MORNING BRIEFING

October 17, 2017

Addictions

See the collection of the individual charts linked below.

(1) Global monetary conditions remain bullish. (2) Forward consensus expected revenues growth rates up from a year ago. (3) China is world's biggest debt abuser. (4) China's "social financing" at record high, led by bank loans and supplemented with lots of shadowy money. (5) China's M2 growing fast too. (6) Ben Bernanke has some advice for the Fed. (7) What if central banks really don't control inflation at all? (8) Then their efforts to boost it will fail, and they will inflate asset prices trying to do so.

Global Economy: Hooked on Central Bank Money. Joe and I have some good news and some bad news. The good news is that the global economy continues to show signs of solid economic growth, as evidenced by data we monitor on the forward revenues of the major MSCI stock market indexes. Over the past couple of weeks, we've focused on five reasons why this is happening: (1) Global monetary policy remains ultra-easy. (2) Chinese bank lending is at a record high. (3) The 50% cut in oil prices since mid-2014 is a big windfall. (4) Mass immigration into Europe is boosting the region's economic growth. (5) The global bull market in stocks is having a very positive wealth effect on economic growth.

The first two are all about monetary conditions. As Melissa and I noted yesterday, while the Fed remains on course to gradually normalize monetary policy, the minutes of the 9/19-20 FOMC meeting and subsequent speeches by several Fed officials suggest that they are turning more dovish, i.e., less inclined to raise the federal funds rate, especially as the Fed is starting to trim its balance sheet. Meanwhile, the ECB continues to expand its balance sheet at a rapid rate, and Japan's "Peter Pan," BOJ Governor Haruhiko Kuroda, said this past Sunday that the central bank would continue its expansive monetary policy in an effort to boost inflation. Here are the latest central banks stats and global forward revenues:

(1) *High-powered money.* The sum of the balance sheets of the Fed, ECB, and BOJ rose to a record $14.2 trillion during September (*Fig. 1* and *Fig. 2*). It's up $1.4 trillion y/y, or 11.3% (*Fig. 3* and *Fig. 4*).

(2) *High-powered revenues.* This cornucopia of liquidity has certainly helped to revive global economic growth following the energy-led slowdown from the second half of 2014 through the first half of 2016. That's quite visible in revenues growth. Joe and I track year-ahead forward consensus expected short-term revenues growth (STRG) for all the major MSCI stock price indexes.

The All Country World growth rate is up from last year's low of 2.7% during the week of March 17 to 5.4% during the first week of October (*Fig. 5*). By the way, both short-term and long-term earnings growth expectations have also picked up significantly over this period. STRG has improved across all the major MSCI indexes over this period: Asia ex-Japan (8.8% from 5.7%), Emerging Markets (8.6, 5.6), United States (5.4, 3.2), United Kingdom (4.9, 0.3), Europe (4.1, 1.4), and Japan (3.2, 0.9) (*Fig. 6*).

So what's the bad news? Much of the world's growth is being driven by China. Nothing wrong with that other than the fact that China is on an unnatural high attributable to record-high injections of debt, which is the Chinese government's drug of choice.

China: Debt Overdose. The problem with drugs that provide a high is that more must be taken over time to maintain the high. In other words, they lose their effectiveness. The abuser is forced to take more drugs or suffer the painful consequences of the inevitable lows. China is the world's greatest abuser of the drug called "debt." China keeps using more of it to sustain economic growth, which is slowing nonetheless. The government has talked about putting the country in a rehab program, but it has been all talk, which is a common characteristic of junkies. Withdrawal is hard to do.

Yesterday, the Chinese reported September data for "social financing," which includes lending by banks and the so-called "shadow banking system." Debbie and I derive the latter stats by subtracting bank lending from the total. Here are the latest data documenting the extent of China's debt addiction:

(1) *Social financing* is up $2.9 trillion over the past 12 months through September (*Fig. 7*). In yuan terms, the y/y pace reached was a record high.

(2) *Bank loans* rose $2.0 trillion over the past 12 months through September, matching August's record high (*Fig. 8*).

(3) *Shadow banking* is mostly unregulated, as implied by its name. The government was concerned about its lending activities during 2013, when the 12-month pace rose to a record $1.65 trillion during May (*Fig. 9*). Some measures were implemented to squelch such activity. Nevertheless, over the past 12 months through September, the shadowy lenders lent out almost $1 trillion.

While China's debt dealers are providing record amounts of it "on the street," the country's debt junkies are getting less of a high. The ratio of China's bank loans outstanding to industrial production rose to a record 173.7 during August, up from 100 near the end of 2008 (*Fig. 10*). The Chinese are clearly getting less output bang per yuan of bank debt. The good news is that the Chinese bank debt is all internally financed, i.e., they owe it to themselves. China's M2 is up $2.5 trillion y/y to a record high of $25.2. trillion during September (*Fig. 11* and *Fig. 12*).

Bernanke: One More Toke. Former Fed Chairman Ben Bernanke is currently a Distinguished Fellow at the Brookings Institution and the Hutchins Center on Fiscal and Monetary Policy in Washington, DC. He remains very actively involved in the academic realm of monetary policy-making. He recently wrote a long paper, *Monetary Policy in a New Era*, that he presented at the Peterson Institute's conference on Rethinking Macroeconomic Policy in Washington, DC, during October 12-13, 2017.

One section was focused on inflation targeting, a subject about which Bernanke literally wrote the book. When Bernanke was an academic economist focusing his research on monetary policy, he became intrigued by inflation targeting and went on to co-author the book *Inflation Targeting: Lessons from the International Experience* (2006) as well as write several articles about this approach.

Under Bernanke, the Fed on January 25, 2012 issued a statement adopting an explicit inflation target: "The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate."

In his recent paper, Bernanke wrote: "I have proposed for consideration a 'temporary price-level targeting' approach, which applies only at times at which policy rates are at or very close to zero; at other times, standard inflation targeting would prevail. Under this approach, monetary policymakers would commit in advance not to raise rates from zero at least until 1) average inflation over the entire ZLB period is at target, and 2) unemployment has returned to normal ranges." (ZLB = the zero lower bound for the federal funds rate.)

In other words, the Fed should keep the federal funds rate near zero until the 2% inflation target has been achieved for a while. Fed Governor Lael Brainard in a 10/12 speech strongly endorsed the concept: "His proposed temporary price-level target would delay the liftoff of the policy rate from the lower bound until the average inflation over the entire lower bound episode has reached 2 percent and full employment is achieved. This type of policy, which would result in temporary overshooting of the inflation target in order to make up for the previous period of undershooting, is designed to, in Bernanke's words, 'calibrate the vigor of the policy response ... to the severity of the episode.'"

Melissa and I concluded yesterday that this idea provides the Fed's doves with more ammo to hold off on raising interest rates. What are they smoking? Here are a few of our objections:

(1) *They just don't get it!* Current and former Fed officials refuse to admit that perhaps monetary policy plays a small part in the inflation process. So targeting inflation is pointless.

(2) *They really should move forward with raising the federal funds rate.* They should do it while the markets aren't having any tightening tantrums. They should do it so that they will have more room to lower rates when bad times come again.

(3) *If they don't proceed with normalizing monetary policy because of their obsession with "lowflation," then the result is likely to be a huge asset bubble.* As we wrote yesterday: "Let the melt-up begin!"

Of course, all this could be irrelevant depending on who President Donald Trump picks to replace Fed Chair Janet Yellen and Fed Vice Chair Stanley Fischer. We have the same clues as everyone else does about who they might be. But we will wait until we know who they are with certainty before we guess what they'll do.

CALENDARS

US. **Tues:** Headline & Manufacturing Industrial Production 0.1%/0.3%, Capacity Utilization 76.2%, Import & Export Prices 0.5%/0.4%, Treasury International Capital. **Wed:** Housing Starts & Building Permits 1.170mu/1.230mu, MBA Mortgage Applications, Atlanta Fed Business Inflation Expectations, EIA Petroleum Status Report, Beige Book, Fischer, Kaplan, Dudley. (*Wall Street Journal* estimates)

Global. **Tues:** European Car Sales, Eurozone Headline & Core CPI 1.5%/1.1% y/y, Germany ZEW Economic Sentiment 20, UK Headline & Core CPI 3.0%/2.7% y/y, Carney, Ramsden, Tenreyro. **Wed:** UK Employment Change & Unemployment Rate 150k/4.3%, Japan Merchandise Trade Balance (yen) 559.5b. (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—climbed 3.0% during the two weeks ending October 7 after sinking 8.6% the prior four weeks on a hurricane-related jump in jobless claims. Before the recent downturn, the WLI had posted a seven-week surge of 5.0% to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB jumped 6.6% over the two-week period, after tumbling 13.7% the prior four weeks, as jobless claims fell to 257,500 (4-wa) from a 19-month high of 277,750 two weeks ago. Claims were as low as 236,750 six weeks ago, not far from late May's 235,500—which was the lowest since April 1973. The CRB raw industrial spot price index—another BBB component—is moving lower. Meanwhile, the

WCCI has dropped during five of the past six weeks by a total of 7%.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to a yet another record high last week for all three indexes as SmallCap posted a third straight high for the first time since mid-July. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, but the easy y/y comparisons may be waning. In the latest week, LargeCap's forward earnings improved to 9.6% y/y from a 24-week low of 9.4%, which compares to a 64-month high of 10.2% in mid-May and a six-year low of -1.8% in October 2015; MidCap's dropped to 13.8% from an eight-week high of 13.9%, which compares to a 66-month high of 14.0% in early August and a six-year low of -1.3% in December 2015; and SmallCap's rose to 8.9% from a 10-month low of 8.0%, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. LargeCap's consensus growth rates expected for 2017 have remained strong throughout this year instead of falling. Furthermore, the growth rates for 2018 should remain strong for all three indexes if the corporate tax rate changes sooner rather than later. Here are the latest consensus earnings growth rates: LargeCap 10.5% and 11.6%, MidCap 9.8% and 15.0%, and SmallCap 5.0% and 21.8%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios were steady for most of the three indexes last week. Looking at the weekly valuation, LargeCap's forward P/E of 17.9 was steady at the highest level since March 2004. 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 Tech bubble's record high of 25.7 in July 1999. SmidCap P/Es had stalled for most of 2017 following the post-election melt-up, but are rising again now. MidCap's forward P/E was steady at a 12-week high of 18.2, and is higher than LargeCap's P/E again after being below during August and September for only the second time since 2009. MidCap's P/E remains below its 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 slipped to 19.9 from a 10-month high of 20.2, which compares to a 15-year high of 20.5 in early December when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016, and only 0.7ppt below SmallCap's record-high P/E of 20.9 in April 2002. Prices remain near record highs for all three indexes, but their "E" still remains low as analysts await the passage of legislative changes to the tax rate and its positive impact on corporate earnings. Looking at their daily forward price/sales (P/S) ratios, valuations last week were similarly higher for the three indexes: LargeCap's P/S of 2.01 was at a record high, MidCap's 1.29 is down from a record high of 1.39 in early March, and SmallCap's 1.03 is down from 1.08 in early March and its record high of 1.17 in November 2013.

US ECONOMIC INDICATORS

Regional M-PMI (*link*): The New York Fed district, the first to report on manufacturing for this month, showed activity expanded at a three-year high. The composite index jumped 5.8 points to 30.2—its best reading since September 2014. The shipments measure (to 27.5 from 16.2) soared 11.3 points to its highest level since October 2009, while employment's (15.6 from 10.6) climbed 5.0 points to a 31-month high; the average workweek index fell to zero, indicating that the average workweek held steady this month. Meanwhile, delivery times (3.1 from 14.6) were longer, while inventories (-7.8 from 6.5) contracted. Measures assessing the six-month outlook remained optimistic, with the index of future business conditions (44.8 from 39.3) improving.

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