MORNING BRIEFING
April 5, 2017

Across the Pond

See the collection of the individual charts linked below.

(1) Worrying about US C&I loans in London. (2) Two significant soft patches in US economy. (3) Toxic fumes from subprime auto loans. (4) Used car prices falling, and so are new car sales. (5) M-PMI is soft data, but it's upbeat. (6) Fed officials mostly predict two more rate hikes this year, with a couple seeing three. (7) One-and-done may be back on the table for 2017. (8) Fixed-income markets aren't buying Fed's hawkish talk.

US Economy: Back to New Normal Already? Greetings from London again. During my meetings over here on Monday and Tuesday, I was surprised by how many times I was asked to explain why commercial and industrial (C&I) loans held by US banks have stopped growing. In addition, there were some questions about the weakness in March auto sales, which were reported on Monday.

Investors on this side of the pond are troubled that there is almost no evidence that the so-called hard economic data are confirming the remarkable strength since Election Day in the soft data that are based on surveys of consumers, purchasing managers, CEOs, small business owners, and regional business surveys, which we continue to track in our *Animal Spirits* chart publication. Actually, the hard data remain surprisingly soft. The FRB-Atlanta's GDPNow is tracking at only 1.2% (saar) for Q1-2017.

At the end of last year, on December 12, Debbie and I raised our real GDP growth estimate for 2017 from 2.5% to 3.0%. We are sticking with that forecast, for now, but note that the economy has a couple of significant soft patches currently. Consider the following:

(1) *Autos spewing toxic fumes.* Last Thursday, Jackie and I reiterated our concerns about the stress in auto financing, especially in the subprime segment, since used car prices have declined 5.1% over the past 21 months through February (*Fig. 1*). We noted that auto loans outstanding increased 6.9% y/y through Q4-2016 to a record $1.1 trillion (*Fig. 2*).

A combination of rising delinquencies and falling used car prices is a toxic mix for auto sales. All this has been widely recognized for a while. However, investors were jarred to see auto sales drop from 17.6 million units (saar) during February to 16.6 million last month, down from a cyclical peak of 18.4 million units during December and the lowest since February 2015 (*Fig. 3*). The domestic auto inventories-to-sales ratio rose to 3.2 months' supply during February, the highest since June 2009 (*Fig. 4*).

The S&P 500 Automobile Manufacturing stock price index (F, GM) lost 2.7% on Monday and Tuesday, with its 200-day moving average remaining on a modest downward trend since 2014 (*Fig. 5*).

Auto manufacturing employed 941,600 workers during February, up from a cyclical low of 623,300 during June 2009. Auto dealers employed 1.3 million workers during February, up from a cyclical low of 998,800 during November 2009. Both could suffer losses if auto sales continue to weaken.

The good news is that the national M-PMI remained high at 57.2 last month, with the employment component at 58.9, the highest since June 2011 (*Fig. 6*). Also remaining elevated were the new orders

(64.5) and production (57.6) components. We reckon that the auto industry isn't rushing to reduce employment and will provide financing incentives to reduce bloated inventories. We also believe that energy-related capital spending should rebound from the oil industry's recession that lasted from the summer of 2014 through the winter of 2016.

(2) *Department stores liquidating inventories and employees.* Also, last Thursday, Jackie and I discussed how Amazon is seriously disrupting (if not outright destroying) in-store retailers who are struggling to compete with the online juggernaut. As we noted, during February, 15.9 million people worked in retailing, while 12.4 million worked in manufacturing. Trump might succeed in bringing back some jobs to robots in American factories.

Meanwhile, lots of humans working in retailing might lose their jobs. Payroll employment in retail stores rose 27,000 over the past 12 months through February (*Fig. 7*). The seasonally adjusted data are volatile, but February payrolls did drop 33,800 during February following a 26,400 gain during January.

Meanwhile, inventories at general merchandise stores are down 3.1% over the past 16 months through January (*Fig. 8*). This might partly explain why short-term business credit—which is the sum of C&I loans at commercial banks plus nonfinancial commercial paper—has stalled in recent weeks (*Fig. 9*). It tends to fluctuate around the trend in total business inventories. On a y/y basis, it is up just $55 billion, the weakest since April 2011 (*Fig. 10*).

Stores that are being closed are liquidating their inventories and generating cash to pay down outstanding short-term business credit. They certainly aren't ordering more merchandise. Apparently, the Census Bureau doesn't publish data on the inventories of online retailers, though Debbie is still working on tracking it down. It stands to reason that Amazon must be increasing its merchandise inventories. The company may be financing those stocks with the cash flow it generates from its enormously profitable cloud services. Are we worried about all these developments? No, but they have our undivided attention.

The Fed: One-&-Done Again? Melissa and I have noted that the majority of FOMC participants agree that barring any unexpected developments, they intend to raise the federal funds rate by 25bps two more times this year. It was one-and-done in 2015, when the Fed raised the rate from 0%-0.25% to 0.25%-0.50% on December 16. At that same meeting, the FOMC signaled in their dot plot that they expected four rate hikes in 2016. It turned out to be one-and-done again at the end of last year on December 14, when the rate was raised to 0.50%-0.75% and the dot plot projected three rate hikes this year.

Sure enough, the FOMC hiked the rate to 0.75%-1.00% on March 15. Most Fed officials have reiterated that two more rate hikes are coming this year, though a couple said that perhaps there might be four rather than three hikes all told in 2017. These hawks seem to be concerned about the post-election melt-up in stock prices.

Melissa and I still expect two more rate hikes this year, but we are losing our conviction based on our concerns, mentioned above, about auto sales and store closings. In other words, we are putting one-and-done back on the table as a possible scenario. The federal funds future market is also relatively dovish, with the fed funds rate projected to be 1.31% within 12 months (*Fig. 11*). Meanwhile, the 10-year US Treasury bond yield has dropped from a recent high of 2.62% on March 13 to 2.36% yesterday. Over this same period, the yield curve spread between 10-year and 2-year Treasuries has narrowed from 122bps to 111bps (*Fig. 12*).

CALENDARS

US. Wed: ADP Employment 170k, ISM NM-PMI 57.0, MBA Mortgage Applications, EIA Petroleum Status, FOMC Minutes. **Thurs:** Jobless Claims 250k, Challenger Job-Cut Report, Weekly Consumer Comfort Index, EIA Natural Gas Report. (Bloomberg estimates)

Global. Wed: Eurozone, Germany, France, and Italy Composite PMIs 56.7/57.0/57.6/54.7, Eurozone, Germany, France, and Italy NM-PMIs 56.5/55.6/58.5/54.3, UK Composite & NM-PMIs 53.8/53.5, Japan NM-PMI. **Thurs:** Germany Factory Orders 3.5%m/m/3.6%y/y, China Composite & NM-PMIs, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q1 Earnings Season Monitor (*link*): With 3% of S&P 500 companies finished reporting Q1-2017 results, their revenue and earnings surprise metrics are mixed, but y/y growth comparisons are stronger than at the comparable point of the Q4 season. Of the 17 companies in the S&P 500 that have reported, 77% exceeded industry analysts' earnings estimates by an average of 5.4%; they have averaged a y/y earnings gain of 22.0%. At the same point during the Q4-2016 reporting period, a lower percentage of companies (69%) in the S&P 500 had beaten consensus earnings estimates by a larger 5.8%, and earnings were up a lower 13.4% y/y. On the revenue side, 47% beat sales estimates so far, with results coming in as forecasted and 7.3% higher than a year earlier. At this point in the Q4 season, a lower 35% had exceeded forecasts, reporters missed estimates by 0.8%, and sales rose only 3.1% y/y. Q1 earnings results are higher for 65% of companies vs 83% at the same point in Q4, and revenues are higher for 88% vs 83%. Although these figures will change markedly as more Q1-2017 results are reported in the coming weeks, the early results are encouraging. Q1-2017 should mark the third straight quarter of positive y/y earnings growth and the first double-digit percentage growth quarter since Q3-2011, but growth is likely to fall back into the single digits for the rest of 2017.

US ECONOMIC INDICATORS

US Trade (*link*): The real merchandise trade deficit in February narrowed sharply after widening dramatically in January, suggesting that trade will likely have little impact on Q1 real GDP, rather than be a big drag as first thought. The real merchandise trade gap was -$59.7 billion, down from January's -$65.1 billion, which was the largest deficit since March 2015. The January/February average deficit was -$62.4 billion, in line with the average monthly deficit of -$62.2 billion during the final quarter of 2016. In February, real exports edged up 0.3% (to a new record high), while real imports tumbled 2.6% (from its record high). Real exports rose for the third straight month, for a total gain of 4.3%, most of which occurred at the end of last year. During February, increases in exports for consumer goods ex autos (4.3%), autos (1.4), and industrial supplies (1.1) more than offset declines in food (-7.4) and capital goods ex autos exports. The decline in real imports was driven by sharp losses in autos (-8.4) and consumer goods ex autos (-6.0); food imports dipped 0.3%. These decreases were only partially offset by advances in imports of industrial supplies and capital goods ex autos of 1.3% and 0.7%, respectively.

Factory Orders (*link*): Capital spending remains on strong footing. Nondefense capital goods shipments ex aircraft (used in calculating GDP) rose for the third time in four months, jumping an impressive 1.0% last month. The comparable orders measure (a proxy for future business investment) was little changed around recent highs. These core shipments accelerated 8.5% (saar) during the three months ending February, based on the three-month average, the strongest growth rate since October 2014. (This measure had declined steadily from October 2015 through October 2016.) Real core orders expanded 9.1% (saar) over the comparable period, the best since September 2014. Headline factory orders rose for the seventh time in eight months, up 1.0% m/m and 6.6% over the period to a new cyclical high. The yearly growth rate accelerated 7.3%, the best since July 2014. In February, billings for transportation orders jumped 4.4%, reflecting a 47.5% surge in civilian aircraft orders. Excluding transportation, orders rose for the seventh month, up 0.4% in February and 5.6% over the period.

Auto Sales (*link*): Motor vehicle sales softened in the early months of 2017 after ending 2016 at a new cyclical high. March sales dropped to 16.6mu (saar)—the lowest since February 2015—from 18.4mu in December. The decline has been widespread, though domestic light truck sales remained robust at 8.6mu (saar) after reaching a cyclical high of 9.3mu in December. Domestic cars sales continue to contract, sinking to more than a five-year low of 4.6mu (saar) last month, while imported sales sank to a nine-month low of 3.4mu (saar) from a cyclical high of 3.9mu in December.

GLOBAL ECONOMIC INDICATORS

Eurozone Retail Sales (*link*): Eurozone retail sales in February rose 0.7% to a new record high, following an upwardly revised 0.1% gain in January—first reported as a 0.1% loss. The increases during the first two months of this year more than reversed the 0.5% declines during the final two months of last year. February's advance was led by gains in sales of nonfood products—excluding fuel (0.9%) and food, drinks & tobacco (0.7), which more than offset a 0.9% decline in automotive fuel. Among member states for which data are available, the Big Two—Germany (1.8%) and France (0.7)—posted solid gains, joined by Portugal (3.1), Slovenia (2.3), Luxembourg (1.7), and Ireland (1.2). The biggest sales losses occurred in Malta (-0.8) and Belgium (-0.6).

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