MORNING BRIEFING  
April 22, 2020

A View to a Kill

Check out the accompanying chart collection.

(1) James Bond and Jerome Powell. (2) The Fed created and exacerbated the zombie problem. (3) The IMF wrote the script for the current version of “Zombie Apocalypse.” (4) Fed recognized that half of investment-grade bonds were BBB. (5) Fed is now scrambling to save them from Zombieland. (6) Powell saw the problem coming and made it worse. (7) T-Fed’s spiffy new SPVs. (8) Fed sets up two homeless shelters for corporate bonds, including the “fallen angels.” (9) Saudi prince gets a new French palace. (10) Pelosi: “Let them eat ice cream.” (11) Industry analysts scrambling to cut their earnings forecasts. (12) Can FAANGMs lead the way higher?

Credit I: Anticipating a Zombie Apocalypse. “A View to a Kill” (1985) is the 14th movie in the James Bond series and the 7th (and last) to star Roger Moore as the fictional MI6 agent James Bond (a.k.a. 007). Critics complained that Moore was too old to play the part. The movie’s theme song, by Duran Duran, was better than the movie, reaching #1 on the Billboard Hot 100 and earning a Golden Globe nomination for Best Song.

Fed Chair Jerome Powell is certainly too old to play James Bond. However, he is doing an admirable job of playing the action hero in “2012 Zombie Apocalypse,” a 2011 film about a fictional virus, VM2, that causes a global pandemic. He is doing whatever it takes to stop the zombies from killing us by ruining our economy and way of life.

In my recently released book Fed Watching for Fun & Profit, I defined the zombies as living-dead firms that continue to produce even though they are bleeding cash. In a purely capitalist system, they should go out of business and be buried. However, these firms survive only because they are kept on life support by government subsidies, usually because of political cronyism, which corrupts and undermines capitalism. In recent years, the Fed’s ultra-easy monetary policies have created and exacerbated the zombie problem. I wrote:

“And why are lenders willing to lend to the zombies? Instead of stimulating demand by borrowers, historically low interest rates incite a reach-for-yield frenzy among lenders. They
are willing to accept more credit risk for the higher returns offered by the zombies. Besides, if enough zombies fail, then surely the central banks will come up with some sort of rescue plan.”

Now consider the following developments just before the Great Virus Crisis (GVC) significantly increased the odds of a zombie apocalypse:

(1) **The IMF’s script.** In my book, I wrote: “If you want to read a very frightening script of how this horror movie plays out, see the October 2019 *Global Financial Stability Report* prepared by the International Monetary Fund (IMF). It is titled ‘Lower for Longer’ but should have been titled ‘Is a Zombie Apocalypse Coming?’ Here is the disturbing conclusion: ‘In a material economic slowdown scenario, half as severe as the global financial crisis, corporate debt-at-risk (debt owed by firms that cannot cover their interest expenses with their earnings) could rise to $19 trillion—or nearly 40 percent of total corporate debt in major economies, and above post-crisis levels.’”

(2) **The Fed’s script.** Also in my book, I observed that the Fed’s second *Financial Stability Report* was released in May 2019. It had the same don’t-worry-we-are-on-it tone as the first report released during November 2018. However, credit quality had clearly eroded in the corporate bond market. The second report observed: “[T]he distribution of ratings among nonfinancial investment-grade corporate bonds has deteriorated. The share of bonds rated at the lowest investment-grade level (for example an S&P rating of triple-B) has reached near-record levels. As of the first quarter of 2019, a little more than 50 percent of investment-grade bonds outstanding were rated triple-B, amounting to about $1.9 trillion.”

The report also raised concerns about leveraged loans, as follows:

“The risks associated with leveraged loans have also intensified, as a greater proportion are to borrowers with lower credit ratings and already high levels of debt. In addition, loan agreements contain fewer financial maintenance covenants, which effectively reduce the incentive to monitor obligors and the ability to influence their behavior. The Moody’s Loan Covenant Quality Indicator suggests that the overall strictness of loan covenants is near its weakest level since the index began in 2012, and the fraction of so-called cov-lite leveraged loans (leveraged loans with no financial maintenance covenants) has risen substantially since the crisis.”
The man who saw it coming. During his October 30, 2019 press conference, Fed Chair Jerome Powell was asked about financial stability. He responded: “Obviously, plenty of households are not in great shape financially, but in the aggregate, the household sector’s in a very good place. That leaves businesses, which is where the issue has been. Leverage among corporations and other forms of business, private businesses, is historically high. We’ve been monitoring it carefully and taking appropriate steps.” He didn’t specify those steps. However, the Fed’s three interest-rate cuts during 2019 undoubtedly kept lots of zombies alive and fed their appetite for more debt.

Credit II: Containing the Zombie Apocalypse. On March 11, the World Health Organization declared that the COVID-19 outbreak had turned into a global pandemic. The pandemic of fear spread just as rapidly in the US capital markets, especially in the bond markets, which seized up as credit-quality yield spreads soared.

On Sunday, March 15, the Fed responded by cutting the federal funds rate by 100bps to zero and announcing a $700 billion QE4 program of Treasury and mortgage-backed securities purchases. That week, the governors of California and New York issued executive orders requiring nonessential workers to stay home. Credit-quality spreads continued to widen significantly. So on March 23, the Fed introduced QE4ever and posted term sheets on five major credit facilities.

Three of the new facilities dated back to the Great Financial Crisis and were reactivated. The big shockers were the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Credit Facility (SMCCF). For the first time ever, the Fed was going to lend a hand to the investment-grade corporate bond market. Here are the specifics from their term sheets:

(1) PMCCF. The Fed is prohibited by law from purchasing corporate bonds. To get around this restriction, the Fed will lend to a special purpose vehicle (SPV) on a recourse basis. “The SPV will (i) purchase qualifying bonds directly from eligible issuers and (ii) provide loans to eligible issuers.” This backstop for investment-grade corporate bonds and loans (with maturities of four years or less) will be backstopped by $10 billion in equity provided by the US Treasury’s Exchange Stabilization Fund. Borrowers may defer paying interest for six months (extendable at the Fed’s discretion), but they must not pay dividends or buy back shares during the period they aren’t paying interest. The facility is scheduled to be terminated on September 30 of this year.
(2) SMCCF. This facility is structured in the same way as the PMCCF, but it purchases eligible individual corporate bonds as well as eligible corporate bond portfolios in the form of exchange-traded funds (ETFs) in the secondary market with maturities of five years or less. Both programs set limits per issuer and ETF.

(3) Another round of drinks for my friends. On March 27, President Donald Trump signed the CARES Act, which gave the US Treasury $450 billion to invest in the Fed’s SPVs, thus effectively converting the Fed into the Bank of the United States, or “T-Fed” as Melissa and I call it. On April 9, the Fed announced how it would leverage up all that capital, initially up to $2.3 trillion in loans and possibly up to $4.0 trillion in total.

That sum includes $750 billion in lending by the two corporate liquidity facilities leveraging up (on a 10-to-1 basis) the Treasury’s $75 billion in capital from the original $20 billion. The ironic shocker was that the eligible bonds now included those BBB-rated bonds that the Fed had warned about in its FSR (cited above) less than a year ago. If those dicey bonds dropped below that rating after March 22, they could still be purchased by both facilities, according to the updated term sheets of the PMCCF and the SMCCF. The Fed opened up these two liquidity facilities for homeless investment-grade corporate bonds to the so-called fallen angels as well.

Now what will the Fed do about all the energy junk bonds that are about to blow up? Probably nothing. Large oil companies and distressed asset funds are likely to scoop up all the frackers, who can’t service their debts, at big discounts. Some portfolio managers will have to take big hits in their junk-bond portfolios.

Strategy I: Negative World Disorder. What a crazy world we live in! German 10-year government bond yields have remained slightly below zero since mid-2019 (Fig. 1). The comparable US Treasury yield has been falling closer to zero since the start of this year. The nearby futures price of a barrel of West Texas Intermediate crude oil turned negative on Monday, plunging to -$37.63—its first time ever below zero (Fig. 2).

The plunge in oil prices just happened to coincide with the completion of the most expensive home in the world owned by Mohammed bin Salman (MBS), the Crown Prince of Saudi Arabia. In 2015, he paid almost $300 million for the 50,000-acre Chateau Louis XIV in Louveciennes, near Versailles, in France. While modeled on a 17th-century French castle, the
current chateau actually was built by Emad Khashoggi, nephew of the late billionaire arms
dealer Adnan Khashoggi, who bulldozed a 19th-century castle in Louveciennes to make way
for the new chateau in 2009. Reportedly, the residence has been remodeled and is now ready
for MBS to move in.

Speaking of Marie Antoinette’s old stomping grounds (Versailles), House Speaker Nancy
Pelosi is featured in a recent video at her waterfront gated home in San Francisco showing off
her big sub-zero stainless steel freezer full of ice cream saying, “I don’t know what I would
have done if ice cream were not invented. I just wonder.” She might as well have said, “Let
them eat ice cream.”

Meanwhile, reflecting the dysfunctional world we live in, industry analysts’ consensus
expectations for S&P 1500 earnings growth rates this year are turning sharply more negative:

(1) Quarterly earnings growth estimates for 2020. Industry analysts have been scrambling to
chop their earnings forecasts in recent weeks for the four quarters of 2020 (Fig. 3). Their
estimates show negative y/y comparisons now for all quarters of this year for the S&P
500/400/600. The only exception is Q4 (up 1.9%) for the S&P 600 (Fig. 4).

Here are their latest dismal estimates for the S&P 500: Q1 (-14.7%), Q2 (-26.8), Q3 (-13.3),
and Q4 (-4.8). 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). So we expect more cuts in analysts’
consensus growth rates.

(2) Annual estimate for 2020 and 2021 earnings. Our quarterly projections take our annual
estimate for the S&P 500 earnings per share down to $120 this year from $164 last year (Fig.
5). Industry analysts were down to $141 for this year during the April 16 week.

We are still expecting a rebound next year to $150 per share. Industry analysts have lowered
their estimate for next year to $173.

(3) Forward earnings. S&P 500 forward earnings has dropped from a record high of $179.01
during the week of January 31 to $151.07 during the April 16 week (Fig. 6). Joe and I reckon it
could trace out a V-shaped pattern similar to the one during 2008-10. If so, then it could
continue to dive down sharply to around $120 by mid-year before rebounding back to $150 by
the end of this year.
Strategy II: In the FAANGMs We Trust? Investors certainly have lost their confidence in analysts' earnings forecasts. No wonder: By CNBC’s count, over 80 of the S&P 500 companies have totally withdrawn their earnings guidance. After the virus news hit the headlines in late January, Apple was first out of the gate to warn investors of a GVC-related revenue shortfall.

The market has rebounded sharply from its March 23 low led by the FAANGM (Facebook, Amazon, Apple, Netflix, Google’s parent Alphabet, and Microsoft) stocks. But can investors trust them to lead the market higher? I asked Joe to weigh in on this important question. Here are his thoughts:

(1) **Valuation.** In the current market environment, the S&P 500’s valuation has become a less useful investment tool, as its forward earnings has fallen off a cliff. On Friday, the index’s forward P/E was 19.0, its highest reading in more than 18 years, and up from a low of 12.9 at the market’s bottom on March 23 ([Fig. 7](#))! During normal times not that long ago (before the GVC), such a high valuation multiple suggested a bullish economic outlook. Not surprisingly, investment strategists (including Joe and me) have started to inject the phrase “normalized earnings” into their valuation conversations.

With respect to the FAANGMs, their valuation and forward earnings still appear to reflect business as usual, mostly. At its record high on February 21, the FAANGM’s forward P/E was 34.8. It dropped to 26.1 during the week ending March 20 before recovering to a near-record 33.9 last Friday. FAANGM now makes a record-high 2.2-point contribution to the S&P 500’s P/E ([Fig. 8](#)). Of course, it makes sense to look at their forward earnings to see whether their valuation is still meaningful.

(2) **Forward earnings.** In the current GVC environment, forward earnings winners are rare. As a group, the FAANGM index has not escaped a drop in forward earnings, but they have fared substantially better than the S&P 500.

During the week of March 5, total forward earnings peaked for both the FAANGM and the S&P 500. Since then through the April 16 week, FAANGM forward earnings is down 4.7% versus a whopping 15.6% decline for the S&P 500. Excluding the FAANGM stocks, the S&P 500 forward earnings is down an even greater 17.0%. Although there are more forward earnings
losers among FAANGM than winners, Joe finds that all six companies have fared much better than the S&P 500 ex-FAANGM.

Netflix and Amazon are the FAANGM leaders, with forward earnings gains of 4.0% and 1.8%, respectively since March 5. They’ve benefitted as home-bound consumers have come to rely more heavily than usual on their home entertainment and shopping services.

The forward earnings losers had varying declines depending on their business models. Facebook (-10.6% since March 5) and Alphabet (-10.5) are both experiencing a big drop in advertising revenues and rates as companies in travel, entertainment, and physical retail freeze spending. That’s according to a CNBC report. In the weeks following the China shutdown, Apple and Microsoft indicated that their sales were falling; the slowdown they were seeing then has since turned global. Apple’s forward earnings is down 5.3% since March 5, while Microsoft’s has edged down 1.1%.

As investors struggle to manage their portfolios during the GVC, they’re classifying companies into three tranches: the losers, the survivors, and the thrivers. We see the FAANGM stocks as among the survivors and thrivers.

**CALENDARS**

**US:** Wed: MBA Mortgage Applications, DOE Crude Oil Inventories. **Thurs:** Jobless Claims 4.5m, New Home Sales 643k, M-PMI & NM-PMI Flash Estimates 36.0/31.3, Kansas City Fed Manufacturing Index -34, EIA Natural Gas Storage. (DailyFX estimates)

**Global:** Wed: Eurozone Consumer Confidence -20.0, UK Headline & Core CPI 1.5%/1.6% y/y, Canada CPI. **Thurs:** Eurozone, Germany, and France C-PMI Flash Estimates 25.9/28.8/25.3, Eurozone, Germany, and France M-PMI Flash Estimates 38.0/39.0/37.5, Eurozone, Germany, and France NM-PMI Flash Estimates 23.5/28.1/25.0, UK C-PMI, M-PMI, and NM-PMI Flash Estimates 31.0/42.0/29.0, Germany Gfk Consumer Confidence -1.7, UK Gfk Consumer Confidence -40, Japan Headline, Core, and Core-Core CPI 0.4%/0.4%/0.6% y/y, Italy & UK Sovereign Debt to be Rated by S&P. (DailyFX estimates)

**STRATEGY INDICATORS**

**Consensus 2020 Revenue & Earnings Changes** (*link*): Over the 12 weeks since the virus hit the news—i.e., from January 23 to April 16—the 2020 revenue forecast for the S&P 500 has
dropped 6.8%, and the index’s earnings forecast has tumbled 20.6%. Revenue and earnings forecasts for the broader MSCI United States, which includes midcap-sized companies, are down a lesser 5.7% and 19.7% in part due to limited visibility for the midcaps. For MSCI China, revenue forecasts are down 8.6% but earnings are only down 11.7%. The following countries have been hit particularly hard: dollar-denominated Chile (-96.0, -95.8), Greece (-24.6, -33.5), Italy (-8.8, -27.7), and Russia (-17.4, -29.8). Here’s how the MSCI World and regional indexes stack up in US dollar terms: World (revenues down 7.4%, earnings down 20.0%), World ex-US (-11.5, -22.8), (EMU -6.3, -24.2), Europe (-9.6, -25.1), Emerging Markets (-21.9, -28.2), EM Asia (-8.4, -13.8), and EM Latin America (-73.0, -75.9). Keep in mind, the results are much worse in local currency terms. Within the US, the following S&P 500 industries are now forecasted to report a loss in 2020: Airlines, Copper, Integrated Oil & Gas, Oil & Gas Drilling, Oil & Gas Exploration. Oil & Gas Drilling is expected to report losses through 2022. Industries well on their way to a substantial earnings decline in 2020 include: Automobile Manufacturers, Casinos & Gaming, Department Stores, Diversified Banks, the entire Energy sector, Hotel & Resort REITs, Hotels, Oil & Gas Equipment & Services, Oil & Gas Refining & Marketing, and Steel. On the revenue side, the following US industries have had their 2020 estimates cut the most: Airlines (-46.0%), Department Stores (-29.8), Oil & Gas Exploration & Production (-28.1), Oil & Gas Refining & Marketing (-26.4), Hotel & Resort REITs (-24.9), Hotels (-24.4), Integrated Oil & Gas (-24.2), Casinos & Gaming (-22.1), and Oil & Gas Equipment & Services (-16.1).

**S&P 500 Sectors Net Earnings Revisions** ([link](#)): NERI readings tumbled in April to their lowest readings since the GFC for the S&P 500 and seven of its 111 sectors. The S&P 500’s NERI weakened m/m to a 133-month low of -28.5% in April from -12.1% in March, and was negative for the 16th time in 18 months. That’s the lowest reading since March 2009 and compares to a record high of 22.1% in March 2018 when earnings were boosted by the TCJA. NERI fell m/m in April for all 11 sectors, continuing the weakening that began in March. It’s down sharply from 5/11 improving in February and 8/11 rising in January, which was the highest since all 11 improved m/m in May 2019. NERI was negative for all 11 sectors in April for the first time since April 2019. That compares to one sector with a positive reading in March and is down from four in January, which was the most since June 2019. Materials has the worst track record, with 19 months of negative NERI, followed by Industrials (18), Consumer Discretionary (17), and Utilities (15). Here are the sectors’ April NERIs compared with their March readings: Utilities (-10.2% in April [61-month low], down from -3.6% in March), Health Care (-12.7 [134-month low], 1.2), Consumer Staples (-15.6 [21-month low], -7.0), Tech (-18.6
S&P 500 Q1 Earnings Season Monitor (link): With nearly 14% of S&P 500 companies finished reporting revenues and earnings for Q1-2020, revenues are beating the consensus forecast by 1.1%, but earnings have missed by an unusually high 3.6% primarily due to a boost in credit and loan loss reserves for the banks. At the same point during the Q4 season, the revenue surprise was a similar 1.1% and the earnings beat was sharply higher at 4.9%. For the 68 companies that have reported through mid-day Tuesday, aggregate y/y revenue growth and the percentage of companies reporting a positive revenue surprise actually improved relative to the same point during Q4. However, all of the earnings measures were markedly weaker. The small sample of Q1 reporters so far has a y/y revenue gain of 4.3%, but earnings are down 24.6% in what’s sure to be the worst quarter since Q1-2009 during the financial crisis. For the time being, slightly fewer companies are reporting a positive revenue surprise (65%) than a positive earnings surprise (66%). More companies are reporting positive y/y revenue growth in Q1 (65%) than are reporting positive y/y earnings growth (47%). That’s the lowest rate for earnings rate since Q3-2009. These figures will change markedly as more Q1-2020 results are reported in the coming weeks, but the earnings results are expected to remain dismal. Now more than ever, what companies say about the state of their business and their plans to ride out the COVID-19 crisis will be investors’ main focus.

US ECONOMIC INDICATORS

Existing Home Sales (link): Existing home sales (tabulated when a purchase closes), tumbled 8.5% in March to 5.27mu (saar), after jumping 6.2% in February to 5.76 mu (saar)—which was the highest rate since February 2007—as effects of the coronavirus hit the housing market. Sales fell in every region last month, though sales in the Midwest and South remained above year-ago levels: Midwest (-3.1% m/m & 4.2% y/y), South (-9.1 & 0.9), West (-13.6 & -0.9), and the Northeast (-7.1 & -3.0). Lawrence Yun, NAR’s chief economist, noted: “More temporary interruptions to home sales should be expected in the next couple of months, though home prices will still likely rise.” That was the case in March, where the median existing-home price was up 8.0% y/y (the 97th straight month of y/y gains)—with prices increasing in every region. NAR’s president provided this perspective: “We have seen an increase in virtual home tours, e-signings and other innovative and secure methods that comply with social distancing
directives. I am confident that Realtors® and brokerages will adapt, evolve and fight, ensuring the real estate industry will be at the forefront of our nation’s upcoming economic recovery.”

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