MORNING BRIEFING
December 13, 2022

The Bubble in Everything Has Burst. Now What?

Check out the accompanying chart collection.

Executive Summary: The bubble in everything has burst without dire consequences so far. Surprisingly, it has been a relatively smooth transition back to the Old Normal from the New Normal. Among the biggest bubbles to pop was in the bond market. The cryptocurrency calamity hasn't turned into a contagion. The SPAC debacle has also been contained. There is still some air in the stock market bubble, but less than there was at the beginning of the year. Home prices may get supported by a shortage of inventory.

Strategy: Bubble, Bubble Toil & Trouble. In Shakespeare's play, *Macbeth*, the three witches predict that Macbeth's troubles will double for killing everyone on his way to the crown: "Double, double toil and trouble / Fire burn and cauldron bubble."

Since 2021, pessimistic prognosticators have been predicting that the "bubble in everything" would burst. They've been mostly right, though they've been much too pessimistic about the implications for the financial system and the economy, so far. Then again, many of them aren't convinced that the worst is over for financial assets and for the economy.

According to the bearish narrative, the bull market from 2009 through 2021 was primarily attributable to the ultra-easy monetary policies of the Fed and the other major central banks. These policies were largely justified by the deflationary forces unleashed by the GFC. The result was that all the major central banks undershot their 2.0% inflation targets. That was their excuse for implementing so-called unconventional monetary policies including zero-interest-rate policies (ZIRP), negative-interest-rate policies (NIRP), yield-curve-control policies, and quantitative easing (QE).

Just when it seemed that these unconventional policies had become the new normal, inflation soared around the world over the past year, and now all the major central banks are scrambling to subdue inflation rates well exceeding their 2.0% targets by tightening their monetary policies.

In the US, the bullish case looking forward is that "this too shall pass," and indeed is passing. In other words, most if not all the bubbles have burst already, so not much more collateral damage lies ahead. The Fed is likely to raise the federal funds rate by 50bps on Wednesday and one more time early next year then pause for a while. Monetary policy has turned restrictive enough to moderate inflation without causing a recession. So corporate earnings are more likely to move sideways than take a dive. The same goes for valuation multiples. Moreover, US financial markets continue to benefit from "TINAC," i.e., the very sound investment rationale that "there is no alternative country" to serve as a safe haven for global investors during these challenging times around the world.

Let's review the latest developments in the bubble-in-everything narrative:

(1) *Bonds*. The unconventional central bank policies became all too conventional. Their response to the GVC was to triple and quadruple down on their QE bond purchases. Fiscal authorities, especially in the US, widened their budget deficits dramatically by providing all sorts of pandemic relief programs. Advocates of this monetary and fiscal extravaganza justified it with Modern Monetary Theory. Others called it a necessary provision of "helicopter money" to avert an economic and financial meltdown.

The US bond yield dropped from 4.04% at the end of 2007 to a record low of 0.52% on August 4, 2020 (*Fig. 1* and *Fig. 2*). Contributing to that drop was the Fed's zero-interest-rate policy during most of the period from the GFC through the GVC (*Fig. 3*). The Fed's four rounds of quantitative easy programs also kept bond yields down (*Fig. 4*). Importantly, negative bond yields in Europe during the pandemic along with the Bank of Japan's pegging of Japan's government bond yield around zero since 2016 also put downward pressure on US bond yields (*Fig. 5*).

These developments all led to a massive bubble in global bond markets. In the US, the 10-year bond's P/E based in the reciprocal of its yield soared to a record 161.3 during July 2020 (*Fig. 6*). It was back down around 25 during November as the yield soared to 4.00% recently.

The bursting of the bubble in the bond market has been extraordinary. Just as extraordinary is how little collateral economic damage there has been, so far. Single-family housing activity has been pushed into a recession. But the overall economy continues to grow.

Of course, there have been substantial capital losses in the bond market this year. The Fed's *US Financial Accounts of the United States* was updated last week through Q3. It shows that the face value of total US debt rose to a record $92.2 trillion (*Fig. 7*). The iShares 20+ Year Treasury Bond ETF (TLT) fell 36% from January 3 through October 24. It was down 26% ytd through Friday's close. Of course, most investors probably didn't sell their bonds and are planning to hold them to maturity rather than take the capital losses.

(2) *Cryptocurrencies.* Arguably, the collapse of crypto exchange FTX was one of the major financial crises that was triggered by the Fed's tightening of monetary policy, so far. However, the price of bitcoin peaked at a record $67,634 on November 8, 2021 (*Fig. 8*). It plunged 70% through October 31 (Halloween). That's before FTX imploded in November.

It probably would have failed regardless since it turned out to be the latest big Ponzi scheme. The Fed's May 6, 2021 *Financial Stability Report* (FSR) mentioned cryptocurrencies just once—as the ninth-greatest risk to US financial stability as determined by a survey of wide-ranging viewpoints. Here is an important excerpt on cryptocurrencies from the Fed's most recent November 4, 2022 *FSR*: "The turmoil in the digital assets ecosystem did not have notable effects on the traditional financial system because the digital assets ecosystem does not provide significant financial services and its interconnections with the broader financial system are limited."

Former Fed Chair Ben Bernanke, in an interview published by the Swedish journal Dagens Nyheter on December 7, stated he does not think cryptocurrencies constitute a threat to the current financial system because no bank is sitting on a large pile of these assets. He added, "I believe that so far cryptocurrencies have not been shown to have any economic value at all."

In May, Bernanke said bitcoin was used "mostly for underground economy activities and often things that are illegal or illicit." He further explained that while bitcoin is being used as a speculative asset, he does not think it can reach the status of an alternative currency. In his latest interview, Bernanke opined, "Either they are not regulated and then they will collapse because people distrust them or they are regulated and then they will collapse because they are mostly used for criminal activity."

(3) *ARK, meme, and SPAC stocks*. This is just one of many speculative bubbles that have burst since early last year—including ARK, SPACs, meme stocks—without causing a credit crunch or a recession, which is consistent with our rolling recession scenario. Indeed, the Fed's latest *Financial Stability Report* didn't mention them at all.

ARK Innovation ETF was the poster child for the speculative excesses of the bull market. It bought lots of stocks with the potential for disruptive innovations, though many of them didn't have earnings. It soared 210% from March 13, 2021 to February 11, 2022. It is currently down 77.6% from its record high.

The December 6 *Financial Times* *observed* that more than 350 companies have gone public in the US since the start of 2020 by merging with a Spac. These entities are cash shells set up to make an acquisition and allow a company to avoid a traditional initial public offering. Companies that come to market via a Spac are sometimes called "de-Spacs."

On December 5, Bloomberg *reported*: 'The market for SPACs has been hit by a broader rout in more speculative assets amid concerns about tighter regulation from the US Securities and Exchange Commission. The De-SPAC Index is down 71% in the past 12 months compared with a 13% drop in the S&P 500 Index. More than one-third of the roughly 400 companies that merged with a SPAC are trading below $2 a share."

(4) *S&P 500*. The bear market in stocks this year may have further to go in early 2023. That's not our view, but there are plenty of vocal bears who think so. They rightly observe that lots of air has come out of the S&P 500's valuation multiple, but there is plenty more that can come out if inflation doesn't moderate, the Fed continues to tighten aggressively, and the economy falls into a hard landing.

The bear market in stocks from January 3 through October 12 was led by a 30% fall in the S&P 500's forward P/E from 21.5 to 15.1 (*Fig. 9*). Over the same period, the forward earnings of the S&P 500 rose 6.2% (*Fig. 10*).

We are impressed with the recent rebound in the forward P/E to above 17.0. That's especially since the forward earnings peaked at a record high during the June 23 week and has been edging lower since then.

Nevertheless, the stock market still does have a valuation problem. That's easier to see by looking at the S&P 500's forward price-to-sales ratio (*Fig. 11*). It was 2.2 at the end of last week. That's down from a record high of 2.9 during the first week of the year, but this weekly daily version of the Buffett Ratio remains elevated.

(5) *Real estate*. Finally, residential real estate is under duress, especially the single-family home market. Over the 24-month period through May, the median existing single-family home price soared 44.9% as the pandemic boosted demand for such housing (*Fig. 12*). They were still up 21.1% through October on the same basis. That's surprising since both new and existing home sales have plummeted this year and mortgage rates soared. A shortage of homes for sales seems to be propping up home prices. In any event, the odds of another housing-led GFC are low in our opinion since homeowners have more equity and less debt in their homes.

(6) *Bottom line*. So far, the transition from the New Normal which spanned the GFC to the GVC back to the Old Normal has been remarkably smooth. Maybe the lags in monetary policy will destabilize the financial markets and the economy in 2023. We doubt it.

Calendars

US: **Tues**: Headline & Core CPI 0.3%m/m/7.3%y/y & 0.3%m/m/6.1%y/y; API Crude Oil Inventories. **Wed**: Import & Export Prices -0.5%/-0.4%; Consumer Inflation Expectations; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Interest Rate Decision 4.50%; FOMC Economic Projections; IEA Monthly Report. (Bloomberg estimates)

Global: **Tues**: Eurozone Economic Sentiment Index -26.4; Germany CPI; Italy Industrial Production -0.5%; UK Employment Change & Unemployment Rate -17k/3.7%; UK Average Earnings Including Bonus 6.2% 3mo/yr; Japan Machinery Orders 2.6% y/y; Japan Tankan Survey; Japan Industrial Production -2.6%; China New Yuan Loans; UK Financial Stability Report; EU Energy Ministers Meeting; Lowe. **Wed**: Eurozone Industrial Production -1.5%m/m/3.4%y/y; Spain CPI -0.1%m/m/6.8%y/y; UK Headline & Core CPI 0.6% m/m/10.9%y/y & 0.5%m/m/6.5%y/y; UK Input & Output CPI 0.2%m/m/18.0%y/y & 0.3%m/m/14.6%y/y; Australia Employment Change 19k; Australia Unemployment & Participation Rates 3.4%/66.6%; China Retail Sales -3.6% y//y; China Industrial Production 3.6% y/y; China Fixed Asset Investment 5.6% y/y; Japan Trade Balance; NBS Press Conference. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose for a fourth week following declines in seven of the prior eight weeks. Constituent changes for the SMidCaps muddied their w/w change. Companies with a lower aggregate P/E moved into MidCap and higher P/E companies were added to SmallCap. As a result, MidCap's forward earnings rose for the first time in 12 weeks, but SmallCap's fell for a tenth straight week. For a 24th straight week, none of these three indexes had forward earnings at a record high. LargeCap's is 3.9% below its record high at the end of June and up 0.3% from a 36-week low in early November. MidCap's rose 0.7% w/w from a 37-week low, and is now 5.6% below its record high in early June. SmallCap's tumbled 1.7% to a 48-week low and 7.4% below its record high in mid-June. Forward earnings momentum continues to fade. The yearly rate of change in LargeCap's forward earnings was down to a 21-month low of 3.9% y/y from 4.1% a week earlier; that's down from a record-high 42.2% at the end of July 2021 and up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate improved w/w to 9.5% y/y from a 21-month low of 8.9%. 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 was down to a 24-month low of 0.1% y/y from 2.1%. That's down from a record high of 124.2% in June 2021. It had been at a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 have been heading lower since June. Here are the latest consensus earnings growth rates for 2022 and 2023: LargeCap (5.9%, 4.9%), MidCap (17.1, -4.6), and SmallCap (5.0, 4.8).

S&P 500/400/600 Valuation (*link*): Valuations fell across the board last week to five-week lows for all three of these indexes. LargeCap's forward P/E fell 0.6pt to 17.1 from a 15-week high of 17.7, and is now up 2.0pts from its 30-month low of 15.1 at the end of September. That compares to a four-month high of 18.1 in early August and an 11-year low of 11.1 during March 2020. MidCap's forward P/E dropped 0.6pt w/w to 13.1 from an eight-month high of 13.7. That's up 2.0pts from a 30-month low of 11.1 at the end of September and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E fell 0.4pt w/w to 12.7 from an eight-month high of 13.1. That's up from a 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. 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. The forward P/Es for the SMidCaps have been mostly below LargeCap since August 2018. MidCap's current 23% discount to LargeCap is near its biggest since September 2000. SmallCap's current 26% 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 78th straight week; the current 3% discount is an improvement from its 9% discount in December 2021 but remains near its lows during 2000-01.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season when the US economy emerged from the covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the declines began to accelerate considerably beginning with Q3-2022. The S&P 500's earnings growth rate weakened q/q in Q3 to 4.0% y/y from 9.9% in Q2 on a frozen actual basis, and to 4.4% from 8.4% on a pro forma basis. Just four sectors recorded double- and triple-digit percentage growth in Q3-2022, two have a single-digit gain, and five have y/y declines. Looking ahead to Q4, analysts expect further deterioration; a 0.7% y/y decline is expected for the S&P 500, with just four sectors expected to record positive y/y earnings growth and seven expected to decline. Here are the S&P 500 sectors' latest expected earnings growth rates for Q4-2022 versus their Q3-2022 growth rates: Energy (69.5% in Q4-2022 versus 140.8% in Q3-2022), Industrials (42.3, 19.7), Real Estate (6.9, 14.8), Utilities (6.8, -7.1), S&P 500 (-0.7, 4.4), Financials (-3.4, -16.4), Consumer Staples (-3.6, 1.3), Health Care (-6.5, 1.5), Information Technology (-8.4, -0.1), Consumer Discretionary (-14.4, 13.2), Communication Services (-20.8, -26.1), and Materials (-21.1, -8.8).

Global Economic Indicators

UK GDP (*link*): Real GDP in October rebounded for the first time in three months, by 0.5%, after contracting 0.6% in September when many businesses closed their doors during the national mourning period for Queen Elizabeth; activity had ticked down 0.1% in August. October's increase likely reflected the number of working days returning to normal rather than a surge in output. *Services output* posted the biggest gain in October, expanding 0.6% after contracting 0.8% in September, led by a 1.9% increase in wholesale and retail trade; repair of motor vehicles and a 1.3% jump in services of health and social work activities. The only negative contribution within the sector came from financial and insurance activities (-0.2%). *Industrial output* was flat in October, after edging up 0.3% in September—which was only the second increase so far this year. Manufacturing output climbed 0.7%, the first increase in five months and also only the second advance this year. As for the *main industrial sectors*, output of capital (-11.4%) and intermediate (-13.0) goods are down sharply from their record highs during December 2020 and November 2020, respectively. Meanwhile consumer nondurable goods output was down 4.1% from its December 2021 record high, though has rebounded 5.0% during the two months through October, while consumer durable goods production has dropped 4.5% during the two months through December after fluctuating in a volatile flat trend at record levels. *Real GDP* fell by 0.3% in the *three months* through October compared with the three months through July. Chancellor Jeremy Hunt warns: "These figures confirm that there is a very challenging economic situation here and across the world. While today's figure show some growth, I want to be honest that there is a tough road ahead. Like the rest of Europe, we are not immune from the aftershocks of Covid-19, Putin's war and high global gas prices."

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