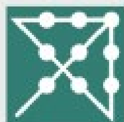
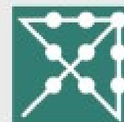
 Yardeni Research 

MORNING BRIEFING
May 17, 2022

Run(off) for the Hills?

Check out the accompanying chart collection.

Executive Summary: It begins next month: the Fed's plan to let its maturing securities run off its balance sheet without replacing them—a.k.a. quantitative tightening (QT). How right are investors to be freaked out? How legitimate are their suspicions that the Fed is erring on the side of overkill after having lost ground in the fight against inflation? … Today, we separate the fears from the facts and assess the likely impacts for the federal deficit, fixed-income markets, the stock market, and the economy. … Also: We lay out the runoff plan, review the last QT episode for insights, and put investors' fears into perspective.

Monetary Policy I: The Big Runoff. In recent conversations with our accounts, we have been hearing more concern about the second round of quantitative tightening (QT2), which starts next month. The first round of quantitative tightening (QT1) lasted from October 1, 2017 to July 31, 2019 (*Fig. 1*).

The fear is that QT2 will push interest rates even higher than would be the case if the Fed focused only on raising the federal funds rate while replacing maturing securities on its balance sheet. By letting maturing securities run off, there could be more upward pressure on interest rates as the fixed-income markets are forced to finance more Treasury and agency debt as well as mortgage-backed securities. In previous tightening cycles, with the exception of QT1, the Fed raised the federal funds rate without running off its balance sheet. This time, such rate hikes could be amplified by QT2.

Indeed, the rapid rise in interest rates so far this year may very well have been exacerbated by the Fed's stated intention to start QT2 during the second half of this year. On January 5, the Fed released the *minutes* of the December 14-15, 2021 FOMC meeting revealing that the committee's members were turning much more hawkish and were seriously discussing quantitative tightening. Indeed, there was a section in the minutes focusing just on "Principles for Reducing the Size of the Balance Sheet."

The consequences of the Fed's pivot from its ultra-easy monetary policy since 2008 to a tightening monetary stance are still ongoing and not in a good way for stocks and bonds. The 2-year US Treasury yield has soared from 0.73% at the start of this year to 2.61% at

the end of last week (*Fig. 2*). The 10-year US Treasury yield has jumped from 1.52% to 2.93% over this same period. The S&P 500 dropped 16.1% from its record high on January 3 (just before the minutes were released on January 5) through Friday's close, led by a 21% plunge in its forward P/E from 21.5 to 17.0 over this period (*Fig. 3* and *Fig. 4*).

The concern is that because the Fed has fallen well behind the inflation curve, Fed officials now are about to err on the side of haste—tightening too much too fast with a monetary cocktail of rising rates and a declining balance sheet. That may very well bring inflation down, but with a hard landing for the economy too. That's not our expectation, but it is a widespread fear. We continue to put the odds of a hard landing/recession at 30%.

Monetary Policy II: The Runoff Plan. Following the May 3-4 meeting of the FOMC, the Fed issued a *press release* titled "Plans for Reducing the Size of the Federal Reserve's Balance Sheet." It noted that "all Committee participants agreed to the following plans for significantly reducing the Federal Reserve's securities holdings." Here are the details:

(1) *First three months of QT.* During June through August, the Fed will reduce its balance sheet by running off maturing securities, dropping its holdings of Treasury securities by $30.0 billion per month and its holdings of agency debt and mortgage-backed securities by $17.5 billion per month. So that's a decline of $142.5 billion over the next three months.

(2) *QT after August.* Starting in September, the runoff will be set at $60 billion for Treasury holdings and $35 billion for agency debt and mortgage-backed securities. That's $95 billion per month and $1.14 trillion over a 12-month period (*Fig. 5*).

(3) *No terminal amount or date.* There's no amount set or termination date specified for the QT2. The press release simply states that "the Committee intends to slow and then stop the decline in the size of the balance sheet when reserve balances are somewhat above the level it judges to be consistent with ample reserves." Assuming that QT2 is terminated at the end of 2024, the Fed's holdings of securities would decline by $2.8 trillion, to $5.7 trillion from $8.5 trillion, in May.

Monetary Policy III: How Big Is the Runoff Shock? Now let's discuss the impact of the Fed's runoff plan on the fixed-income markets from a flow-of-funds perspective. In particular, what flows might either exacerbate or offset the bearish impact of the Fed's plan? Consider the following:

(1) *Federal deficit.* In effect, running off the Fed's balance sheet by $95 billion per month

amounts to adding $1.14 trillion to the US federal budget deficit on a 12-month-moving-average basis. This deficit was $1.2 trillion through April, the narrowest it has been since March 2020 (*Fig. 6*).

Over the 12 months through April, the Fed's holdings of US Treasuries rose $0.8 trillion. Consolidating the income statements of the US Treasury and the Fed into one shows that their combined deficit was $0.5 trillion through April (*Fig. 7*). However, starting next month, the Fed in effect will be a seller rather than a buyer of US Treasuries.

The good news is that the federal budget deficit has declined significantly since it reached a record high of $4.1 trillion through March 2021, narrowing to $1.2 trillion through April of this year. Outlays, also on a 12-month basis, have dropped 20% since they peaked at a record $7.6 trillion during March (*Fig. 8*). Federal government receipts have been soaring to record highs since April 2021, led by an almost vertical ascent in individual income-tax receipts (*Fig. 9*). Total federal tax receipts are up 31.5% y/y through April, led by a 53.8% jump in individual income-tax receipts. Yes, Virginia, inflation is a tax, and it is showing up in federal tax receipts.

Since tax receipts are up much more than inflation, is the economy much further from the edge of recession than widely feared? Actually, some of the past 12 months' tax receipts were boosted when the IRS pushed back the 2021 filing deadline for a second year in a row, both to ease pandemic-related complications for taxpayers and to give them extra time to take advantage of the numerous tax provisions created by the American Rescue Plan.

The bad news is that the federal government's outlay on net interest paid rose to a record high of $404.2 billion over the 12 months through April (*Fig. 10*). This item will be heading higher in coming months, reflecting the rise in interest rates.

(2) *Foreign capital inflows*. In addition to inflation boosting federal tax revenues, another offset to the Fed's runoff is massive net capital inflows, which have been boosting the dollar in the face of record current-account deficits. Monthly data compiled by the US Treasury show that total net capital inflows added up to $1.34 trillion during the 12 months through March, matching the previous month's record high (*Fig. 11*). Over this same period, the total private net capital inflow rose to $1.58 trillion, while the total official net capital inflow was -$238.3 billion (*Fig. 12*).

Here are the major components of the 12-month private net capital inflows through March: total ($1.6 trillion), bonds ($634 billion), Treasury bonds ($405 billion), government agency

bonds ($115 billion), corporate bonds ($115 billion), equities (-159 billion), Treasury bills ($143 billion), and other negotiable instruments ($318 billion). (See *Treasury International Capital Data for March*.)

(3) *Bank purchases.* Commercial banks have been major purchasers of US Treasury and agency securities. Over the past two years through the week of May 4, their holdings rose $1.5 trillion (*Fig. 13*). However, they may be starting to reduce their holdings now that their loan demand seems to be improving.

(4) *Bond funds.* Last year saw record inflows into bond mutual funds and ETFs (*Fig. 14*). The 12-month sum of these inflows peaked at a record $1.0 trillion during April 2020. However, these funds saw net outflows totaling $45.1 billion during the three months through March of this year, when bond yields soared (*Fig. 15*). Weekly data estimated by the Investment Company Institute show that new outflows continued through the May 4 week (*Fig. 16*). The question is whether interest rates have risen high enough to attract retail and institutional bond buyers. The recent stability in bond yields suggests that some nibbling has started.

Monetary Policy IV: The Previous Runoff. During QT1, the Fed's holdings of securities was pared by $675 billion from $4.2 trillion to $3.6 trillion. QT2 would reduce the Fed's balance sheet at a much faster pace, by more than $1.0 trillion over the next 12 months for starters. The Fed terminated QT1 earlier than expected because economic growth slowed. Let's look at the impacts that the Fed's past tapering episode had on various key financial variables for some guidance on what might be in store for us as the Fed starts QT2:

(1) *Monetary aggregates.* During QT1, M2 continued to expand at about the same pace as in the years prior to the program (*Fig. 17*). On the other hand, demand deposits were noticeably flat compared to the years prior to the program (*Fig. 18*).

(2) *Bond yield.* The 10-year US Treasury bond yield rose from 2.33% at the start of the QT1 period to peak at 3.24% on November 8, 2018. It then fell sharply to end the period at 2.02% (*Fig. 19*).

(3) *Stock market.* The S&P 500 was quite volatile during QT1, which included a taper tantrum during the last three months of 2018 (*Fig. 20*). But it managed to rise 18.3% nonetheless over the QT1 period.

Calendars

US: Tues: Retail Sales Total, Core, and Control Group 0.8%/0.3%/0.5%; Headline & Manufacturing Industrial Production 0.4%/0.5%; Capacity Utilization 78.5%; Business Inventories 1.9%; NAHB Housing Market Index 75; Weekly Crude Oil Inventories; Powell; Mester; Bullard. **Wed:** Housing Starts & Building Permits 1.773mu/1.810mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: Tues: Eurozone GDP 0.2%q/q/5.0%y/y; France Unemployment Rate 7.4%; Italy CPI 0.2%m/m/6.2%y/y; UK Average Earnings Including & Excluding Bonus 5.4%4.2%; UK Employment Change 3m/3m & Unemployment Rate 5k/3.8%; UK Claimant Count Change -38.8K; Japan GDP -0.4%q/q/-1.8%y/y; Lagarde; Enria; Cunliffe. **Wed:** Eurozone Headline & Core CPI 0.6%m/m/7.5%y/y & 1.1%m/m/3.5%y/y; UK Headline & Core CPI 2.6%m/m/9.1%y/y & 0.8%m/m/6.2%y/y; UK PPI Input & Output Prices 1.1%m/m/19.0%y/y & 1.0%m/m/12.5%y/y; Japan Industrial Production & Capacity Utilization; Japan Core Machinery Orders 3.7%; Canada Headline & Core CPI 0.5%m/m/6.7%y/y & 0.4%m/m/5.4%y/y; Australia Employment Change 30k; Australia Unemployment & Participation Rates 3.9%/66.4%; ECB Financial Stability Review; ECB Non-monetary Policy Meeting; McCaul; Enria; Balz; Beermann. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): All three of these indexes had forward earnings at a record high last week. LargeCap's returned to a record high after falling 0.2% below a week earlier for the first time in 19 weeks due to Amazon's Q1 earnings miss and lowered future guidance. MidCap's was at a record high for a 23rd straight week. SmallCap's rose for the eighth time in nine weeks, and was at a record high for a third week. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 98 of the past 103 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 97 of the past 101 weeks, and SmallCap's posted 93 gains in the past 102 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 67.9% from its lowest

level since August 2017; MidCap's is now up 138.2% from its lowest level since May 2015; and SmallCap's has soared 198.4% 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 20.3% y/y from 20.5%; 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 34.6% y/y from 36.3%. 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 43.3% y/y from 43.0% and is from a 25-month low of 41.2% at the end of April. 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 (9.8%, 9.8%), MidCap (14.2, 6.9), and SmallCap (13.1, 12.0).

S&P 500/400/600 Valuation (*link*): Valuations mostly ticked lower for these three indexes last week. LargeCap's forward P/E dropped to a 25-month low of 17.0 from 17.5. 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 0.4pts to a 25-month low of 12.3 from 12.7. That's down from a 13-week high of 17.1 in early November and is 9.6pts below its record high of 22.9 in June 2020. SmallCap's fell 0.3pt w/w to a 26-month low of 11.8 from 12.1. That's down from a 13-week high of 16.1 in early November and is now down 14.8pts 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 91st week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 30% 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 48th straight week; the current 4% discount is up from a 9% discount in December but remains near its lows during 2000-01.

US Economic Indicators

Regional M-PMI (*link*): The New York Fed has provided the first glimpse of manufacturing activity for May, which shows an unexpected return to contractionary territory. May's composite index plunged 36.2 points to -11.6 this month after spiking 36.4 points (to 24.6 from -11.8) last month. That's the third negative reading this year; it averaged 23.3 for all of last year. (May's reading was expected to slow to 17.0, marking this the biggest miss on expectations since April 2020 when the pandemic first struck.) Both new orders (to -8.8 from 25.1) and shipments (-15.4 from 34.5) contracted this month—with the latter falling at its fastest pace since early in the pandemic. In the meantime, employment indicators showed a pickup in hiring (14.0 from 7.3), while the increase in the average workweek (11.9 from 10.0) continued at a steady pace. Delivery times (20.2 from 21.8) continued to lengthen, and inventories (7.9 from 13.6) continued to accumulate, though at a slower pace. The unfilled orders index plunged from 17.3 last month to 2.6 this month. As for prices, the prices-paid index slowed to 73.7 this month from April's record high of 86.4, while the prices-received index eased for the second month, from a record-high 56.1 in March to 45.6 this month. Looking ahead, optimism about the six-month outlook remained subdued, edging up to 18.0 this month, after sinking from 36.6 to 15.2 last month. It was at a recent high of 52.0 in October. The capital expenditures measure fell to its lowest level since last summer. The six-month outlook for both prices-paid (63.2 from 72.7) and -received (45.6 from 55.5) remained elevated, though eased a bit; they were at record highs of 76.7 and 62.1, respectively, in January.

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