MORNING BRIEFING
April 15, 2020

Taking Stock

Check out the accompanying chart collection.

(1) The Age of Future Shocks. (2) From reaching for yield to dashing for cash to rebalancing into equities, all in two months. (3) Retesting the February 19 high rather than the March 23 low? (4) Some more numbers on the dash for cash. (5) Stock prices soar as P/Es jump more than earnings dive. (6) Record drop in S&P 500 forward earnings last week. (7) Chinese social financing at record-setting pace during March. (8) Fed's balance sheet up $1.8 trillion in past four weeks to record $6.0 trillion. (9) A primer on some of the Fed's lending facilities.

Strategy I: Another Mad Dash. We live in an age of future shocks. It wasn't too long ago that everyone seemed to be reaching for yield in the bond and stock markets. Actually, that was evident as recently as January 17 of this year, when the yield spread between high-yield corporate bonds and the 10-year US Treasury bond fell to 322bps, the lowest since October 8, 2018 (*Fig. 1*). That was followed by a mad dash for cash, as evidenced by the jump in this spread to 1,062bps on March 23, which was the highest reading since May 26, 2009. That also happened to be the day that the Fed announced QE4ever. Since March 24, it's been a mad dash to rebalance away from cash and bonds into stocks.

That's evidenced by the 27.2% jump in the S&P 500 since March 23 through yesterday's close (*Fig. 2*). The index is still down 15.9% from its record high on February 19 but down just 2.1% versus a year ago. Joe and I have been among the few optimists lately: We declared on March 25 that the S&P 500 had bottomed on March 23 and forecasted that it would reach 2900 by year-end. It has to rise only another 1.9% to get there, well ahead of schedule. That's truly astonishing under the circumstances!

Admittedly, before the virus hit the fan and spread throughout the world, our year-end target had been 3500. We got close when the index peaked at a record 3386.15 on February 19, appearing at that point to be on track to hit that target well ahead of schedule.

So where do we go from here? We are sticking with 3500 by the end of next year. There will obviously be setbacks along the way, but we don't expect to see the March 23 low again as long as progress continues in the war against the virus.

By the way, here are some updates on the unprecedented mad dash for cash that occurred during March:

(1) *Bond and equity funds.* During the four weeks through April 1, bond and equity funds, including mutual funds and exchange-traded funds (ETFs), had estimated net outflows of $301.6 billion, according to the Investment Company Institute (*Fig. 3* and *Fig. 4*). Bond funds had outflows of $277.9 billion, while stock funds lost $23.7 billion.

(2) *Liquid assets.* During the four weeks through March 30, liquid assets jumped by $1.1 trillion, led by money market mutual funds held by institutions ($511.8 billion) and savings deposits ($492.9 billion) (*Fig. 5*).

(3) *Bank balance sheets.* Total deposits at US commercial banks jumped $811 billion during the four weeks through April 1 (*Fig. 6*). Their borrowing increased $330 billion over the same period. On the asset side of their balance sheets, commercial & industrial loans rose $486 billion, while their portfolios of US Treasury and agency securities rose $38 billion.

Strategy II: As Earnings Dive, Valuations Soar. The rebound in the stock market since March 23 occurred as industry analysts just started to slash their earnings estimates. As a result, valuation multiples are soaring, and may continue to do so. One of our wittier accounts, who has a particularly good sense of irony, yesterday observed that the S&P 500 might unexpectedly retest its February 19 record high rather than its March 23 bear market low as widely expected!

Let's review the latest developments on the P/E x E front:

(1) *Annual 2020 and 2021 earnings forecasts.* We first cut our S&P 500 earnings forecast for 2020 on March 1 to zero growth even as the analysts' consensus estimate was still just below 10%. When it became apparent that the US economy was getting shut down, we followed up with another more radical cut on March 29 to a 26% drop in 2020 earnings from $163 per share in 2019 to $120 this year. (See *YRI S&P 500 Earnings Forecast*).

Industry analysts slashed their 2020 earnings growth rate forecast from 8.9% y/y at the start of this year to -4.5% y/y during the April 2 week, for a consensus earnings estimate of $152.91 per share (*Fig. 7*). We reckon they have a lot more slashing to do in coming weeks. Meanwhile, they've raised their projected 2021 growth rate to 15.9% to $177.20 per share. We are forecasting $150 for next year.

(2) *Quarterly 2020 consensus earnings forecasts.* For the four quarters of 2020, we are forecasting the following y/y growth rates: Q1 (-23.4%), Q2 (-51.6), Q3 (-28.8), and Q4 (-4.8). The analysts are moving in our direction, with the following forecasts as of the April 9 week: Q1 (-10.0%), Q2 (-19.8), Q3 (-8.8), and Q4 (-1.7) (*Fig. 8*). But again, they have much more cutting to do, in our opinion.

(3) *Forward earnings forecasts.* The S&P 500's forward earnings is available weekly back to 1994. It peaked 11 weeks ago on January 31 at a record high of $179.01 per share, just after the GVC hit the headlines on January 23 (*Fig. 9*). Forward earnings then stalled slightly below its record high for four weeks before starting to move slightly lower during the week of March 6. The decline has accelerated every week since then. The latest week, ending April 9, was one for the record books, as the rate of decline surpassed even that of the worst week of the Great Financial Crisis (GFC). S&P 500 forward earnings tumbled 4.0% last week to its lowest level since February 2018. We expect it will fall toward $150 in coming months.

(4) *Forward P/Es.* However, investors are already looking past the earnings decline and dashing back into equities as they anticipate the reopening of the US economy. As stock prices surged higher after March 23 and forward earning fell, forward P/Es soared.

The forward P/E of the S&P 500 rose to 18.1 yesterday, up from the March 23 low of 12.9 and down only slightly from the February 19 high of the year (*Fig. 10*). Over the same period, the forward P/Es of the S&P 400/600 are up from 10.3 to 15.3 and from 11.0 to 16.2.

We believe that forward P/Es won't be very useful measures of valuation until consensus earnings expectations begin to stabilize and return to normal. If they remain elevated while forward earnings declines, as we expect, they will be discounting a return to more normal earnings in 2021.

Central Banks I: Dashing To Pump Cash. There has been a mad dash by the major central banks to pump liquidity into their financial systems to avert a credit crunch as a result of the

GVC. Melissa and I recently reviewed the latest such moves by the Fed, the European Central Bank (ECB), and Bank of Japan (BOJ). Below, we provide an update—but first a look at the latest efforts of the People's Bank of China (PBOC) to pump up China's economy with lots of credit:

(1) *PBOC.* Following the GFC, China's central bank didn't engage in unconventional monetary policies as the other major central banks did. Instead, it worked through the banks, by raising and lowering their reserve requirement ratios (RRR) as needed (*Fig. 11*). The PBOC has been lowering RRRs since early December 2011, when they peaked at 21.5% and 19.5% for large and small banks. The ratios were down to 12.5% and 10.5% in early April of this year.

The PBOC undoubtedly pushed the banks and other lenders to lend more in response to the GVC. Sure enough, social financing rose by a record-high $736 billion during March, surpassing January's $732 billion (*Fig. 12*). By the way, that makes $1.6 trillion in just the first three months of this year!

(2) *Fed & ECB*. A trillion there, a trillion here: The Fed's balance sheet soared $1.8 trillion over the past four weeks to a record $6.0 trillion during the April 8 week (*Fig. 13*). The ECB's assets rose €498 billion over the past four weeks through the April 3 week (*Fig. 14*).

Central Banks II: Crib Sheet for Fed's Liquidity Facilities. On April 9, the Federal Reserve announced a $2.3 trillion lending program. While massive, it's just a start: The program amounts to only a bit more than half of the Fed's lending power under the Coronavirus Aid, Relief, and. Economic Security (CARES) Act, signed into law on March 27. Under CARES, the US Treasury allocated $454 billion in capital as backing for the Fed's Special Purpose Vehicles (SPVs) that can be leveraged up to a total of $4 trillion in new loans to bolster the US economy. (For an explanation of why the Fed is using SPVs, see the technical note at end.)

The Fed's March 23 announcement outlined how the April 9 package would be implemented. Below, Melissa provides a crib sheet on the Fed's liquidity facilities (with underlined amounts totaling to the $2.3 trillion under the April 9 package):

(1) *Primary & Secondary Market Corporate Credit Facilities (PMCCF & SMCCF)*. The PMCCF and SMCCF were created on March 23 to provide credit to large corporates (see technical note)—the former by financing new bond and loan issuances, the latter by increasing the liquidity of outstanding corporate bonds. The PMCCF is open to investment-grade companies

and provides bridge financing for four years; borrowers may elect to defer interest and principal payments during the first six months of the loan, an option that may be extended at the discretion of the Fed.

On April 9, the Fed expanded the amount of credit that the PMCCF and SMCCF can extend to $750 billion, backed by $75 billion in credit protection ($50 billion for PMCCF, $25 billion for SMCCF) provided by the Treasury—up from an initial (on March 23), $20 billion ($10 billion to each) under the Exchange Stabilization Fund (ESF).

The scope of the PMCCF and SMCCF were expanded on April 9 to include purchases of bonds that were rated BBB-/Baa3 as of March 22, 2020 but subsequently downgraded, i.e., “fallen angels.” These issues must be rated at least BB-/Ba3 at the time that either facility buys them.

The SMCCF also may purchase US-listed corporate-bond ETFs, with a focus on ETF holdings exposed to US investment-grade corporate bonds but including high-yield corporate bonds as well. Notably, there is a cap on the maximum amount of outstanding bonds or loans that the facilities can purchase. The SMCCF will avoid purchasing shares of eligible ETFs when they trade at a material premium to the estimated net asset value of the underlying portfolio.

(2) *Term Asset-Backed Securities Loan Facility (TALF)*. The TALF was originally created during the GFC. After a hiatus, it was brought back on March 23 to support the flow of credit to consumers and businesses. The TALF enables the issuance of asset-backed securities (ABS) backed by student loans, auto loans, credit card loans, loans guaranteed by the Small Business Administration (SBA), and certain other assets. Importantly, the Fed’s lending under TALF is on a non-recourse basis to entities and individuals for the purchase of ABS. (“Non-recourse” means that borrowers assume no liability beyond the collateral—in this case, ABS—put up against them.)

On April 9, the range of assets eligible as collateral for TALF was broadened to include the triple-A-rated tranches of both outstanding commercial mortgage-backed bonds (CMBS) and newly issued collateralized loan obligations (CLOs). TALF will continue to support the issuance of ABS that fund student loans, auto loans, and credit-card loans. The size of the facility will remain $100 billion, backed by $10 billion in equity from the Treasury. The loans will have a three-year term.

(3) *Main Street New Loan Facility & Main Street Expanded Loan Facility (MSNLF & MSELF)*. The Fed will purchase up to $600 billion in loans through two facilities dedicated to the Main Street Lending Program. The Department of the Treasury will provide $75 billion in equity to the facility. This program will offer four-year loans to eligible companies in good financial standing before the crisis, employing up to 10,000 workers or with annual revenues of less than $2.5 billion.

(4) *Municipal Liquidity Facilities*. On March 17, the Fed established the Commercial Paper Funding Facility (CPFF) to provide a liquidity backstop to US issuers of commercial paper (backed by $10 billion from the Treasury's ESF).

On March 18, the Fed established the MMLF, under which the Boston Fed would make loans to eligible financial institutions secured by their own purchases of high-quality assets from money market mutual funds (also backed by $10 billion from the Treasury's ESF). Eligible assets included unsecured and secured commercial paper, agency securities, and Treasury securities.

On March 20, the Fed expanded the MMLF to include "certain high-quality assets purchased from single state and other tax-exempt municipal money market mutual funds."

On March 23, the Fed expanded the MMLF and the CPFF to include a wider range of securities in order to facilitate the flow of credit to municipalities. MMLF securities were expanded to include municipal variable rate demand notes (VRDNs), and bank certificates of deposit and CPFF securities were expanded to include high-quality, tax-exempt commercial paper issued by municipal borrowers.

On April 9, the Fed established the Municipal Lending Facility (MLF), under which it would purchase up to $500 billion in short-term notes of less than two-year maturities directly from US states, US counties with a population of at least 2 million residents, and US cities with a population of at least 1 million. The Treasury will provide $35 billion of credit protection to the Fed to support municipal liquidity. Total purchases from any one issuer will be capped at 20% of the issuer's own-source revenue as of 2017.

(5) *Paycheck Protection Program Liquidity Facility (PPPLF)*. The PPFL was established on April 6 to supply liquidity to financial institutions that originate small business loans under Congress' $350 billion Paycheck Protection Program (PPP). The Small Business Association's

PPP is intended to help small businesses keep their workers on payroll. The PPPLF will extend credit to eligible financial institutions that originate these loans. An interim final rule for the Fed's PPPLF effectively excluded these loans from a banking organization's regulatory capital.

(6) *Primary Dealer Credit Facility (PDCF).* On March 17, the Fed announced the establishment of the PDCF, under which it will lend overnight and 90-day term funding directly to its 24 primary dealers. The loans will be secured by a range of securities, including to Treasury securities, agency debt, and agency MBS.

Technical note: Many of these facilities that expand the Fed's buying power effectively circumvent previous legal limitations around the direct purchase of assets. In other words, the SPVs can buy assets that would not otherwise be permissible for the Fed to purchase. The SPVs can also lend funds to other entities for the purpose of buying specific assets.

Under the PMCCF, SMCCF, TALF, MSNLF, MSELF, CPFF, MMLF, and MLF, the Fed provides loans to SPVs. SPVs do the purchasing and lending and may become subject to losses should defaults occur. So that the Fed does not incur these losses, as stipulated by the Federal Reserve Act, the Treasury Department provides taxpayer money as equity capital to each SPV. Initially using funds from the ESF, then later those authorized under the CARES Act, the Treasury has committed to making equity investments in the Fed's SPVs.

CALENDARS

US: **Wed:** Retail Sales Total, Ex Autos, Ex Autos & Gas, Control Group -8.0%/-4.8%/-6.2%,-1.8%, Headline & Manufacturing Industrial Production -4.2%/-3.6%, Capacity Utilization 73.9%, Empire State Manufacturing Index -32.5, Business Inventories -0.4%, NAHB Housing Market Index 58, MBA Mortgage Applications, DOE Crude Oil Inventories, Beige Book, Bostic. **Thurs:** Housing Starts & Building Permits 1.317mu/1.300mu, Philadelphia Fed Manufacturing Index -30.0, Jobless Claims, EIA Natural Gas Storage. (DailyFX estimates)

Global: **Wed:**Australia Employment Change & Unemployment Rate -30k/5.4%, BOC Rate Decision 0.25%. **Thurs:** Eurozone Industrial Production -.02%m/m/-1.9%y/y, Germany CPI -0.2%m/m/-1.9%y/y, UK Sovereign Debt to be Rated by Moody's, BOE Bank Liabilities/Credit Co Wed: nditions, China GDP -9.8%q/q/-6.0%y/y, China Industrial Production & Retail Sales -5.8%/-10.0% y/y, Japan Industrial Production, Tenreyro. (DailyFX estimates)

US ECONOMIC INDICATORS

Import Prices (*link*): Import prices in March sank 2.3% after a 0.7% drop in February—the first back-to-back decline since the end of 2018—pushing the yearly rate further below zero, to -4.1% y/y (the steepest decline since mid-2016). Petroleum prices tanked for the second month, by 27.4% in March, after an 8.8% decline in February; the yearly rate sank to -36.0% y/y—the steepest decline since March 2017. Meanwhile, nonpetroleum prices dipped 0.1% after a 0.4% gain during the three months through February. The yearly rate was little changed at -0.9% y/y—the 15th consecutive reading below zero; it had bottomed at -1.5% during the final three months of 2019. The rate for capital goods imports (-1.2) was in negative territory for the 19th consecutive month, while the rate for industrial supplies & materials (-15.6) tanked to its lowest reading since May 2016. In the meantime, rates for consumer goods ex autos (-0.6) and auto prices (0.5) remained near zero. The yearly rate for food prices (0.1) headed back toward negative territory after accelerating from -3.7% in October to 0.8% in February. The US is importing deflation from its Asian trading partners, with import prices for goods from China (-1.2% y/y) and the NICs (-3.2) falling and those from Japan remaining fractionally above zero. Meanwhile, there's no sign of inflation in EU (-0.1) import prices, which has decelerated sharply from May 2018's 4.1%, while import prices for goods from Latin America (-4.5) were negative for the 16th month in a row.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In March, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—is currently being viewed as a coincident rather than a leading indicator. The report notes: "[W]ith considerable uncertainty around the duration of lockdown measures, the ability of leading indicators to predict future movements in the business cycle have been severely curtailed." That being said, March's CLI (to 98.8 from 99.6) posted its largest monthly drop on record, with most major economies following suit: namely, the UK (to 98.2 from 100.1), Germany (97.5 from 99.4), Canada (97.8 from 99.4), Italy (98.1 from 99.5), Spain (97.8 from 99.0), and France (98.8 from 99.4). CLIs for the US (98.9 from 99.5) and Japan (98.4 from 98.9) also fell, but didn't post record declines. As for emerging economies, India's CLI (to 99.5 from 99.6) barely budged, while China's (98.8 from 99.1) showed little change; CLIs for (Brazil (100.8 from 101.8) and Russia (97.5 from 99.1) showed larger monthly declines, but didn't make the record books.

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