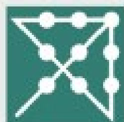

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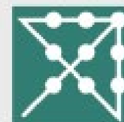

MORNING BRIEFING
May 10, 2022

Inflation, Bonds & Stocks

Check out the accompanying chart collection.

Executive Summary: Since 2008, the Fed's quantitative easing had kept a lid on bond yields. But with the Fed now tightening—releasing bond yields to move solely by market forces—will yields be pushed above the inflation rate (where they usually reside)? A reversal from negative to positive real bond yields could trigger a credit crisis and recession; but we put the odds of that scenario at only 30%. Rather, we expect a soft landing for the economy, inflation moderating soon, and the Treasury bond yield marking time between 3.00%-3.25%. … For the stock market, high inflation boosts earnings yet depresses the valuations investors are willing to pay for those earnings. The lower valuations reflect investors' fears that this will all end badly.

Strategy I: The Case Against & For Bonds. In the May 4 *Morning Briefing*, we examined the case for bonds now that the 10-year Treasury yield is just north of 3.00%, up from a record low of 0.52% on August 4, 2020 (*Fig. 1*). The Aaa-rate and Baa-rated corporate bond yield recently rose above 4.00% and 5.00%, respectively (*Fig. 2*). Mortgage securities are also yielding over 5.00%. Bond yields are certainly more attractive now than they were one or two years ago.

However, they aren't attractive relative to inflation with the headline CPI and PCED rates at 8.5% and 6.6% y/y through March. During Q1-2022, the real bond yield—measured as the difference between the 10-year Treasury bond yield (2.0%) and the yearly percent change in the GDP deflator (6.8%)—was -4.8%, the most negative reading on record (*Fig. 3* and *Fig. 4*). During March, the difference between the bond yield (2.1%) and the headline CPI inflation rate (8.5%) was -6.4%, also the most negative reading on record (*Fig. 5* and *Fig. 6*).

It's especially unsettling to see that since the start of the bond yield data in 1953, the yield was usually well above the inflation rate. That was particularly true during the 1980s and 1990s, after bond investors suffered big losses during the 1960s and 1970s. However, during the 2000s, the spread fell toward zero as inflation remain subdued. Following the Great Financial Crisis of 2008 through the start of the pandemic in 2020, the bond yield remained just barely higher than the inflation rate, which remained mostly below 2.0%.

During this period, the Fed kept the federal funds rate mostly near zero and executed three

rounds of quantitative easing (QE1, QE2, and QE3). Such an ultra-easy monetary policy kept a lid on the bond yield. When monetary policy turned even more ultra-easy in response to the pandemic with QE4, the bond yield fell below the inflation rate. It has remained below the inflation rate consistently since July 2020. And its spread with inflation turned increasingly negative as the inflation rate soared above 2.0% during March 2021 to 8.5% in March of this year, based on the headline CPI inflation rate.

Fed officials turned increasingly hawkish as inflation soared. They finally raised the federal funds rate by 25bps on March 16 and by 50bps on May 4—for a total of 75bps—to a range of 0.75% to 1.00%. In addition, they terminated QE4 bond purchases in mid-March. In other words, the bond market is no longer rigged by the Fed, and market forces have been unleashed to drive yields up or down.

The question is: Will market forces push bond yields back above inflation, as was the norm prior to the pandemic? Bond investors already have experienced significant losses since yields bottomed during the summer of 2020. Even if inflation moderates from 6%-7% (based on the PCED) now to 3%-4% next year, as we are forecasting, a dramatic reversal from negative to positive real yields would be even more horrible for current bondholders. It would also be very bad news for the economy and the stock market.

In this scenario, perma-bears would gloat that the biggest bubble of them all was hiding in plain sight in the bond market. And they would be right. Such a calamity would constitute the widely feared "something-will-break" credit crisis that could cause a recession. That would bring bond yields back down along with inflation.

The odds of this scenario unfolding are 30%, in our opinion. That's the odds that we're placing on a recession. We think that if a recession occurs, it will be more likely triggered by the Bond Vigilantes than by the Fed. I knew former Fed Chair Paul Volcker (when I started my career at the Federal Reserve Bank of New York). Fed Chair Powell is no Paul Volcker. He won't tighten the way that Volcker did to break the back of inflation with a severe recession in from late 1979 through the first half of 1982.

Our base-case 70% scenario remains a soft landing with inflation peaking soon and moderating significantly, as noted above. We don't think bond yields will jump above inflation anytime soon if inflation peaks and moderates.

As we observed in yesterday's *Morning Briefing*, there are already some signs that inflation is peaking. We see that in several measures of consumer prices and wages in which the

three-month annualized inflation rates are falling below the 12-month inflation rates. We will be slicing and dicing April's CPI report, which will be released tomorrow, very carefully.

For now, we see the bond yield marking time between 3.00% and 3.25% as current fixed-income investors take their lumps, while other fixed-income investors are attracted to the higher yields.

Foreign investors should be especially aggressive buyers as long as they continue to believe that US bonds are a safe haven in a world that has turned more turbulent recently. We'll be watching to see if the dollar remains strong in forex markets, signaling that foreigners are investing in the US (*Fig. 7*). We also will be looking for signs of weakness in commodity markets, reflecting slower global economic growth. We are seeing some weakness in industrial commodity prices but not in energy commodity prices (*Fig. 8*).

Strategy II: Inflation Boosts Earnings & Depresses Valuation. Over the past year, inflation has been having a positive impact on analysts' consensus forecasts for earnings in 2022 and 2023 but a negative impact on the valuation multiple that investors are willing to pay for those earnings estimates. Needless to say, the former positive effect has been trumped by the latter negative effect. The negative impact reflects the jump in bond yields so far, concerns that bond yields will continue to move higher, and fears that this will all end with a recession.

This clearly hasn't been another one of the garden-variety panic attacks that we have been chronicling in the stock market since 2009. Most of them turned out to be minor, short-lived selloffs. A few were full-fledged corrections. The selloff in 2020 technically was a bear market, but it didn't last very long, and we included it in our list of *panic attacks*. The S&P 500's selloff to date leaves it still in correction territory, but the Nasdaq is in a bear market. That's because the latter is dominated by Growth stocks that are more adversely affected by rising bond yields than are Value stocks.

The current stock market selloff is also unique because for the first time since former Fed Chair Alan Greenspan invented the so-called "Fed Put" during the 1987 stock market crash, the Fed Put is now kaput. The Fed has long been expected to step in to bail out markets whenever things got tricky. But now it can no longer be counted on to do. That's because inflation hasn't been as serious a problem as it is today since the Great Inflation of the 1970s.

As a result, we are now experiencing a meltdown of valuation multiples in the stock market

even though industry analysts are continuing to raise both their revenues- and earnings-per-share estimates. Consider the following:

(1) *Revenues, earnings, and margins.* S&P 500 forward revenues per share is up 5.1% ytd to yet another record high of $1,749 during the April 28 week (*Fig. 9*). S&P 500 forward operating earnings per share is up 6.1% ytd through the April 28 week to a record $233. The S&P 500 forward profit margin—which we calculate from forward revenues and operating earnings—edged up to a record 13.4% during the April 28 week.

Here are the ytd growth rates of forward earnings and forward revenues for the S&P 500 and its 11 sectors: S&P 500 (6.1%, 5.1%), Communication Services (-1.2, 3.2), Consumer Discretionary (5.6, 3.4), Consumer Staples (1.4, 3.4), Energy (45.8, 20.8), Financials (3.8, 3.2), Health Care (1.5, 2.6), Industrials (4.5, 4.2), Information Technology (7.0, 5.5), Materials (8.3, 7.6), Real Estate (7.6, 5.7), and Utilities (2.0, 6.2).

Industry analysts obviously didn't get the recession memo. In addition, their estimates imply that most companies are passing their rising costs through to their selling prices. So margins are holding up well, as both revenues and earnings are keeping pace with inflation.

(2) *Valuations.* The bad news is that none of this seems to matter to stock investors, who've been unnerved by rapidly rising bond yields, which have had a double-barreled negative influence on valuations. Higher yields reduce the present discounted value of future earnings and raise the risk of a recession. So the freefall in the forward P/E of the S&P 500 since the start of this year has coincided with the vertical ascent of bond yields (*Fig. 10* and *Fig. 11*).

The forward P/E of the S&P 500 is down 18.2% from 21.4 at the start of this year to 17.5 on Friday of last week. In the March 8 *Morning Briefing*, we wrote: "We are giving up on the notion that the S&P 500's forward P/E will hold above 20.0. It is already down to around 19.0. We are now estimating 16.0 by year-end …" We are on course to get there ahead of schedule. We expect the 16.0 level to hold assuming, as we do, that a recession isn't in the cards.

Calendars

US: Tues: NFIB Small Business Survey; API Crude Oil Inventories; Williams; Waller;

Mester. **Wed:** Headline & Core CPI 0.2%m/m/8.1%y/y & 0.4%m/m/6.0%y/y; Real Earnings -0.6%; Fed Budget Balance $220.6b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: **Tues:** Germany ZEW Economic Sentiment -42.5; Italy Industrial Production -2.0%; China CPI & PPI 1.9%/7.8% y/y; Mauderer; Guindos. **Wed:** Germany CPI 0.8%m/m/7.4%y/y; UK RICS House Price Balance 70%; Japan Leading & Coincident Indicators; Lagarde; Schnabel; Elderson; Nagel; Buch. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Two of these three these indexes had forward earnings at a record high last week. LargeCap's dropped for the first time in 19 weeks to 0.2% below its week-earlier record high due to Amazon's Q1 earnings miss and lowered future guidance. MidCap's was at a record high for a 22nd straight week. SmallCap's rose for the seventh time in eight weeks, and was at a record high for a second week. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 97 of the past 102 weeks, with the down weeks due to Tesla's addition to the index in December 2020, Amazon's earnings misses for Q1-2022 and Q2-2021, and index changes last September and December. MidCap's forward earnings is up in 96 of the past 100 weeks, and SmallCap's posted 92 gains in the past 101 weeks. SmallCap had been steadily making new highs each week until mid-December, but then dropped 1.4% below its record by early March. 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 67.0% from its lowest level since August 2017; MidCap's is now up 135.8% from its lowest level since May 2015; and SmallCap's has soared 196.7% from its lowest point since August 2013. In the latest week, the yearly rate of change in LargeCap's forward earnings weakened to a 25-month low of 20.5% y/y from 22.6%; that's down from a record-high 42.2% at the end of July and 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 a 25-month low of 36.3% y/y from 37.6%. 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 improved to 43.0% y/y from a 25-month low of 41.2%. 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 (9.3%, 10.1%), MidCap (12.8, 7.9), and SmallCap (12.7, 12.1).

S&P 500/400/600 Valuation (*link*): Valuations mostly ticked lower for these three indexes last week. LargeCap's forward P/E remained steady w/w at a 25-month low of 17.5, down from 18.2 at the beginning of the month. That's 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 fell 0.2pts to a 25-month low of 12.7 from 12.9. That's down from a 13-week high of 17.1 in early November and is 9.3pts below its record high of 22.9 in June 2020. SmallCap's fell 0.4pt w/w to a 26-month low of 12.1 from 12.5. That's down from a 13-week high of 16.1 in early November and is now down 14.5pts 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 27% discount to LargeCap is near its biggest since September 2000. SmallCap's P/E was below LargeCap's for a 90th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 29% reading is near its biggest discount 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 47th straight week; the current 3% discount 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. That six-quarter streak of positive revisions throughout the quarter officially ended with Q1-2022. In the latest week, the Q1-2022 earnings-per-share forecast rose $1.38 w/w to $53.01, and is now 4.2% above its $52.22 forecast at the start of the quarter. Analysts expect S&P 500 earnings growth to weaken substantially to 10.7% y/y on a frozen actual basis and 10.2% on a pro forma basis. That's down from Q4-2021's 26.9% y/y on a frozen actual basis and a 32.1% y/y gain on a pro forma basis. Double-digit growth is expected for seven 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 (266.1% in Q1-2022 versus 12,611.0% in Q4-2021), Materials (45.2, 64.2), Industrials (39.9, 43.8), Real Estate (27.3, 17.6), Health Care (17.5, 28.0), Information Technology (13.4, 24.6), S&P 500 (10.2, 32.1), Utilities (12.3, -1.3), Consumer Staples (7.5, 7.7), Communication Services (-3.9, 16.6), Financials (-17.1, 9.9), and Consumer Discretionary (-29.1, 54.1).

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