MORNING BRIEFING
July 31, 2017

2-2-2 Scenario

See the collection of the individual charts linked below.

(1) Time to reminisce about old times. (2) On the mark. (3) Tom Hanks and Da Vinci. (4) 666: Permutations and combinations of a devilish number. (5) More on the 2-2-2 scenario. (6) Productivity and labor force trends argue for low secular growth. (7) Shooting for 2700 on S&P 500 by mid-2018. (8) Speaking of old times: Will it soon be 1987 all over again? (9) Movie Review: "Atomic Blonde" (+).

US Economy: Symbolism. On March 12, 2009, a subcommittee of the House Financial Services Committee held a hearing on the mark-to-market (MTM) accounting rule. Rep. Paul Kanjorski, who headed the subcommittee, warned the chairman of the Financial Accounting Standards Board (FASB) that if his organization didn't suspend MTM, Congress would. At the hearing, my congressman Gary Ackerman reminded the man from FASB that Congress was considering a bill to broaden oversight of his organization. Ackerman instructed him to fix MTM: "It will be done in three weeks. Can and will." On April 2, FASB did just that. (For more, see the 3/12/09 *FT* story titled "Congress warns on mark-to-market rule," the 4/3/09 *WSJ* story titled "FASB Eases Mark-to-Market Rules," and the 6/3/09 *WSJ* article titled "Congress Helped Banks Defang Key Rule.")

Since I firmly believed that MTM had been a major contributor to the bear market in stocks—and shared that view with Ackerman at his Queens, NY office on November 25, 2008—I turned bullish four days after the hearing. On March 16, 2009, I wrote:

"We've been to Hades and back. The S&P 500 bottomed last week on March 6 at an intraday low of 666. This is a number commonly associated with the Devil. … The latest relief rally was sparked by lots of good news for a refreshing change, which I believe may have some staying power … I'm rooting for more good news, and hoping that 666 was THE low."

That very same day (March 16), the bullish news included the Fed's announcement that its QE1 bond-buying program would be expanded to $1.25 trillion in mortgage-related securities and $300 billion in Treasury bonds. On July 27, 2009, I wrote:

"I prefer melt-ups to meltdowns. The S&P 500 has been on a tear ever since it bottomed at the intraday low of 666 on Friday, March 6. We should have known immediately that this devilish number was the bear market low. It took me a few days to conclude that it probably was the low. … I felt like Tom Hanks in the 'The Da Vinci Code.'" Subsequently, when I told this story to our accounts, I said that I called the bottom in stocks more as a symbolist than as an investment strategist.

Admittedly, I've recounted this story a few times since the start of the bull market. That's what happens as I get older—I start repeating myself more often. Speaking of symbolism, my latest shtick is 2-2-2 for the US economy, with real GDP continuing to rise 2%, CPI inflation remaining around 2%, and the federal funds rate likely to top out at 2% during the current economic cycle. I'm not ready to call the next recession in 2022, but I do think it could be a while before the next downturn.

As for the S&P 500, we've already blasted through 1998, which is 666 times 3. The next objective is

2664 (666 times 4), which is my target, as a symbolist, for the middle of next year. Now let's have a closer look at 222, which is 666 divided by 3:

(1) *Real GDP at 2%.* As Debbie reviews below, real GDP rose 2.6% (saar) during Q2, up from 1.2% during Q1. On a y/y basis, real GDP growth has been remarkably steady since 2010, fluctuating around 2.0% (*Fig. 1*). It was 2.1% during Q2, following Q1's 2.0% (*Fig. 2*).

The growth of the economy during the latest expansion looks better using the real output of the nonfarm business (NFB) sector, which is essentially the same as real GDP excluding government (*Fig. 3*). It's been hovering around 3.0% since the start of the current expansion. However, it may be slowing to 2.0% as nonfarm productivity growth remains weak, while the growth of hours worked is slowing for demographic reasons.

Over the past 10 years (40 quarters through Q1), NFB productivity is up just 1.3% per year, on average (*Fig. 4*). The civilian working-age age population is up just 1.0% on average over the past 10 years (120 months), while the 16- to 64-year-old segment is up just 0.5% through June (*Fig. 5*). Over that same period, the civilian labor force is up only 0.5%, while the 16- to 64-year-old segment is barely up, with a gain of 0.2% (*Fig. 6*). The only segments of the labor force that are growing are the 55 to 64 year olds and the 65+ year olds, with more of them dropping out for retirement (*Fig. 7*).

The 10-year annualized growth trend of the US was down to 1.5% during Q2 (*Fig. 8*). The Congressional Budget Office projects that real GDP growth will remain below 2.0% through 2027, based on a lackluster outlook for productivity combined with slow population growth rates (*Fig. 9*).

(2) *CPI at 2%.* The core CPI inflation rate, excluding food and energy, has been fluctuating around 2.0% since 1999 (*Fig. 10*). The Fed tends to focus on the core PCED inflation rate, which has been mostly below 2.0% since 1997, though that's been the FOMC's target since January 2012. In June, the headline CPI was up 1.6%, while the core was up 1.7%.

(3) *Federal funds rate at 2%*. The latest economic projections table of the FOMC participants was released after the 6/14 FOMC meeting. It shows that the median forecast for the federal funds rate is 1.4% by the end of this year. That implies one more 25bps rate hike this year to 1.25%-1.50%. The projection for the end of 2018 is 2.1%, implying an additional two or three rate hikes next year. Key Fed officials have been saying that while they expect the real "neutral" interest rate to rise, it is probably close to zero right now and for the foreseeable future. It's hard to see what will make it move higher since they attribute the historically low rate to productivity and demographic factors, which don't change very rapidly. They've also signaled that the nominal rate should be 2 percentage points above the real rate. That's consistent with their forecast of 2.1% for the federal funds rate at the end of next year.

Strategy: Four-Bagger. Stock prices edged down on Friday, with the S&P 500 closing only 0.2% below the record high of 2477.83 set on Wednesday. So where do we go from here? On Thursday and Friday, there was some buzz about a bearish research note sent to clients by JPMorgan's quantitative and derivative strategist Marko Kolanovic. According to an article posted on CNBC, he is warning about a possibility of a 1987-style meltdown. His main fundamental concern seems to be that "global central banks are likely to commence reducing their balance-sheet accommodation (level for Fed, and inflows for ECB/BOJ) in the near future." He notes that all three have September meetings scheduled.

Kolanovic cited how the VIX closed below 10 every day for the past two weeks through last Wednesday, which is the "lowest level of volatility" since 1983. He is concerned if the market falls, levered investors will begin "selling into market weakness to cut losses," just like what happened in 1987.

It's a reasonable concern. Melissa and I have written that the next major selloff could be exacerbated by all the money that has been pouring into equity ETFs in recent months suddenly pouring out of them when/if something terrible occurs. We are hard-pressed to imagine what that might be. We are not convinced that a synchronized reduction in the balance sheets of the Fed/ECB/BOJ is either imminent or even likely to be the trigger for the next stock market selloff.

So, for now, the path of least resistance is still higher for stocks, especially since forward earnings continue to blaze that trail, as Joe and I have been noting since last summer. So the answer to "where do we go from here?" is probably "higher, for now." Our yearend target of 2400-2500 has been achieved way ahead of schedule. Now, as strategists, we are aiming for 2700 by the middle of next year, a four-fold increase since March 2009 (*Fig. 11*). Assuming a forward P/E of 18, we would need to see forward earnings climb to $150 per share by the middle of next year, up about 7.4% from the latest reading in late July. That's realistic, in our estimation.

Movie. "Atomic Blonde" (+) (*link*) features Charlize Theron playing a spy working for M16 British intelligence just as the Berlin Wall is coming down. The movie is intentionally campy with lots of pop hits from the late 1980s. Charlize leaves a long trail of dead bad guys as the one-woman death squad mercilessly pursues her mission impossible. This could be the beginning of a new spy thriller series. After all, James Bond must be ready for the nursing home of retired spies by now. The movie starts slow, but the pace of mayhem speeds up along the way.

CALENDARS

US. Mon: Pending Home Sales 0.9%, Dallas Fed Manufacturing Index 13.8, Chicago PMI 62.0. **Tues:** Personal Income & Spending 0.4%/0.1%, Headline & Core PCED 1.3%/1.4% y/y, ISM & Markit M-PMIs 56.4/53.2, Motor Vehicle Sales 16.8mu, Construction Spending 0.5%. (Bloomberg estimates)

Global. Mon: Eurozone Headline & Core CPI 1.3%/1.1% y/y, Eurozone Unemployment Rate 9.2%, Germany Retail Sales 0.2%m/m/2.7%y/y, China M-PMI 51.5. **Tues:** Eurozone GDP 0.6%q/q/2.1%y/y, Eurozone, Germany, France, and Italy M-PMIs 56.8/58.3/55.4/55.1, UK M-PMI 54.5, Germany Unemployment Change & Unemployment Rate -5k/5.7%, China Caixin M-PMI 50.4, RBA Rate Decision 1.50%. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index edged down less than 0.1% last week, ranking 34th of the 49 markets as 33 rose in US dollar terms—compared to 28th a week earlier, when it rose 0.6% as 34 markets moved higher. The AC World ex-US index outperformed the US MSCI for a third straight week, rising 0.2% compared to a 0.7% gain a week earlier. BRIC led all regions with a gain of 1.3%, followed by EMU (1.0%), EM Latin America (0.3), and EM Asia (0.3). EM Eastern Europe (0.0) was the week's worst-performing region, followed by EMEA (0.1), and EAFE (0.2). Austria (4.6) was the best-performing country, followed by Belgium (4.2), Norway (2.9), Colombia (2.2), Spain (2.2), and Peru (2.2). Greece (-3.5) was the worst performer, followed by Korea (-3.2), Egypt (-1.9), and Pakistan (-1.5). The US MSCI is up 10.6% ytd, with its ranking down one place w/w to 38th of the 49 markets, and continues to trail the AC World ex-US (16.1) on a ytd basis. Forty-six of the 49 markets are positive ytd, now led by Austria (42.2), Poland (39.7), Turkey (37.0), Argentina (33.3), and China (32.9). The worst country performers ytd: Russia (-13.8), Pakistan (-12.1), Jordan (-0.1), Canada (6.5), and Ireland (6.5). EM Asia is the best-performing region ytd with a gain of 27.7%, ahead of BRIC (24.1), EMU (19.5), and EM Latin America (17.3). The worst-performing regions: EM Eastern Europe (-0.8), EMEA (4.9), and EAFE (14.7).

S&P 1500/500/400/600 Performance (*link*): All three indexes fell last week as MidCap's 0.7% drop trailed those of SmallCap (-0.4%) and LargeCap (less than 0.1). Fourteen of the 33 sectors rose w/w, down from 24 rising a week earlier. At the week's end, LargeCap stood at 0.2% below its July 26 record high, MidCap was 1.7% below its July 25 high, and SmallCap was 1.3% below its July 25 peak. Energy dominated last week's best performers, but LargeCap Telecom was the winner as it soared 7.0% for its biggest weekly gain since March 2009. Also performing well were SmallCap Energy (3.3), MidCap Energy (2.0), and LargeCap Energy (1.9). Last week's worst performers: MidCap Health Care (-2.5), SmallCap Telecom (-2.1), MidCap Materials (-2.0), SmallCap Materials (-1.5), and SmallCap Industrials (-1.5). Twenty-three of the 33 sectors are positive ytd, with LargeCap (10.4) beating MidCap (6.1) and both easily ahead of SmallCap (3.2). Health Care and Tech dominate the biggest sector gainers ytd: LargeCap Tech (22.0), MidCap Health Care (19.8), SmallCap Health Care (18.8), MidCap Tech (16.0), and LargeCap Health Care (16.0). Energy and Telecom dominate the worst performers ytd: SmallCap Energy (-36.0), MidCap Telecom (-34.1), MidCap Energy (-28.7), LargeCap Energy (-11.9), and LargeCap Telecom (-8.7).

S&P 500 Sectors and Industries Performance (*link*): Six of the 11 sectors rose last week, and six outperformed the S&P 500's less than 0.1% decline. This compares to seven sectors rising a week earlier, when seven outperformed the S&P 500's 0.5% gain. Telecom was the best-performing sector for the first time in eight weeks as its 7.0% gain was ahead of these outperforming sectors: Energy (1.9%), Real Estate (0.5), Financials (0.5), Consumer Staples (0.4), and Consumer Discretionary (0.3). Health Care (-1.3) was the worst-performing sector, followed by Tech (-0.6), Industrials (-0.6), Utilities (-0.5), and Materials (-0.4). So far in 2017, nine of the 11 sectors are higher, and four have outperformed the S&P 500's 10.4% gain. The best performers in 2017 to date: Tech (22.0), Health Care (16.0), Consumer Discretionary (12.2), and Materials (10.4). The seven sectors underperforming the S&P 500 ytd: Energy (-11.9), Telecom (-8.7), Real Estate (5.9), Financials (7.0), Consumer Staples (7.1), Industrials (8.5), and Utilities (9.0).

Commodities Performance (*link*): Fourteen of the 24 commodities we follow rose last week as the S&P GSCI commodities index rose 4.2%, up from 13 commodities rising a week earlier, when the GSCI index fell 0.6%. Energy-related commodities dominated the week's best performers: Crude Oil (8.6%), Brent Crude (8.1), Heating Oil (8.0), and Unleaded Gasoline (7.3). Last week's laggards: Live Cattle (-4.2), Feeder Cattle (-4.0), Wheat (-3.7), and Kansas Wheat (-3.0). The best performers in 2017 so far: Wheat (17.9), Feeder Cattle (17.6), Lead (15.3), Kansas Wheat (14.9), and Copper (14.2). The energy-related commodities still dominate this year's laggards: Sugar (-26.3), Natural Gas (-21.0), Brent Crude (-8.1), Crude Oil (-7.5), Heating Oil (-5.1), and GasOil (-3.9).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 15/24 commodities, 3/9 global stock indexes, and 10/33 US stock indexes compared to 11/24, 3/9, and 20/33 rising a week earlier, respectively. Fifteen commodities trade above their 200-dmas, up from 11 a week earlier. Commodities' average spread improved w/w to 1.0% from -0.6%. Copper leads all commodities 10.6% above its 200-dma, followed by Wheat (9.3%), and Feeder Cattle (9.1). Crude Oil (0.1) performed the best of all commodities last week as it improved 8.1ppts. Sugar (-19.1) trades the lowest of all commodities, but Feeder Cattle tumbled 5.2ppts last week for the worst performance of all commodities and all assets. The global indexes trade at an average of 5.1% above their 200-dmas, down from 5.6% above in the prior week. Eight of the nine global indexes trade above their 200-dmas, unchanged from a week earlier. Chile (11.4) leads the global indexes and all assets, but Brazil had the best performance among its peers as it gained 1.2ppts to 3.1%. Canada (-1.4) trades the lowest relative of the global assets to their 200-dmas, but Korea (11.0) performed the worst of its country peers last week, falling 2.8ppts. The US indexes trade at an average of 2.1% above their 200-dmas, with 28 of the 33 sectors above, down from a 2.4% average a week earlier, when 25 sectors were above. LargeCap Tech now leads all US stock indexes at 11.3% above its 200-dma, followed by SmallCap Health Care (11.2), MidCap Health Care (10.3), and SmallCap Utilities (9.7). LargeCap Telecom (-1.5) improved 6.6ppts w/w, the most among the US stock indexes. MidCap Telecom trades 23.7% below its 200-dma, now the lowest among the US stock indexes and all assets; MidCap Health Care fell 3.4ppts w/w for the worst performance of the US stock indexes.

S&P 500 Technical Indicators (*link*): The S&P 500 index remained in a Golden Cross last week for a 66th week (after 17 weeks in a Death Cross). The index's 50-day moving average (50-dma) relative to its 200-dma improved for the first time in five weeks, edging up to 4.6% above its 200-dma. That's down from a 34-month high of 5.4% in early April and compares to a six-month low of 2.0% in early December and a 52-month low of -4.5% in March 2016. The S&P 500's 50-dma moved higher for a 36th week as the index closed above its 50-dma for a 14th week, after trading below for two weeks during late April for the first time since the November election. However, the S&P 500 weakened to 1.4% above its rising 50-dma from 1.8%, and is down from an 11-week high of 2.5% in early June. These readings compare to a 23-week low of -1.0% in mid-April, a 38-week high of 4.8% on December 13, and a 52-month high of 6.2% in March 2016. The S&P 500 fell to 6.1% above its rising 200-dma from a six-week high of 6.5% above its rising 200-dma a week earlier week from 6.3% above the week before, and is down from an 11-week high of 7.4% in early June. That's up from mid-April's 19-week low of 4.2%, but down from a 38-month high of 9.4% on March 1. The 50-dma and 200-dma both rose together for a 33rd week.

S&P 500 Sectors Technical Indicators (*link*): Four of the 11 sectors improved w/w relative to their 50-dmas and 200-dmas (Consumer Staples, Energy, Real Estate, and Telecom). Ten of the 11 sectors trade above their 50-day moving averages (50-dmas), up from eight a week earlier, as Energy turned positive after 27 weeks below and Telecom for just the second time in 19 weeks. Consumer Staples is the only sector trading below its 50-dma. Telecom has been below in 18 of the past 19 weeks, and Consumer Staples has been below for a sixth week. During mid-April, just three sectors were above their 50-dmas, which was the lowest since the election. All 11 sectors had been above their 50-dmas during mid-January, and all 11 were below the week before the election, for the first time since December 11, 2015. The longer-term picture is better: Ten of the 11 sectors were above their 200-dmas last week, up from nine a week earlier, as Telecom was below for a 19th week. Nine sectors are in a Golden Cross, with 50-dmas higher than their 200-dmas, unchanged from a week earlier and leaving Energy and Telecom still out of the club. All 11 had been in a Golden Cross during a 21-week streak that ended October 24, the longest such stretch since October 2014. Nine of the 11 sectors have rising 50-dmas, up from eight a week earlier, as Consumer Staples turned up after falling for two weeks. Energy's 50-dma fell for a 24th week. Ten sectors have rising 200-dmas, up from nine a week earlier as Telecom's fell for a 17th week.

US ECONOMIC INDICATORS

GDP (*link*): Real GDP growth during Q2 more than doubled from Q1's pace, according to the advance estimate, as consumers stepped up spending after their weakest spending growth in a year during the first three months of 2017. Real GDP accelerated 2.6% (saar) after a downwardly revised gain of 1.2% (from 1.4%) during Q1. Real personal consumption expenditures expanded 2.8% (saar), up from 1.9% during Q1, as goods consumption (to 4.7% from 0.7%, saar) accelerated from a near standstill during Q1 while services consumption (1.9 from 2.5) decelerated slightly. Within goods consumption, both durable (6.3 from -0.1) and nondurable (3.8 from 1.1) goods spending escalated. Real capital spending expanded 5.2% (saar), building on Q1's 7.2% advance, with investment in equipment (8.2% saar), structures (4.9), and intellectual property products (1.4) all in the plus column. Trade also contributed positively as exports (4.1) once again outpaced imports (2.1). Partially offsetting these gains was a

6.8% (saar) contraction in residential investment, after soaring 11.1% and 7.1% the prior two quarters, while state & local government spending recorded a negligible 0.2% decline. Meanwhile, inventory investment (to -$0.3 billion from $1.2 billion, saar) posted its first negative reading since Q3-2011, as farm inventories contracted.

Contributions to GDP Growth (*link*): Real consumer spending once again was the number-one contributor to real GDP last quarter, after yielding that distinction to capital spending during Q1; residential investment and business inventories were both drags on growth last quarter. Some details: (1) Real consumer spending accounted for 1.93ppt of real GDP growth during Q2 as goods consumption added 1.02ppt—nondurable (0.55ppt) and durable (0.47)—while services contributed 0.91ppt. (2) Nonresidential fixed investment (0.64ppt) also contributed positively to GDP growth as spending on equipment (0.44), structures (0.14), and intellectual property products (0.06) were all in the plus column. (3) Trade (0.18) added to growth for the second consecutive quarter after detracting from growth at the end of last year; exports contributed 0.48ppt during Q2, while imports subtracted -0.31ppt. (4) Real government expenditures kicked in 0.12 ppt, after subtracting from GDP growth for the first time in three quarters during Q1; a positive contribution from federal government (0.15) spending more than offset a negative contribution from state & local government (-0.02) spending. (5) Inventory investment (-0.02) was a small drag on growth—entirely farm-related (-0.13). (6) Residential investment (-0.27) was the largest negative contributor after adding to growth the previous two quarters.

Durable Goods Orders & Shipments (*link*): June durable goods orders soared to a three-year high, lifted by a big jump in Boeing orders; core capital goods orders, on the other hand, posted the first decline this year. Nondefense capital goods orders ex aircraft (a proxy for future business investment) slipped 0.1% last month after rising 2.5% the first five months of the year to an 18-month high. The comparable shipments measure (used in calculating GDP) climbed for the fifth consecutive month, up 0.2% m/m and 2.2% over the period to its highest reading since the end of 2015. Both core capital goods orders (to 3.2% from 6.9%, saar) and shipments (4.1 from 6.8) expanded at solid rates during Q2, though grew at slower paces than during Q1. Headline durable goods orders skyrocketed 6.5% in June, but excluding transportation the increase was only 0.2%. Looking ahead, Markit's flash estimate saw July's M-PMI rebound to a four-month high of 53.2 from June's nine-month low of 52.0 as activity in the manufacturing sector was supported by the strongest increase in new orders in six months and the fastest job gains so far this year.

Employment Cost Index (*link*): Gains in yearly compensation costs remained subdued last quarter, though benefits costs are accelerating. Private industry compensation increased 2.4% y/y during Q2, in line with prior quarters. The rate for wages & salaries was also 2.4% y/y, with its yearly rate moving sideways, while the yearly rate for benefits' costs accelerated 2.2% y/y, after eight quarters below 2.0%. The latter was as low as 1.1% during Q1-2016. For Q2, compensation costs rose 0.5%, slowing from Q1's 0.8% gain, as the increase in wages & salaries also slowed to 0.5% from 0.9% during Q1. Benefits costs rose 0.6%, matching Q1's gain, which was the largest in two years.

Consumer Sentiment (*link*): The post-election bump appears to be fading, though optimism remains relatively high. The Consumer Sentiment Index fell to 93.4 in July, the lowest reading since October, though slightly above the mid-July reading of 93.1; it was at a cyclical high of 98.5 in January. Richard Curtin, director of the University of Michigan consumer survey observed, "The relatively small decline still left the Sentiment Index higher in the first seven months of 2017 than in any other year since 2004." The present situation component surpassed March's cyclical peak of 113.2, climbing from 111.7 in May to 113.4 in July—above the mid-month reading of 113.2. The expectations component sank to 80.5, its lowest reading since right before the election; it peaked at 90.3 at the start of the year. It was also slightly above its mid-July reading of 80.2.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators (*link*): The July Economic Sentiment Index (ESI) for both the Eurozone (+0.1 points to 111.2) and the EU (+0.8 points to 112.1) added slightly to June's sharp increases, which lifted the indicators to their highest levels in a decade. This month, two of the five largest Eurozone economies posted gains, Germany (+0.6 to 112.5) and the Netherlands (+0.3 to 109.5)—the latter to a new cyclical high. ESIs weakened in Italy (-0.6 to 105.5), France (-0.7 to 108.8), and Spain (-1.0 to 107.9), though France's held around June's cyclical high. At the sector level, construction (+1.8 to -1.7) and services confidence (+0.8 to 14.1) both rose—the former to a new cyclical high—while consumer and retail trade confidence each fell 0.4pt to -1.7 and 4.0, respectively; industry confidence was unchanged at June's cyclical high of 4.5.

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