



MORNING BRIEFING

February 14, 2018

Ups & Downs of the Dollar

See the [collection](#) of the individual charts linked below.

(1) Will the weak dollar boost earnings and inflation too? (2) The stock market's tug-of-war between earnings and valuation. (3) Dollar bulls have been surprised by dollar's weakness since early 2017 despite three Fed rate hikes. (4) Dollar inversely correlated with Global Growth Barometer. (5) Dollar inversely correlated with S&P 500 revenues and earnings. (6) Dollar's impact on inflation is fuzzy. (7) Go Global has made more sense than Stay Home since dollar peaked in early 2017. (8) Sandra's scorecard for Italy's political and economic scene.

Currencies & Commodities: Growth Matters. What about the dollar? It has been weak since early 2017. The good news is that should boost S&P 500 earnings. The bad news is that it might revive inflationary pressures. If so, then Jerome Powell, the new Fed chairman, might feel compelled to normalize monetary policy more aggressively than did his predecessor, Janet Yellen. The stock market seems to have entered a tug-of-war phase in recent weeks between a very bullish outlook for earnings and a potentially bearish outlook for valuation multiples. The multiples took a dive in early February on concerns that inflation may be heating up, forcing the Fed to raise rates more aggressively. The resulting rise in bond yields has weighed on P/Es as well.

Debbie and I track three measures of the trade-weighted dollar. The Fed compiles two daily series of the "major" and the "broad" trade-weighted dollar ([Fig. 1](#)). They tend to be reported with a lag of a few days, so we also track the more timely JP Morgan broad measure of the dollar ([Fig. 2](#)). The two broad measures start in 1995, while the Fed's major index starts in 1973.

Dollar bulls have been surprised by the weakness in the dollar since early 2017. They were expecting that it would continue to strengthen given that the Fed was gradually normalizing US monetary policy, while the ECB and BOJ remained committed to their ultra-easy monetary policies. What they missed was that the JPM dollar index had already appreciated dramatically, soaring 26% from a 2014 low of 99.89 on July 1 to a 2017 high of 126.21 on January 11.

What they also missed is that the foreign-exchange markets were starting to discount a rebound in global economic activity outside of the US. Debbie and I previously have shown that the trade-weighted dollar is inversely correlated with our Global Growth Barometer, which is simply an average of the CRB raw industrials spot price index and the price of a barrel of Brent crude oil ([Fig. 3](#) and [Fig. 4](#)). We figure that commodity prices are the most sensitive, real-time indicators of global economic growth.

We agree that a weak dollar should boost corporate earnings. However, strong global economic growth is much more important for boosting earnings. Both together is even better, especially since they often do go together. Adding a major cut in corporate tax rates puts this bullish scenario for earnings on steroids, as Joe and I discussed yesterday. Debbie and I aren't convinced that the bullish scenario for growth and earnings has to cause trouble on the inflation front. Consider the following:

(1) *The dollar, revenues, and earnings.* There is a relatively strong inverse correlation between the yearly percent change in the dollar and S&P 500 revenues ([Fig. 5](#)). That's not surprising since nearly half of S&P 500 revenues comes from abroad. So in theory, the 8% y/y drop in the dollar should boost

revenues by 4%. In practice, there is no such simple rule of thumb since US companies must pay more for the imported goods they use. All we can say with some certainty is that a weaker dollar tends to be good for the revenues of US companies.

The same story applies for S&P 500 forward earnings growth on a y/y basis. It is also inversely correlated with the dollar ([Fig. 6](#)). Again, there is no simple rule of thumb that can easily translate a given percentage drop in the dollar to a percentage increase in earnings.

(2) *The dollar and inflation.* The relationship between the value of the US dollar and inflation in the US is even fuzzier. There is a fairly loose inverse relationship between the yearly percent change in the dollar and the yearly percent change in the US import price index excluding nonpetroleum imports ([Fig. 7](#)). In turn, there is a weak correlation between the latter and the yearly percent change in the PPI for finished goods excluding food and energy ([Fig. 8](#)).

(3) *The dollar and the Fed.* The dollar did rise sharply after the Fed started to normalize monetary policy at the end of October 2014, when QE was terminated ([Fig. 9](#)). It had already started moving higher during the summer of that year in reaction to the drop in the prices of oil and other commodities. It basically made a top following the Fed's first post-crisis rate hike at the end of 2015. That's because the prices of oil and other commodities troughed in early 2016.

After falling in early 2016, the dollar slowly recovered, then jumped above its high at the beginning of the year on Trump's Election Day victory. It is now down 9.8% from its peak at the beginning of 2017 despite four Fed rate hikes since Trump's win.

Global Stocks: Stay Home or Go Global? After the dollar's peak in early 2017, our Stay Home investment strategy stopped outperforming the Go Global alternative ([Fig. 10](#)). In late 2016, we anticipated as much and noted that on a valuation basis the EMU and Emerging Markets MSCI indexes looked cheap compared to the valuation of US stocks. We also started to see more signs of rebounding growth overseas. We would stay with a market-weighted Go Global approach for now even though the US remains relatively expensive, though certainly not as expensive as it was before the recent P/E meltdown.

Italy: Mambo Italiano. Italy goes to the polls on March 4 to elect a new prime minister. The field is as mixed up a jumble as the lyrics to the hit '50s song "Mambo Italiano." So many candidates and parties are vying for a shot at leading the government of the Eurozone's third-largest economy that a flow chart is required to keep track of it all. I asked Sandra Ward, our contributing editor, to chart the political and economic flows in Italy. Her report follows:

The colorful cast of characters includes the popular anti-establishment party, Five Star Movement, or M5S, founded by comedian Beppe Grillo and now led by 31-year-old Luigi Di Maio. There is also the center-right party Forza Italia, led by former Prime Minister and media magnate Silvio Berlusconi, a convicted tax cheat whose political career has been marked by sex and corruption scandals. Other parties include the anti-immigration Northern League and the nationalist far-right Brothers of Italy, two groups that in the past formed a coalition with Forza Italia and the leftist Free and Equal party. The Democratic Party (PD), known for its center-left leanings and head of the ruling coalition during this current period of economic recovery and expansion, is also a contender. The PD is led by Prime Minister Paolo Gentiloni, a former foreign affairs minister appointed after former Prime Minister Matteo Renzi was forced to resign after voters rejected his plan for constitutional reforms.

Despite pushing through pension and labor reforms and ruling at a time when Italy's GDP growth rate is the highest it's been since Q2-2011 and manufacturing output is at its highest level since August 2011,

the PD is running second to the M5S in the polls, according to a 1/31 [report](#) in the *Financial Times*. Notwithstanding recent strides, Italy's economic growth has lagged that of its Eurozone peers. High unemployment, high government debt, and a banking system riddled with bad loans continue to impede Italy's progress. Indeed, a top M5S economic adviser recently called on the EU to consider restructuring the public debt of Italy and other countries, noted a 2/11 [report](#) in the *Financial Times*.

With no party solidly in the majority, gridlock is the expected outcome of the forthcoming election. Gridlock is never desirable, but it's even less so at a time when the economy is widely projected to begin to decelerate and monetary policy is becoming less accommodative. Let's take a deeper look at Italy's economy:

(1) *GDP*. The economy grew at a revised 0.4% q/q clip in Q3, or 1.4% (saar), driven by solid domestic demand, export growth, and strong growth in gross fixed capital investment. The gains represented an acceleration from the 0.3% q/q advance in Q2. The revised 1.7% y/y gain marked the fastest annual expansion since Q2-2011. (The advance estimate for Q4 GDP is due out this morning, with the detail being released on March 2.)

Gross fixed capital investment expanded by 12.6% q/q (saar). The machinery, equipment, and agriculture category jumped 26.2% (saar) in Q3. Companies responded to improvements in the tax structure and tax incentives included in the 2018 budget that provide a more stable framework, according to a 12/1 [report](#) in FocusEconomics. Construction, the biggest component of gross fixed capital investment, expanded by 1.3% (saar) in Q3 after contracting in Q2. Exports jumped 6.4% q/q in Q3 (saar). Italy's top export items are machinery, including computers, at 20% of total exports, followed by vehicles at 8.5%. The fastest-growing export category is pharmaceuticals, representing 4.6% of the total and up 42.7% in value since 2009, according to a 10/29 [report](#) on World's Top Exports. Nearly one-third of the country's exports, 63.5%, are shipped to other European nations ([Fig. 11](#)).

Italy's National Institute for Statistics (Istat) sees GDP growth of 1.5% for full-year 2017 and 1.4% in 2018, according to its 11/21 [outlook](#).

(2) *Industrial Production*. Output in Italy advanced in seven of the last eight months of 2017 to its highest level since August 2011 ([Fig. 12](#)). Production, excluding construction, jumped in December to a two-year high of 1.6%, putting it up 4.4% over the final eight months of last year. Manufacturing output followed a similar script, soaring 2.1% during December and 5.2% over the eight-month period, also to its highest reading since August 2011. Output of capital goods accelerated 8.9% over the eight months, followed by intermediate (5.2) and consumer goods (3.8)—with the latter led by a 10.2% surge in consumer durable goods production.

(3) *Manufacturing*. The manufacturing sector in January registered the strongest growth in output in seven years, and new orders were among the highest recorded since 2000, according to the 2/1 [release](#) of the IHS Markit Italy Manufacturing PMI, which tracks developments in business conditions. Italy's PMI came in at 59.0 in January, up from 57.4 in December. Expansionary conditions, reflected by a PMI above 50.0, have been recorded for 17 straight months. Growth was broad-based, and new orders came in at a pace just behind November's 17.5-year record. Capacity pressures led to rising backlogs, which led to a boost in employment. January's survey marked the second-strongest gains in employment in the survey's history. Raw material prices continued to rise amid supply shortages. Raw material prices continued to rise amid supply shortages. Rising input costs and strong demand led manufacturers to raise prices by the sharpest amount in seven years.

Optimism abounded in Italy's service sector, as indicated by the IHS Markit Italy Services PMI survey in January. The headline Business Activity Index, seasonally adjusted, registered 57.7, the highest

reading since July 2007 and up from December's 55.4 ([Fig. 13](#)).

(4) *Business confidence*. Despite the heady manufacturing climate, Italy's business confidence indicator—which covers the manufacturing, construction, services, and retail sectors—slipped to 105.6 in January from a revised 108.7 in December—which was the second highest reading since September 2007. Deterioration in the retail and services sectors were to blame, as expectations for future sales fell sharply. Confidence in the construction sector rose based on expectations of higher employment ([Fig. 14](#)).

(5) *Jobs*. Unemployment in Italy has been falling steadily since its peak in 2014 and stood at 10.8% in December, its lowest level since 2012 ([Fig. 15](#)). Still, it remains one of the highest levels in Europe—behind only those of Greece, Spain, and Cyprus—and compares with a 7.3% rate for the European Union, according to [data](#) from Statista.

Italy's youth unemployment rate, encompassing 15- to 24-year-olds, was 32.2% in December, the third-highest level after those of Greece and Spain and double the rate of the European Union. Nonetheless, youth unemployment has dropped significantly from its high of 43.6% in March 2014. Tax incentives included in the 2018 budget to encourage the hiring of younger workers, such as lowering social security contributions for young people hired on a permanent basis, are designed to continue to improve jobs growth among the young.

(6) *Banking and bad loans*. Stronger GDP growth, a credit-rating upgrade from Standard & Poor's, and the creation of a secondary market have combined to reduce the level of bad bank loans through mid-November 2017 by 25%, according to a 11/15 [interview](#) by CNBC with Italy's finance minister. Italy accounts for one-quarter of the trillion in bad debts in the EU that accumulated as a result of the global financial crisis, and managing those debts will be critical to the health of its economy. Italy also is saddled with enormous public debt (130% of GDP), and Italian banks haven't been free to extend new credit, which has weighed on the economy.

Now, however, restructuring is picking up the pace and freeing up capital, thanks to acquisitions, investor interest in the distressed debt, and government pressure on banks to improve their balance sheets, according to a 1/22 [report](#) by financial services researcher RFI Group. In December, the government approved a 20 billion euro rescue fund to aid its troubled banking sector, with the priority being Monte dei Paschi di Siena, Italy's third-largest and the world's oldest bank. BMPS, as it is known, failed to raise enough capital from private investors to continue operating, according to a 12/23 CNBC [report](#). Just last week, UniCredit, Italy's biggest bank, posted its best results in a decade, on stronger revenue, lower operating costs, and a drop in provisions for bad loans.

(7) *Valuation*. The Italy MSCI stock price index may be valued at appealing levels if history is a guide. At 12.5 as of Monday's close, its forward P/E is comfortably below the historical average of 15.3, as earnings and revenues estimates have been on the rise ([Fig. 16](#) and [Fig. 17](#)). The Italy stock price index P/E is lower than that of the EMU's daily P/E of 13.6 but its 2018 consensus earnings growth forecast is among the highest in the world at 16.8%. That compares with 10.0% for the EMU. Revenues are forecast to grow 4.3% this year compared with 3.7% for the EMU.

Whether Italy can continue to deliver for investors depends a lot on the outcome its election.

CALENDARS

US. Wed: Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.3%/0.5%/0.4%/0.4%, Business Inventories 0.2%, Headline & Core CPI 2.0%/1.7% y/y, Atlanta Fed Business Inflation

Expectations, MBA Mortgage Applications, EIA Petroleum Status Report. **Thurs:** Headline & Manufacturing Industrial Production 0.2%/0.2%, Capacity Utilization 78.0%, Philadelphia Fed Manufacturing Index 21.0, Empire State Manufacturing Index 17.5, Jobless Claims 229k, Housing Market Index 72, Weekly Consumer Comfort Index, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: Eurozone Industrial Production 0.1%*m/m*/4.2%*y/y*, Eurozone GDP 0.6%*q/q*/2.7%*y/y*, Germany GDP 0.6%*q/q*/3.0%*y/y*, Italy GDP 0.4%*q/q*/1.7%*y/y*, Germany CPI -0.7%*m/m*/1.6%*y/y*, Japan Machine Orders -2.3%*m/m*/1.8%*y/y*. **Thurs:** European Car Registrations, Japan Industrial Production, Australia Employment Change & Unemployment Rate 15k/5.5%, RBA Governor Gives Testimony to Parliamentary Committee. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): LargeCaps are easily beating the SMidCaps so far in 2018, but all the price indexes are down at least 7% from their record highs now. Here's the ytd score through Monday's close, their 2017 performance, and their percentage changes since their record highs in January: S&P LargeCap 500 (-0.7% ytd, 19.4% in 2017, and -7.5% from record high), Russell LargeCap 1000 (-0.8, 19.3, -7.5), S&P MidCap 400 (-3.2, 14.5, -7.8), Russell SmallCap 2000 (-2.9, 13.1, -7.4), and S&P SmallCap 600 (-2.7, 11.7, -7.0). Forward revenues and earnings are at record highs now for all the S&P and Russell indexes. Momentum remains strong, as the yearly change in forward earnings is getting a big boost from the TCJA. In the latest week, the rate of change in LargeCap's forward earnings surged to 19.0% y/y from 17.5%, which is its highest since June 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's jumped to 23.5% from 21.9%, which is the highest since May 2011 and compares to a six-year low of -1.3% in December 2015; but SmallCap's edged down to 18.0% from 18.1%, which was the highest since October 2011 and compares to a six-year low of 0.3% in December 2015. Consensus growth rates expected for 2018 improved w/w for all three indexes. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 18.5% and 10.1%, MidCap 21.4% and 11.2%, and SmallCap 25.3% and 14.7%.

S&P 500 Growth vs. Value ([link](#)): The S&P 500 Growth index is up 1.2% ytd, well ahead of the 2.6% decline for its Value counterpart. During 2017, Growth's 25.4% was double the 12.6% rise for Value. Growth had trailed Value in the four months following the election. Now, Growth's 29.2% gain since the election is leading the 17.9% increase for Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver more than double the rate of revenue growth (STRG) than Value over the next 12 months, but forward earnings growth (STEG) is only slightly higher for growth: 9.0% STRG and 16.6% STEG for Growth, respectively, vs 4.2% and 15.8% for Value. Prior to February's selloff, Growth's P/E of 21.8 was the highest since May 2002, while Value's 16.6 was the highest since April 2002. Through Monday, Growth's P/E was down 9% to 19.8 and Value's had declined 11% to 14.8. Regarding NERI, Growth's was positive in January for a ninth straight month, and improved to a seven-year high of 11.4% from 4.1% in December; that compares to a five-year low of -16.2% in April 2015. Value's NERI was also positive in January for a ninth month (following 33 months of negative readings), and rose to an eight-year high of 12.7% from 2.8%; that compares to a five-year low of -20.3% in April 2015. The TCJA has boosted the consensus 2018 earnings estimate and the forward profit margin for both Growth and Value. Growth's 2018 estimate has risen 5.1% versus Value's 5.0% gain. Growth's forward profit margin has jumped to a record high of 15.9% from 14.4% prior to the TCJA, and Value's has risen to a 10-year high of 9.8% from 9.1%.

S&P 500 Q4 Earnings Season Monitor ([link](#)): With nearly 70% of S&P 500 companies finished reporting earnings and revenues for Q4-2017, their revenue and earnings surprise metrics are mostly

better compared to the same point during the Q3 earnings season. Of the 349 companies in the S&P 500 that have reported through mid-day Tuesday, 78% exceeded industry analysts' earnings estimates by an average of 4.8%; they have averaged a y/y earnings gain of 16.6%. At the same point during the Q3-2017 reporting period, a lower percentage of companies (75%) in the S&P 500 had beaten consensus earnings estimates by a slightly higher 5.1%, and earnings were up a lower 8.9% y/y. On the revenue side, 79% beat sales estimates so far, with results coming in 1.3% above forecast and 9.0% higher than a year earlier. At this point in the Q3 season, a lower 67% had exceeded revenue forecasts by a higher 1.5%, and sales had risen by a lower 6.5% y/y. Q4 earnings results are higher y/y for 79% of companies vs a lower 72% at the same point in Q3, and revenues are higher y/y for 88% during Q4 vs a lower 82% a quarter ago. These figures will continue to change as more Q4-2017 results are reported in the coming weeks. Q4's early results on revenues are very encouraging, particularly with the percentage of companies growing y/y. Despite the potential negative impact of write-offs related to the TCJA, Q4-2017 should mark the sixth straight quarter of positive y/y earnings growth and the seventh quarter of positive revenue growth.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): "The historically high index readings over the last year tell us small business owners have never been more positive about the economy," said NFIB Chief Economist Bill Dunkelberg. "This is in large response to the new management in Washington tackling the biggest concerns of small business owners—high taxes and regulations." January's Small Business Optimism Index (SBOI) rose 2.0 points to 106.9—one of the strongest readings in the 45-history of the survey—within 1.1ppt of July 1983's record high of 108.0. It was at 94.9 during October 2016, just before the election. (The SBOI averaged 104.9 for all of 2017—making last year the strongest year in the history of the survey.) In January, six of the 10 components posted a gain, with a record number of small business owners saying now is a good time to expand, which climbed 5ppts to 32%! Leading January's gain was earnings trends (+11ppts to -4%); also contributing to the advance were: expect the economy to improve (+4 to 41%), plans to increase inventories (+4 to 3%), current job openings (+3 to 34%), and capital spending plans (+2 to 29%). Only two components fell last month, sales expectations (-3 to 25%) and current inventory (-3 to -5%), while plans to increase employment (20%) and expected credit conditions (-4%) were unchanged.

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