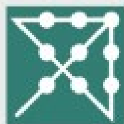

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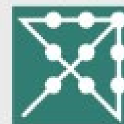

MORNING BRIEFING
January 4, 2023

All About Central Banks

Check out the accompanying chart collection.

Executive Summary: Bears warning that the worst is yet to come for financial assets and the economy emphasize the effects on asset prices of central banks' recent tightening policy moves, in the US and around the world. Yes, the unconventionally easy monetary policy that greased financial markets for more than a decade is over, but quite a bit of the tightening that has replaced it has been discounted by financial markets already. Moreover, most asset bubbles have burst already without much collateral damage. And the US markets continue to benefit from record foreign capital inflows. … Also: Melissa recaps recent monetary policy developments in Europe, Japan, and China.

YRI Weekly Webcast. A replay of Dr. Ed's webinar broadcast yesterday is available *here*.

Central Banks I: Bursting the Bubbles. 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 Great Financial Crisis. 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 (YCC), and quantitative easing (QE).

These unconventional policies had begun to seem like the "new normal" when suddenly, over the past year, inflation soared around the world. 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, without much

collateral damage. The FOMC will probably raise the federal funds rate by 25bps at each of its next three meetings to 5.00%-5.25% and then pause. Monetary policy will have 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 stock 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. Indeed, investment funds have been flooding into the US: Although the dollar index (DXY) peaked at 114.10 on September 27 last year, falling to 103.52 by year-end, US Treasury data show that US private net capital inflows totaled a record $1.7 trillion over the 12 months through October 2022 (*Fig. 1*). Private net foreign purchases of US Treasury, agency, and corporate bonds soared to a record $1.2 trillion over this period, led by $1.0 trillion purchases of US Treasury notes and bonds (*Fig. 2*).

Central Banks II: The Bears' Favorite Chart. One of the bears' favorite charts shows the relationship between the S&P 500 and the size of the Fed's balance sheet. The former rose 609% from March 9, 2009 through January 3, 2022 (*Fig. 3*).

Over this same period, the Fed's assets rose 1,005% from $760 billion in March 2009 to $8.4 trillion in January 2022. That was all wildly bullish for stocks and bonds.

On January 5, 2022, the Fed released the *minutes* of its December 14-15, 2021 FOMC meeting. It included a long section titled "Discussion of Policy Normalization Considerations." It signaled that the Fed soon would respond to rising inflation by reducing the size of its balance sheet.

The Fed's quantitative tightening (QT) program began in June of last year and started accelerating in September. At the current runoff pace of $95 billion per month, the Fed's asset holdings would drop by $2.8 trillion from a record high of $8.5 trillion during May 2022 to $5.7 trillion by the end of 2024.

The bears reckon that QT of this magnitude will continue to send stock prices lower. They might be right. But keep in mind that the forward P/E of the S&P 500 has already dropped from 21.5 on January 3 of 2022 to 16.7 at the end of the year (*Fig. 4*). So the market already has discounted quite a bit of the Fed's pivot from accommodative to restrictive monetary policy.

The S&P 500 is also highly correlated with the sum of the assets of the Fed, the European Central Bank (ECB), and the Bank of Japan (BOJ) (*Fig. 5*). This series rose from about $3.3 trillion during mid-2008 to a record high of $25.1 trillion during February 2022 and was down 12% to $22.1 trillion in November of last year. The problem with this series is that it is in dollars, which exaggerates the decline of the assets held by the ECB in euros and BOJ in yen. Nevertheless, we acknowledge that the two series have been and remain highly correlated.

Central Banks III: ECB Scrambling. The Eurozone's headline CPI inflation rate soared to a record 10.6% y/y in October, with the core rate at a record 5.0%. The former fell slightly to 10.1% in November, while the latter remained at 5.0% (*Fig. 6*).

The ECB responded by raising interest rates on December 15 for the fourth consecutive time, ECB President Christine Lagarde clearly telegraphed that the tightening wasn't over. We have "more ground to cover," she *said*, adding: "The ECB is not pivoting." She noted that at least two more 50bps rate increases could be expected in February and March. In its latest move, the ECB increased its deposit rate to 2.0% from 1.5%. The rate had been at -0.50% during the first half of 2022 (*Fig. 7*).

The ECB also announced plans to decrease its over €8 trillion lending and bond portfolio and recently has begun doing so. But not all the European central bankers agree on what should happen next. And Lagarde has a history of changing her mind.

Here's more:

(1) *Risk of overtightening.* Other ECB board members don't appear to be on board with raising rates as aggressively as Lagarde implied, as we observed in our November 15 *Morning Briefing*. For example, ECB board member Fabio Panetta had said in November that monetary policy should not "ignore the risks of overtightening."

(2) *Bad forecasts.* Vítor Constâncio, former ECB vice-president, *wrote* on Twitter that the ECB's December move indicated "an excessively hawkish policy that will aggravate the coming recession unnecessarily." Constâncio explained that Lagarde's statements were "grounded on controversial inflation forecasts." The ECB has different procedures to calculate the forecasts in June and December, he said. In these months, the forecasts are coordinated by the national central banks, "whereas in the other quarters ECB staff does it."

In turn, the national bank *forecasts* resulted in the following rather large increases: to 8.4%

(from 8.1%) for 2022, 6.3% (from 5.5%) for 2023, and 3.4% (from 2.4%) for 2024. Rates closer to 2.0% are not expected until 2025. It's hard to believe the inflation forecasts, however, when recently the bank issued a *mea culpa* for its poor job in creating them, *observed* the April 28 *Financial Times.* Then again, the ECB's forecasts may be no worse than those that the other global central banks put out.

(3) *Quantitative tightening.* The ECB has started its QT program to reduce the size of its balance sheet. At December's end, the ECB posted its update for the total assets on its balance sheet, which plunged by €492 billion from the week before to €7.98 trillion, led by a big drop in its Targeted Longer-Term Refinancing Operations programs (TLTRO) (*Fig. 8*). That was the lowest since July 2021 and €850 billion below the June peak.

During the October meeting, the ECB *announced* that it would make the terms less favorable on pandemic-related TLTRO loans and allow for voluntary early repayment of them. At its December 2022 meeting, the ECB *announced* that it would reduce its bond holdings beginning in March 2023 at a rate of €15 billion a month.

We also are watching for the ECB's potential use of its untested "Transmission Protection Instrument" (TPI), an important backstop. Officials are acutely aware that its aggressive tightening is at the risk of disorderly market adjustments, as outlined the ECB's *November 2022 Financial Stability Report*. After longer-term government bond yields went haywire for debt-ridden Eurozone regions in response to the initial steps of the ECB's tightening phase, the bank *announced* in July 2022 that it could give special treatment (i.e., via increased targeted liquidity with the purchase of specified bonds) to qualifying areas if necessary. Use of the TPI could indicate that the ECB could tip into a pivot.

(4) *Whatever-it-takes.* Notably, Lagarde is no stranger to pivots. She once disavowed the "whatever-it-takes" mantle associated with her predecessor Mario Draghi, who delivered on his pledge to "do whatever it takes" to defend the euro following the previous crisis—saying she's not "whatever-it-takes number two." Yet on March 18, 2020, she pivoted to an all-in stance on ECB's Pandemic Emergency Purchase Program, essentially saying the ECB would do what it takes to end the pandemic.

We don't know how long Lagarde will remain a vigilant hawk this time. But if the ECB's aggressive interest-rate hiking and QT tips the Eurozone into a recession, it might not be for long.

Central Banks IV: BOJ's Mixed Message. Rising inflation in Japan has increased the

odds that the BOJ soon could let go of its long held accommodative monetary policy stance. That includes negative short-term interest rates and its Yield Curve Control (YCC) policy (introduced in 2016) to hold 10-year Japanese Government Bond yields (JGB) near 0.0% with its bond purchases.

For now, the bank's Governor Haruhiko Kuroda has *said* that it is "too early to consider reviewing or exiting" current policies, mainly because demand-driven inflation remains lacking, according to the bank. The bank has maintained in its policy *statement* that it will "not hesitate to take additional easing measures, if necessary." But Kuroda won't be heading the BOJ for much longer.

Here's more:

(1) *Inflation soaring for headline & core.* Japan's inflation jumped to record-high rates of 3.9% for the headline and 3.7% for the core (excluding food) during November, showing that it's not just energy and food prices driving inflation higher (*Fig. 9*). Both the headline and core rates had fallen well below the BOJ's 2.0% inflation target up until April 2022. Nikkei *reported* on December 31 that, according to sources, the BOJ is considering raising its inflation forecasts in January to show price growth close to its 2% target in fiscal 2024, a move that could provide grounds for a pivot away from ultra-loose monetary policy.

(2) *Yields rising as caps raised.* Last week, on December 20, the bank raised its YCC cap to 0.5%, saying that it was not a mark of a policy shift but a move to ensure the functioning of the bond markets. Consensus thinking was that the bank would stand pat on policy until this year, so the move surprised markets. In addition, the bank's statement said it would increase its monthly bond purchases to $67 billion from about $55 billion. But its near-zero short-term interest rates were kept unchanged. Total assets on the BOJ's balance sheet have declined from a peak of ¥742.3 trillion during the June 17 week to a recent low of ¥684.9 trillion during the final week of September; but they subsequently rose slightly to ¥698.2 trillion through the week of December 16 (*Fig. 10*).

(3) *Kuroda exits.* Recent monetary policy moves (or non-moves) could be moot given that the bank's entire monetary policy framework comes up for review when Kuroda's term expires in April, after two more policy meetings.

Current Deputy Governor Masayoshi Amamiya and former Deputy Governor Hiroshi Nakaso are among the names floated to take Kuroda's spot, *according* to the *Japan Times*. The current deputy presumably would follow along Kuroda's track. The former deputy has

not worked at the BOJ since 2018 and has criticized Japan's economic policies as too reliant on monetary rather than fiscal approaches.

(4) *Weak demand.* Some say a fundamental policy shift in Japan is unlikely because household spending and consumer confidence remain weak. Contractual earnings per employee on a real basis have been mostly negative since fall 2021. Also, the BOJ *projects* that core inflation will decline to 1.6% during 2023 as pricing pressure on oil imports declines (as of October, the latest projections available).

Central Banks V: PBOC Is Easing. Keep injecting money into the financial system, Xi Jinping, China's President, effectively *told* the People's Bank of China (PBOC) late last year. The Politburo, the top decision-making body of the Communist party, has *pledged* to make monetary policy "targeted and forceful" in 2023. With the leadership push, the central bank is expected to maintain its accommodative monetary in early 2023.

Most of Chinese households' assets are tied up in real estate, however, limiting the effectiveness of central bank stimulus. Corporate demand for loans has been weak given the wave of insolvencies in China's property market. Recently, China has relaxed its zero-Covid policies, aiming to revive its economy. However, that's caused a rampant rise in infections, and residents may opt to remain at safe social distances in any case. So what's a central bank to do? Consider the following:

(1) *Injecting cash.* On Friday, December 23, China's key money rate fell to the lowest level on record after the central bank made its largest weekly cash injection (a net 704 billion yuan, or $100.76 billion) via open-market operations since late October, *reported* Reuters. China's required reserve ratios were cut five times over the past two years (*Fig. 11*).

(2) *Disinflation & deflation.* Despite all the stimulus, China's CPI eked out a mere 1.6% y/y rate, and China's PPI for industrial products fell into deflationary territory at a -1.3% y/y rate during November (*Fig. 12*). Domestic demand has been weak amid the Covid restrictions, with China's retail sales falling 5.9% y/y during November.

(3) *Ailing property market.* Last month, Chinese regulators released a 16-point plan to rescue the struggling property industry, *reported* the *South China Morning Post*. New home sales fell 31% y/y in November after declining 23% in October, according to National Bureau of Statistics data. President Xi recently reaffirmed the importance of the property sector as a "pillar" of the Chinese economy.

(4) *Contagion spreading.* Meanwhile, nearly 37 million people in China may have been infected with Covid-19 on a single day this week, according to estimates from the government's top health authority, *reported* Bloomberg on December 23.

Calendars

US: Wed: ISM M-PMI & Price Index 48.5/42.5; Job Openings 10.0m; Motor Vehicle Sales; MBA Mortgage Applications. **Thurs:** ADP Employment 150k; Challenger Job Cuts; Initial & Continuous Jobless Claims 230k/1.705m; S&P Global C-PMI & NM-PMI 44.6/44.4; Natural Gas Storage; Crude Oil Inventories. (Bloomberg estimates)

Global: Wed: Eurozone, Germany, and France C-PMIs 48.8/48.9/48.0; Eurozone, Germany, France, Italy, and Spain NM-PMIs 49.1/49.0/48.1/49.5/50.8; Germany Import Prices -1.6%m/m/18.0%y/y; France CPI; France Consumer Confidence 84; Spain Unemployment; China Caixin NM-PMI. **Thurs:** Eurozone PPI -0.9%m/m/27.5%y/y; Germany Trade Balance 7.5b; Italy CPI 0.1%m/m/11.6%y/y; UK C-PMI & NM-PMI 49.0/50.0; Canada Trade Balance $0.61b; Japan Consumer Confidence; Japan NM-PMI 51.7. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings remains on a modest downtrend for these three indexes compared to their deep declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's fell for a third week to a 44-week low and is down in nine of the past 13 weeks. MidCap's fell for a third week to a 42-week low and has dropped in 14 of the past 15 weeks. SmallCap's rose w/w for the first time in 13 weeks from a 57-week low. For a 27th straight week, none of these three indexes had forward earnings at a record high. LargeCap's is 4.3% below its record high at the end of June; MidCap's is now 6.7% below its record high in early June; and SmallCap's is 9.5% below its mid-June record. Forward earnings momentum continues to fade. The yearly rate of change in LargeCap's forward earnings was down to a 21-month low of 2.9% y/y; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate is at a 22-month low of 4.8% y/y, down from a record high of 78.8% in May 2021 and compares to a record low of -32.7% in May 2020. SmallCap's rate of -0.3% y/y remains near a 24-month low, 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 (5.6%, 4.4%), MidCap (15.6, -4.2), and SmallCap (4.9, 3.9).

S&P 500/400/600 Valuation (*link*): Valuations were mostly steady w/w for these three indexes, but remain near eight-week lows. LargeCap's forward P/E of 16.7 is down 1.0pt from a four-month high of 17.7 in early December, but is up 2.6pts 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 of 13.0 is down 0.7pt from an eight-month high of 13.7 in early December. That's up 1.9pts 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 0.1pt w/w to 12.5, but remains above its 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. The forward P/Es for the SMidCaps have been mostly below LargeCap since August 2018. MidCap's current 22% discount to LargeCap is near its biggest since September 2000. SmallCap's current 25% 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 an 81st straight week; the current 4% discount is an improvement from its 9% discount in December 2021 but remains near its lows during 2000-01.

US Economic Indicators

Construction Spending (*link*): Construction spending edged up 0.2% in November, following a 0.2% downtick and a 0.5% uptick the prior two months. Year to date, spending is up 7.5%, driven by a strong first half of the year. Private construction spending follows a similar pattern, rising 0.3% in November following a 0.7% loss and a 0.3% gain the prior two months, posting a 6.6% year-to-date gain—with most of the strength occurring during the first six months of the year. Public construction spending was little changed, down 0.1% in November, following a five-month gain of 9.8%. Within private construction spending, residential investment contracted for the sixth successive month since reaching a record high in May, slumping 8.2% over the period, after not posting a decline since May 2020. The recent weakness in residential investment was driven by single-family construction spending, which hasn't recorded a gain since April, plunging 17.9% during the seven months through November. Meanwhile, multi-family construction rose in November for the

eighth time in 11 months, climbing 10.5% ytd to a new record high. Meanwhile, home improvement spending has posted only two declines since September 2020—dropping 6.2% during the two months ending October and recovering 2.0% of the decline during the two months ending November to within 4.3% of July's record high. Private nonresidential spending climbed for the sixth time in seven months in November—jumping 11.8% over the period to slipped 0.8% in October, after advancing four of the past five months by a total of 7.6% to a new record high.

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