MORNING BRIEFING
December 6, 2017

World Equities & QE

See the pdf and the collection of the individual charts linked below.

(1) They didn't read the memo. (2) Combined assets of Fed, ECB, & BOJ flattening. (3) The Fed taking baby steps to shrink balance sheet. (4) ECB scheduled to cut monthly asset purchases in half next year. (5) BOJ's stealth tapering underway? (6) PBOC is back in the easing game. (7) S&P 500 forward earnings remarkably strong, outpacing lots of strengthening global economic indicators. (8) Bottom line: Global economic outlook remains upbeat.

Strategy I: Equities & Central Banks. Equity investors didn't get the memo sent by the world's major central banks a couple of months ago. The growth rate of the assets (priced in dollars) held by the Fed, the ECB, and the BOJ rose 12.9% y/y through November (*Fig. 1*). However, that's down from the most recent peak growth rate of 23.7% during August 2016. More interesting is that their combined assets have been flat around $14 trillion for the past four months through November, yet stock markets continue to rally around the world.

Arguably, the bull market in global stock markets has been driven to an important extent by the central bankers. That notion makes sense and has been supported by the relatively close correlation between the combined assets of the three central banks and the All Country World MSCI stock price index (in dollars) (*Fig. 2*). On the other hand, there was also a seemingly close relationship between the assets held by the Fed and the S&P 500 during the current bull market—until the Fed terminated QE asset purchases at the end of October 2014; the S&P 500 then continued nonetheless to rally to record highs (*Fig. 3*). Let's have a look behind the curtain to see what the central banks' wizards are up to:

(1) *Fed.* The Fed started to reduce its assets during October by discontinuing purchases of securities to replace maturing ones. It's hard to describe this as the "Great Unwinding" since the Fed is aiming to trim its portfolio by $10 billion per month. The FOMC's 9/20 "Implementation Note" to the FRB-NY's Open Market Desk stated:

"Effective in October 2017, the Committee directs the Desk to roll over at auction the amount of principal payments from the Federal Reserve's holdings of Treasury securities maturing during each calendar month that exceeds $6 billion, and to reinvest in agency mortgage-backed securities the amount of principal payments from the Federal Reserve's holdings of agency debt and agency mortgage-backed securities received during each calendar month that exceeds $4 billion."

So far, the US stock market hasn't skipped a beat. The S&P 500 is up 4.8% since the Fed started to shrink its balance sheet at the beginning of October, and 30.8% since the FOMC terminated QE purchases at the end of October 2014.

(2) *ECB.* The ECB hasn't skipped a beat either in continuing its program of ultra-easy monetary policy. Focusing on the ECB's weekly balance sheet priced in euros, we can see that the central bank's assets rose to a record high of €4.44 trillion at the start of December, up €853 billion y/y and €2.45 trillion since late 2014 (*Fig. 4*).

But the ECB's balance sheet is set for a subtle pause, as the bank's President Mario Draghi revealed during his 10/26 monetary policy press conference. He discussed the bank's latest decision to continue the asset purchase program (APP) at the current monthly pace of €60 billion until the end of this year. Starting in the new year, the ECB's net purchases will be reduced to a monthly pace of €30 billion until at least the end of September 2018. Importantly, the ECB will reinvest the principal payments from maturing securities. The reinvestments will be sizable at about €10 billion per month, ECB Vice President Vítor Constâncio said at the press conference.

Draghi didn't say that the reduction in purchases would be permanent. He added: "If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase the APP in terms of size and/or duration." But Draghi also left the door open for purchases to be further reduced or halted.

During the Q&A, Draghi seemed pleased with the results, saying: "[M]y understanding is the market reaction was pretty muted to … our policy announcement in spite of the fact that it's a policy announcement of a certain importance, which seems to say that our communication to the market has been pretty effective." So it seems that there may be less ECB QE to come. However, the ECB's tapering will be slow and steady, at least for the first nine months of 2018.

(3) *BOJ.* In Japan, bank reserves balances at the BOJ have soared since the central bank implemented its QE program during April 2013 (*Fig. 5*). However, the pace of increases has slowed this year and edged down in November.

In our 9/28/2016 *Morning Briefing*, Melissa and I suggested that Haruhiko Kuroda, the governor of the Bank of Japan, had "just ditched the BOJ's QE program" because it wasn't working. On September 21, the BOJ announced its intention to control the shape of the yield curve by pegging the 10-year JGB yield at zero. To do so, the BOJ altered the quantitative target for its annual JGB purchases simply by adding three words: "more or less" than 80 trillion yen.

This year, in an 11/13 speech, Kuroda mentioned the phrase "reversal rate." Kuroda defined it as the risk that central banks lower interest rates too far, so that that "the effects of monetary easing on the economy reverse and become contractionary." Kuroda added: "the Bank will continue to pay attention to this risk." That could be interpreted as an admission that monetary policy in Japan is now too accommodative.

Two weeks later, Kuroda seemingly attempted to take back the admission that the BOJ is in the process of reversing course. In an 11/30 speech with business leaders, he stated: "At this point in time, the Bank has not reached any decisions on an exit policy." However, that comment was made in the context of a longer speech in which Kuroda argued that an exit from QQE would not pose any "danger." Even so, Kuroda said that "it makes perfect sense" to him that Japan's exit should come after those of central banks in the US and Europe.

(4) *PBOC.* Meanwhile, China's central bank has increased its balance sheet by $531 billion over the past seven months from April through October (*Fig. 6*). That gain reverses most of the decline since this series peaked at a record $5.63 trillion during February 2015.

(5) *All told*. As a result, the total assets of the Fed, ECB, BOJ, and PBOC rose to a record high of $19.6 trillion during October, up 10% y/y. The bottom line is that the global bull market in stocks continues to be supported by the combined QE expansion of the major central banks. So far, there is no disconnection between what the central banks are collectively doing and the global stock market's performance.

Strategy II: Looking Forward. Earnings have also been powering the bull market in US equities. Analysts' consensus expectations for earnings has been remarkably strong since mid-2016, when the energy-led earnings recession ended. There has been a steep upward slope in both S&P 500 forward revenues and forward earnings, both on a 52-week basis, since then (*Fig. 7*).

Forward revenues is a great coincident indicator of S&P 500 revenues. The former implies that the latter will continue to make record highs in coming quarters. The strength in forward earnings is downright remarkable, outpacing its past correlation with numerous business indicators:

(1) *Actual earnings.* S&P 500 forward earnings rose to a record $145 a share at the end of November, up 17.2% from last year's low during the week of March 4 (*Fig. 8*). Actual S&P 500 operating earnings (using Thomson Reuters data) rose to a record $128 per share over the past four quarters through Q3. Forward earnings tends to be a great year-ahead leading indicator for trailing earnings, and supports our forecast that 2018 earnings could be $147 per share.

(2) *Leading indicators.* Not surprisingly, forward earnings is highly correlated with the Index of Leading Economic Indicators (LEI) (*Fig. 9*). What is surprising is that forward earnings seems to have been increasing at a faster pace than the LEI over the past year or so.

(3) *World exports.* S&P 500 forward earnings has also been highly correlated with the volume of world exports (*Fig. 10*). The same can be said of its relationship with world industrial production (*Fig. 11*). In both cases, forward earnings is outpacing the other two indicators.

(4) *US business sales.* In the past, forward earnings also tracked US manufacturing and trade sales very closely and coincidently (*Fig. 12*). They've both been rising into record-high territory in tandem over the past year. But again, the former is outpacing the latter.

(5) *Bottom line.* Debbie and I started to detect a significant improvement in global economic growth last fall. Industry analysts apparently started doing the same at about the same time, but have shown much more exuberance for the earnings outlook than suggested by the actual upturns in key global economic indicators. They could be right in anticipating a global boom. In any event, it sure looks like more growth is ahead for the global economy.

CALENDARS

US. Wed: ADP Employment 192k, Productivity & Unit Labor Costs 3.0%/0.5%, MBA Mortgage Applications, EIA Petroleum Status Report. **Thurs:** Jobless Claims 240k, Consumer Credit $17.3b, Challenger Job-Cut Report, Weekly Consumer Comfort Index, EIA Natural Gas Report, Dudley. (*Wall Street Journal* estimates)

Global. Wed: Germany Factory Orders -0.2%m/m/7.0%y/y, Australia GDP 3.0%, BOC Rate Decision 1.00%. **Thurs:** Eurozone GDP 0.6%q/q/2.5%y/y, Germany Industrial Production 1.0%m/m/4.3%y/y, Japan GDP 1.5% (saar), Japan Leading & Coincident Indexes 106.1/116.2, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

AC World ex-US MSCI (*link*): This index is up 21.2% ytd in dollar terms after rising 1.7% in 2016. In local-currency terms, the index has risen a lower 13.8% ytd compared to its 4.1% gain for all of 2016. Local-currency forward revenues has risen 7.0% from a five-year low in March 2016 to near its highest level since November 2015. Forward revenues has been more stable longer term and is down just

4.0% from its October 2014 record high. Local-currency forward earnings has performed better, with a 21.1% rise from its six-year low in March 2016 to its highest level since October 2008, but remains 5.8% below its September 2008 record. Revenues are expected to rise 7.3% in 2017 and 4.9% in 2018 following a 1.0% decline in 2016, and earnings are expected to rise 17.4% (2017) and 8.7% (2018) after rising 3.8% (2016). Analysts are forecasting STRG of 5.2%, down from a seven-year high of 6.8% in March and up from a cyclical low of 2.3% in March 2016. Their STEG forecast of 9.9% is down from a four-year high of 14.1% in March, but up from their 6.3% forecast in January 2016, which was the lowest in seven years. The implied profit margin is expected to rise to 7.7% in 2017 from 7.1% in 2016 before improving to 8.0% in 2018. The forward profit margin forecast of 8.0% is at a nine-year high now. NERI was positive in November for a second straight month as it improved to 1.3% from 0.5%, but is down from a 76-month high of 2.7% in May. That compares to a 51-month low of -11.3% in March 2016. The P/E edged down to 14.4 in November from a 15-month high of 14.5 in October, which compares to a 16-month low of 12.4 in February 2016 and a six-year high of 15.3 in April 2015. The index's 11% discount to the World P/E has improved from a record-low 13% discount in early March.

EMU MSCI (*link*): The EMU's MSCI price index has gained 25.1% ytd in dollar terms after falling 1.2% in 2016. In euro terms, the price index is up a lower 11.5% ytd following a 1.8% gain for all of 2016. Euro-based forward revenues has improved 3.0% from its six-year low in May 2016 to 1.3% below its cyclical high (August 2015) and 7.9% from its record high (September 2008). Euro-based forward earnings had stalled from 2011 to 2016—but is now 7.7% above its prior cyclical high in September 2015 to near its highest level since September 2011. It remains 22.4% below its record high in January 2008, but has improved 15.1% from its 23-month low in June 2016. Analysts expect revenues to rise 4.5% and 3.6% in 2017 and 2018, respectively, after falling 1.8% in 2016, but think earnings will rise 10.1% in 2017 and 9.2% in 2018 following a 4.9% increase in 2016. Forecasted STRG of 3.7% is down from a six-year high of 5.0% in April, but up from 2.0% in May 2016. Forecasted STEG of 9.3% is down from a 78-month high of 21.0% in February, which compares to a seven-year low of 5.7% in April 2016. STEG had been higher than LTEG (currently 12.7%) from July 2016 to May 2017, but is trailing now. The forward profit margin has improved 1.8ppts to a six-year high of 7.5% from a cyclical bottom of 6.2% in May 2013. The implied profit margin is expected to improve to 7.1% in 2017 from 6.8% in 2016 before rising another 0.4ppt to 7.5% in 2018. NERI was negative in November for a fourth month following eight straight positive readings, edging down to -3.9% from -3.8%. Those readings are down from a 131-month high of 8.1% in May, which compares to a 24-month low of -13.2% in April 2016. The P/E of 14.5 is down slightly from 14.6 in October, which compares to a 13-year high of 16.4 in April 2015 and a 30-month low of 12.2 in February 2016. That represents a 10% discount to the World MSCI's P/E now, up from a record-low 25% discount during 2011. But the current reading is still well below the 1% premium during April 2015—the post-euro-inception record high.

Emerging Markets MSCI (*link*): The EM MSCI price index is up 30.1% ytd in US dollar terms after rising 8.6% in 2016. In local-currency terms, EM has gained a lower 25.0% ytd compared to a 7.1% gain in 2016. Local-currency forward revenues is up 8.6% from a four-year low in June 2016 to 8.5% below its November 2014 record. Local-currency forward earnings has fared substantially better, rising to a third straight monthly record high for the first time since January 2014; it has improved 28.2% from April 2016's six-year low. Revenues are expected to rise 10.4% in 2017 and 8.4% in 2018 following a 2.3% gain in 2016, leading to earnings gains of 22.5% (2017) and 12.8% (2018) following a 7.7% rise in 2016. Forecasted STRG of 8.6% is back on an uptrend since early 2016, but is down from a four-year high of 9.6% in late January. STEG of 13.4% is unchanged m/m, but down from 13.9% in September, and is below LTEG (22.3%) again. The implied profit margin is expected to improve to 7.0% in 2017 from 6.3% last year before edging up to 7.3% in 2018. The forward profit margin of 7.2% is the highest since January 2013 and up from a record low of 6.0% in February 2016, but remains more than 3ppts below its 10.3% record high in December 2007. NERI turned positive in November for the first time in 81 months, improving m/m to 1.6% from -0.1%. That compares to an 83-month low of -10.2% in March

2016. Emerging Markets' valuation has been more stable recently than that of the rest of the world. The P/E was steady at 12.8 In November. That's the highest P/E since January 2010 and compares to a 17-month low of 10.2 in August 2015. The index is trading at a 21% discount to the World MSCI P/E, up from a 10-year-low 30% discount in August 2016.

MSCI World & Region Net Earnings Revisions (*link*): Analysts' recent earnings revisions through November point toward improving optimism about profits across the world as all emerging markets regions improved m/m. The AC World MSCI's NERI was positive for a tenth month and for the first time since June 2011, improving 0.4ppt to 1.9% from 1.5% in October, but is down from a 74-month high of 3.3% in May. The AC World Ex-US was positive for a second month as it improved 0.8ppt to 1.3%, which compares to a 76-month high of 2.6% in May. Emerging Markets' NERI turned positive for the first time in 81 months, as it rose 1.7ppts to an 82-month high of 1.7%. EM Latin America remained negative for a 16th month despite rising 1.3ppts to a 10-month high of -2.0%; EM Asia was positive for a second month as it surged 2.1ppts to an 82-month high of 2.1%; EM Eastern Europe was the strongest at a 93-month high of 4.8% and has been positive in 13 of the past 15 months, rising 1.7ppts m/m; Europe (-2.1%) was negative for a fourth month following 10 positive readings; EAFE (0.9%) was positive for a 12th month; EMU (-3.9%) was the weakest and negative for a fourth straight month following eight positive readings. November's scores among the regional MSCIs: EM Eastern Europe (4.8% in November, up from 3.1% in October), United States (3.1, 3.7), EM Asia (2.1, 0.0), AC World (1.9, 1.5), Emerging Markets (1.7, 0.0), AC World ex-US (1.3, 0.5), EAFE (0.9, 0.8), EM Latin America (-2.0, -3.3), Europe (-2.1, -1.8), Europe ex-UK (-2.6, -3.4), and EMU (-3.9, -3.8).

MSCI Countries Net Earnings Revisions (*link*): NERI was positive for 22/44 MSCI countries in November, the most since July. That's up from 16/44 in October and 12/44 in September, which was the lowest since July 2016, and compares to 29/44 in June, which was the highest since June 2010. NERI improved m/m in November for 28/44 countries compared to 30/44 rising in October, but that's still down from 32/44 in May, which had been the most since June 2016. Austria's NERI was at a 143-month high in November, followed by Norway's at a 136-month high, China (96-month high), Switzerland (96), Poland (93), Brazil (89), and Singapore (82). On the flip side, Ireland's was at a 48-month low, followed by those of Mexico (31), Netherlands (24), United Kingdom (19), and Spain (16). The 20-month positive NERI streak for Hungary is the best, followed by those of Austria (18), China (15), Hong Kong (13), Poland (13), Turkey (13), and Japan (12). Brazil turned positive in November for the first time in 89 months. South Africa's NERI has been negative for 42 straight months, followed by the negative streaks for India (37), New Zealand (18), Mexico (13), and Pakistan (12). NERI turned positive in November for seven countries: Brazil, Finland, Korea, Peru, Singapore, Taiwan, and Thailand.

US ECONOMIC INDICATORS

Merchandise Trade (*link*): It's still too early to call, but trade data for the first month of the current quarter suggest trade could be a drag on Q4 GDP growth, after contributing positively the first three quarters of this year. The real merchandise trade deficit in October widened to $65.3 billion, the largest since January, deteriorating steadily from June's $60.8 billion gap. That compares to an average monthly deficit of $62.0 billion during Q3. The widening in October's deficit reflected a 1.5% gain in real merchandise imports to a new record high; real exports slipped 0.2%, remaining stalled at its record high the past four months. October's increase in real imports was led by industrial supplies (2.6%) and consumer goods ex autos (1.8), followed by autos (0.6) and food (0.3); imports of capital goods less autos slipped 0.6% after a 2.9% rebound in September. As for exports, food (-12.6), capital goods less autos (-3.0), autos (-1.9), and consumer goods less autos (-1.4) were all in the red, while exports of industrial supplies jumped 8.2% in October and 10.4% the past two months to a new record high.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (*link*): Global economic activity in November continued to grow at a steady elevated pace. The J.P. Morgan Global Composite Output Index (C-PMI) remained at October's two-and-a-half-year high of 54.0 last month, at the top of the 53.5 to 54.0 range during the first 11 months of this year. The M-PMI (54.0 from 53.5), which has been on a steep accelerating trend in recent months, is now outpacing the NM-PMI (to 53.7 from 54.1) for the first time since February 2014. Developed markets (54.9 from 55.0) continued to outperform emerging markets (51.9 from 51.5), with the former decelerating slightly and the latter accelerating slightly during November. The Eurozone C-PMI (57.5 from 56.0) expanded at its fastest pace in six and a half years last month, with growth accelerating across the 'big-four' nations: France (60.3 from 57.4), Germany (57.3 from 56.6), Italy (56.0 from 53.9), and Spain (55.2 from 55.1), with growth also picking up in Ireland (57.7 from 56.0). Rates of expansion also improved in Russia (56.3 from 53.2) and China (51.5 from 51.0). Meanwhile, C-PMIs showed an easing of growth in the UK (54.9 from 55.8), US (54.5 from 55.2), Japan (52.2 from 53.4), and India (50.3 from 51.3); growth in all four accelerated during October. Once again, Brazil (48.9 from 49.5) was the only major nation to signal a contraction in economic activity.

Global Non-Manufacturing PMIs (*link*): Global service-sector growth in November expanded for the 100th successive month, though the latest reading was slightly below its long-run average. J.P. Morgan's NM-PMI slipped to 53.7 after climbing from 53.8 to 54.1 in October. Last month, the Eurozone NM-PMI (to 56.2 from 55.0) revealed the service sector continued to expand at a robust pace, led by stronger growth in France (60.4 from 57.3) and Italy (54.7 from 52.1), with the former registering its strongest rate since May 2011. Meanwhile, service sector growth in Ireland (56.0 from 57.5), Germany (54.3 from 54.7), and Spain (54.4 from 54.6) eased, though remained solid. NM-PMIs for the UK (53.8 from 55.6), the US (54.5 from 55.3), and Japan (51.2 from 53.4) also saw growth slow a bit, while growth accelerated in Russia (57.4 from 53.8) and China (51.9 from 51.2). Moreover, Brazil's (46.9 from 48.7) service sector contracted for the sixth time in seven months, while India's (48.5 from 51.7) has been swinging between expansion and contraction in recent months.

US Non-Manufacturing PMI (*link*): The US service sector in November slowed a bit, according to both the ISM and Markit surveys, though continued to expand at a healthy pace. ISM's NM-PMI fell to 57.4 last month after rebounding from an 11-month low of 53.9 in July to 60.1 in October—which was the best pace since August 2005. All four components eased: The business activity (to 61.4 from 62.2) index held above 60.0, while the new orders (58.7 from 62.8) measure slipped just below. Meanwhile, the employment (55.3 from 57.5) gauge showed the service sector hired at a slower but still robust pace, while the supplier deliveries (54.0 from 58.0) measure fell from a 12-year high in September/October. Markit's NM-PMI declined to 54.5 from 55.3 the prior two months, not far from August's 56.0—which was the highest reading since November 2015. According to the report, while service sector growth slowed it was still strong by recent standards. Output softened to a five-month low, but both new business and employment growth accelerated last month.

Eurozone Retail Sales (*link*): October retail sales fell more than expected after reaching a new record high in September. Sales sank 1.1%, steeper than the expected drop of 0.7%, after climbing 0.8% in September. October's weakness was widespread, led by declines in spending on food, drinks & tobacco (-1.3%) and non-food products (-1.1), which had increased 1.0% and 0.5%, respectively, in September. Meanwhile, automotive fuel sales dropped for the fourth month by 0.1% m/m and 1.8% over the period. Available data for three of the Big Four economies show sales fell as much as, or more than, the overall Eurozone: France (-1.5%), Germany (-1.2%), and Spain (-1.1), with the sales of the big two stalled at record highs. The biggest sales declines among the Eurozone economies were recorded by Luxembourg (-5.3), Portugal (-2.3), and Austria (-1.9); Slovakia (0.6) was the only member nation to record a gain.

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