Bottom Fishing

**Bottoming I: US Interest Rates.** The 10-year US Treasury bond yield bottomed this year at 1.47% on 9/4 (Fig. 1). It rose to 1.85% yesterday. That’s despite widespread expectations that the Fed will cut the federal funds rate a third time this year at the FOMC meeting today and tomorrow. If that happens, the federal funds rate range would be lowered to 1.50%-1.75% with a midpoint of 1.63%. That would put the yield-curve spread between the 10-year bond and the overnight rate at plus 22bps, up from minus 62bps at the end of August (Fig. 2).

The S&P 500 rose to a new record high yesterday partly on expectations of a Fed rate cut. Just as important is that the inversion of the yield curve may be over, reducing the fears of an imminent recession. Importantly, the backup in the bond yield is viewed as a healthy sign for the economic outlook. It is also widely expected that if the Fed cuts the federal funds rate for a third time, then the FOMC statement is likely to emphasize that the committee’s next decision will be data dependent.

In our 4/7 study titled *The Yield Curve: What Is It Really Predicting?*, Melissa and I concluded that the Fed should use the shape of the yield curve to set monetary policy. When it is ascending, the Fed should be raising interest rates. When it is inverted, the Fed should be lowering interest rates. When it is flat, the Fed should do nothing, i.e., pause. In effect, that’s what the Fed has been doing since last year. The current flattening of the yield curve suggests that the Fed should pause after this week’s rate cut.

Here in brief is why the bond yield has been rising lately:

1. **Reversing the self-fulfilling prophecy.** The US bond yield fell to this year’s low and inverted the yield curve on recession fears that were heightened by the inversion of the yield curve. The flattening of the yield curve in recent days has reduced recession fears.

2. **De-escalating the trade war.** Also stoking recession fears was Trump’s escalating trade war with China. It has been deescalated in recent days as trade negotiators work on completing a Phase One deal.

3. **Postponing Brexit.** The possibility of a hard Brexit also raised fears of a global recession. The deadline has been postponed until 1/31/20, providing time to complete a soft Brexit.

See the collection of the individual charts linked below.

(1) Yield-curve spread swings from negative to positive. (2) Recession fears abating. (3) Why rising bond yields are bullish for stocks. (4) Simple yield-curve rules for managing monetary policy. (5) A bearish list for bonds. (6) Signs of better economic growth. (7) Even the German bond yield may be bottoming along with German economy. (8) Waiting for a bottom in industrial commodity prices. (9) S&P 500 earnings growth close to zero this year. Closer to 5% next year. (10) A few brief thoughts on Value versus Growth and SmallCaps versus LargeCaps.
Showing better survey data. As we discussed yesterday, the business surveys conducted by four Fed district banks (NY, Philly, Richmond, and KC) show that new orders and employment improved during October, suggesting that the national PMIs might have bottomed during September. Yesterday, we learned that the Dallas Fed survey was disappointing (Fig. 3). However, the averages of the five surveys still suggest that economic activity bottomed during the summer (Fig. 4). (See our Regional Business Surveys chart publication.)

Surprising the pessimists. Previously, we have shown the strong correlation between the Citibank Economic Surprise Index (CESI) and the 13-week changes in both the nominal and TIPS 10-year US Treasury bonds (Fig. 5 and Fig. 6). The CESI has dropped from a recent high of 45.7 on 9/25 to 4.9 on Friday, but it is still up from this year’s low of -68.8 on 4/25.

Heating up CPI inflation. In recent meetings with our accounts, a few have noted that the core CPI inflation rate jumped to 2.4% y/y during September (Fig. 7). It was 2.7% at an annual rate during the three months through September (Fig. 8). Debbie and I aren’t concerned because the core PCED inflation rate remained subdued at 1.8% y/y during August. However, we are adding this CPI inflation concern to this bearish list for bonds because we are hearing more about it in our meetings with our accounts.

Bottoming II: German Bond Yield. Interestingly, the German 10-year government bond yield seems to have bottomed at a record low of -0.75% on 9/3. It was up to -0.36% yesterday (Fig. 9). At their 10/24 meeting, the European Central Bank’s (ECB) Governing Council implemented a package of stimulative initiatives, including reviving its asset purchase program (APP), committing to buy €20 billion per month in bonds. So why might the German bond yield be bottoming?

Incoming ECB President Christine Lagarde agrees with outgoing President Mario Draghi that the fiscal authorities in the Eurozone, and especially in Germany, should take advantage of the ECB’s offer to purchase €240 billion per year in bonds to finance fiscal stimulus programs.

For now, the German authorities aren’t embracing the idea. In a 10/15 CNBC interview, German Finance Minister Olaf Scholz made it clear that Germany is “not willing to have extra debts.” German officials believe that world trade conflicts are weighing on the German economy. Scholz said, “The economic situation in Germany is still stable, we have lower growth, but we will [have] better growth in the next year.” He added that the country’s labor market is robust.

Nevertheless, Germany has been running large budget surpluses for years and is now under pressure from other Eurozone countries, the ECB, and the International Monetary Fund to spend more to help prevent an economic slowdown in the region. Germany’s seasonally adjusted budget surplus was 1.7% of the country’s GDP in Q2, down from 2.0% in Q1, according to Eurostat.

Meanwhile, a few important data series suggest that the German economy may be starting to bottom:

Ifo business confidence index. Debbie and I may be seeing things, but we think that the Ifo business confidence index is bottoming. It held at 94.6 in October after climbing in September for the first time in six months, from August’s 94.3 (Fig. 10). It’s down from last year’s record high of 105.2 during January. Granted, it has upticked before on the way down since then, but we are encouraged to see that the Ifo diffusion index for motor vehicles bottomed during May at -11.9 and was up to 3.8 during October (Fig. 11).

Auto production. We may also be seeing a bottom in the 12-month sum of German passenger car
production. It plunged from 5.8 million units through March 2017 to 4.8 million units last month, which was a small uptick from the low of 4.7 million units during July and August (Fig. 12).

**Bottoming III: Commodity Prices & Emerging Markets.** Central banks around the world have been lowering their interest rates this year, which should revive global economic growth. Joining the Fed has been the ECB, which cut its official deposit rate from -0.40% to -0.50% at the 10/24 meeting of the Governing Council. The central banks of Brazil, India, and Russia have been lowering their rates this year too.

We may be starting to see a bottom in the CRB spot commodity price index for 23 industrial and agricultural commodities in recent days (Fig. 13). We would be more confident of that if we saw a bottom in the CRB raw industrials spot price index of 13 raw industrial commodities (Fig. 14). (Both indexes exclude energy and wood commodities.)

We are encouraged to see that the Emerging Markets MSCI stock price index (in dollars) has been relatively stable this year after weakening last year. That’s because this stock price index has been highly correlated with the CRB raw industrials spot price index. So the stock price index has been holding up much better than the CRB index so far this year.

In the past, emerging market economies along with their stock, bond, and currency markets fared badly when the Fed was tightening monetary policy. The Fed’s easing this year should benefit these economies and their financial markets. As noted above, it has allowed their central banks to lower interest rates without unsettling their financial markets, as it might if the Fed were moving rates the other way.

**Bottoming IV: S&P 500 Earnings Growth.** Also bottoming should be the growth in S&P 500 operating earnings per share, assuming, as we do, that there won’t be a recession next year. Industry analysts’ consensus earnings estimates imply they’ve lowered their expectations for 2019 growth to 1.4% this year over last year (Fig. 15).

Meanwhile, their estimates for 2020 and 2021 undoubtedly are too optimistic, at 9.8% and 10.6%, respectively. Joe and I reckon that with the profit margin at an all-time high, earnings aren’t likely to grow faster than revenues; we see both rising around 5% per year over the next two years. That outlook for revenues growth coincides with that implied by the consensus estimates of industry analysts, at 5.3% next year and 4.6% in 2021 (Fig. 16).

**Bottoming V: Value & SmallCaps.** In my meetings in Texas last week, I was asked about Value versus Growth and SmallCaps versus LargeCaps. S&P 500 Value has been outperforming S&P 500 Growth since 8/27 (Fig. 17). That has coincided with the backup in the bond yield and the reversal in the yield-curve spread from slightly negative to slightly positive. Financials, which tend to be classified as Value stocks, do better when the yield curve is ascending rather than inverting. The current mix of interest-rate trends—with short-term rates falling while long-term rates are rising—is especially good for Financials.

The outlook for SmallCaps relative to LargeCaps is less clear. The former has underperformed the latter since early July (Fig. 18). It’s possible that SmallCaps will outperform for a while if risk-on makes a comeback as the S&P 500 moves to new record highs.

On the other hand, the fundamentals of forward earnings and forward profit margins have been looking better for LargeCaps than for MidCaps and SmallCaps since the beginning of the year (Fig. 19 and Fig.
We’re thinking that labor costs and shortages may be squeezing the profit margins of smaller firms more than of larger ones.

CALENDARS

US. Tues: Consumer Confidence 127.5, Pending Home Sales 0.2%, S&P/Case-Shiller Composite 20-City Home Price Index 2.0% y/y, FOMC Meeting. Wed: GDP & PCE 1.6%/2.6%, GDP & Core PCE Price Deflators 1.9%/2.2%, ADP Employment Change 115k, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Rate Decision 1.63% (1.50%-1.75%), Interest Rate on Excess Reserves 1.55%. (DailyFX estimates)

Global. Tues: UK Nationwide House Price Index 0.3% y/y, UK Mortgage Approvals 65k, Japan Retail Trade 6.1% y/y, Australia CPI 1.7% y/y, Lowe. Wed: Eurozone Economic Confidence 101.1, Germany Unemployment Change & Unemployment Rate 2k/5.0%, Germany CPI 0.0%m/m/1.1%y/y, France GDP 0.2%q/q/1.3%y/y, UK Gfk Consumer Confidence -13, BOC Rate Decision 1.75%, BOJ Rate Decision. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (link): Forward earnings edged lower for two of these three indexes last week. These indexes began a forward-earnings uptrend during March, but only LargeCap is near a record high. LargeCap’s forward earnings has risen during 28 of the past 37 weeks, MidCap’s 19 of the past 33 weeks, and SmallCap’s 17 of the past 31 weeks. LargeCap’s is just 0.2% below its record high six weeks ago, while MidCap’s and SmallCap’s are 3.7% and 8.2% below their October 2018 highs. MidCap’s forward earnings is near a 14-month low now, while SmallCap’s forward earnings is near a 15-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. At their bottoms earlier in 2019, LargeCap’s forward EPS had been the most below its record high since June 2016 and MidCap’s was the lowest since May 2015. During mid-September, SmallCap’s had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap’s forward earnings dropped to a 38-month low of 1.1% y/y from 1.3%. That’s down from 23.2% in September 2018, which was the highest since January 2011. MidCap’s -3.6% y/y change is up from -3.8%, which was the lowest since December 2009 and compares to 24.1% in September 2018 (the highest since April 2011). SmallCap’s -8.2% y/y change is up from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 0.6%, 10.7%), MidCap (22.7, -5.1, 12.9), and SmallCap (22.4, -16.7, 37.5).

S&P 500/400/600 Valuation (link): Valuations rose last week for all three of these S&P market-cap indexes, and continue to improve from their three-month lows during the late summer. LargeCap’s forward P/E rose 0.2pt w/w to a 13-week high of 17.0, and is back near its 17-month high of 17.2 at the end of July. That compares to a five-year low of 13.9 during December and a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week’s level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap’s forward P/E was up 0.1pt w/w, to a 12-month high of 16.3, and is up from 13.0 during December, which was the lowest reading since November 2011. MidCap’s P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap’s P/E has been at or below LargeCap’s P/E for most of the time since August 2017—the first time that alignment has
prevailed since 2009. SmallCap’s P/E surged 0.4pt w/w to a five-week high of 16.8, but remains a full point below the 12-month high of 17.8 in mid-September. That’s still well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed. SmallCap’s P/E was above LargeCap’s again for a second week primarily due to substantially lower forward earnings for Frontier Communications. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (link): With the Q3 books closed and earnings reports beginning to pour in, Q3’s blended estimate/actual improved for a second straight week. The S&P 500’s Q3-2019 EPS forecast surged 31 cents w/w to $41.32. That represents an earnings decline of 3.1% y/y compared to the prior week’s forecasted earnings drop of 3.9%. While the consensus Q3 EPS estimate is below our forecasts of $43.00 and slightly positive y/y earnings growth of 0.8%, it’s now above the $41.31 reported for Q2. On a pro forma basis, Q3 earnings are expected to decline 2.0% y/y, which would be the first drop in 13 quarters and compares to y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Six of the 11 sectors are expected to record positive y/y earnings growth in Q3-2019, with none rising at a double-digit percentage rate. That compares to seven positive during Q2, when three rose at a double-digit percentage rate. However, eight sectors are expected to beat the S&P 500’s Q3 growth rate, up sharply from just three beating the S&P 500 during Q2. Industrials, Materials, Real Estate, and Utilities are the only sectors expected to post better (or less worse) growth on a q/q basis during Q3. On an ex-Energy basis, the consensus expects earnings to rise 0.5% y/y in Q3. That compares to ex-Energy gains of 3.9% in Q2 and 3.0% in Q1, and is well below the 14.2% y/y gain in Q4-2018. Here are the latest blended Q3-2019 earnings growth rates versus their Q2-2019 growth rates: Real Estate (4.7% in Q3-2019 versus 3.1% in Q2-2019), Health Care (4.5, 10.3), Utilities (3.7, 1.1), Financials (3.1, 10.0), Industrials (1.8, -9.5), Consumer Staples (1.7, 1.7), Communication Services (-0.1, 17.6), Consumer Discretionary (-0.4, 2.7), Information Technology (-4.6, -2.2), Materials (-11.8, -12.7), and Energy (-38.8, -8.9).

S&P 500 Q3 Earnings Season Monitor (link): With nearly 41% of the S&P 500 companies finished reporting revenues and earnings for Q3-2019, revenues and earnings are beating the consensus forecasts by 0.9% and 4.5%, respectively. At the same point during the previous earnings season for Q2, revenues and earnings had beaten forecasts by a larger 1.1% and 6.3%, respectively. A higher percentage of companies recorded a positive earnings surprise in Q3 than Q2—78% versus 76%. However, a slightly lower percentage of companies showed a positive revenue surprise—61% versus 62%. The 203 companies in the S&P 500 that have reported through mid-day Monday collectively have recorded a y/y earnings gain of 2.1%, dragged down by Micron Technology’s earnings deceleration. On the revenue side, results are 3.9% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps 1.9ppt to 4.0% and revenue growth improves 0.3ppt to 4.2%. Overall, Q3 earnings growth results are positive y/y for 70% of companies versus a lower 69% at the same point in Q2, and revenues have risen y/y for 75% compared to a much lower 71% in Q2. These figures will continue to change markedly as more Q3-2019 results are reported in the coming weeks, but the near-midpoint results indicate that y/y earnings growth could be positive after all. However, y/y earnings growth may trail revenue growth for a third straight quarter. Regardless, what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors’ main focus.

US ECONOMIC INDICATORS

Regional M-PMIs (link): Five Fed districts have now reported on manufacturing activity for October—Philadelphia, New York, Richmond, Kansas City, and Dallas—and they show that activity has remained depressed. The composite (to 1.9 from 0.9) index picked up only slightly last month, though showed little growth; it was considerably below the 19.0 reading a year ago. Richmond’s composite (8.0 from -
(9.0) index revealed manufacturing in its area moved from contraction to expansion, increasing at its best pace in six months, while Dallas’ (-5.1 from 1.5) moved from expansion to contraction. Meanwhile, Philadelphia’s composite (5.6 from 12.0) showed activity expanded at half September’s pace, while New York’s (4.0 from 2.0) grew at double September’s pace—though was still near a standstill; activity in the Kansas City (-3.0 from -2.0) region contracted for the fourth consecutive month. New orders (3.9 from 3.7) expanded at its best rate since May, though it too was a mixed bag. The Philadelphia (26.2 from 24.8) region recorded its strongest gain in billings since May 2018, while Richmond’s (7.0 from -14.0) turned positive again after dropping sharply in September; New York’s index was unchanged at 3.5. Meanwhile, Kansas City’s (-13.0 from -3.0) billings contracted at their second-fastest pace since the beginning of 2016, while Dallas’ (-4.2 from 7.1) contracted for the first time in three years.

Employment (11.7 from 6.9) grew at its best pace in seven months, with Philadelphia (32.9 from 15.8) factories hiring at a record rate and Dallas’ (11.0 from 18.8) continuing to hire at a robust pace. In the meantime, New York (7.6 from 9.7) and Richmond (13.0 from 3.0) manufacturers are hiring again after cutting payrolls in prior months, while factories in the Kansas City (-6.0 from -13.0) region cut payrolls for the fourth straight month, though the pace slowed in October.

**Regional Manufacturing Price Indexes** (link): In October, the average of the New York, Philadelphia, Richmond, Kansas City, and Dallas regions’ prices-paid (to 17.1 from 20.7) and prices-received measures (9.7 from 11.6) continued to bounce around recent lows, down from their 2018 peaks of 47.7 and 25.4, respectively. The regions appear to be mixed, with only Philadelphia showing signs of an acceleration in both measures the past few months, though both eased a bit this month. Dallas’ prices-paid index has been trending higher the past two months, while its prices-received index moved out of negative territory, though barely. In the meantime, the prices-paid and prices-received indexes in the Kansas City region remain on disinflationary trends, while New York’s and Richmond’s may be finding a bottom.

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