MORNING BRIEFING
April 19, 2017

Go With the Flows

See the collection of the individual charts linked below.

(1) Fed provides lots of data about capital market flows. (2) Looking at US-based equity mutual funds and ETFs that invest in the US or around the world, we see big inflows to domestic ETFs since election. (3) World equity mutual funds and ETFs (based in US) were less popular last year. (4) Production is yet another weak indicator in auto industry's soft patch. (5) Truck freight and sales stalled. (6) Economic Surprise Index is down. (7) Washington may have to respond sooner with fiscal stimulus, while the Fed can wait on next rate hike. (8) Chinese economy remains too dependent on government and debt.

Strategy: Homeward-Bound ETFs. The Fed publishes the *Financial Accounts of the United States* on a quarterly basis. This excellent compilation was updated through Q4-2016 on March 9. It is an overwhelming amount of data about the flows and levels of assets and liabilities in the US capital markets. Debbie and I are always coming across something either new or that we had overlooked before. We recently sorted out the data available for US-based equity mutual funds and ETFs. We were especially pleased to find that data are available for both by "investment objective" under the following categories: domestic equity funds, world equity funds, hybrid funds, taxable bond funds, and municipal bond funds. They appear in Table F.122 in the Fed's publication for mutual funds and F.124 for ETFs.

As is our nature, we posted them all in a new chart publication titled *Mutual Funds & ETFs By Investment Objective*. Let's focus on equity funds that invest in US stocks only and those that invest around the world, using four-quarter sums to smooth out the quarterly volatility:

(1) *Domestic funds.* On a combined basis, domestic equity mutual funds and ETFs contributed to the previous bull market with sizable net inflows, particularly during late 2003 through 2005 (*Fig. 1*). Net inflows dried up from 2008 through early 2011. Then there was some significant selling during the second half of 2011 and in 2012 before buyers came back in 2013 and 2014. Despite some selling at the beginning of last year, there was a tiny inflow of $8 billion into domestic funds last year.

Focusing on domestic equity mutual funds, we see that the bear market of 2000 slowed net inflows, but they remained mostly positive right through the next bull market that started in 2003, with a brief period of minor net outflows during late 2002 and early 2003 when corporate accounting scandals might have scared off some retail investors. They turned into consistent sellers during the bear market that started in late 2007 and never really came back: Outflows continued unabated; in fact, only seven of the past 38 quarters have had net inflows based on four-quarter sums for US mutual funds investing at home.

On the other hand, domestic equity ETFs never experienced any net outflows on this basis since the start of the data during Q4-2002. The trend has been mostly upward for these net inflows, with a record high of $167.5 billion last year. The actual Q4-2016 net inflow was a whopping $413.0 billion (saar). This may very well have reflected the animal spirits unleashed by Trump's election, though it certainly didn't show up in domestic mutual funds, which had record net outflows totaling $159.5 billion last year, with the actual Q4-2016 outflow at $174.1 billion (saar).

(2) *World funds.* Since the start of the four-quarter-sum data during Q4-2002, net inflows into US mutual funds and ETFs that invest globally have been negative during only five quarters (*Fig. 2*). During the bull market from Q4-2002 through Q3-2007, they attracted $607 billion in net inflows, while domestic funds (mutual and exchange-traded) had net inflows of $476 billion. So far, during the current bull market since Q1-2009 through Q4-2016, world equity funds had net inflows of $1.0 trillion, while domestic ones had $227 billion.

Both equity mutual funds and ETFs contributed to the popularity of global investing during the latest two bull markets, presumably mostly by American investors. Interestingly, they both became much less less popular last year. Among the domestic and world funds, the category that stands out as attracting a record net inflow is domestic ETFs. It's arguable that investors responded to Trump's "America First" presidential theme by jumping into US ETFs that invest only in American companies.

That could change if Trump continues to soften this theme and adopts a more centrist foreign policy. Already, the new administration's policies are looking less and less protectionist, as most recently evidenced by giving the Chinese government a pass on getting labeled as currency manipulator, while offering to ease off on trade issues if the Chinese do something about North Korea's Li'l Kim.

(3) *Monthly data.* The Fed's quarterly funds data are mostly based on the monthly series compiled by the Investment Company Institute (ICI). Because that data are also volatile, we track the 12-month sum of the net inflows, which are available for domestic versus world mutual funds based in the US (*Fig. 3*). They show that over the past year through February, all mutual funds had a total net outflow of $161.3 billion, led by domestic mutual fund outflows of $159.8 billion, while international ones lost just $1.5 billion.

What about ETFs? Understanding the monthly flows into domestic versus world ETFs is a bit more complicated because ICI only provides net issuance of shares by all US-based ETFs, combining those that invest in equities and bonds. The former continue to attract most of the inflows. The share issuance data show US ETFs raising a record $368.0 billion over the past 12 months through February, led by $227.5 billion going into domestic ETFs, followed by $53.1 billion into international ETFs (*Fig. 4*).

US Economy: Driving in the Slow Lane. Following the latest reports on housing starts (down 6.8% m/m during March) and manufacturing output (down 0.4% last month), the Atlanta Fed's GDPNow model showed an increase of just 0.5% (saar) in Q1's real GDP. As we noted yesterday, the auto industry is a major soft patch in the economy. Sure enough, auto output fell 3.6% during March (*Fig. 5*). Auto assemblies are down 7.3% over the past five months to 11.1 million units (saar) from last year's peak of 12.0mu. The weather can be blamed for the drop in housing starts, but not for the weakness in auto sales and production.

There are other soft patches in the economy. For example, the ATA Truck Tonnage Index dipped 1.0% m/m in March, and is up by only 0.7% y/y. In other words, it has stalled at a record high over the past year (*Fig. 6*). Sales of medium-weight and heavy trucks dropped 8.0% m/m in March and 19.0% y/y (*Fig. 7*).

So it comes as no surprise that the Citigroup Economic Surprise Index (CESI) has plunged from a recent high of 57.9 on March 15 to 6.6 on Tuesday (*Fig. 8*). These developments are likely to put pressure on the Fed to hold off on another rate hike for now, and on the Trump administration to move forward with its fiscal stimulus agenda. Treasury Security Steve Mnuchin said on Monday that tax reform might not happen until after the summer. We think the weakness in the economy will prompt a faster response by Washington.

By the way, there is a reasonably good fit between the CESI and the 13-week change in the US Treasury 10-year bond yield (*Fig. 9* and *Fig. 10*). The actual yield has dropped from a recent peak of 2.62% on March 13 to 2.17% yesterday. It seems to be heading toward the bottom end of our predicted trading range of 2.00%-2.50% for the first half of this year.

China: Command Economy. China's recently released output figures suggest that China's economy is back operating with full steam ahead. However, the Chinese government is using the same old growth engine that seems to require increasing injections of high-octane debt to keep cruising along. China's leaders have said that they are aiming to downshift the government's role in the economy. They've said they would like to see consumer spending driving their economy more than government infrastructure projects and state-owned enterprises (SOEs) that export manufactured goods.

They just can't figure out how to make this transition. So the government continues to do more of the same. That means more infrastructure spending to keep workers busy and more debt to prop up the SOEs. Consider the following:

(1) *Growth chugging along*. China's preliminary GDP increased at a healthy clip of 6.9% y/y during Q1, according to a recent press release from China's National Bureau of Statistics (NBS) (*Fig. 11*). It was China's strongest economic performance since Q3-2015. The government has set a target of around 6.5% for growth this year, an NBS spokesperson told reporters on Monday according to the 4/17 *WSJ*.

(2) *Speeding down the rails*. The Chinese government claims that the sharp rebound in the y/y PPI inflation rate from a recent low of -5.9% to 7.6% during March proves that efforts to reduce excess capacity among SOEs have succeeded. More likely is that renewed stimulus measures have done the trick. There is a reasonably good correlation between the PPI inflation rate and the growth in railway freight traffic. The latter soared 19.4% y/y during February (*Fig. 12*).

(3) *Three categories of growth.* In the GDP press release, the NBS breaks out China's output into three categories: primary (includes farming, forestry, fishing), secondary (includes manufacturing), and tertiary (includes services). China's tertiary industry (i.e., the "new" economy) grew the fastest at 7.7% y/y and contributed to more than half of China's GDP for Q1. However, the primary and secondary industries (i.e., the "old" economy) continue to make up the balance of China's GDP, with the secondary (including manufacturing) industry rising 6.4% y/y.

(4) *Manufacturing going strong*. China's Q1 figures show that "industry" (which includes manufacturing) continues to compose 34.3% of China's GDP, the largest of the industry sub-group breakdown. It grew at a rate of 6.5% y/y during Q1. Wholesale and retail trades rose 7.4% y/y, contributing to 9.8% of China's overall GDP. Growth rates for technology, business services, and real estate were especially high compared to the overall growth rate, but those sectors individually contributed to less than 7.0% of GDP. However, "other" services grew 6.9% and did contribute to 16.8% of GDP.

(5) *SOEs leading investment.* China's private-sector investment increased 7.7% y/y during Q1. For the same time period, investment from SOEs grew at nearly double that rate, reported the *WSJ* based on NBS data. China's government-led growth might be even larger than reported. Public-policy think-tank American Enterprise Institute explained in a note last year that China's NBS definition of private may include some firms that are neither wholly state- or private-funded, but a mix of both.

(6) *Debt-fueled growth*. China's debt-fueled boom is a big concern for China's officials, as discussed in a 3/22 *FT* article. The aforementioned *WSJ* article adds some detail: "Total debt is now at an estimated 277% of the economy, up from 125% at the end of 2008. Credit continues to expand significantly faster than economic growth despite Beijing's bid to address growing economic risk." Evidence of China's

further inflating credit bubble is China social financing, a broad credit and liquidity measure. It is up $2.7 trillion over the past 12 months through March, led by a $1.8 trillion increase in bank loans (*Fig. 13* and *Fig. 14*).

(7) *Twice the size of NYC.* According to the *WSJ* article cited above, China's property industry contributes to around one-quarter of GDP when related industries like construction are taken into account. Apparently, government officials have no shortage of long-term projects to help avoid slower growth or a meltdown. For example, on April 1, the Chinese government announced its plans to build a new city that would be more than double the square mileage of New York City. Since the announcement, real estate investors have rushed in to purchase local properties there, pushing up prices.

CALENDARS

US. Wed: MBA Mortgage Applications, EIA Petroleum Status, Beige Book. **Thurs:** Jobless Claims 242k, Leading Indicators 0.2%, Philadelphia Fed Manufacturing Index 25.5, Weekly Consumer Comfort Index, EIA Natural Gas Report, Powell. (Bloomberg estimates)

Global. Wed: Eurozone Headline & Core CPI 1.5%/0.7% y/y, Japan Merchandise Trade Balance (yen) 605.6b. **Thurs:** Carney. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week to record highs for LargeCap and MidCap. SmallCap's rose too, but remains 0.5% below its early February 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 rose to a 63-month high of 9.2% y/y from 8.8%, which compares to a six-year low of -1.8% in October 2015; MidCap's edged up to 11.1% from 11.0%, which compares to a 30-month high of 11.5% in late March and a six-year low of -1.3% in December 2015; and SmallCap's rose to 12.2% from 12.1%, which compares to a 34-month high of 12.8% in mid-March and 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 11.2% and 11.8%, MidCap 10.2% and 13.2%, and SmallCap 9.1% and 20.2%.

S&P 500/400/600 Forward Valuation (*link*): Valuations fell across the board last week, and remain slightly below multi-year highs in early March. P/Es had been melting up recently 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 fell down to an 11-week low of 17.2 from 17.4, but remains near the 13-year high of 17.8 in early March. 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 dropped to a 22-week low of 18.0 from 18.3; that compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's fell to a 22-week low of 19.1 from 19.4; that's up from a three-year low of 15.5 in February 2016 and compares to a 15-year high of 20.5 in early December, when Energy's earnings were depressed, and a record high of 20.9 in April 2002. 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 1.90 and MidCap's 1.28 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 0.99 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 revisions activity tilted to the downside last week as analysts made last minute adjustments ahead of the earnings season. The Q1 consensus rose w/w for two of the 11 S&P 500 sectors, was steady for three, and fell for six. Industrials' rose 0.5% w/w, and Consumer Discretionary's gained 0.1%. These three sectors had the biggest w/w percentage declines in their Q1 forecasts: Real Estate (-0.9%), Materials (-0.7), and Utilities (-0.6). The S&P 500's Q1-2017 EPS forecast fell 4 cents w/w to $29.40, and is down 3.9% from $30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 10.4% y/y, the strongest growth since Q3-2011, with the forecast up from 10.1% a week earlier and down from 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are lower for all 11 sectors. The Q1 forecast for Real Estate has edged down only 0.9% and Tech is down just 1.1%. Energy is down 8.3% for the worst decline, followed by Industrials (7.5%), Consumer Discretionary (-5.8), Consumer Staples (-5.1), and Materials (-4.2). The S&P 500's Q1-2017 forecasted earnings gain of 10.4% y/y would be its third straight gain after four declines and the highest since Q3-2011. Eight of the 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 10.1%. That's below the 9/11 sectors that rose y/y during Q4-2016 and Q3-2016, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. 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 at the end of January. 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. 5.3% in Q4), Financials (17.7% vs. 11.6%), Materials (14.6, 7.1), Tech (14.7, 12.7), S&P 500 (10.4, 8.0), Health Care (2.7, 7.2), Consumer Staples (2.5, 7.2), Real Estate (1.7, 8.7), Utilities (0.3, 10.1), Consumer Discretionary (-1.8, 5.3),Telecom (-3.6, -0.2), and Industrials (-5.3, -0.9).

US ECONOMIC INDICATORS

Industrial Production (*link*): A record 8.6% surge in utilities output in March boosted headline production by 0.5%, while manufacturing output suffered its first setback in seven months. Factory production contracted 0.4% after a six-month advance of 1.5% to a new cyclical high. Among the major components, only computer & electronic products (0.9%) recorded a gain last month, while auto output (-3.0) posted the biggest loss. In February, US manufacturers had produced more autos, steel, and computers. By market grouping, consumer goods production increased 1.2% last month as a gain in output of nondurable goods (2.1) more than offset a decline in durable goods (-1.7)—which was dragged lower by a 2.6% auto-related drop. Business equipment output (-0.4) suffered its first loss since last fall, driven by a 2.0% drop in transit equipment; industrial equipment output (-0.3) slipped for the first time in four months. Meanwhile, production of information processing equipment advanced for the seventh time in eight months by a total of 5.0%, nearing a new record high. Despite March's loss, factory output expanded 2.6% (saar) during Q1, its best quarterly performance since June 2014.

Capacity Utilization (*link*): The headline capacity utilization rate in March climbed to 76.1% from 75.7% the prior two months. Last month's rate was 3.8ppts below its long-run (1972-2016) average. Manufacturing's capacity utilization rate, on the other hand, sank to 75.3% after climbing the prior six months from 74.7% in August to a 13-month high of 75.6% in February. March's reading was 3.1ppts below its long-run average. The capacity utilization rate for mining was 81.9%, little changed from February's 18-month high of 82.0%; the utilities rate rebounded to 75.7% from February's record low of 69.7%.

Housing Starts & Building Permits (*link*): Housing starts in March dropped more than expected, as severe winter weather depressed activity, after unseasonably warm temperatures boosted February building. Builders broke ground on 1.215mu (saar) last month, 6.8% less than February's 1.303mu. Single-family starts sank 6.2% to 821,000 units (saar) last month, while multi-family starts were 7.9% lower at 394,000; singe-family starts had jumped 7.6% in February to more than a nine-year high. Regionally, the biggest drag on activity occurred in the Midwest, where March single-family starts plummeted 35.0%—the biggest decline in three years. While starts declined last month, building permits recovered 3.6% to 1.260mu (saar) after falling 6.0% in February. Multi-family permits rebounded 13.8% to 437,000 units (saar) after sliding 21.0% in February, while single-family permits slipped 1.1% to 823,000 units—not far from February's more-than-nine-year high.

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