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Are Stocks and Bonds Actually Agreeing with Each Other?

Monday, July 26, 2021

Donald Luskin

Yes: Bond yields topped out when Biden abandoned Modern Monetary Theory.

Equity and fixed income markets would appear to have two very different views of reality. *The 10-year yield is 50 bp off its March 30 recovery high at 1.77%, suggesting that economic recovery expectations are waning*. Indeed, the *real* 10-year yield (inflation-protected Treasuries), making a new all-time low just this morning, suggests we're still in the coronavirus lockdown recession. But the S&P 500 at new all-time highs ratifies more than that the recession is over (last week the NBER finally agreed with us that it ended in April 2020 -- see "Now That We Are In a Boom, Can We Please Declare the Recession Over?" April 5, 2021). And it ratifies more than that the V-shaped recovery we predicted is complete (see "On the March Jobs Report, and Being in Recession (Whatever that Means)" April 3, 2020). Indeed, *stocks are saying we're now in the midst of the outright boom we started forecasting late last year* (see, first, "Do We Need More Stimulus?" December 14, 2020).

- *It seemed last week, especially on Monday's big risk-off day, that stocks and bond yields were finally in synch on the downside*. *That's* what a growth-scare looks like. But as we predicted that day, the Delta variant panic wouldn't last – the fear-porn headlines just didn't line up with the case data (see "Video: What you're not hearing about what you just think you know about the Delta variant" July 19, 2021). Stocks then made new highs, and nominal Treasury yields backed up a bit – but especially with today's move in *real* yields, the apparent divergence in outlook between stocks and bonds is as great as ever.

In client conversations, this divergence is causing both consternation and concern, *suggesting to some clients that the more sober and rational bond market is sending a warning to the dangerously excitable stock market*. We can't perform the magic trick of entirely squaring this circle, but *we can see some explanatory paths that at least move in the direction of healing the stock/bond schism.*

There may be an important clue in the exact timing of the Treasury market's reversal this year. Again, *the 10-year yield topped out at 1.77% on March 30. That was the day that the Biden administration* officially rolled out the "American Jobs Plan," *a $2 trillion "infrastructure" spending program funded by hiking corporate taxes*.

Update to strategic view

US BONDS, US STOCKS, US MACRO, FEDERAL RESERVE: Stocks at new all-time highs, but the nominal 10-year yield well off its late-March peak (and real yields making all-time lows), suggest that these two markets have conflicting views of growth prospects. Bonds may be in fact more sensitive to the abandonment by the Biden administration of Modern Monetary Theory, that is, debt-financing huge spending programs. The 10-year yield topped the same day the administration announced that its next spending program would be tax-funded, which importantly deflects the bond markets estimates of the volume of future issuance and US credit-worthiness – and makes the enactment of such programs highly unlikely. This makes little difference to stocks, because at this point of diminishing returns debt-funded spending will not be very stimulative, and tax-funded spending definitely won't be. Lower bond yields operate through the equity risk premium to make stocks…

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- That was also the day that the Biden administration made the mistake of abandoning what amounted to "Modern Monetary Theory," which had been used to speed through three massive Covid-relief bills funded 100% by new debt. MMT makes politics easy – everyone's a winner, and nobody pays. That's how the Biden administration quickly accomplished February's massive "American Rescue Plan," long after the Covid crisis that justified it was effectively over. *The bond market had every reason to expect more of the same – more deficits, more debt – because that was the smart political move.*
- *But the Biden administration didn't make the smart move.*
- *So the bond market was surprised by a sudden change in the prospects for future issuance – and at the same time, a sudden change for the better in the creditworthiness of the United States – both of which should point to lower yields.*
- *We said right away a tax-funded spending program couldn't get done* (see "On the Coming Corporate Tax Hikes" March 31, 2021), and we've said that over and over, as the Biden administration has rolled out more and bigger tax-funded spending programs (see, most recently, "Video: What you're not hearing about the death of Biden's corporate tax hikes" June 21, 2021). Our argument has been that the narrowly-elected new president, the 50-50 Senate and the nearly-tied House (altogether, the 2020 election was effectively determined by a margin of just 4 out of 10,000 eligible voters) utterly lack a mandate for any large-footprint legislation – when anyone has to pay for it.
- *The bond market's entirely rational downgrade of the prospects for further large growth in deficits and debt is not at the same time a judgment about growth prospects, because despite the way these programs are advertised, they are not pro-growth*. Yes, you can make the case with a straight face that debt-funding of positive net present value projects is pro-growth. Bailing the economy out of the self-inflicted Covid recession was definitely positive NPV. But any spending at this point has to overcome the challenge of diminishing returns when so much relief spending has already been done, and households are glutted with record savings. And after the bitter 2009 experience with "shovel-ready" infrastructure spending, it's not clear at all that there really are any positive NPV projects in a world tangled up in modern permitting and environmental approval requirements.
- *So while the bond market was surprised by the sudden prospect of less issuance than expected, the stock market was not surprised by the sudden prospect of slower growth than expected, because none of the programs the bond market expected were pro-growth anyway*.
- From the stock market's perspective, the growth risk is not that the proposed programs won't get done, but that they will. The "American Jobs Plan" – paid for with *corporate* tax hikes – and the "American Families Plan" – a second spending program paid for with *personal* tax hikes – are anti-growth. Even granting that the government would spend on positive NPV projects, the fact that the spending is tax-funded means the individuals and firms will have to

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…more relatively attractive, so the ERP has mean-reverted close to the post-GFC mean from a record narrow with stocks still able to make new highs. At the same time, consensus forward earnings are being upgraded at a record pace, despite which this earnings season is already another record beat. Market-implied inflation expectations haven't changed much, but that is significant – they've held steady during a surge of fearsome hot CPI prints, and helped the Fed stick to its "transitory" guns. A premature taper or lift-off is off the table. The governing dynamic to which all markets are ultimately subject is that we are in a post-pandemic economic boom.

[Strategy dashboard]

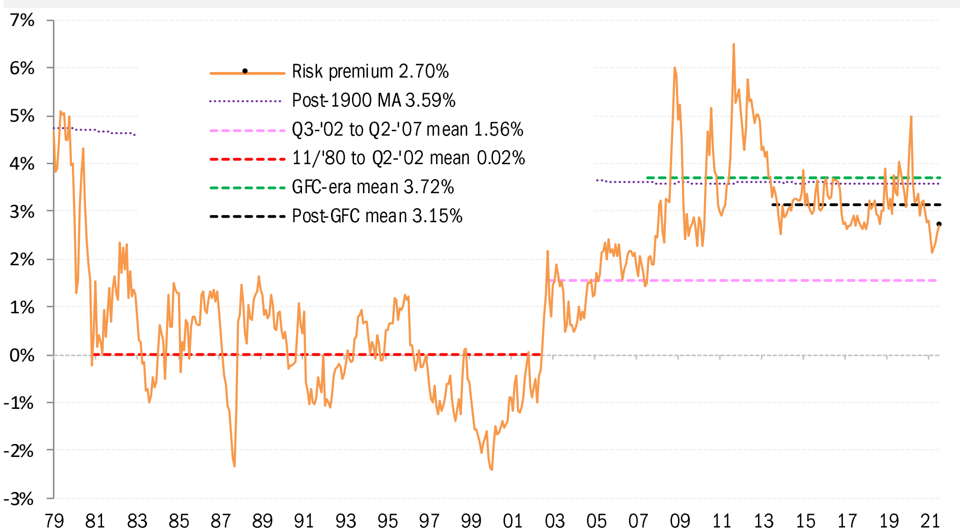
forsake their own projects (and we expect the public sector would not invest the money as wisely as the private sector).

- *If the growth risk, then, is that these programs will be enacted – not that they won't be – stocks at new all-time highs means the market is expecting they won't be*. We agree with that appraisal, and have all along.
- What about the so-called "bipartisan infrastructure deal" still going through fitful negotiations in Washington? While small by today's standards at something like $600 billion, it seems that it will be entirely debt-funded. One by one, ideas for funding it with various revenue increases have fallen away, including hiking the federal excise tax on gasoline, and empowering the Internal Revenue Service to crack down more vigorously on tax-evasion. We recognize that "hard infrastructure" spending polls well in swing districts, and that the GOP doesn't want to go into the midterms with nothing to show but being "the party of 'no'". But depriving the Biden administration of a victory has its benefits too, especially when the GOP can claim at least it tried. If anything at all gets done, it will be this – but color us very skeptical. Even if something like it does pass, spread out over many years it's not a big deal for bond markets, and probably won't make any difference to growth.

Another way of squaring the circle is to recognize that *lower bond yields, which some argue point to lower growth expectations, support higher stock prices, all else equal, by widening the equity risk premium* (that is, making the expected return of stocks higher relative to the expected return of bonds).

- The S&P 500 equity risk premium (which we calculate as the forward earnings yield of the S&P 500 minus the 30-year Treasury yield) made a new post-Global Financial Crisis low on April 9 (please see the chart below).
- That would have seemed to be cause for caution on apparently

S&P 500 equity risk premium Month-end data-points except most recent day



Source: Various, TrendMacro calculations

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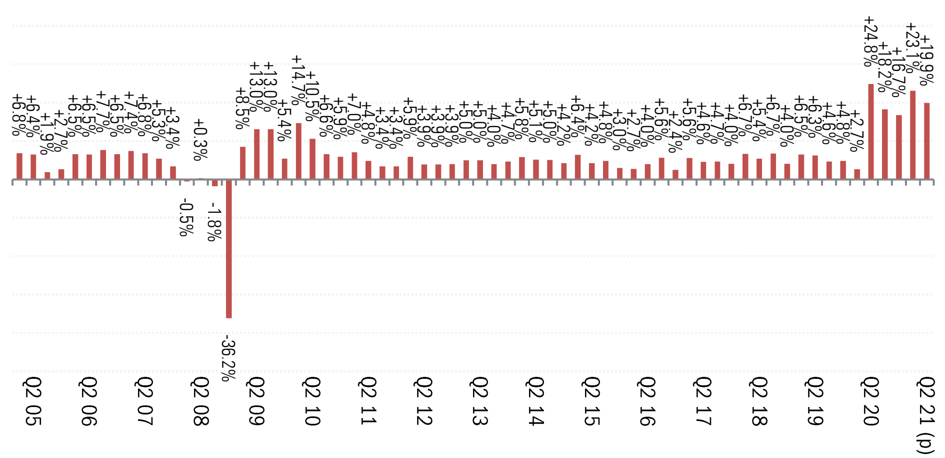
overvalued stocks. But shortly after we argued that the narrow ERP in fact argued for a "regime change" driven by a post-pandemic productivity revolution and the Fed's official abandonment of the toxic Phillips Curve doctrine (see "Regime Change for the Equity Risk Premium?" April 19, 2021). Obviously, we're glad we called it that way. Yes, *the ERP has since mean-reverted most of the way back to the post-GFC mean – yet stocks have made new all-time highs*. While raw PE's are high by historical standards, stocks are actually not much more highly valued than they've been since the end of GFC.

- Why? *Two-thirds of the ERP's widening is explained by the 30-year Treasury yield in the calculation falling 42 bp since the April 9 narrow*.
- *The rest is explained by a nearly unprecedented surge in forward earnings estimates.* (see "Earnings Versus the Bubble" May 26, 2021).
- Since the ERP narrow on April 9, one-year forward S&P 500 EPS have grown by 12.2%. Estimates for the second quarter were upgraded 8% during that quarter itself. *Yet with the expectational bar having been raised that high, in this earnings season – in which so far 108 S&P 500 companies have reported – actual earnings have beaten the higher consensus by 19.9% on average*.
- That would be an all-time record beat, if it weren't for the other all-time record beats that have been logged during the four previous pandemic and post-pandemic quarters (please see the chart below). *So the secret sauce that explains stocks at new highs is not just that they are discounting growth and lots of it – they are discounting more growth than they had expected, despite having erred in the direction of insufficient optimism four previous quarters in a row!*

Our final potential explanation for how the outlooks of stocks and bonds might be more in harmony than they seem is Fed expectations.

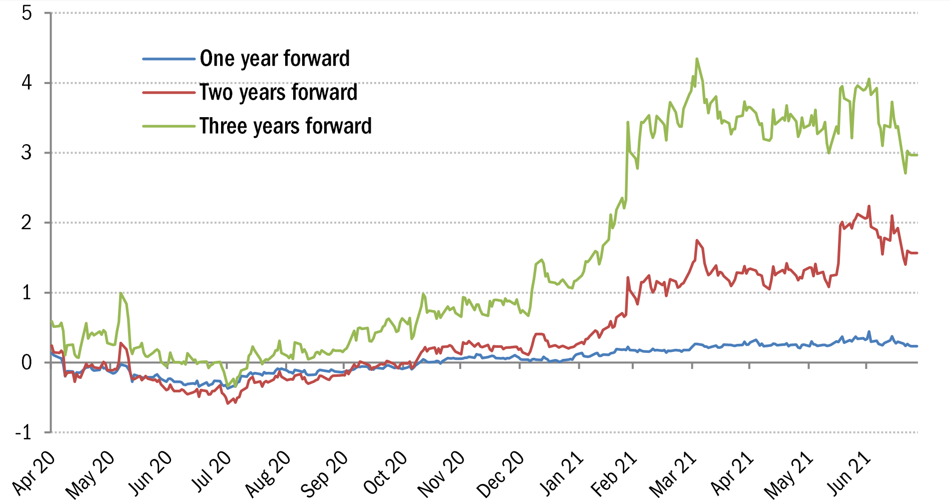
S&P 500 earnings season surprise factor (by quarter of earnings)



Source: Bloomberg, TrendMacro calculations

- We note that the three-year forward funds rate implied by the money-market curve topped out at 1.17% -- more than four rate hikes expected over three years – on April 2, just 4 days after the nominal 10-year yield had topped out on March 30. It has gradually fallen to 0.84%, taking out more than a complete rate hike at the same time as its time-horizon moved more than three months further into the future (please see the chart below).

Number of Fed rate hikes implied in money-market forward curve



Source: Bloomberg, TrendMacro calculations

- To be sure, this could very well be understood as a reflection of mounting growth fears – except that would leave us with the very different view of the stock market still to be reconciled.
- We rule out that it is a simple reflection of retreating inflation expectations. Over the last several months, inflation statistics have dealt with both base effects from the year-ago deflation, and the worst of the post-pandemic mismatch of surging consumer demand and depleted inventories (see, among others, "What you're not hearing about today's CPI bombshell" May 12, 2021). But while there has been much handwringing in the media, market-implied inflation expectations haven't really moved at all.
- *This is one of those "the dog that didn't bark in the night" situations – the important thing is that inflation expectations didn't move, when they surely could have, given the scary-seeming data. And more important, the Fed bravely took the signal from markets and has stuck to its guns that the present inflation is "transitory." The Fed having passed that test of its conviction means a growth-crippling error of premature tapering or lift-off is off the table.*
- While the historical record of bond yields versus Fed asset purchases is complicated, as the first expectation that markets seem primed to act on, *the idea that tapering will be further deferred than previously expected could lead, at least in the near time, to the lower yields we've seen – especially the real yields*.

We respect markets and want to listen to what they are telling us. When different markets seem to tell us different things at the same time, we seek to reconcile their messages. But at the end of the day, *we rely more on our own interpretation of the facts on the ground. For us, those facts say we are in a self-sustaining boom*. Stocks clearly see that. Maybe bonds do in their own way, as we have explained. Or maybe they don't. In which case, until we see evidence that changes our minds, we say bonds are just plain wrong. As the boom plays out, the day will come when stocks will have finally gotten optimistic enough, and there are no more absurd earnings season beats like the one we're experiencing now. And bond yields will be higher.

Bottom line

Stocks at new all-time highs, but the nominal 10-year yield well off its late-March peak (and real yields making all-time lows), suggest that these two markets have conflicting views of growth prospects. Bonds may be in fact more sensitive to the abandonment by the Biden administration of Modern Monetary Theory, that is, debt-financing huge spending programs. The 10-year yield topped the same day the administration announced that its next spending program would be tax-funded, which importantly deflects the bond markets estimates of the volume of future issuance – and makes the enactment of such programs highly unlikely. This makes little difference to stocks, because at this point of diminishing returns debt-funded spending will not be very stimulative, and tax-funded spending definitely won't be. Lower bond yields operate through the equity risk premium to make stocks more relatively attractive, so the ERP has mean-reverted close to the post-GFC mean from a record narrow with stocks still able to make new highs. At the same time, consensus forward earnings are being upgraded at a record pace, despite which this earnings season is already another record beat. Market-implied inflation expectations haven't changed much, but that is significant – they've held steady during a surge of fearsome hot CPI prints, and helped the Fed stick to its "transitory" guns. A premature taper or lift-off is off the table. The governing dynamic to which all markets are ultimately subject is that we are in a post-pandemic economic boom.