



MORNING BRIEFING

August 18, 2016

No Shortage of Gluts

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

(1) Dudley and Lockhart provide a summertime jolt. (2) Dudley also says Fed may not have to tighten much. (3) Dudley sees bond bubble, and blames it on other central banks. (4) Williams advocates bigger role for fiscal policy. (5) Legacy of easy money: Lots of gluts. (6) Sinking ships. (7) The good Earth. (8) Closing stores. (9) Hard to renovate a bathroom with Amazon. (10) Six benefits of blockchain.

The Fed: The Great Reassessment. Regional Fed presidents William Dudley (FRB-NY) and Dennis Lockhart (FRB-Atlanta) jolted markets on Tuesday by suggesting that a rate hike in 2016 remains possible. Dudley was [interviewed](#) on the Fox Business Network, while Lockhart [spoke](#) at the Rotary Club of Knoxville. Their comments increased the probability of a Fed move above 50% in the futures market for the first time since June 23, when the UK voted to leave the EU.

Yet Dudley also indicated that the Fed may not have much further to go in normalizing monetary policy. In the U.S., “there are reasons to think that monetary policy isn’t particularly stimulative right now, and you can sort of judge that by the fact that we only grew at a 1 percent annual rate in the first half of the year,” he said. “So we probably don’t have a lot of monetary policy tightenings to actually do over time.” Melissa and I believe that’s a very significant statement.

Last Friday, FRB-SF President John Williams urged a rethink of both monetary and fiscal policies to deal with subpar growth. He is worrying that growth will remain too slow, which would heighten the risk of deflation. Like Dudley, he seems to be thinking that interest rates might remain permanently lower than in the past. We will be watching and listening carefully for what may be the beginning of the “Great Reassessment” of monetary policy by Fed officials. For now, here are some of our thoughts on their latest thinking:

(1) *What Dudley actually said.* When asked in his Fox interview if his highly cautious optimism had changed from his [speech](#) on July 31, Dudley said that his views haven’t changed much. That speech occurred just a few days after the July 26-27 FOMC meeting at which Dudley voted not to raise rates.

The media jumped all over Dudley’s suggestion to Fox that the markets were being too complacent about a rate hike. However, Dudley was referring to the assumption that there would be just one rate hike through 2017, not 2016. The headlines also focused on Dudley’s soundbite when asked about a September rate hike: “Yeah, I think it is possible,” he said. But some reports left out the rest of that thought: “We’ll have to see where the data falls.” That’s no different than what he said in July.

Dudley said that “the economy is in okay shape.” While he sees strength in consumption and output, inflation, and wages all moving higher, he chose to emphasize the weakness in business investment, which could be exacerbated by election uncertainty! That’s certainly an excuse for postponing the next rate hike until after November.

Dudley doesn’t see any asset bubbles, though he admitted that the bond market seems stretched. In his view, that’s the fault of other central banks around the world that are creating demand for long-term

assets via their asset purchase programs. That's resulting in a search for yield, which is spilling over into US markets. He may be preparing an excuse for the next bubble bursting in the US that recalls the Greenspan/Bernanke "global savings glut" explanation for the US housing bubble.

(2) *Lockhart isn't locked in.* In his [speech](#) on Tuesday, Lockhart (a non-voting FOMC participant) said: "I'm not locked in to any policy position at this stage, but if my confidence in the economy proves to be justified, I think at least one increase of the policy rate could be appropriate later this year." Interestingly, like Dudley, he mentioned that the election may be weighing on business investment: "I don't have direct causal evidence linking weak business investment and current political uncertainty, but it's possible the election is a factor--maybe not a primary factor--but a factor nonetheless affecting investment decision making."

(3) *Williams promotes fiscal policy.* While he isn't a voter on the FOMC this year, Williams seems to be back in the dovish camp that continues to dominate the votes of the FOMC--an observation we discussed in our 8/1 [Morning Briefing](#). Recall that back in January he [suggested](#) that several rate hikes were likely in 2016. He also [said](#) in May that this election cycle won't stop the Fed from raising rates. Reading between the lines of his 8/15 [Economic Letter](#), it seems that Williams now is putting a lot of weight on the upcoming election cycle given the importance of fiscal measures to his outlook.

The letter was obviously his primer for the upcoming Jackson Hole [symposium](#) later this month. The theme is "2016: Designing Resilient Monetary Policy Frameworks for the Future." Williams writes that monetary policies are challenged in this historically abnormal new normal in which interest rates, growth, and inflation are persistently low. He stated: "There is simply not enough room for central banks to cut interest rates in response to an economic downturn when both natural rates and inflation are very low." So what's the Fed to do?

Williams still believes that the Fed's job is to stabilize prices and employment. But in his opinion, it's also the job of fiscal policymakers to focus on "longer-run goals such as economic efficiency and equity." Williams even suggests that fiscal policy should be a "first responder" to recessions! Separately, Williams suggests that the Fed might consider changing the way it operates altogether, either by pursuing a higher inflation target or changing the target to nominal GDP growth rather than inflation.

(4) *What are they all missing?* Apparently, it hasn't dawned on Fed officials that their ultra-easy monetary policies might have contributed greatly to the forces of global economic stagnation and deflation. The availability of so much cheap credit has done more to create excess capacity around the world than to boost demand. In the following section, Jackie highlights a few of the resulting gluts.

Strategy: Glut Ridden. The good times have been rolling for quite a while now, boosting stocks markets to new highs. Higher stock prices have been accompanied by--or driven by, depending on your perspective--easy, low-cost money. It's now becoming increasingly apparent that some industries have used that cheap funding to build out too much capacity, which is coming back to bite them.

The energy sector is the poster child for overbuilding, as sector players assumed \$100 oil was here to stay and took "drill, baby, drill" to heart. But look a little deeper, and other areas are showing overcapacity woes as well. Some gluts are related to the decline in commodity prices, like the overcapacity in the shipping industry or the abundance of grain. Others aren't related to commodities but are problematic nonetheless, like the over-stored retail industry. Conversely, the housing market is still showing tightness as mortgage lending remains far below the pre-recession pace. Here's a closer look at a three glut-ridden industries and a glut-free one:

(1) *Shipwrecked*. Shipping companies are encountering rough seas. Years of export growth and easy funding had helped to spur a ship-building boom. But now that export volumes have flat-lined, the industry finds itself with too many ships and not enough cargo.

From 1995 through 2014, the volume of world exports rose 160%, thwarted only temporarily by recessions. Since the start of 2015, exports have been flat, though in record-high territory ([Fig. 1](#)). The dearth of growth coincided with the flattening of the sum of US real exports plus imports as well as with the sharp decline in commodity prices and the slowdown in China's economy ([Fig. 2](#) and [Fig. 3](#)).

The decline in trade has run the shipping industry aground. The Baltic Dry Index, which tracks the cost to transport raw materials by sea, fell from its most recent high of 2337 (1/4/85=100) in December 2013 to 290 through early 2016 ([Fig. 4](#)). The good news for the shipping industry is that the index may have bottomed on February 11, climbing to 687 since then.

Perhaps the recent bounce has occurred because the industry has begun to address its overcapacity. "Companies operating in the oversupplied shipping market face four choices, all of them money-losers: They can continue to hire out their vessels at rates that do not cover the operating expenses; they can pay to tie up their unneeded ships and wait for demand to return; they can sell their ships into the lousy used market; or, they can sell the ship for scrap even as prices paid by ship-breakers in Bangladesh, India and Pakistan are low, reflecting a glut in scrap metal," [reported](#) the *Globe and Mail* on 4/3.

In fact, the industry has dramatically reduced the number of new ships ordered this year. These orders rose from roughly 500 in 2010 and again in 2011 to more than 1,000 in 2012 and north of 2,000 in each of 2013 and 2014. Last year, orders retreated to just over 1,500, and through July of this year the number of ships ordered stands at only 293, the 8/14 *WSJ* [reported](#).

It's definitely a ship buyer's market. The price of a five-year-old capsized bulker has fallen from roughly \$180 million in 2008 to just \$22 million today, the *Globe and Mail* noted. And that leads some ship owners to scrap their ships. About 1,000 ships with the combined capacity to haul 52 million metric tons of cargo are slated to be sold for scrap this year, according to the *WSJ* article. That's second only to the ships with 61 million tons of hauling capacity scrapped in 2012. "Given the tremendous overcapacity, it will take much more recycling and at least two to three years of no growth in capacity to see some balance between supply and demand," Basil Karatzas, CEO of Karatzas Marine Advisors Co., told the *WSJ*.

(2) *Bumper crop*. The prices of many crops have fallen sharply from highs hit over the past three to five years. Despite the depressed prices, farmers have kept planting, and this fall's corn and soybean harvest is expected to be a record. "Farmers have tried to plant their way out of a three-year slump in incomes as higher production helped boost world inventories and depressed prices, and industry advocates warned the impact could be dire," the 8/14 *WSJ* [noted](#).

The price of corn futures has fallen to \$3.28 per bushel, down from a 2012 peak of \$8.31 ([Fig. 5](#)). Likewise, soybeans fetch \$10.20 per bushel, down from 2012's high of \$17.71 ([Fig. 6](#)).

The drop in farm commodity prices has had a wide-ranging impact. "The USDA estimates U.S. farm incomes will fall to \$54.8 billion in 2016, the lowest level since 2002. On Thursday, Federal Reserve regional banks said farmland values continued to decline in the Farm Belt due to low crop prices and weak farm incomes. Dairy farmers on Friday pleaded with U.S. Agriculture Secretary Tom Vilsack to buy \$150 million in cheese to help them through the glut. Farm-supply companies like Monsanto Co., DuPont Co. and Deere & Co. have cut thousands of jobs and curtailed research projects," the *WSJ* article continued.

There are indications that credit to farmers has begun to tighten up ever so slightly. In the Kansas City region, nearly 15% of lenders in 2016 reported that they denied over 10% of applications for farm loans, the 8/11 *WSJ* [wrote](#). But it may take more drastic measures to bring the market into balance.

Farm equipment shipments are the weakest since 2010 ([Fig. 7](#)). The sum of construction, farm, and mining equipment orders was down 28% y/y during June, while the sum of industrial, metalworking, and materials handling machinery was up 5%. The latter exceeded the former by 66% during June ([Fig. 8](#)).

(3) *Over-stored*. Last week, we took a look at why total retail sales was growing while same-store sales at some retailers and restaurants was negative. One of our conclusions was that there are too many stores, especially in an era of online competition. As if on cue, Macy's announced late last week that it plans to close 100 stores.

"We believe there is too much retail square footage in the department store space," [said](#) Macy's President Jeff Gennette in an 8/11 *WSJ* article. The stores being closed are cash flow positive, but most are underperformers or in weak locations. Others will be sold because their real estate value is greater than their value as a store, explained CFO Karen Hoguet. Macy's stock jumped 17% on the news and added slightly to those gains in subsequent days.

Bloomberg [produced](#) an 8/15 article that examined the over-stored state of the US retail market. One notable chart revealed that even as retailers increased square footage by 3%-5% annually from 2011 to 2015, the productivity of those stores fell from about 2.5% in 2011 to -1% last year. Another chart highlighted that the US has more retail square footage per capita than the UK, Germany, and Mexico combined. The US has 23.6 square feet per capita, while in Australia the figure is 10.1, in the UK it's 4.7 and in Germany it's 2.4.

Store closures at retailers like Macy's and Sears will only benefit the overall retail environment if they're not offset by store openings by the likes of TJX. The off-priced retailer believes it's gaining market share and plans to continue opening new stores. In Q2, it added 14 stores, bringing its total to 3,675, and plans are to open "hundreds of stores in coming years, including 1,400 in North America," the 8/16 *WSJ* [reported](#). The company sees its same-store sales rising 3%-4% this year, but the shares fell 5.8% Tuesday because the company forecast 83-85 cents a share for earnings in the current quarter compared to analysts' consensus expectation of a 90 cents profit.

Similarly, Walmart announced in January plans to close 154 locations in the US, including 102 Walmart Express locations. In July, Walmart sold 41 of its small-store locations to Dollar General, which is in expansion mode. "By October, Dollar General plans to open the new locations and add them to a growing list of slightly larger stores that stock some perishable food," the 7/27 *WSJ* [reported](#). "Dollar General plans to grow from 13,000 locations to 20,000 U.S. stores by 2020 and wants to add more perishable food, health and beauty care items to aisles, executives have said in recent months." Well, that's certainly not helpful if the industry needs glut reduction.

(4) *Solid foundation*. One of the reasons the housing market strength may have legs is the fact that mortgage lending remains far below the peak seen before the last recession. Mortgage applications for new home purchases peaked at 501.8 in July 2005, based on the four-week average, before tumbling to a low of 159.7 in November 2014. They've climbed 37% in the ensuing years, but remain far off their peak levels ([Fig. 9](#)). Likewise, existing home sales and new home sales remain well below their pre-recession peaks. The lack of a glut has helped housing prices and the S&P 500 Homebuilding stock price index alike ([Fig. 10](#)).

In addition, the S&P 500 Home Improvement Retail stock price index has been boosted by the strong uptrend in retail sales of building materials and supply dealers ([Fig. 11](#) and [Fig. 12](#)). Home Depot reported that its US same-store sales rose 5.4% in Q2. Lowe's US same-store sales were less robust, but at 1.9% still in positive territory. "Home Depot is boosted by the rising housing market, which gives homeowners the confidence to take on pricey projects like renovating bathrooms or replacing roofs and air conditioning systems. The chain said the number of transactions over \$900 rose 8.1% in the period and that the number of items purchased at a time rose because more ambitious projects require more tools and parts," the 8/16 *WSJ* [explained](#).

So far, the retailer has dodged the Internet competition that plagues other types of retailers. We're not quite sure why, since toilets are available on Amazon, and Prime members can avoid the \$60 shipping fee on some models offered. Perhaps shoppers are looking for advice on their home improvement projects or maybe contractors need things immediately to finish jobs in progress? Either way, the strong foundation in housing undoubtedly has helped.

Technology: Blockchain Blockbuster. The World Economic Forum [published](#) a report on blockchain and how it might be used by financial institutions in the future. The upshot: Blockchain has "great potential to drive simplicity and efficiency," and the application of blockchain will require "deep collaboration between incumbents, innovators and regulators, adding complexity and delaying implementation." Translated into English, that means: "This is great stuff but turf wars could delay anyone from actually using it." Here are some more details:

(1) *Lots of activity.* The report, which was highlighted in an 8/12 *NYT* [article](#), notes just how much interest in blockchain there is. More than 24 countries are investing in distributed ledger technology (DLT), 80% of banks are predicted to initiate DLT projects by 2017, more than 90 corporations have joined blockchain consortia, more than 90 central banks are engaged in DLT discussions worldwide, more than 2,500 patents have been filed over the last three years, and more than \$1.4 billion in investments have been made in the area over the past three years.

(2) *Six benefits.* Such excitement around the technology is occurring because of six potential benefits it offers. Blockchain should simplify operations, make regulation more efficient, reduce counterparty risk, reduce the time to clear and settle transactions, improve liquidity and capital, and reduce fraud.

(3) *Rethinking trade.* One recently announced initiative comes from HSBC and Bank of America Merrill Lynch, which together are trying to use blockchain to simplify \$2 trillion of trades by eliminating the paperwork involved with letters of credit. The hope is to use blockchain as a centralized place to share information between buyers, sellers, and their banks to make international trading quicker and cheaper, *CNBC* [reported](#) Tuesday.

Separately, R3, a technology firm, made a similar blockchain announcement. "[m]ore than 15 of [R3's] consortium member banks have also designed self-executing transaction agreements, known as smart contracts, on R3's distributed ledger platform to process accounts receivable purchase transactions, known as invoice financing or factoring, and LOC transactions," Reuters [reported](#) on 8/10. Now the question is: Who will be the first to pull the trigger and actually move blockchain from the theoretical to the practical?

CALENDARS

US. Thurs: Jobless Claims 265k, Leading Indicators 0.2%, Philadelphia Fed Manufacturing Index 2.0, Weekly Consumer Comfort Index. **Fri:** None. (Bloomberg estimates)

Global. Thurs: Eurozone CPI -0.5%*m/m*/0.2%*y/y*, UK Retail Sales 0.1%*m/m*/3.8%*y/y*, ECB Account of Monetary Policy Meeting. **Fri:** Canada CPI 0.0%*m/m*/1.3%*y/y*, Canada Retail Sales. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Investors Intelligence Bull/Bear Ratio (BBR) rose for the sixth time in seven weeks this week to 2.81 from 1.75 during the final week of June. Bullish sentiment is up 3.3ppts the past two weeks to 56.2%--the most bulls since April 2015; bearish sentiment fell for the fifth week from 24.7% to a 12-month low of 20.0% over the period. The correction count is down to 23.8% from 25.9% two weeks ago. The AAI Bull Ratio rose for the second week last week to 53.9% after falling from 60.2% to 52.4% the prior two weeks. Bullish sentiment climbed to 31.3% following a three-week slide of 7.1ppts to 29.8%; bearish sentiment was unchanged at 26.8% after falling from 28.4% two weeks ago.

S&P 500 Earnings, Revenues, & Valuation ([link](#)): S&P 500 consensus forward revenues edged down last week from a 22-month high, but forward earnings rose to a 20-month high. The forward profit margin forecast was steady at 10.6%, which is little changed from its 24-month low of 10.4% in late March and 10.9% record high in September. Forward revenue growth for the S&P 500 edged down to 4.8% from a 49-month high of 4.9% the prior week--up from a seven-month low of 2.7% in late February. Forward earnings growth was steady at a 20-month high of 9.5%, up from an 11-month low of 4.8% in late February. Valuation rose last week to 17.1 from 17.0, which compares to a 17-month high of 17.2 in late July and February 2015's 12-year high of 17.4. Despite the collapse in Energy sector forecasts beginning in early 2015 and currency translation headwinds, forward revenues and forward earnings both have held up well and now are close to their record highs hit in October 2014: Forward revenues is down 0.4%, and forward earnings is down 1.2%. Ex-Energy, the forward revenue and earnings growth rates are 4.3% and 8.5%, respectively. Ex-Energy, the forward profit margin edged up to 11.3% from 11.2%, down from 11.5% in September.

S&P 500 Sectors Earnings, Revenues, & Valuation ([link](#)): Consensus forward revenue forecasts rose last week for 3/10 sectors, and forward earnings rose for 4/10. Energy and Tech were the only sectors to see both rise. Forward revenues and earnings are at or around record highs for 5/10 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy continues to rebound; its forward revenues rose 0.4% *w/w*, and forward earnings improved 0.5% to seven-month highs. Forward P/E ratios rose for 6/10 sectors, though, and P/S ratios increased for 7/10. P/E and P/S ratios have rebounded sharply for most sectors from cyclical lows in February, but struggle to surpass their six- to 10-year highs achieved in early 2015. Health Care's P/E of 15.6 and P/S of 1.67 remain well below their 2015 highs of 17.9 and 1.88, respectively. Consumer Staples' P/E of 20.7 remains near mid-July's 21.1, which was the highest since 1999, and Utilities' P/E of 17.8 is down from an early-July record high of 18.8. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.39 compares to a record high of 1.56 in early May, and its P/E of 38.6 is down from a record high of 57.5 then. Higher *y/y* margins are expected for only 4/10 sectors in 2016: Consumer Discretionary (to 7.5% from 7.1%), Consumer Staples (6.6, 6.5), Materials (8.9, 8.8), and Tech (19.0, 18.7). Margins are expected to remain flat for Health Care (10.4), Industrials (9.0), and Utilities (10.7), and to deteriorate for Energy (1.4, 4.6), Telecom (10.9, 11.3), and Financials (15.1, 15.4).

GLOBAL ECONOMIC INDICATORS

World CPI ([link](#)): World consumer inflation moved further below 3.0% in June after moving above at the start of the year. The CPI inflation rate was 2.3% *y/y* in June, down from a recent high of 3.5% in

January. The emerging economies' yearly inflation rate decelerated from 6.8% in January to 4.6% in May--the lowest since October 2009. The rate for advanced economies continues to fluctuate between zero and 1.0%, recording 0.6% y/y in June--below its recent high of 0.8% in January but above the 0.1% recorded last September.

US CPI ([link](#)): The core CPI rate was just above the Fed's target rate of 2.0% y/y again in July. It edged down to 2.2% y/y last month after matching February's 2.3% peak rate in June--which was the highest since May 2012. On a monthly basis, core prices advanced 0.1% after rising 0.2% in each of the prior three months. The three-month rate slowed to 1.8% (saar), more than a percentage point below the recent high of 2.9% in February. During July, prices rose for shelter (at its slowest pace since March), medical care, new vehicles, and motor vehicle insurance and were partially offset by declines in prices for air fares, used cars & trucks, communication, and recreation. July's headline CPI was flat after climbing 0.2% in June and May. The CPI yearly rate was 0.8%, slowing from a 15-month high of 1.4% at the start of the year.

Emerging Markets CPI ([link](#)): There's not much inflation in emerging economies, and there is some deflation: (1) Asia: Rates are at or near zero in several countries we track. Singapore's remains below zero, while Thailand's moved above in the spring for the first time since December 2014; Taiwan's climbed above zero in January after being below for all of 2015. South Korea's rate continues to hold just above zero; the Philippines' has accelerated recently. Indonesia's rate continues in a volatile flat trend, near the bottom of its range; India's rate looks to have moved out of its flat trend, reaching a 23-month high of 6.1% in July. China's inflation rate slowed to 1.8% in July from its high for the year of 2.3% recorded from February through April. Malaysia's rate slowed to a 15-month low of 1.7% in June, less than half of February's 4.2%, which was the highest since December 2008. (2) Latin America: Venezuela's rate is skyrocketing, while Chile's is fluctuating around recent highs. Mexico's is near a record low; Peru's rate fell to 2.9% y/y in July from its recent high of 4.6% in January. (3) Eastern Europe: Inflation is nonexistent in most economies--having remained negative in Poland, Croatia, Romania, and Bulgaria, though the latter two appear to be flirting with zero. The Czech Republic's rate is just above zero, while Hungary's has slipped below zero. Rates in Russia and the Ukraine have slowed sharply from recent peaks.

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