



MORNING BRIEFING

July 6, 2016

Explaining the Backlash

See the [collection](#) of the individual charts linked below.

(1) The father of Globalization. (2) The division of labor and the size of the market. (3) It hasn't been a win-win for everyone. (4) Is the backlash really about free trade or about unchecked immigration? (5) Free trade should prevail because it increases the wealth of nations. (6) Why are government bond yields plunging toward zero or going sub-zero? (7) Fed and US bonds have been globalized. (8) Global economy still growing, but may be more vulnerable to recession after Brexit. (9) Will Brexit be followed by Quitaly? (10) The Italian banking system is an awful mess.

Globalization: Pros & Cons. Adam Smith was the father of Globalization. Almost all economists agree that free trade is a good thing. That's been true ever since Adam Smith first laid out the very logical case for free trade in [The Wealth of Nations](#) (1776). In the first chapter, he explained that the wealth of nations increases as a result of the "division of labor." We all specialize in what we do best and exchange the fruits of our labor for the goods and services we need that are produced by others. It's a win-win situation. In the second chapter, Smith observed that there is "a certain propensity in human nature ... to truck, barter, and exchange one thing for another."

In the third chapter, he argued that "the division of labor is limited by the extent of the market." In other words, there will be more of it the bigger the market and less of it the smaller the market. The bigger the market, the greater are the opportunities to trade and to benefit from the division of labor. Smith observed that history shows that countries that have engaged in trade with other countries around the world prospered greatly by doing so.

So why are we seeing a backlash against the latest era of Globalization? The end of the Cold War in the late 1980s was the end of the greatest trade barrier in history. Ever since then, prosperity has proliferated in both emerging economies and advanced ones as more, better, and cheaper goods were produced in the former and sold in the latter. While this obviously has increased standards of living and income equality around the world, there have been both winners and losers. It hasn't been a win-win situation for many people in developed economies who feel that Globalization has reduced their standard of living by either driving down their wages or eliminating their jobs.

It isn't obvious that the backlash is actually against free trade. Consumers surely must know that their paychecks buy more because many of the products they purchase are imported from abroad, where they can be made more cheaply than at home. Many US workers who have lost their jobs because their factories were shuttered as a result of foreign competition have found other jobs. It may be that American workers lost lots of jobs to Chinese workers over the past couple of decades, but bringing those jobs back home through trade protectionism would mean higher prices at home. It might not even mean more jobs if the work increasingly is done by robots!

It seems to me that the backlash against Globalization reflects that in the real world, rather than the theoretical world of economists, free trade can come at a high price. The citizens of the UK have been enjoying the benefits of free trade within the European Union. However, they've also had to accept

more and more regulations imposed by the EU's parliament and regulators.

However, of all the reasons for the Brexit vote, it seems to me that the majority of British citizens were most concerned about the immigration issue. When German Chancellor Angela Merkel opened Germany's (and therefore Europe's) door to the flood of immigrants streaming from the Middle East and Africa, many Europeans, not just the Brits, were alarmed by her doing so.

Here at home, Donald Trump became the presumptive Republican presidential candidate first and foremost by promising to build a wall between the US and Mexico to stop illegal immigration. He even promised to deport all illegal aliens. He broadened his populist message by also sounding protectionist themes stating that he will renegotiate America's trade agreements to make them fairer and bring jobs back home. It's hard to deconstruct how much of his appeal is based on his supporters' fear of unchecked immigration versus free trade. Again, it seems that immigration was the issue that swung so much support behind Trump in the first place.

The backlash against Globalization in the UK and the US is a vote of no confidence in the governing elites who have promoted unchecked immigration, in my opinion. I doubt that Brexit and Trump would have succeeded if the issue were just about free trade. However, now that they have succeeded, free trade is at risk.

My hunch is that around the world, people understand that free trade is beneficial. However, they want governments that will promote it without also opening up their borders to all comers and imposing more and more regulations on them without their say-so. In other words, Globalization is getting a bad rap because it has been wrapped up with other controversial issues. Nevertheless, I expect that free trade will remain relatively free since on balance it tends to be a win-win even in the real world.

Credit: Globalization of Bonds. The ongoing plunge in bond yields to new record lows around the world is starting to become worrisome ([Fig. 1](#) and [Fig. 2](#)). The concern is that the bond market is foreshadowing a global recession. Here is the latest roundup of a selection of key 10-year government bond yields around the world from highest to lowest: US (1.37%), Italy (1.25), Spain (1.19), UK (0.77), France (0.13), Sweden (0.10), Germany (-0.19), and Japan (-0.25).

The yield curve is widely viewed as a good business cycle indicator. Indeed, it is one of the 10 components of the Index of Leading Economic indicators in the US. Yield curves around the world are flattening, though they haven't inverted just yet, which is widely viewed as a sure sign of an imminent recession. The yield spread between 10-year US Treasury bond and the two-year note is down to 81bps, the lowest since November 14, 2007 ([Fig. 3](#)). The former is falling faster than the latter ([Fig. 4](#)).

Following the Brexit vote, the federal funds rate in the futures market 12 months from now fell 17bps to 0.42%, implying no change in Fed policy over this period ([Fig. 5](#)). This is certainly consistent with our forecast since the end of last year that one-and-done or even none-and-done were the most likely outlooks for rate-hiking this year. It also has contributed to the bond rally, especially in the US. In the past, the Fed rarely gave much weight to overseas economic developments. Now that the Fed seems to be doing so, the globalization of US monetary policy also has globalized the US bond market.

Debbie and I aren't convinced that the bond market is signaling a recession in the US or even in the global economy. It is confirming that overseas central banks will continue to pursue their ultra-easy monetary policies, and that the Fed will postpone additional rate hikes. Undoubtedly, the negative official interest rates of the ECB and BOJ are major contributors to the race to zero and below in bond yields. So is the ECB's corporate bond-buying program, which started in June, and may be hard to implement given that the reach-for-yield mania is back with a vengeance, with everyone swooping up

bonds and putting them away.

The problem is that the flattening of the yield curve around zero percent is bad news for banks and other financial intermediaries. As Melissa reviews in the next section, the Brexit vote seems to have brought Italy's banking crisis to the fore. Before we go there, let's review some of the latest bond-related news:

(1) *Global economy is weak.* Low bond yields are justified by the lackluster pace of global economic activity. The global economy is still growing, though slowly. We doubt that Brexit will cause a global recession, but it does increase the vulnerability of the global economy to a downturn should more bad stuff happen. If Brexit leads to the meltdown of the Italian banks (as discussed below) or to "Quitaly," then Europe could fall into a recession and drag down the global economy.

As Debbie discusses below in more detail, the latest global composite PMI was 51.1 during June, unchanged from the previous month ([Fig. 6](#)). The M-PMI component edged up from 50.0 to 50.4, while the NM-PMI edged down from 51.4 to 51.3. Interestingly, the composite index is a bit higher in developed economies at 51.5 than in emerging economies at 50.1 ([Fig. 7](#) and [Fig. 8](#)).

The Eurozone's composite has been relatively stable around 53.0 for the past five months. As Debbie reports below, the volume of retail sales in the Eurozone is up 1.6% y/y in May, and is back near the previous record high during 2007 ([Fig. 9](#)). (See our [Eurozone Retail Sales](#).) All of the above is consistent with a scenario of global secular stagnation rather than a recession.

(2) *US economy is mixed.* Another upbeat indicator popped up on Friday in the US. The ISM M-PMI rose from 51.3 during May to 53.2 during June. Leading the way were solid readings in the new orders and production components, at 57.0 and 54.7 respectively ([Fig. 10](#)). In May, the ATA truck tonnage index rose 2.7% m/m after spiking up in March and down in April ([Fig. 11](#)). The 12-month average rose to yet another new record high in May. The bad news is that non-defense capital goods orders excluding aircraft was down 3.8% y/y in May to the lowest since April 2011 ([Fig. 12](#)).

Brexit: Fallout in Italy. According to a 7/4 *WSJ* [article](#), Italy's Prime Minister Matteo Renzi pulled the Brexit card last week. In response to the uncertainty caused by the Brexit vote, he called for a six-month suspension of EU banking rules. He also wants to inject €40 billion into the Italian banking system. But the answer to these requests from other European leaders has been "no."

According to EU rules that went into effect in January, public money cannot be used to support failed banks "until private-sector creditors accounting for 8% of the bank's liabilities have been bailed in." Multiple banks could fail if Italy has to follow the new rules, though only one is considered to be globally significant, i.e., UniCredit.

If Italy isn't forced to allow that to happen, the credibility of EU leaders could suffer. So "Quitaly" could be the next crack in the EU's foundation after the Brexit vote. However, Italy would have a harder time leaving the EU than the UK, since it is a member of the Eurozone. In any event, it wouldn't be summer without a crisis in the region; let's review the latest one:

(1) *Fault lines.* Europe's largest banks have lost market capitalization in the range of 25% to 61% ytd, [according](#) to Bloomberg. Italy's UniCredit has fared the worst (-61%) compared to Germany's Deutsche Bank (-45), the UK's Barclay's (-38), and Spain's Santander (-25). Italy's largest bank by 2015 [assets](#) now has a market capitalization of around just €12 billion. Meanwhile, its non-performing loans (NPLs) have grown to €51 billion. The bank's poor loan performance is a trend apparent throughout Italy's banking sector.

(2) *Shaky ground*. NPLs in Italy reached over €333 billion in June 2014, or about a quarter of GDP, according to a 2015 IMF [working paper](#) on Italy's banking sector. "Sofferenze," or bad debt (i.e., the worst category of NPLs), accounted for more than half of the total. The IMF further noted that more than 80% of NPLs were corporate in nature, largely reflecting the weak profitability and heavy indebtedness of Italian SMEs.

Data from the World Bank [credited](#) to the IMF showed that Italy's ratio of bank NPLs to total gross loans had grown to 17.3% during 2014 from 5.8% during 2007. Keep in mind that the US ratio of bank nonperforming loans to total gross loans had peaked at 5.0% in 2009 during the dark days of the financial crisis. For 2014, Italy had a much higher [ratio](#) than other countries, including Germany (2.3%), France (4.2), and Spain (8.5).

More recent data were detailed in a June 2016 PwC [publication](#) on the Italian NPL problem. The average NPL ratio stood at 10.4% while the NPL coverage ratio was equal to 55.6%. However, there was a fairly diversified picture among the banks.

(3) *The full Monte*. Banca Monte dei Paschi di Siena (BMPS), Italy's third-largest bank by 2015 assets, represented the most extreme gross NPL ratio in 2015 at around 20%, with an NPL coverage ratio just exceeding the average. The ECB has notified the Italian bank that it plans to request that the lender outlines measures by October to reduce the ratio of bad loans to total loans by 2018, according to the WSJ's [report](#). Moreover, the ECB will ask the bank to reduce its total gross bad loans portfolio from €46.9 billion to €32.6 billion by 2018.

(4) *Quitaly tremors*. The next clues as to how bad this all could get will be provided in coming months. The European Banking Authority is conducting stress tests of the EU banks, the results of which are due by the end of July. Then in the fall, Italy will vote on constitutional reforms that are intended to improve the stability of the political system. It's not a "Quitaly" referendum. But if it fails to pass, Renzi has pledged to leave his post as PM--and Italy's government might very well plunge into chaos, leaving an opening for potentially extremist anti-EU leadership to step in.

CALENDARS

US. Wed: Merchandise Trade Balance -\$40.0b, ISM NM-PMI 53.3, MBA Mortgage Applications, Dudley, Tarullo, FOMC Minutes. **Thurs:** ADP Employment 150k, Jobless Claims 269k, Challenger Job-Cut Report, Weekly Consumer Comfort Index. (Bloomberg estimates)

Global. Wed: Germany Factory Orders 1.0%/m/m/0.9%/y. **Thurs:** Germany Industrial Production 0.0%/m/m/1.5%/y/y, UK Headline & Manufacturing Industrial Production -1.0%/m/m/0.5%/y/y & -1.2%/m/m/0.6%/y/y, ECB Account of the Monetary Policy Meeting. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)--a good coincident indicator that can confirm or raise doubts about stock market swings--was flat during the final week of June after rising three of the prior four weeks by a total of 2.7%. The WLI is 9.2% above this year's bottom in mid-January. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB rose for the fifth week by a total of 3.9% after a three-week decline of 6.7%. Jobless claims were unchanged at 266,750 (4-wa) after falling the prior four weeks from 278,500. The CRB raw industrials spot price index--another BBB component--has been moving sideways at recent highs. The WCCI slipped 0.7% after climbing three of the prior four weeks by 5.2%.

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of the market-cap indexes last week, hitting record highs for MidCap and SmallCap. LargeCap's was up for a ninth straight week and SmallCap's for a seventh; all three have risen for the past 17 weeks--which makes the best multi-week streak since August 2014. LargeCap's forward earnings is up to a 25-week high from a 10-month low in early March and is now 2.2% below its record high (October 2014); MidCap's was at a record high in four of the past five weeks, which is its first since January 2015; and SmallCap's was at a third straight weekly record high and its first since October 2015. The yearly change in forward earnings for all three indexes has been edging higher recently from six-year lows as y/y comparisons have eased. In the latest week, LargeCap's forward earnings was steady at 0.2% y/y, which compares to a 10-month high of 1.1% y/y in early February and a six-year low of -1.8% in mid-October; MidCap's was steady at 2.4% y/y, which is down from a 12-month high of 3.2% nine weeks ago and compares to a six-year low of -1.3% at the end of December; and SmallCap's fell to 4.6% from 4.9%, which compares to a 14-month high of 5.2% in early May and a six-year low of 0.3% in early December. Growth rates now expected for 2016 and 2017: LargeCap 0.7% and 14.4%, MidCap 3.6% and 12.8%, and SmallCap 7.0% and 17.0%.

S&P 500/400/600 Forward Valuation ([link](#)): Valuations recovered across the board last week, but remain below their 2016 highs and their multi-year highs in 2015 for all three indexes. LargeCap's rose to 16.6 from a 17-week low of 16.1 the prior week--but remains below the 11-month high of 16.8 in April and 11-year high of 17.2 in February 2015, although up from a 15-month low of 14.9 in mid-January. MidCap's 17.5 was up from a six-week low of 17.0 a week earlier--but below a 42-week high of 17.6 in early June and a 13-year high of 18.6 in May 2015, while up from a three-year low of 15.0 in mid-January. SmallCap's rose to 17.9 from 17.5--which is down from a nine-month high of 18.3 in late April and a 13-year high of 19.6 in March 2015, and above a three-year low of 15.5 in mid-February.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Q2 earnings estimate revision activity was quiet last week as analysts seemed content not to make further adjustments in the final week of the quarter. The consensus rose w/w for one of the S&P 500's 10 sectors, fell for three, and was unchanged for six. Consumer Discretionary was the sole Q2 EPS gainer w/w with an increase of 0.1%. The Q2 EPS decliners w/w: Energy (-0.9%), Materials (-0.2), and Industrials (-0.1). The S&P 500's Q2-2016 EPS forecast edged down 3 cents w/w to \$28.71 from \$28.74, representing a forecasted pro forma earnings decline of 3.9% y/y, unchanged from a week earlier; it has fallen 2.5% since the end of Q1, with 7/10 sectors lower. Since Q1 ended, Energy is up the most (3.7), followed by Industrials (2.5) and Materials (0.2). Tech is down the most (-7.1), followed by Financials (-6.6), Telecom (-3.8), Consumer Staples (-1.9), and Consumer Discretionary (-1.5). The S&P 500's Q2-2016 forecasted earnings decline of 3.9% y/y would be the fourth straight decline and compares to Q1-2016's -5.0%, Q4-2015's -2.9%, Q3-2015's -0.8%, Q2-2015's 1.3%, and Q1-2015's 2.2%. Analysts expect a y/y earnings gain in Q2-2016 for four sectors compared to five in Q1-2016 and Q4-2015, six in Q3-2015, seven in Q2-2015, and nine in Q1-2015. However, only three sectors are expected to trail the S&P 500's y/y earnings decline of 3.9% in Q2-2016. The latest forecasted Q2-2016 earnings growth rates vs. their blended Q1-2016 growth rates: Consumer Discretionary (9.1% vs. 24.3%), Industrials (4.2, 0.3), Health Care (4.4, 9.3), Utilities (2.1, -4.3), Telecom (-0.8, 8.5), Financials (-2.2, -10.4), Consumer Staples (-1.7, 1.5), S&P 500 (-3.9, -5.0), Tech (-6.0, -4.1), Materials (-10.6, -12.1), and Energy (-78.0, -105.7).

S&P 500 Q2 Earnings Trend vs. Past Quarters ([link](#)): With the June-quarter books closed, the current Q2-2016 EPS forecast of \$28.71 has dropped 2.6% over the 13 weeks since the quarter's start. That's the smallest decline in Q2 forecasts over comparable weeks since Q2-2014, but surpasses the average 1.9% decline since 1994. Analysts expect EPS for Q2-2016 to be down 4.6% y/y, better than the 5.7% decline for Q1-2016 and the fourth straight quarter of lower EPS on a y/y basis. Since 1995, the Q2 earnings surprise has been positive in 17/22 years, and final EPS has exceeded Q1's 21 out of 22

times. We think that Q2's EPS will be \$30.00 and exceed Q1's \$26.97, and that earnings will decline 0.3% y/y in Q2. That would mark the S&P 500's fourth straight quarter of declining earnings y/y, but its 30th straight quarter of positive surprises--longer than its prior, 10-quarter positive surprise streak (Q1-2003 to Q2-2005).

US ECONOMIC INDICATORS

Factory Orders ([link](#)): Factory orders contracted 1.0% in May after expanding 3.5% the prior two months. May's decline was driven by a 5.7% drop in transportation equipment orders; ex transportation, orders eked out a 0.1% gain. Business investment remained depressed in May. Nondefense capital goods orders ex aircraft (a proxy for future business investment) contracted for the fifth time in seven months, losing 0.4% last month (smaller than the initial estimate of a 0.7% drop). These core orders sank 4.3% (saar) through the three months ended May (based on the three-month average), the sixth straight negative reading. Core shipments (used in calculating GDP) didn't fare any better. They fell for the third time this year, down 0.5% last month. The comparable three-month growth rate dropped 5.3% (saar), and was in the red for the eighth consecutive month. There was some good news in June's ISM manufacturing survey. The M-PMI rose for the fifth time in six months, from 48.0 at the end of last year to 53.2 last month (the highest since February 2015). New orders climbed from 55.7 to 57.0 last month as new exports orders (from 52.5 to 53.5) recorded their best performance in 19 months.

GLOBAL ECONOMIC INDICATORS

Global Composite PMI ([link](#)): "The global economy remained in a low growth gear in June, rounding off its weakest quarter since the end of 2012," according to the latest survey. The J.P. Morgan Global Composite Output Index was unchanged at 51.1 in June, near February's 40-month low of 50.8 and below its long-run average for the tenth straight month. The M-PMI (from 50.0 to 50.4) remained around the breakeven point, while the NM-PMI (51.4 to 51.3) edged down to a four-month low. The report noted that all industry growth in the Eurozone and Russia was relatively solid. Within the former, expansions in Germany, Italy, Spain, and Ireland helped offset France's contraction. Growth was only moderate in the US and India and near dormant in China. Meanwhile, all industry growth in Brazil and Japan continued to slide.

Eurozone Nonmanufacturing PMIs ([link](#)): The Eurozone's service sector slowed in June, rounding off its weakest quarter since Q4-2014. The Eurozone's NM-PMI fell from 53.3 in May to a 17-month low of 52.8 in June, lowering the Q2 average to 53.1. Activity in Germany (from 55.2 to 53.7) was the weakest since May 2015, while it slipped into contraction territory again in France (51.6 to 49.9). Outside the "Big Two," output growth accelerated at a four-month high as the service sector in Italy returned to expansionary territory and Spain's grew at the fastest pace in seven months. Ireland's once again recorded the fastest rate of expansion overall, though at a slightly slower pace than in May. Similar trends were recorded for new business. As for employment, jobs growth reached a nine-year record in Spain and six-month highs in both Germany and Italy; Ireland's also posted a sizable gain.

UK Nonmanufacturing PMI ([link](#)): Business activity in the UK's service sector slowed again in June after picking up slightly in May. The UK's NM-PMI fell from 53.5 in May to 52.3 in June, back down at April's 38-month low, signaling a relatively weak rate of growth in services output. The index averaged only 52.7 last quarter--the weakest since Q1-2013. According to the report, the volume of new business rose at a slightly faster pace last month, though the increase was the second weakest since the upturn began three and a half years ago, as the EU referendum led to postponed or cancelled orders. Job creation for the sector was the lowest since August 2013. Moreover, the 12-month outlook was the bleakest since December 2012. (The data collection window for the June survey was June 13-28, with 89% of the responses received before June 24.)

China Nonmanufacturing PMI ([link](#)): China's service sector grew at its fastest pace in nearly a year last month, according to Caixin's measure, while it remained subdued according to the official measure. Caixin's NM-PMI rose for the first time in three months, jumping from 51.2 to 52.7 last month, the highest reading since July 2015. New business expanded at its fastest rate since July 2015, while service providers continued to adopt a cautious approach toward hiring, increasing employment only slightly for the third straight month. The official NM-PMI, which includes construction, climbed from 53.1 to 53.7, near its high for the year. However, the sub-index for the service sector barely changed, edging up from 52.0 to 52.2.

Japan Nonmanufacturing PMI ([link](#)): Business activity in Japan's service sector contracted in two of the three months of Q2. Nikkei/Markit's NM-PMI sank to 49.4 last month after increasing from 49.3 to 50.4 in May. New orders declined at the fastest pace since September 2011, leading service providers to cut staff for the first time in three months. The 12-month outlook fell to its lowest reading in just over a year, reflecting uncertainty surrounding the Chinese economy and fears that demand will fall with the impending sales tax increase.

Eurozone Retail Sales ([link](#)): May Eurozone retail sales posted the best increase so far this year and was just shy of February's cyclical high. Sales advanced 0.4% after an upwardly revised 0.2% gain in April, first reported as unchanged. May's gain was due to a 0.7% jump in spending on non-food products--the fifth increase in six months--while expenditures on food, drinks & tobacco and auto fuel were flat for the month. Among member states for which data are available, Estonia (1.5%), Ireland (1.3), Finland (1.1), Germany (0.9), Belgium (0.9), and Malta (0.7) posed the largest gains, with sales in Austria and Slovakia fractionally higher and France's unchanged. Partially offsetting these gains were declines in Portugal (-1.7), Luxembourg (-0.8), Spain (-0.4), and Slovenia (-0.3). Sales were up 1.6% y/y, led by Luxembourg (10.0% y/y) and Ireland (6.7); Belgium (-1.0) was the sole country in the red.

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