MORNING BRIEFING
March 8, 2017

The Doors

See the collection of the individual charts linked below.

(1) An untimely death of a poet. (2) Will Trump light a fire under corporate earnings? (3) Remarkable Zen-like calm of most stock investors. (4) Low VIX and bearishness agitating contrarians. (5) Behind Door #1: Nirvana. (6) Behind Door #2: Melt-up. (7) Behind Door #3: Meltdown. (8) Lowering bullish probability a notch from 90% to 80%. (9) Inflationary pressures are blowing in the wind. (10) No sign of clear and present danger of higher wage inflation.

Strategy: Alternative Acts. "An American Prayer" is the ninth and final studio album by the Doors, a rock band founded in 1965 in Venice, California. The group's first hit single was "Light My Fire." In 1978, seven years after lead singer Jim Morrison died at the age of 25 and five years after the remaining members of the band broke up, three of them reunited and recorded backing tracks over Morrison's poetry, which was originally recorded in 1969 and 1970. Morrison penned some resonant stuff, like "There are things known and things unknown, and in between are the doors." Like Bob Dylan, who recently won a Nobel Prize in literature for his poetry, Morrison might have done the same had he lived long enough.

American investors today are praying that the new Trump administration will light the fire for corporate earnings. They clearly are betting that their prayers will be heard. While political partisans on the left and the right are shouting at one another, investors are quietly chanting an American prayer for better economic times ahead so that broadly shared prosperity might turn down the volume of acrimonious cacophony. Given the intensity of the political ferment in our country, the Zen-like calm of stock market investors is truly remarkable. There isn't much antagonistic market partisanship because there are only a few bears, and they aren't growling as much at the bulls as they did during most of the bull market.

The S&P 500 VIX is downright serene, with readings below 15 since Election Day when it was 18.74 (*Fig. 1*). The VIX is highly correlated with the yield spread between corporate high-yield and US Treasury 10-year bonds (*Fig. 2*). This spread was down to 313bps last Thursday, the lowest reading since August 26, 2014. The VIX is also highly correlated with the weekly percentage-of-bears series compiled by Investors Intelligence (*Fig. 3*). The latter fell from a recent high of 25.7% during the week of November 8 to 16.5% at the end of February, the lowest bearish sentiment reading since July 2015. Meanwhile, the percentage of bulls rose from 42.9% to 63.1%—the most bears since 1987—over the same period, boosting the Bull-Bear Ratio from 1.67 to 3.82, the highest since April 2015 (*Fig. 4*).

To contrarians, all this quiet serenity sounds like a blaring sell signal. However, as Debbie and I have noted before, the Bull-Bear Ratio works better as a contrary buy signal when it is at 1.0 or less than as a contrary sell signal when it is 3.0 or more (*Fig. 5* and *Fig. 6*).

Joe and I aren't poets. We know it. However, we can be inspired by poets, or game shows. As we observed yesterday, we believe that investors have to pick among three doors:

(1) *Door #1: Nirvana.* Behind this door is a stock market that continues to move up led by higher earnings, which may or may not get a meaningful boost from a cut in the corporate tax rate. Our bet is

that it will be significant. However, while investors may be pricing that into stock prices, they might not be disappointed much if it doesn't happen. That's because they may also be upbeat about the prospects of a very pro-business administration that is already reducing the cost of government regulations on business.

Investors may also be giving more weight to the possibility that the economic expansion may have much longer to run. Debbie and I have previously observed that the average performance of the Index of Coincident Indicators pinpoints the next recession to start during March 2019 (*Fig. 7*). Obviously, the prospect of a gradual normalization of monetary policy, including three rate hikes, hasn't spooked investors at all. The yield curve tends to invert prior to recessions (*Fig. 8*). Since Election Day, it has steepened.

(2) *Door #2: Melt-up.* Behind this door is a stock market melt-up. It is fueled by money pouring into passive equity funds by retail investors, who appear suddenly to have decided that stocks are worth owning for the long run—even though they should have done so a few years ago when stocks were much cheaper. As Melissa and I discussed yesterday, they may be more focused on finding index funds with low fees than investing in cheap stocks.

The melt-up already may have started on expectations that Trump's tax reform will significantly cut taxes for both corporations and individuals. If he delivers, the initial result could be a deluge of $1 trillion to $2 trillion of repatriated earnings that will boost stock buybacks, dividend payouts, and even economic growth. Amazingly, productivity makes a big comeback as US corporations ramp up the automation of their US facilities with robotics and artificial intelligence to comply with Trump's "America First" campaign. Yet the jobless rate remains low in the US, and pay does improve.

(3) *Door #3: Meltdown.* The bull market continues in the scenarios behind Doors #1 and #2; of course, there can be corrections, with the S&P 500 falling 10%-20%. Behind Door #3 is a bear market, with the S&P 500 losing at least 20%. It could turn into a meltdown, especially if it follows Door #2's melt-up. Investors may be very disappointed with the economic plan eventually passed by Congress. Or they might get what they hoped for, but conclude that selling on the news is the smart thing to do, since actually implementing the program could be difficult and could have unintended consequences.

So which door will it be? Yesterday, Joe and I changed our odds from 60/30/10% for Doors #1, #2, and # 3 to 40/40/20%. In our opinion, if the risk of a melt-up is increasing, so is the risk of a meltdown. Nevertheless, the bullish outlook gets an 80% probability from us, down a bit from 90%. After, all the bull market has just turned eight years old. The animal variety can live between 5 and 15 years.

US Economy: Inflation Blowing in the Wind? What about inflation? What is it likely to be doing behind the three doors? To paraphrase Bob Dylan, the answer may be blowing in the wind. There are some whiffs of it, but they smell like gasoline. That's because headline inflation rates around the world have been boosted by the rebound in oil prices since early last year. Let's have a closer look:

(1) Among the G7 industrial economies, the CPI inflation rate has rebounded from a recent low of zero during September 2015 to 2.0% y/y during January (*Fig. 9*). The core CPI has continued to hover around 1.5% since the second half of 2011.

(2) The core PCED inflation rate in the US was 1.7% during January (*Fig. 10*). In the Eurozone, the headline CPI inflation rate soared from zero to 2.0% over the past nine months through February (*Fig. 11*). The region's core rate continued to hover around 1.0%, where it has been since the second half of 2013.

(3) The price indexes in both the M-PMI and NM-PMI surveys in the US have rebounded since the middle of last year through January (*Fig. 12*). However, these indexes tend to bounce around with the price of oil rather than to provide a useful insight into broad-based inflationary pressures.

(4) Inflationary pressures might build if Trump's economic plans stimulate an economy that is arguably at full employment. So we would see these pressures first in the labor market. In this scenario, the Fed might be forced to raise interest rates more aggressively. A stock market melt-up might proceed initially on signs of better economic growth and rising wages. It might then take a dive if the Fed tightens to the point of inverting the yield curve. There is no reason to believe that this is a clear and present danger since wage inflation remains remarkably subdued, and may remain so if automation, robotics, and artificial intelligence continue to displace workers.

CALENDARS

US. Wed: ADP Employment 183k, Productivity & Unit Labor Costs 1.4%/1.6%, MBA Mortgage Applications, Wholesale Trade Inventories. **Thurs:** Jobless Claims 238k, Import & Export Prices 0.2%/0.2%, Weekly Consumer Comfort Index, Challenger Job-Cut Report. (Bloomberg estimates)

Global. Wed: Germany Industrial Production 2.6%m/m/-0.6%y/y, China Foreign Direct Investment -4.2% y/y, China Trade Balance $27.5b, Japan Coincident & Leading Indicators 105.4/114.3. **Thurs:** Germany Industrial Production, China CPI & PPI 1.8%/7.5% y/y, OECD Economic Outlook, ECB Rate Decision 0.00%, Marginal Lending Facility & Deposit Facility Rate 0.25%/-0.40%, ECB Asset Target (euros) 80b. (DailyFX estimates)

US ECONOMIC INDICATORS

US Trade (*link*): The real merchandise trade deficit in January widened to $65.3 billion—the largest since March 2015—suggesting that trade once again will be a drag on GDP growth this quarter. December's deficit had narrowed to $62.0 billion after widening the prior two months from $54.4 billion in September to $63.9 billion in November. January's trade gap of $65.3 billion is considerably above the average monthly deficit of $62.2 billion during Q4 and $56.8 billion during Q3. In January, real exports (0.4%) rose at a considerably slower pace than imports (2.1)—which posted its biggest monthly gain in nearly a year. Real exports of autos (10.4), industrial supplies (5.8), food (5.1) and consumer goods ex autos (1.4) all rose, while capital goods exports ex autos (-4.2) was the sole loser. Real imports also saw broad-based gains with consumer goods ex autos (5.1), autos (3.4), food (1.8), and capital goods ex autos (1.3) rising and only industrial supply (-1.1) imports falling.

GLOBAL ECONOMIC INDICATORS

Eurozone GDP (*link*): Real GDP in the Eurozone expanded 1.6% (saar) during Q4, similar to Q3's gain, led by a 2.3% acceleration in domestic demand—a four-quarter high. Trade was a negative as exports (6.1%, saar) grew at a slower pace than imports (8.0%). The increase in real domestic demand was driven by an acceleration in both household (to 1.8% from 1.3%, saar) and gross fixed capital formation (2.3 from -2.7); real government spending (1.8 from 0.5) was also stronger than during Q3. Of the four largest economies, real GDP growth in Spain (2.8%, saar) once again led the back, while gains in Germany (1.7) and France (1.7) were identical, and Italy's (0.7) dropped back below 1.0%.

Germany Manufacturing Orders (*link*): German factory orders in January contracted at the fastest pace in eight years, after soaring to a new cyclical high at the end of last year. Billings tumbled 7.4%—the most since January 2009—after jumping 5.3% in December. Both domestic (-10.5%) and foreign (-4.9) orders plunged, the former's at the steepest pace since June 2011. The drop in domestic orders was led by a record 16.8% dive in investment goods billings; intermediate (-3.9) and consumer (-2.4) goods orders were smaller contributors to the decline. As for foreign orders, those from within the Eurozone sank 7.8% after climbing 9.1% during the final three months of 2016; orders from outside the Eurozone dropped 2.9% after declines of 0.1% and 5.2% the prior two months. An 11.0% plunge in billings for investment goods drove January's decline from within the Eurozone; intermediate goods orders (-4.8) also fell, while consumer goods orders (2.2) rose. The decline in orders from outside the Eurozone was widespread, with consumer (-4.8), intermediate (-3.3), and investment (-2.5) goods orders all in the red. Following the weaker-than-expected January report, the economy ministry released a statement saying, "The weak start to the year should be manageable. Business confidence in manufacturing is significantly brighter than the long-term average, so that a revival in manufacturing can be expected."

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