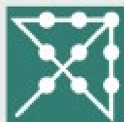
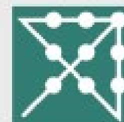
 Yardeni Research 

MORNING BRIEFING
April 7, 2022

Fed's Hawks, China's New Priority & Europe's Gas Seekers

Check out the accompanying chart collection.

Executive Summary: The newly released minutes of the FOMC's March meeting suggest that even the Committee's long-time doves now are hawks. So expect upcoming rate hikes of 50bps, not 25bps. The Fed aims to tamp down inflation without igniting a recession; investors are skeptical, but we expect inflation will moderate later this year, bringing the doves back. … Also: Can China achieve its heady economic growth goals amid a Covid resurgence, strict lockdown policies, and all the economic disruptions caused by both? We doubt it. … And: A look at the odds arrayed against EU countries trying to wean themselves off Russian oil and gas.

The Fed: We Are All Hawks Now. Yesterday's release of the March FOMC *minutes* indicated that the committee "generally agreed" to reducing the Fed's balance sheet by $95 billion per month. A maximum of $60 billion in Treasuries and $35 billion in mortgage-backed securities would be allowed to roll off, phased in over three months and probably starting in May. The minutes also suggested potential rate hikes of 50bps at upcoming meetings. In other words, the March meeting was much more hawkish than the previous meeting during January.

That wasn't a surprise after Tuesday's hawkish *speech* by Fed Governor Lael Brainard, who in the past has tended to side with the FOMC's doves. She squawked like a hawk: "It is of paramount importance to get inflation down. Accordingly, the Committee will continue tightening monetary policy methodically through a series of interest rate increases and by starting to reduce the balance sheet at a rapid pace as soon as our May meeting." Here are a few more key points from her speech:

(1) She expressed the following hawkish view on running off the Fed's balance sheet: "Given that the recovery has been considerably stronger and faster than in the previous cycle, I expect the balance sheet to shrink considerably more rapidly than in the previous recovery, with significantly larger caps and a much shorter period to phase in the maximum caps compared with 2017–19."

(2) She added: "Currently, inflation is much too high and is subject to upside risks. The Committee is prepared to take stronger action if indicators of inflation and inflation expectations indicate that such action is warranted." Spoken like a true hawk. The next

major inflation indicator will be the March CPI released on April 12. It will undoubtedly warrant a 50bps hike in the federal funds rate at the early May FOMC meeting and more rate hikes after that.

(3) She concluded: "We are committed to bringing inflation back down to its 2 percent target, recognizing that stable low inflation is vital to maintaining a strong economy and a labor market that works for everyone."

(4) Brainard did mention that she expects that durable goods inflation should moderate. Melissa and I agree with that. She hopes that "the services sector is able to absorb higher demand without generating undue inflationary pressure." The problem we see is that rent inflation has nowhere to go but higher over the next 12-24 months.

(5) So we doubt that the Fed can get inflation back down to a 2.0% y/y rate without causing a recession. Fed officials seem to think that if they raise the federal funds rate to the "neutral" rate of say 2.50%—or a bit higher for a while, say to 3.00%—they will be able to engineer a soft landing for the economy and bring inflation back down to 2.0%.

We wish them luck, seriously. We are still in the soft-landing camp. We expect that inflation will peak around 6.0%-7.0% by mid-year and moderate to 3.0%-4.0% next year, i.e., above the Fed's target.

We expect to hear doves cooing again later this year, counselling their hawkish colleagues to restrain themselves lest a recession is triggered. Nevertheless, we are on the alert for a recession, just in case.

China: Growth Challenged. The Chinese Communist Party's 5.5% GDP growth target for China this year looks like a stretch. Despite the country's Zero Covid policy, the disease has been plaguing Hong Kong since December, and a recent outbreak in Shanghai has its 25 million residents locked down. About "193 million people are currently subject to full or partial lockdowns in 23 cities across China. The 23 cities account for 13.6% of the population and 22% of GDP," according to Nomura research cited in an April 5 Reuters *article*.

The latest economic data for China has been disappointing. China's Caixin Manufacturing PMI, China's official M-PMI, slipped below the breakeven point of 50.0, to 49.5 in March, indicating that manufacturing activity is contracting. New orders for March were 48.8, and employment was 48.6 (*Fig. 1*). The S&P Global Manufacturing PMI fell to 48.1 in March

from 50.4 in February (*Fig. 2*). Meanwhile, the Caixin/S&P Global NM-PMI sank to 42.0 in March, the weakest reading since the height of the pandemic, from 50.2 in February (*Fig. 3*).

Unlike the Fed, the People's Bank of China has been easing—reducing reserve requirements, most recently by 50bps in December (*Fig. 4*). The China MSCI stock price index has bounced 26.8% from its five-year low on March 15 but remains 42% off its record high on February 17, 2021 (*Fig. 5*). The index's forward P/E has been nearly halved to 10.6 from 18.3 in mid-February (*Fig. 6*). That might look cheap compared to the forward P/Es of the past 25 years, but analysts' expectations for earnings growth of 16.6% this year and 14.9% in 2023 seem optimistic given all the challenges business leaders are facing (*Fig. 7*). If those earnings forecasts decrease as the year progresses, the P/E will rise, all else being equal.

Let's take a look at Covid's impact on China as well as the country's "common prosperity" plans and its role in the Ukraine war:

(1) *Covid in Shanghai.* Covid has returned to China despite the country's Zero Covid policy, which involves lockdowns, quarantines, and contact tracing. There have been 73,000 cases in Shanghai since March 1, including 13,354 just on Tuesday, an April 5 *South China Morning Post* (*SCMP*) *article* reported. While most cases are asymptomatic, all who test positive are sent to quarantine sites. That includes very young children, who have been separated from parents who test negative. A number of nursing homes have Covid-infected patients and healthcare workers, which is a potential problem because barely half of China's elderly population has had two or more vaccine doses, an April 1 the *WSJ* *article* reported.

The city, which has been under lockdown since April 1, started the three-day process of testing all Shanghai residents on Monday. The goal is to bring the new cases down to zero by April 15.

Lockdowns are impacting all manner of businesses there. Shanghai Disney has been closed since late March. Tesla's Gigafactory was shut for several days. And the nation's travel industry is being hit hard, as Shanghai is a major travel destination. Companies in Shanghai that continue to operate, like the Shanghai Port, are housing their employees on the premises.

Covid again is affecting transportation and supply chains, with many warehouses in the

Shanghai area closed. Truckers are wary about going to Shanghai, as doing so requires a negative Covid test within the past 48 hours (and testing capacity is strained), and exiting requires quarantining after reaching their destination, an April 3 *SCMP* *article* reported. Maersk and the Shanghai Port group are trying to ship containers from the port inland by using rail or barge.

The number of ships waiting outside the Shanghai Port has risen almost fivefold in recent weeks to more than 300, according to data from VesselsValue quoted by *SCMP*. Port officials told the *SCMP* that the ships were mainly non-container ships, like oil tankers and dry bulk carriers. Covid's ripple effects on trade could reach US shores in the coming weeks.

Nationwide, China reported a total of 16,412 cases on Tuesday, with more than 2,850 cases in Jilin province in northeastern China. Jilin lockdowns have prevented many farmers quarantined in cities from returning home to prepare their fields for spring planting, which takes place late April to early May. Moreover, local stores don't have seed or fertilizer in stock, an April 5 SCMP *article* reported. The area produces 10% of the nation's corn crop.

(2) *Covid in Hong Kong.* Covid cases appear to be waning in Hong Kong, but only after the disease infected almost 1.2 million people and resulted in 8,262 deaths since late December. The number of new cases ticked up slightly on Tuesday to 3,254 after 11 straight days of decline. The percentage of positive cases has fallen to 2%-3% from more than 10% a week ago, an April 4 *SCMP* *article* reported.

All Hong Kong residents must take at-home Covid tests for three days in a row starting this week. The city has banned gatherings of more than two people; most public venues are closed, including beaches and playgrounds; and there's no in-person learning for students. Restrictions, which began on January 7, are expected to ease later this month.

(3) *'Common prosperity' fades away.* The phrase "common prosperity"—which was so popular among Chinese government officials last year—has largely disappeared from public discourse. Common prosperity was the rationale behind the recent regulatory crackdown on large tech companies, shutdown of the private tutoring industry, and curbing of individuals' video-game playing. This year, however, officials have hardly uttered the phrase, indicating that the policy has been set aside, an April 3 *WSJ* *article* reported.

Plans for a new property tax earmarked to fund social welfare programs were scrapped after opposition mounted from elites and policymakers concerned about the tax's impact on

property values. President Xi Jinping was unable to push through changes to make China's income tax more progressive. China's wealthiest 10% own 68% of total household wealth, the *WSJ* stated. Targeting the country's engine of economic and jobs growth spooked businesspeople and investors.

Now Xi seems focused on reigniting China's slowing economy. The government recently announced that China indeed would grant US regulators' request for full access to auditing reports for most Chinese companies listed on US exchanges as soon as mid-year, an April 1 Bloomberg *article* reported. Before that news, investors were concerned the Chinese stocks would be delisted from US exchanges for not complying.

Xi presumably would like the economy to rebound before this fall, when he might be nominated for a third term as president. The nomination, fully expected last year, is now less certain.

(4) *Hear no evil, see no evil.* US and European leaders want China's President Xi to use his chummy relationship with Russia's President Vladimir Putin to cajole the latter into dialing back the war in Ukraine. But with the resurgence of Covid and the economy slowing, it's not surprising President Xi does not want to get drawn into the morass. China has yet to condemn the Ukraine war and has refused to withhold military or economic support from Russia. Chinese officials have said the country does "not seek geopolitical self-interests" nor does it want to do anything to add fuel to the fire.

The EU's top diplomat Josep Borrell described last week's meeting between Chinese and EU leaders as a "dialogue of the deaf" because Chinese leaders didn't want to talk about Ukraine, an April 6 *SCMP* *article* reported. "China cannot pretend to be a great power but close its eyes or cover its ears when it comes to a conflict that obviously makes it uncomfortable because it knows very well who the aggressor is, although for political reasons, refuses to name them." At least Europe has had its eyes opened to China's priorities.

Europe: Desperately Seeking Non-Russian Gas. The EU buys 155 billion cubic meters of natural gas annually from Russia. European governments are facing pressure to end this dependency, which critics say is akin to funding the Ukraine war and leaves the EU vulnerable to the possibility that Russia might turn off the taps.

Unfortunately, there are no easy, fast ways to replace Russian gas. Those who champion fossil fuels encourage more drilling of natural gas, oil, and coal while throwing in an "I told

you so." The green contingent is suggesting more funding for renewables and sweater wearing. Ask Jimmy Carter how that worked out. Here's a look at some of the tough solutions being offered up:

(1) *The EU plan.* The European Commission has a plan to replace most of the gas it buys from Russia, detailed in a March 28 *article* in *Die Welt*. The EU can import about 50 billion cubic meters of LNG from the US and other friendly nations and boost natural gas delivered via existing pipelines by another 10 billion cubic meters. Fifteen billion cubic meters of natural gas can be replaced by biogas, solar, and wind turbine projects by year-end. Lowering room temperatures by 1C-2C and making structures more energy efficient could reduce gas consumption by 14 billion cubic meters. Three German nuclear power plants and two Belgium plants that were to be shut down could continue operating, replacing 12 billion cubic meters of gas. Burning coal and oil in German electric plants is controversial but could replace a combined 30 billion cubic meters of Russian gas.

These options would only replace about two-thirds of the Russian natural gas. Any shortfall might limit the amount of gas supplied to companies. There's little room for error or an unusually cold winter.

(2) *Fill up those tanks.* Europe aims to fill up its natural gas storage tanks to at least 80% of capacity before the winter heating season arrives. European nations have increased their LNG purchases from the US, Qatar, and other friendly nations. How much longer they will continue to buy natural gas from Russia is unknown, especially if they refuse to pay for it in rubles as Russia demands.

Hungary, which sources all of its gas from Russia, was the first European nation to agree to pay for it with rubles, an April 6 Reuters *article* reported. Conversely, Lithuania stopped importing Russian gas on April 1 but is fortunate to have an LNG terminal, allowing it to import LNG from other nations.

Germany aims to stop buying Russian oil by year-end and Russian natural gas by mid-2024.That will be a tall order given that Germany received 58% of its natural gas from Russia in 2020. At the end of March, Germany's gas in storage was historically low. Germany has no LNG facilities that can be used to import natural gas and won't before 2026, when two LNG terminals on the drawing board may go online, an *article* in Germany's *Deutsche Welle* reported. Meanwhile, Germany will need to depend on LNG deliveries via terminals in Belgium, France, and the Netherlands. It may also build floating LNG terminals, which could be operational by year-end 2023, according to German estimates.

(3) *Institute price caps.* The UK government announced last year a price cap that limits the amount suppliers can charge households for electricity and natural gas even if wholesale gas prices rise sharply. The cap was recently increased by 54% and financial aid, in the form of loans and tax rebates, was offered to customers, a March 11 *FT* *article* stated. Another 50% increase in the cap is expected in October. While price caps can prevent price gouging, they can backfire if they cause suppliers to go out of business.

(4) *Pouncing on a crisis.* While fossil fuel proponents are using the Ukraine crisis as a reason to encourage the EU to double down on traditional fuel sources, backers of green energy are using the crisis to bolster the development of renewable energy sources. It's possible the need for energy independence from Russia will prompt entrepreneurs and scientists to solve some of the problems related to green energy.

Scientists may be able to find a solution to wind and solar power's intermittency problem that avoids huge, expensive batteries filled with expensive metals. Small nuclear plants and green hydrogen offer vast quantities of energy if they can be safely developed. And generating energy using nuclear fusion could be a game changer. We can only hope.

Calendars

US: **Thurs:** Initial & Continuous Jobless Claims 200k/1.331m; Consumer Credit $16.7b; Natural Gas Storage; Williams; Evans; Bullard. **Fri:** Wholesale Inventories 2.1%; Baker-Hughes Rig Count. (Bloomberg estimates)

Global: **Thurs:** Eurozone Retail Sales 0.6%m/m/4.8%y/y; Germany Industrial Production -0.2%; Japan Leading & Coincident Indicators; ECB Publishes Account of Monetary Policy Meeting; RBA Financial Stability Review; Balz. **Fri:** Italy Retail Sales; Spain Industrial Production 1.7% y/y; Canada Employment Change 80k; Canada Unemployment & Participation Rates 5.3%/65.4%; Japan Consumer Confidence; Panetta. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) climbed further

above 1.00 this week, as bullish sentiment continued to bounce back from the 29.9% reading at the end of February—which was lowest since the start of 2019. The BBR advanced for the third week to 1.26 this week from 0.84 in mid-March—which was the lowest since last March 2020. Bullish sentiment increased for the fourth time in five weeks by 9.2ppts (to 39.1% from 29.9%), while bearish sentiment fell to 31.0% from 36.5% three weeks ago—which was the most bears since March 2020. The correction count moved up to 29.9% this week after slumping six of the prior seven weeks to 28.2% from 40.0%—which just missed equaling March 2020's high count of 40.9%. The AAII Ratio climbed for the second week last week from 31.1% to 53.7%, as bearish sentiment fell from 49.8% to 27.5% over the two-week period and bullish sentiment edged down from 32.8% to 31.9%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady last week at 13.3%, down from a record high of 13.4% in early March. Since the end of April 2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 3.0ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings were both back at record highs after ticking down briefly in early February. They have both been making new highs since the beginning of March 2021 after peaking just before Covid-19 in February 2020. Since the Q2-2021 earnings season came in way better than expected, analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown period. Prior to this catch-up period, consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth rose 0.1ppt w/w to 8.3%, up from its 12-month low of 7.1% from early December. That's down from a record high of 9.6% growth at the end of May 2021. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth remained steady w/w at 9.6%. It remains above its 16-month low of 8.2% in early December. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. So far this year, analysts' revisions to their forecasts for 2022 revenues have outpaced their revisions for 2022 earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts has ticked lower. They expect revenues to rise 9.8% (up 0.2ppt w/w) in 2022 and 5.2% in 2023 (down 0.2ppt w/w) compared to the 16.4% gain reported in 2021. They expect earnings gains of 9.9% in 2022 (unchanged w/w) and 9.8% in 2023 (unchanged w/w) compared to an earnings gain of 51.5% in 2021. Analysts expect the profit margin to remain steady in 2022 at 13.1% (unchanged w/w) compared to 13.1% in 2021 and to improve 0.6ppt y/y to 13.7% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E rose 0.7pt w/w to a seven-week high of 20.0, up from a 23-month low of 18.6 four weeks ago. That's down from an eight-month high of 21.7 at the end of

2021 and compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio rose 0.09pt w/w to a seven-week high of 2.66, up from its 15-month low of 2.48 at the end of February. That's down from a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues and earnings rise for seven of the 11 S&P 500 sectors, but the forward profit margin rose for only four. Nearly all sectors are at or near record highs in their forward revenues, earnings, and profit margins. Energy still has forward revenues and earnings well below record highs, but its profit margin of 10.2% is at its highest reading since March 2008. Financials and Utilities have forward earnings at or near record highs, but their forward revenues and margins are lagging. Only three sectors posted a higher profit margin y/y in 2020: Consumer Staples, Tech, and Utilities. For 2021, all but the Utilities sector posted a y/y improvement. Four sectors are expected to see margins decline or remain flat y/y in 2022: Communication Services, Consumer Staples, Financials, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.2%, down from its 25.4% record high four weeks earlier), Financials (18.5, down from its 19.8 record high in August 2021), Real Estate (16.2, down from its 19.2 record high in 2016), Communication Services (16.3, down from its 17.0 record high in October), Utilities (14.1, down from its 14.8 record high in April 2021), Materials (13.3, down from its 13.4 record high in December), S&P 500 (13.3, down from its 13.4 record in early March), Health Care (11.3, down from its 11.5 record high in early March), Industrials (10.1, down from its 10.5 record high in December 2019), Energy (10.2 [14-year high], down from a record-high 11.2 in 2007), Consumer Staples (7.5, down from its 7.7 record high in June), and Consumer Discretionary (8.0, down from its 8.3 record high in 2018).

Global Economic Indicators

Global Composite PMIs (*link*): Global demand eased during the final month of Q1, as "rising inflationary pressures, stretched supply chains and geopolitical tensions stymied growth and hit confidence," according to the report. The C-PMI slipped to 52.7 in March after climbing from an 18-month low of 51.1 in January to 53.5 in February; it was at 58.5 last May. The M-PMI (to 53.0 from 53.7) and NM-PMI (53.4 from 54.0) measures showed growth slowed a bit in both the manufacturing and service sectors last month. The C-PMI

for the advanced economies accelerated for the second month, from an 18-month low of 51.2 in January to 56.0 by March, while the C-PMI (46.8 from 51.3) for the emerging economies moved from expansion to contraction in March—only the second reading below 50.0 since the height of the pandemic. According to the report, 11 of the 14 countries for which March data were available expanded, with the strongest growth recorded in Ireland (61.0), the UK (60.9), and the US (57.7). Japan (50.8) showed a slight expansion of activity after contracting the first two months of this year. Meanwhile, Kazakhstan (48.8), China (43.9), and Russia (37.7) were the only nations in contractionary territory. Meanwhile, inflationary pressures intensified in March as rates for both input costs and output charges accelerated, with rates of inflation faster at manufacturers than service providers and steeper in developed nations than in emerging economies.

Germany Manufacturing Orders (*link*): German factory orders in February fell for the first time in four months, driven by a drop in foreign demand—and the economy ministry warned the war in Ukraine "leads to high uncertainty regarding the further development of demand." Manufacturing orders slumped a larger-than-expected 2.2% (vs the -0.2% consensus forecast) after a three-month surge of 8.0%. Foreign demand sank 3.3% in February after climbing two of the prior three months by 12.4%. Demand from within the Eurozone dropped for the third successive month, by 3.3% m/m and 7.1% over the period, while billings from outside the Eurozone fell 3.4% after jumping 16.2% in January—remaining in a volatile flat trend around record highs. Meanwhile, domestic orders ticked down 0.2% in February, after contracting 7.3% in January and expanding 10.5% in December. Compared to a year ago, growth in total orders slowed to 2.9% from 8.2% in January, with growth in domestic and foreign orders slowing to 1.6% and 3.8%, respectively. Within foreign orders, billings within the Eurozone were 2.6% below a year ago, while those from outside the Eurozone were 7.9% above. Here's a look at movements in domestic orders along with the breakdown from both inside and outside the Eurozone for the main industry groupings during February, both m/m and y/y: consumer durable goods (+10.0%, +5.3%, -5.7% & +2.6%, +32.0%, +6.3%), capital goods (+1.0, -5.6, -4.0 & +3.1, -9.4, +14.6), consumer nondurable goods (-2.3, -1.8, +3.5 & +19.8, +20.0, -1.0), and intermediate goods (-1.7, -1.1, -2.7 & -2.4, +1.0, -5.5).

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