are all out for March. The average of the prices-paid indexes was 84.1, remaining in its record-high range of the past 11 months (*Fig. 10*). The average prices-received index rose to a new record high of 60.2 in March.

By the way, the average of the regional indexes for unfilled orders or delivery times rose to 16.5 in March (*Fig. 11*). That’s still below the record high of 28.2 during May 2021, but it well exceeds previous cyclical peaks in this series. Our conclusion is that supply-chain disruptions remain challenging and inflationary.

Finally, we should note that the average of the five business activity indexes edged up to 14.9 in March, consistent with slower economic growth than last year (*Fig. 12*). It all adds up to a relatively stagflationary economic outlook, for now.

Strategy: The Bond Delusion. The bond market is finally doing this year what we were expecting it to do last year. Bond investors were mostly delusional about the outlook for inflation last year. They drank the Fed's Kool-Aid about the transitory nature of inflation. So the 10-year Treasury yield stayed below 2.00% even though the CPI inflation rate, on a y/y basis, rose from 2.6% last March to 7.9% in February (*Fig. 13*). Meanwhile, the copper/gold price ratio has been signaling that the yield should be around 2.50% since the spring of 2021 (*Fig. 14*).

The Fed perpetuated the delusion-based divergence between the bond yield and inflation by purchasing $120 billion per month in Treasury and mortgage-backed securities (*Fig. 15*). Commercial banks joined the buying binge because their deposits were growing faster than their loan demand as a result of the Fed's ultra-easy monetary policies.

The Fed's rigging of the bond market also enticed individual and institutional investors into that market. Last year saw record annual inflows of $700 billion into bond mutual funds and ETFs (*Fig. 16*).

Investors must have been lulled into believing that the Fed would be their BFF in the bond market. At the beginning of the year, they started to realize that Powell was pivoting again, but this time from being a dove to a hawk. The *Minutes* of the December 15-16 FOMC meeting, released on January 5, showed that the committee was likely to raise interest rates, to stop buying bonds, and to start running off the Fed's balance sheet sooner than expected in 2022.

On March 11, the bond yield rose to 2.00% on its way to 2.48% on Friday of last week. That's still well below the inflation rate. However, some bond investors may be taking comfort from the recession signal coming from the near inversion of the yield spread between the 10-year Treasury bond and 2-year Treasury notes (*Fig. 17*). The more traditional yield spread between the 10-year and the federal funds rate (FFR) continues to widen, as does the spread between the 2-year and the FFR (*Fig. 18*).

How high might the bond yield go in a stagflationary economy that manages to avoid falling into a recession? History shows that the yield-curve spread between the 10-year Treasury bond and the FFR has tended to peak around 300bps. It's currently about 200bps (*Fig. 19*).

If the FFR rises to 1.00% by the end of this year and this spread widens to 300bps, the yield would rise to 4.00%. However, before it gets there, the spread could narrow as it typically does when the Fed is raising the FFR. Our bet is that we will see 3.00% on the yield by year-end; but if it gets there earlier, ask us again.

Calendars

US: Tues: Consumer Confidence 107.0; JOLTS Report; S&P/CS Composite 20-City Index 1.3%m/m/18.3%y/y; API Weekly Crude Oil Inventories; Williams. **Wed:** ADP Employment 438k; GDP 7.1%; GDP Price Index 7.2%; Headline & Core PCED 6.3%/4.5% (quarterly) y/y; MBA Mortgage Applications; Crude Oil Inventories. (Bloomberg estimates)

Global: Tues: Germany Retail Sales 1.8%m/m/9.8%y/y; Germany Gfk Consumer Climate -12.0; France Consumer Confidence 94; Spain Retail Sales; UK Nationwide HMI; Japan Retail Sales -0.3%. **Wed:** Eurozone Business & Consumer Survey 109.0; Germany CPI 1.6%m/m/6.3%y/y; Germany Import Price Index 2.0%m/m/26.9%y/y; Italy Consumer & Business Confidence 110.5/111.5; Spain CPI 8.1% y/y; UK Current Account -15.6b; Japan Industrial Production 0.5%; Broadbent.(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 13th week after dropping for a week earlier due to index changes. MidCap's was at a record high for a 16th straight week after dropping 0.1% below at the end of November. SmallCap's rose for a second week to 0.3% below its record at the end of February. It had been steadily making new highs until mid-December, but since then it has done so in only 10 of the 14 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 92 of the past 96 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings shortfall last August, and index changes in September and December. MidCap's forward earnings is up in 90 of the past 94 weeks, and SmallCap's posted 87 gains in the past 95 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 64.8% from its lowest level since August 2017; MidCap's is now up 126.7% from its lowest level since May 2015; and SmallCap's has soared 185.2% 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 remained steady at an 11-month low of 28.1% y/y; 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 dropped to an 11-month low of 39.9% y/y from 43.9%. 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 fell to an 11-month low of 46.9% y/y from 47.5% y/y. 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' consensus earnings forecasts for 2021 and 2022 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (9.2%, 9.8%), MidCap (9.6, 8.4), and SmallCap (10.1, 13.0).

S&P 500/400/600 Valuation (*link*): Valuations were mixed for these three indexes last week. LargeCap's forward P/E rose 0.3pt w/w to 19.5 from 19.2. That's up from a 23-month low of 18.2 in early March and down from a six-month high of 21.5 in early November. LargeCap's forward P/E also compares to a 19-year high of 22.7 in January 2021 and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's was steady w/w at 14.5, up from a 23-month low of 13.8 in early March. That's down from a 13-week high of 17.1 in early November. That also compares to a seven-month high of 20.5 in March 2021 and is 8.4pts below its record high of 22.9 in June 2020. SmallCap's edged down 0.1pt w/w to 13.9 from 14.0, but remains above its 23-month low of 13.5 the week before that. That's down from a 13-week high of 16.1 in early November and is now down 13.3pts 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 26% discount to LargeCap is up from a 28% discount on February 2, which was its biggest since September 2000. SmallCap's P/E was below LargeCap's for an 83rd week.

That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% reading has improved from 32% on February 2, which was its biggest since February 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 39th straight week; SmallCap's current 4% discount to MidCap's is up from a 9% discount in December, but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q3-2020 earnings season, analysts as a whole have been raising their consensus forecasts for future quarters instead of lowering them as is the norm through the earnings warnings seasons. It appears that six-quarter streak of positive revisions throughout the quarter will end in Q1-2022. In the latest week, the Q1-2022 earnings-per-share forecast dropped 12 cents w/w to $51.62, and is down 1.1% from $52.22 at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 5.1% y/y on a frozen actual basis and 6.5% on a pro forma basis. That's down from Q4-2021's 26.9% y/y on a frozen actual basis and a 32.0% y/y gain on a pro forma basis. Double-digit growth is expected for just five sectors in Q1-2022, and three are expected to record a y/y decline. That compares to Q4-2021's count of eight sectors with double-digit growth and one sector with a y/y decline. Here are the S&P 500 sectors' latest earnings growth rates for Q1-2022 versus their Q4-2021 growth rates: Energy (228.9% in Q1-2022 versus 12,611.0% in Q4-2021), Industrials (37.0, 43.8), Materials (35.4, 64.2), Real Estate (15.7, 17.6), Health Care (10.2, 28.0), Information Technology (8.5, 24.6), Utilities (6.7, -1.3), S&P 500 (6.4, 32.1), Consumer Staples (1.2, 7.7), Communication Services (-5.0, 16.6), Consumer Discretionary (-11.6, 54.1), and Financials (-20.6, 9.9).

US Economic Indicators

Regional M-PMIs (*link*): Five Fed districts (New York, Philadelphia, Richmond, Kansas City, and Dallas) now have reported on manufacturing activity for March and show manufacturing is growing at a sluggish rate. The composite index did show a slight acceleration for a second month, climbing from 11.3 in January to 14.9 by March—half the rate of last July. Growth in the Kansas City (37.0 from 29.0), Philadelphia (27.4 from 16.0), and Richmond (13.0 from 1.0) regions accelerated this month—the latter from near zero—while growth in the Dallas (8.7 from 14.0) area slowed a bit. Meanwhile, New York's (-11.8 from 3.1) manufacturing sector contracted for only the second time since mid-2020, posting its weakest performance since May 2020's -48.5 reading at the height of the pandemic. The

new orders (13.6 from 13.5) measure held steady this month, though the regions were a mixed bag: Orders in the Philadelphia (25.8 from 14.2) region accelerated at a four-month high, and Richmond's (10.0 from -3.0) measure moved from contraction to expansion. Billings in the Richmond (33.0 from 32.0) region held steady at a robust rate, while growth in Dallas (10.5 from 23.1) orders were cut in half and New York's (-11.2 from 1.4) contracted at the fastest pace since May 2020. March jobs' (unchanged at 24.0) growth matched February's robust pace, with factory hirings in the Philadelphia (38.9 from 32.3) region accelerating at a record rate, while Dallas' (25.5 from 18.4) picked up and Richmond's (23.0 from 20.0) expanded at a steady, though strong, pace. Meanwhile, New York (14.5 from 23.1) and Kansas City (18.0 from 26.0) factories hired at a slower rate than last month—with New York's at roughly half the pace of recent highs.

Regional Prices Paid & Received Measures (*link*): We now have prices-paid and -received data for March from the Philadelphia, New York, Kansas City, Richmond, and Dallas regions, and it's a mixed bag. (Note: The Philadelphia, New York, Kansas City, and Dallas measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.) The prices-paid measure climbed to 84.1 this month after falling from a record-high 89.2 in November to 81.2 by February. Two of the regions showed an acceleration in prices paid, while two showed a slowing, and Dallas' (to 74.0 from 73.4) measure held steady—in record territory. Philadelphia's prices-paid gauge accelerated from 69.3 in February to 81.0 this month—the highest since mid-1979—while Kansas City's (81.0 from 64.0) rebounded back toward last May's record high of 88.0. Meanwhile, New York's input prices eased for the fourth month, from 83.0 in November—which was near last May's record high of 83.5—to 73.8 in March; prices paid in the Richmond (110.5 from 122.7) region eased for the second month since reaching a record high of 143.2 in January. Looking at the prices-received measure, it accelerated to a new record high of 60.2 in March from 56.6 in February; its previous record high was 56.9 this past October. Prices-received measures remained in record territory, with New York's (56.1 from 54.1) gauge reaching a new record high this month, while measures in the Kansas City (51.0 from 47.0) and Dallas (47.8 from 44.6) regions weren't far from their respective record highs of 57.0 and 50.9 last August and October. In the meantime, Richmond's prices-received (91.6 from 87.7) gauge accelerated this month after slowing in February, though remains below January's record high of 112.7, while Philadelphia's prices-received (54.4 from 49.8) measure picked up a bit, though was below the November reading of 62.9, which was close to its record high of 63.8 in the mid-1970s.

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

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.