MORNING BRIEFING
August 22, 2023

Bond Yields Returning To Normal

Check out the accompanying chart collection.

Executive Summary: My bond market outlook over the past 40 years was misrepresented in a Bloomberg story on Friday. To set the record straight, I was bullish on bonds from 1983-2021, not regularly predicting a return of the Bond Vigilantes as reported. … But they are back now, driving up the 10-year Treasury bond yield on concerns about the mounting federal deficit. The Bond Vigilantes still care about inflation (which is moderating), but they also care more about supply and demand than in the past, with the federal government straining both (via fiscal spending and QT). … What's next? We think the Treasury bond yield is returning to normal around 4.50%-4.75% as the economy returns to its Old Normal.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Bonds I: Bloomberg on the Bond Vigilantes & Me. I am rarely misquoted or taken out of context by my friends in the financial press. However, I recently was compared to the boy who cried "Wolf!" in an August 18 Bloomberg *article* titled "Yardeni, Economist Who Cried 'Bond Vigilantes,' Spots Them Again."

I would like to set the record straight with the help of three articles about me and the Bond Vigilantes previously posted on Bloomberg and actually referenced in the latest one. The latest article states: "Edward Yardeni, the economist who coined the term 'bond vigilantes' during the 1980s and has regularly predicted their return to the investment landscape ever since, said they're 'saddling up.'"

I did not regularly predict their return. I did coin the term "Bond Vigilantes" in 1983. I was consistently bullish on bonds from then through 2021. I was among the first disinflationists at the start of the 1980s. I changed my mind about bonds along with everyone else in early 2022 when inflation reared its ugly head. Yet the Bloomberg story implies that I was mostly *bearish* that whole time since the early 1980s, presumably because I saw Bond Vigilantes around every corner.

For the record, I did see them three times during the 1980s, when yields rose and effectively slowed nominal GDP growth. In the early 1990s, I observed that the Clinton administration maintained fiscal discipline largely because they feared the Bond Vigilantes.

Inflation remained subdued during the second half of the 1990s through 2021, and I remained mostly bullish on bonds. I didn't cry "Wolf!"

Now let's go to the Bloomberg stories, referenced in the article, that got it right:

(1) *Bond Vigilantes Are 'Baaaack!', Says Economist Who Coined Term* (September 27, 2022). "In a note titled 'The Bond Vigilantes: They're Baaaack!' Ed Yardeni said the huge amount of monetary and fiscal stimulus released during the pandemic has unleashed forces that haven't been seen for decades, forcing central banks to respond with the massive policy tightening seen this year. 'Once the central banks were forced to stop their Great Financial Repression, the bond vigilantes were set loose,' wrote Yardeni … His comments came as the worst bond selloff in decades is seeing few signs of ending."

(2) *Yardeni Says Bond Vigilantes May Return After Virus Crisis Fades* (March 18, 2020). "The market veteran credited with coining the term 'bond vigilantes' says there's a chance they could make a return in the aftermath of the coronavirus, after being largely absent for decades. Government debt in most developed nations has seen a powerful rally the past two months as the deadly epidemic throttled economic growth. But once the outbreak finally subsides, they might start tumbling when investors consider the tremendous amount of stimulus enacted by policy makers, says Ed Yardeni, president and chief investment strategist of Yardeni Research Inc. 'After we get through this GVC [Great Virus Crisis], we may very well have an inflation scare where the bond vigilantes might very well be able to push bond yields higher,' Yardeni said in an interview."

The story also quotes me as saying, "I haven't seen them [i.e., the Bond Vigilantes] for quite some time." As noted in the story, I said that the last time I saw them was during the Greek debt crisis in 2010. Furthermore, according to the article: "In the end, they may return 'because even the central banks will recognize that they need to at least try to do some normalization of monetary policy to head off inflationary consequences of all the stimulus provided,' he said."

(3) *Bond Vigilantes Lie In Wait for Trump's Debt-Swelling Tax Plan* (April 27, 2017). I was quoted in this article with a title suggesting that it might have represented my view, since I am widely associated with the Wild Bunch. Here was what I said in the story: "Bond vigilantes are now clearly showing no signs of vigilantism." I explained: "'The bond vigilantes get much more excited about inflation than they do about the supply of government securities,' Yardeni said. 'We are trained that market prices are dictated by supply and demand, so having bigger and bigger deficits should matter. It does matter to bond

vigilantes, but much more weight seems to be given to inflation.'" I added that since the 2008 financial crisis, "'the bond vigilantes have been pretty quiet.'"

Just for the record: "*The Bond Vigilantes*," an excerpt from my 2018 book *Predicting the Markets*, is posted on our website.

Bonds II: What Is Normal? So now what? Where do we go from here? Since 1983, I have been keeping track of the Bond Vigilantes, and not regularly ringing the alarm bell about their return. I viewed them as a disinflationary force that was bullish for bonds. They've undoubtedly returned recently, as the 10-year Treasury bond yield—which had dropped from 4.25% on October 24 to 3.30% on April 6—rebounded to 4.34% yesterday on mounting concerns about mounting federal deficits, as Melissa and I discussed in yesterday's *Morning Briefing*.

The question we need to answer is whether bond yields can fall if inflation continues to moderate, as we expect, while the federal deficit widens even though the economy is growing? As I observed in the April 27, 2017 Bloomberg article cited above, supply and demand for bonds mattered to the level of bond yields in the past, but not as much as inflation mattered. Now the former may matter at least as much as inflation given the unprecedented profligate fiscal excesses occurring since the pandemic.

Of course, if we are wrong about inflation—either because it stops moderating or it starts moving up again—we all know that bond yields are going higher. But if inflation does moderate, can bonds rally or at least stabilize at current levels despite the large supply of Treasuries while the Fed is tapering its holdings of Treasuries? Now that the Fed and other central banks have been forced to normalize their monetary policies, what should the normal bond yield be under the circumstances?

Consider the following:

(1) *The Bond Vigilante Model* relates the bond yield to the growth rate in nominal GDP, which reflects inflation as well as the growth rate of real GDP. This model shows that since 1953, the yield has fluctuated around the growth rate of nominal GDP (*Fig. 1*). However, both the bond yield and nominal GDP growth tend to be volatile. While they usually are in the same ballpark, they rarely coincide. When their trajectories diverge, the model forces us to explain why this is happening.

During Q2, nominal GDP was up 6.3% y/y, which was down from a peak of 17.4% y/y

during Q2-2021. It seems to be converging with the 10-year Treasury bond yield, which rose from a record low of 0.52% during August 2020 to 4.34% on Monday. Nominal GDP growth should continue to moderate along with inflation.

The GDP deflator (GDP-D) peaked at 7.6% y/y during Q2-2022 (*Fig. 2*). It was down to 3.6% during Q2-2023. It has converged with the bond yield. However, in the past, the bond yield almost always has exceeded the GDP-D inflation rate (*Fig. 3*). But there is no constant or even consistent value for this measure of the real bond yield. Our forecast is that the deflator is heading toward 2.0%-2.5% by 2025. If the real bond yield rises from zero during Q2-2023 to 1.50%-2.50% (where it was just before the pandemic), the nominal yield would be 3.50%-5.00%. Admittedly, that's a wide range, but it would be a return to normal compared to the period from the GFC through the GVC.

(2) *The TIPS Model* defines the nominal 10-year Treasury bond yield as equaling the 10-year TIPS yield plus an expected inflation proxy, i.e., the nominal yield minus the comparable TIPS yield (*Fig. 4* and *Fig. 5*).

The recent rebound in the nominal yield has been driven by the rebound in the TIPS yield from a low of 1.06% on April 6 to 2.00% yesterday. The latter seems to be normalizing back around 2.00%, which is where it was during 2003-06, the years just before the Great Financial Crisis (GFC) of 2008 set the stage for the TIPS yield to fluctuate around 1.00% to -1.00% from 2010-22.

The history of the 10-year expected inflation proxy shows that it mostly has hovered around 2.50% since 2003 except for during the recessions associated with the GFC and the GVC, along with the mid-cycle slowdown of 2015-16. During those three periods of economic weakness, the TIPS yield fell below 1.50%.

This model suggests that during normal times, the 10-year nominal bond yield should be around 4.50%.

(3) *The Yield Curve Model* is based on investors' expectations of how monetary policy will respond to inflation and impact the business cycle. In the past, inverted yield curves signaled that the 10-year Treasury bond yield was getting close to peaking (*Fig. 6* and *Fig. 7*). That's because inverted yield curves typically imply that bond investors believe that if the Fed continues to raise short-term interest rates, something in the financial system will break, triggering an economy-wide credit crunch and a recession.

This time, the inverted yield curve correctly anticipated the banking crisis that occurred during March. But there has been no credit crunch because the Fed responded quickly with an emergency lending facility for the banks. So there has been no recession attributable to a credit crunch. The bond yield has been rising since April as investors became increasingly impressed with the resilience of the economy.

As a result, the inverted yield curve is disinverting, with the bond yield rising toward the 2-year Treasury note yield (*Fig. 8*). We think that the yield curve is normalizing as the economy returns to its Old Normal, leaving behind the New Abnormal that spanned from the GFC through the GVC periods. In the past, the yield curve disinverted, with the 2-year yield falling faster than the 10-year yield, during recessions and early recovery periods.

In our opinion, what we are seeing now is the bond yield returning to its normal pre-GFC range of 4.50%-4.75%.

Calendars

US: Tues: Existing Home Sales 4.15mu; Richmond Fed Manufacturing Index -7; API Weekly Crude Oil Inventories; Bowman; Goolsbee; Barkin. **Wed:** C-PMI, M-PMI & NM-PMI Flash Estimates 52.0/49.4/52.3; New Home Sales 701k; Crude Oil Inventories & Gasoline Production. (Bloomberg estimates)

Global: Tues: Eurozone Current Account -€6.9b; UK Industrial Trend Orders. **Wed:** Eurozone, Germany, France C-PMI Flash Estimates 48.4/48.3/46.6; Eurozone, Germany, and France M-PMI Flash Estimates 42.4/38.6/45.2; Eurozone, Germany, and France NM-PMI Flash Estimates 50.4/51.5/47.3; Eurozone Consumer Confidence -14.0 European Union Economic Forecasts. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for LargeCap and MidCap but fell for SmallCap. While it's been 60 weeks since any of these indexes has hit a record high, all three are up from their lows during February and March. Through the week ending August 18, LargeCap's forward earnings is 4.9% above its 54-week low during the week of February 10; MidCap's is 3.0% above its 55-week low during the week of March

10; and SmallCap's is struggling at just 0.2% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrend since mid-2022 has been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's forward earnings is now 1.2% below its record high at the end of June 2022; MidCap's is 5.3% below its record high in early June 2022; and SmallCap's is 13.4% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative last week for a 28th straight week but barely so, at -0.1% y/y; that's improved from a 29-month low of -3.2% y/y during the June 23 week. Those levels compare to a record-high 42.2% at the end of July 2021 and, on the downside, to -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -5.0% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -11.1% y/y rate is up from a 32-month low of -12.9% in mid-June and down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since June last year, but 2023's estimates ticked higher during the Q1 and Q2 reporting seasons as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.1% and 11.8%), MidCap (-11.9, 13.4), and SmallCap (-13.0, 14.7).

S&P 500/400/600 Valuation (*link*): Valuations mostly ticked lower for these three indexes through the August 11 week. LargeCap's forward P/E fell 0.6pt w/w to a 12-week low of 18.4 and is down from an 18-month high of 19.6 during the July 28 week. It's up 3.3pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E dropped 0.5pt w/w to an eight-week low of 13.6, down from a 21-week high of 14.4 during the July 28 week, and is now 1.0pt below its recent 10-month high of 14.7 in early February. It's up 2.5pts from its 30-month low of 11.1 at the end of September, which 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 to a six-week low of 13.5, which compares to a 21-week high of 14.1 during the July 28 week and is now 0.8pt below its recent 12-month high of 14.3 in early February. It's 2.9 pts 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's since August 2018. MidCap's 26% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021.

SmallCap's 27% discount to LargeCap's P/E last week is not much improved from its 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest discount since August 2021. 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 114th straight week; the current 1% discount is near its lowest since July 2021 and an improvement from its 20-year-low 9% discount in December 2021.

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 estimate declines accelerated considerably for the three quarters ending through Q4-2022 before easing for Q1-2023. Looking ahead to Q2-2023, analysts are forecasting that the S&P 500's y/y earnings growth rate will mark its cyclical bottom with a 6.5% decline, down from -2.8% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -3.4% in Q2, down from a 0.1% gain in Q1-2023. However, S&P 500 ex-Energy earnings are forecasted to be up 3.0% y/y in Q2-2023, an improvement from the 1.6% decline in Q1-2023 and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q2-2023, up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their final earnings growth rates for Q1-2023: Consumer Discretionary (53.6% in Q2-2023 versus 56.2% in Q1-2023), Communication Services (16.0, -8.9), Industrials (15.7, 27.1), Financials (9.9, 7.7), Consumer Staples (8.7, 0.4), S&P 500 ex-Energy (3.0, -1.6), Information Technology (2.6, -8.3), Utilities (0.6, -21.8), Real Estate (-2.2, -6.2), S&P 500 (-3.4, 0.1), Materials (-26.4, -22.2), Health Care (-26.7, -14.8), and Energy (-47.7, 21.0).

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