



MORNING BRIEFING

February 22, 2017

Hard To Reconcile

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

(1) Easy to believe Trump reviving animal spirits in US. (2) Hard to imagine he is doing that overseas. (3) The recovery from the Energy recession explains some of the recent global upturn. (4) China still addicted to credit, which soared \$2.7 trillion over past 12 months through January. (5) Flash PMIs are flashing green. (6) Retail sales strong in Europe. (7) Two-step: Reconcile Trump-Cohen and Ryan-Brady bills then get merged one fast-tracked through Congress with reconciliation process. (8) A couple of hurdles such as border adjustment tax and R&R of ACA. (9) Bismarck's sausage warning.

Global Economy I: Hard To Believe. It's easy to believe that the strength in the US economy since Election Day has a great deal to do with Trump's surprising and stunning victory, including Republican majorities in both houses of Congress. His promises to cut taxes and reduce regulations seem to have revived animal spirits across the board among US consumers, small business owners, manufacturers, purchasing managers, and investors, Debbie and I have been reporting on the incredible vertical ascents since the election in the Consumer Optimism Index, the Small Business Optimism Index, the average of the Fed districts' composite business indicators, the M-PMI and NM-PMI, and the stock market. Also going vertical have been our Boom-Bust Barometer and our Weekly Leading Index.

It's harder to imagine that Trump's victory can explain the recent strength in global economic indicators. It's possible that he revived animal spirits overseas on expectations that his fiscal policies might boost US economic growth, which should benefit the global economy. But his protectionist "America First" rhetoric, championing bringing jobs and manufacturing capacity back to the US, should squelch any optimism that better growth in the US will be shared with the rest of the world through the US trade deficit. Despite the media's 24/7 focus on everything Trump, there may be a couple of other reasons why the global economy is showing signs of better growth:

(1) *The energy recession is over.* For starters, the 76% plunge in the price of a barrel of Brent crude oil from June 19, 2014 through January 20, 2016 triggered a global recession in the oil industry, which depressed other industrial commodity prices as well ([Fig. 1](#)). The CRB raw industrials spot price index dropped 27% from April 24, 2014 through November 23, 2015. The price of oil and the CRB index have rebounded 102% and nearly 30% from their recent lows.

So the global energy industry's recession is over, and it is no longer weighing on global economic growth. A good way to see this is to compare the y/y growth rates in S&P 500 revenues—which is a good indicator of global economic activity, since about half of those sales occur overseas—with and without the revenues of the Energy sector ([Fig. 2](#)). With Energy, the growth rate turned negative from Q1-2015 through Q2-2016. It turned positive during Q3-2016. Excluding Energy, the growth rate remained positive over this same period, though it did weaken to a low of 0.2% during Q4-2015.

(2) *China is back to its old tricks.* China is also boosting economic growth by continuing to stimulate it with plenty of credit. During January, total "social financing" rose by a record \$542.3 billion ([Fig. 3](#)). That's not on a y/y basis, but rather on a m/m basis! On a y/y basis, social financing totaled \$2.7 trillion over the past 12 months through January ([Fig. 4](#)). Bank loans, which are included in social financing,

rose \$335.7 billion during January m/m and \$1.8 trillion over the past 12 months ([Fig. 5](#)).

Global Economy II: Hard-Charging? Debbie and I aren't surprised by the rebound in the global economy because we were on top of the Energy recession story. We didn't see it coming, but when it unfolded we argued that it wouldn't turn into a widespread downturn and that the widening of credit quality spreads wouldn't turn into a financial contagion. Joe and I started to surmise last summer that the Energy-led earnings recession was over. The high-yield spread peaked on February 11, 2016 at 844bps, and is back down to 338bps ([Fig. 6](#)). Most reassuring to us was the V-shaped recovery in our trusty CRB raw industrials spot price index. Nevertheless, we are impressed with the latest batch of global economic indicators:

(1) *Flash M-PMIs*. Markit's flash M-PMI for the Eurozone rose to 55.5 during February, the highest since April 2011 ([Fig. 7](#)). Comparable strength was visible in the indexes for Germany (57.0) and France (52.3). Japan's flash M-PMI rose to 53.5 during February, the highest since March 2014 ([Fig. 8](#)).

On the other hand, in the US, the flash M-PMI (54.3) and NM-PMI (53.9) ticked down this month, though they both remain high ([Fig. 9](#)). The composite PMI edged down to 54.3 from a 14-month high of 55.8 last month.

(2) *European retail sales*. In the Eurozone, the volume of retail sales excluding motor vehicles edged down during December, but it was up by 1.1% y/y ([Fig. 10](#)). Sales are in record-high territory, led by France (up 3.0% y/y). Last year, new passenger car registrations rose to a record 15.2 million units in the European Union and European Free Trade Association ([Fig. 11](#)).

(3) *Trade*. Last week, we noted that China's exports and imports showed strength last month. The same can be said of Japan's—both have been moving higher in recent months through January ([Fig. 12](#)).

US Fiscal Policy: Now the Hard Part. The hard part now is to reconcile a couple of Republican tax plans and to pass the resulting compromise plan using the reconciliation legislative process in Congress. The question is whether this all can be done this fiscal year. Of the two plans, one is based on the bits and pieces included in President Trump's campaign promises and various speeches. Trump recently said that Gary Cohen, the director of the US National Economic Council, is working on the specifics of the administration's "phenomenal" plan. The other plan is "A Better Way," the GOP's tax reform [blueprint](#) proposed by House Speaker Paul Ryan (R-WI) and Ways and Means Committee Chairman Kevin Brady (R-TX).

The Trump-Cohen proposal is expected to be similar to the Ryan-Brady version. However, a major sticking point is the "border adjustment tax," which is important for raising revenues so that the plan can be revenue-neutral or at least get closer to it. Trump thinks the idea is too complicated and prefers a flat 35% tax on imports produced by US companies, which should be producing their products in the US, in his opinion. Nevertheless, Brady recently insisted that border adjustment would be included in the combined version during a recent [interview](#) with Fox News.

The good news and the bad news is that there is a streamlined legislative process available for pushing Trump's tax plan through. It's called "reconciliation." Here's an overview of that and how it might impact the timing of any proposal:

(1) *ACA first*. Reconciliation is a process by which a qualifying budget resolution can pass the Senate with only 51 votes. In other words, the Republicans should have the votes to pass their tax bill through

reconciliation. Importantly, budget resolutions under a reconciliation directive cannot be filibustered.

Senate Majority Leader Mitch McConnell (R-KY) [said](#) late last year that the GOP intends to leverage reconciliation to get both the repeal and replacement of the Affordable Care Act (ACA) and tax reform passed. Brady confirmed in the aforementioned Fox News interview that the GOP priority right now is the ACA.

There's one important catch: The Congressional Budget Act of 1974 allows for the annual adoption of one resolution on the budget each fiscal year (October-September), according to the Congressional Research Service (CRS), which outlined the reconciliation process in great detail in a November 2015 [report](#).

Under Senate interpretations of the Act, the legislative body can consider the three basic subjects of reconciliation—spending, revenues, and debt limit—in a single bill or multiple bills. However, it can consider each of these three in only one bill per budget year (unless Congress passes a second budget resolution). As a result, the Senate is limited to a maximum of three reconciliation bills in a year, one for each of the basic subjects of reconciliation.

According to a fact sheet [posted](#) by the Center on Budget and Policy Priorities, “This rule is most significant if the first reconciliation bill that the Senate takes up affects both spending and revenues. Even if that bill is overwhelmingly devoted to only one of those subjects, no subsequent reconciliation bill can affect either revenues or spending because the first bill already addressed them.” This seems to preclude getting both ACA and tax reform done between now and October.

(2) *Two's a stretch*. According to the CRS report, during the 41 years since the congressional budget process was established, 24 budget reconciliation directives were put forth within 22 budget resolutions. Only on four occasions has Congress adopted two budget reconciliation measures in one year (in 1982, 1986, 1997, and 2006). The target date for completion of the annual budget resolution is April 15, a deadline that has been met only six times.

So if ACA replacement is the GOP leadership's priority for the 2017 timetable this spring, then it has to clear lots of hurdles before any tax reform can come into play. Tax reform could be written this summer with the intent of meeting the budget resolution deadline during the spring of 2018. Brady did suggest during his Fox interview that there might be a possibility that the tax reform could apply retroactively to 2017. But his tone implied that this was a bit of a stretch.

(3) *The directive*. The CRS report further explained: “Budget reconciliation is an optional two-step process Congress may use to bring direct spending, revenue, and debt limit levels into compliance with those set forth in budget resolutions. In order to accomplish this, Congress first includes budget reconciliation directives in a budget resolution directing one or more committees in each chamber to recommend changes in statute to achieve the levels of direct spending, revenues, debt limit, or a combination thereof agreed to in the budget resolution. The legislative language recommended by committees then is packaged ‘without any substantive revision’ into one or more budget reconciliation bills as set forth in the budget resolution by the House and Senate Budget Committees. In some instances, a committee may be required to report its legislative recommendations directly to its chamber.

“Once the Budget Committees (or individual committees if so directed) report budget reconciliation legislation to their respective chambers, consideration is governed by special procedures. These special rules serve to limit what may be included in budget reconciliation legislation, to prohibit certain amendments, and to encourage its completion in a timely fashion.”

The report further noted: “As a concurrent resolution, it is not presented to the President for his signature and thus does not become law. Instead, when adopted by Congress, the budget resolution serves as an agreement between the House and Senate on a congressional budget plan. As such, it provides the framework for subsequent legislative action on budget matters during each congressional session.” In other words, even if Congress adopts the two potential reconciliations this year, the process to turn them into law isn’t over yet.

Otto von Bismarck was right when he said, “Laws are like sausages. It’s better not to see them being made.”

CALENDARS

US. Wed: Existing Home Sales 5.75mu, MBA Mortgage Applications, Powell, FOMC Minutes. **Thurs:** Jobless Claims 244k, FHFA House Price Index 0.4%, Kansas City Fed Manufacturing Index, Chicago Fed National Activity Index, Weekly Consumer Comfort Index, EIA Petroleum Status Report. (Bloomberg estimates)

Global. Wed: Eurozone Headline & Core CPI 1.8%/0.9% y/y, Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 109.6/116.7/103.0, UK GDP 0.6%q/q/2.2%y/y. **Thurs:** Germany GDP 0.4%q/q/1.7%y/y, Germany GfK Consumer Confidence 10.1. (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—rose for the eighth week during the week of February 11 to another new record high, up 0.2% w/w and 6.6% over the period. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg’s Weekly Consumer Comfort Index (WCCI). Our BBB was little changed after climbing six of the prior seven weeks by 10.5% to a new record high. Jobless claims edged up to 245,250 (4-wa) after dropping to 244,750 (4-wa)—the lowest reading since 1973. The CRB raw industrials spot price index—another BBB component—is stalled around recent highs; meanwhile, the WCCI has rebounded 6.4% the past three weeks after falling three of the prior four weeks by 3.2%.

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose last week for LargeCap and was at a record high for MidCap. LargeCap’s is 0.3% below its late January record high, and SmallCap’s is down 0.1% from its prior-week record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap’s forward earnings was steady at a 28-month high of 7.6% y/y, which compares to a six-year low of -1.8% in October 2015; MidCap’s jumped to a 25-month high of 8.8% from 8.1%, which compares to a six-year low of -1.3% in December 2015; and SmallCap’s jumped to a 29-month high of 11.9% from 11.4%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax rate changes: LargeCap 10.9% and 12.1%, MidCap 11.5% and 12.7%, and SmallCap 15.0% and 17.1%.

S&P 500/400/600 Forward Valuation ([link](#)): Valuations rose across the board last week, and most are at multi-year highs. P/Es are melting up and beginning to reflect the impact of lower tax rates on corporate earnings, but the ‘E’ still remains low as analysts await legislative changes to the tax rate. LargeCap’s forward P/E rose to a 13-year high of 17.6 from 17.4. That’s up from a 15-month low of 14.9 in January 2016 and the post-Lehman meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap’s forward P/E improved to a 15-year high of 19.2

from 19.1; that compares to a three-year low of 15.0 in January 2016 and a record high of 20.6 in January 2002. SmallCap's improved to 19.9 from 19.8; that's up from a three-year low of 15.5 in February 2016, and compares to a record high of 20.9 in April 2002 and a 15-year high of 20.5 in early December when Energy's earnings were depressed. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.91 and MidCap's 1.37 are at record highs, while SmallCap's 1.07 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Q1 earnings estimate revision activity remained robust last week for the S&P 500 sectors as more companies reported Q4 earnings. The Q1 consensus was steady w/w for two of the 11 S&P 500 sectors and fell for nine. Q1 forecasts were unchanged for Telecom and Utilities. Sectors with the biggest w/w percentage declines in their Q1 forecasts: Real Estate (-0.9%), Consumer Staples (-0.7), Energy (-0.6), and Consumer Discretionary (-0.5). The S&P 500's Q1-2017 EPS forecast fell 8 cents w/w to \$29.73, and is down 2.8% from \$30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 10.7% y/y, the strongest growth since Q3-2011, with the forecast down from 10.8% a week earlier and 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are unchanged for 1/11 sectors and lower for 10/11. The Q1 forecast for Energy is unchanged, followed by a slight decreases for Financials (-0.5%) and Consumer Discretionary (-0.6). Industrials is down the most (-6.4), followed by Materials (-5.1), Consumer Staples (-2.5), and Health Care (-2.0). The S&P 500's Q1-2017 forecasted earnings gain of 10.7% y/y would be its third straight gain after four declines and the highest since Q3-2011. All 11 sectors are expected to record positive y/y earnings growth in Q1-2017, and four are expected to beat the S&P 500's y/y earnings gain of 10.7%. Analysts expect Energy to report a profit relative to a year-ago loss and no longer think Industrials and Telecom will record y/y earnings declines as they had expected three weeks ago. That's an improvement from the 8/11 sectors rising y/y in Q4-2016, and compares to 9/11 rising in Q3 and 6/10 rising during the quarters from Q4-2015 to Q2-2016. The latest forecasted Q1-2017 earnings growth rates vs. their blended Q4-2016 growth rates: Energy (returning to a profit in Q1 from a year-ago loss vs. -0.8% in Q4), Financials (15.5% vs. 11.6%), Materials (13.1 vs. 7.9), Tech (13.2, 12.1), S&P 500 (10.7, 7.5), Consumer Staples (4.0, 7.0), Industrials (4.0, -1.0), Health Care (3.4, 7.1), Telecom (2.4, -1.5), Utilities (1.6, 11.4), Real Estate (1.5, 8.5), and Consumer Discretionary (1.1, 3.8).

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI improved to -2.3% in February from -2.8% in January. That compares to a 25-month high of 0.7% in October and a seven-month low of -3.1% in November. NERI was positive for 3/11 sectors and improved m/m for six (unchanged from three positive and six improving in January). Financials topped all sectors again in January, and Utilities was the highest since November 2015. Telecom fell to a 25-month low. Energy has the longest positive NERI streak of eight months, followed by Tech (7) and Financials (5). Real Estate is the worst, with 18 straight months of negative NERIs, followed by Utilities (15) and Telecom (10). Here are the sectors' February NERIs compared with their January readings, ranked in descending order: Financials (13.1% in February, down from 15.7% in January [a record high since the data series started in 1995]), Energy (7.9, 13.3 [67-month high]), Tech (2.2, 4.3), Utilities (-0.6 [15-month high], -1.1), S&P 500 (-2.3, -2.8), Industrials (-1.0, -9.1), Materials (-7.2, -5.7), Consumer Discretionary (-9.3, -11.5), Health Care (-11.4, -12.6 [95-month low]), Real Estate (-12.4, -17.0 [92-month low]), Consumer Staples (-15.0, -16.2 [21-month low]), and Telecom (-23.3, -18.6).

S&P 500 Earnings Season Monitor ([link](#)): With 82% of S&P 500 companies finished reporting Q4-2016 results, their revenue and earnings surprise metrics are mostly weaker than at the comparable point of the Q3 season. On a positive note, their y/y revenue and earnings growth comparisons are the highest since Q3-2014. Of the 410 companies in the S&P 500 that have reported, 70% exceeded industry analysts' earnings estimates by an average of 3.5%; they have averaged a y/y earnings gain of 10.1%. At the same point in Q3-2016, a higher percentage of companies (71%) in the S&P 500 had

beaten consensus earnings estimates by a larger 6.2%, and earnings were up a smaller 3.8% y/y. On the revenue side, 50% beat sales estimates so far, coming in 0.2% above forecast and 4.3% higher than a year earlier. During Q3, a higher 53% of companies beat forecasts and results beat by a slightly higher 0.3%, but revenues rose a lower 2.1% y/y. Q4 earnings results are higher y/y for 70% of companies versus 71% at the same point in Q3, and revenues are higher for 71% versus 68%. These figures will change marginally as the remaining 90 companies report Q4 results, but the results to date suggest that Q1-2016 was the bottom for y/y revenue growth and that Q2-2016 was the earnings growth bottom.

GLOBAL ECONOMIC INDICATORS

US PMI Flash Estimates ([link](#)): Private-sector growth slowed this month from January's 14-month high, though remained healthy. Markit's Composite Output Index slipped to 54.3 from 55.8 in January as both the M-PMI (to 54.3 from 55.0) and NM-PMI (53.9 from 55.6) slowed to two-month lows. According to the report, the weaker business activity was mainly driven by slower momentum across the service sector, as new business expansion was the weakest in five months and job growth the slowest in three months. This weakened business confidence in the sector, with respondents the least upbeat about growth since last September. As for manufacturing, the output index (55.7 from 56.7) continued to expand at a robust pace, keeping the sector on course to achieve its best quarterly performance in two years this quarter. New orders growth remained faster than at any other time since March 2015, driven by strong sales to domestic clients, helping to offset weaker foreign demand. Input cost inflation at factories was the highest since September 2014.

Eurozone PMI Flash Estimates ([link](#)): Growth in the Eurozone this month is approaching its best growth in six years, according to the flash estimate, on widespread strength. The Composite Output Index accelerated from 54.4 in January to 56.0 this month—the best reading since April 2011. Growth accelerated in both the manufacturing and service sectors, with the flash M-PMI (to 55.5 from 55.2) the highest in 70 months and the NM-PMI (55.6 from 53.7) the highest in 69 months. For the region, job creation was the best in nine and a half years, while orders growth accelerated and business optimism moved higher. Inflationary pressures continued to intensify. By country, growth accelerated in both France (56.2 from 54.1) and Germany (56.1 from 54.8), with France's Composite Output Index above Germany's for the first time since August 2012. France's acceleration this month was driven by the service sector, Germany's by the manufacturing sector. Elsewhere in the Eurozone, the rate of growth of business activity hit a 14-month high, with growth in both the manufacturing and service sectors picking up.

Japan M-PMI Flash Estimate ([link](#)): Japan's manufacturing sector grew this month at its sharpest rate in nearly three years, according to the flash estimate. The M-PMI continued to improve since bottoming at 47.7 last May, climbing to 53.5 this month—the highest reading since March 2014. Production, new orders, and hirings all accelerated this month, and backlogs of work accumulated for the first time in 14 months. Business confidence hit a survey high.

GLOBAL INFLATION INDICATORS

World CPI ([link](#)): World consumer inflation in December remained near eight-year lows. The rate ticked up to 2.6% y/y—not far from October's 2.2%—which was the lowest reading since October 2009; it's roughly a percentage point below the recent peak of 3.5% at the start of 2016. The emerging economies' inflation rate climbed to 4.1% y/y in November after sinking in October to a record low of 3.6% for the series going back to 1969; November's rate was the second lowest reading since 1970. The rate for advanced economies rose to a 28-month high of 1.5% in December after fluctuating between zero and 1.0% from December 2014 through September 2016.

US CPI ([link](#)): The core CPI rate was just above the Fed's target rate of 2.0% y/y again in January, edging up to 2.3%—matching its peak rate recorded in August and February of last year—which was the highest since May 2012. On a monthly basis, core prices rose 0.3% after increasing 0.2% in each of the prior two months; the three-month rate was 2.8% (saar), the highest since August 2011. During January, most of the major component indexes increased, with prices for apparel, new vehicles, motor vehicle insurance, and air fares all rising 0.8%; the shelter index rose 0.2%—a smaller increase than in recent months. The yearly rate for the headline CPI has been steadily rising since July, climbing 2.5% y/y in January, the fastest pace since March 2012.

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