



MORNING BRIEFING

March 13, 2018

From Headwinds to Tailwinds

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

(1) Top Fed heads now seeing tailwinds rather than headwinds. (2) The Powell/Brainard tag team. (3) “Gradual” remains the word for rate hikes. (4) Transitory vs structural forces keeping a lid on inflation. (5) Fed is focused on still-depressed labor force participation rate of prime-aged males. (6) House of dollars built on stronger foundation than house of cards. (7) Record net worth for households, with new highs for stocks and homes. (8) Solid rebound in owners’ equity in homes. (9) Ratio of mortgage debt to disposable personal income is down sharply.

The Fed: Governors in Sync. “Navigating Monetary Policy as Headwinds Shift to Tailwinds” was the title of Federal Reserve Governor Lael Brainard’s 3/6 [speech](#). It was her first speech since Jerome Powell swore into his new role as Fed chair on February 13. Brainard and Powell aren’t new to working together, having served concurrently as Fed governors for nearly four years. Recently, it appears that the two are tag-teaming on developing new lingo for Fed communications, as Powell used the headwinds-turning-into-tailwinds metaphor in his 2/27 [testimony](#) presenting the *Semiannual Monetary Policy Report (MPR) to the Congress*.

Powell and Brainard are both bullish on the US economy. However, both also continue to advocate for a “gradual” normalization of monetary policy. Both see room for improvement in labor force participation, especially given the numbers of prime working-aged people currently on the sidelines. Both remain unconcerned about inflation overheating despite the fiscal tailwinds that both expect to boost US economic growth.

Only in the nuances of inflationary trends do the Fed governors have a difference of opinion. But those nuances probably won’t make a difference for monetary policy-setting, at least in the near future. Until the word “gradual” ceases to appear in Fed governors’ communications, we expect that will be the pace of federal funds rate hikes. Consider the following:

(1) *Laying low.* Brainard believes that the theoretical inverse relationship between inflation and unemployment (a.k.a. the Phillips curve) has flattened in practice. She said: “While transitory factors” have “played a role,” core inflation has remained “stubbornly low” as a result of “persistent factors.” As Melissa and I discussed in our 3/5 [Morning Briefing](#), Powell seems to put more weight on the transitory factors weighing on inflation than on the structural forces. Nevertheless, neither Brainard nor Powell is concerned about inflation overheating. Brainard said that “stronger tailwinds” may “re-anchor inflation expectations.” She added, however, that any “mild” overshoot that could occur would likely be temporary. Powell similarly said that he expects inflation to stabilize around 2%.

(2) *Prime slack.* Both Powell and Brainard suggested that discouraged prime-aged workers currently not in the labor force might rejoin it. “[T]he employment-to-population ratio for prime aged workers remains more than 1 percentage point below its pre-crisis level,” Brainard stated. But she added that “it is an open question as to what portion” of prime-aged workers not in the labor force may respond to tight labor market conditions. During the [Q&A portion](#) of Powell’s testimony, he cited the exact same employment-to-population statistic. Likewise, he stated that the amount of sidelined prime-aged workers who may come back into the labor force is unknown.

(3) *Gradual pace*. “Headwinds to tailwinds” might be the Fed’s new favored phrase. But use of the word “gradual” to characterize the pace of federal funds tightening has yet to be dropped. Powell said the word numerous times during his testimony. Brainard concluded: “Continued gradual increases in the federal funds rate are likely to remain appropriate to ensure inflation rises sustainably to our target and to sustain full employment.” Even so, she hedged by saying that recent tailwinds could take the weight off the “path of policy.”

(4) *Tightening abroad*. Brainard opened her talk focusing on “stronger economies abroad” as a tailwind for US exports and, thus, domestic multinationals. She also noted that US import prices have increased, driven by currency appreciation abroad resulting from the expectation of monetary policy tightening abroad. Sure enough, the European Central Bank dropped language relating to its commitment to increasing the size of its quantitative easing from its March 8 monetary policy [statement](#) (compared to its previous [one](#)), a few days after Brainard spoke. On March 1, a few days before Brainard’s speech, the Bank of Japan’s Kuroda [said](#) that the bank would probably start considering an exit strategy for monetary policy in 2019.

(5) *Tariff murmurs*. It will be interesting to see whether the recent White House trade developments influence monetary policy at all at home or abroad. During her 3/6 speech, Brainard said nothing of Trump’s March 1 aluminum and steel tariff announcement. During the March 1 *MPR* follow-up Q&A with the Senate, Powell [hesitated](#) to comment on the tariffs. But he did say, quoting prior Fed Chair Bernanke, that tariffs might not be the best approach to trade deals. Already, the Trump administration seems willing to negotiate tariff carve-outs for allies, including [Japan](#) and the [European Union](#). Therefore, the tariffs may be irrelevant for policy-setting, at least for now.

US Economy: House of Money. There are some economists of the pessimistic persuasion who believe that America’s prosperity is built on a shaky foundation. They see our economy as a house of cards. Debbie and I see it as a house of money, built on the solid foundation of record-high real GDP, real incomes, and corporate earnings.

US consumers have never been wealthier than they are today. Granted, some are wealthier than others. However, practically everyone with a long-standing retirement plan, especially if it is a 401(k) plan, has some impressive capital gains in their stock portfolio. That’s true measuring performance not only since the start of the current bull market but also since the peak of the previous bull market. The same can be said about owners of real estate. The Fed’s [Financial Accounts of the United States](#), updated through Q4-2017, was released on March 8. The net worth of Americans is truly impressive. Let’s review the happy stats:

(1) *Net worth*. The net worth of the household sector rose to a record \$98.7 trillion at the end of last year ([Fig. 1](#)). It is up \$43.8 trillion since Q1-2009, when the latest bull market in stocks commenced. It exceeds the previous cycle’s peak during Q2-2007 by \$31.0 trillion. The ratio of the household sector’s net worth to disposable personal income rose to a record 6.8 at the end of last year ([Fig. 2](#)).

This achievement was accomplished with less debt expansion than in the past ([Fig. 3](#) and [Fig. 4](#)). The household sector’s assets are up 65.5% since Q1-2009, while the sector’s liabilities are 10.5% higher.

(2) *Total assets*. Households held total assets valued at \$114.4 trillion at the end of last year. That total consisted of \$80.4 trillion in financial assets and \$34.0 trillion in nonfinancial assets ([Fig. 5](#)). Both were at record highs.

(3) *Financial assets*. The biggest component of households’ financial assets is pension entitlements,

which rose to a record \$23.2 trillion at the end of last year ([Fig. 6](#)). It includes public and private defined benefit and defined contribution pension plans and annuities, including those in IRAs and at life insurance companies. It excludes Social Security. This category has doubled since Q1-2004.

The second-biggest asset category in the Fed's accounting for the balance sheet of the household sector is corporate equities directly held, at market value. It rose to a record \$17.9 trillion at the end of last year. It includes closed-end funds and the shares of ETFs and REITs. Also making a new record high, at \$11.6 trillion, was equity in noncorporate business. Another big item in the financial assets of households is mutual fund shares, which rose to a record \$8.7 trillion at the end of last year.

(4) *Nonfinancial assets*. Real estate accounts for the bulk of assets held by households in nonfinancial assets. The value of homes rose to a record \$24.5 trillion during Q4-2017, exceeding the previous cycles high during Q2-2006 by 8.0% ([Fig. 7](#)). The 12-month average of the median existing single-family home price dropped 26.6% from July 2006 through February 2012. It has rebounded 51.1% since then through January of this year. Real estate is highly leveraged in the US. As a result, owners' equity—i.e., the value of household real estate minus home mortgages—plummeted 55.2% from Q1-2006 through Q1-2009 ([Fig. 8](#)). It leveled out and finally started recovering at the start of 2013. It is up 84.2% since then.

The aggregate of owners' equity fell below the value of home mortgages from Q4-2007 through Q3-2013. So on balance, the entire country was "underwater," owing more on their homes than the equity they owned in their homes. The situation has improved since Q4-2013 with owners' equity once again exceeding home mortgage loans outstanding. At the end of last year, homeowners collectively owned 58.8% of their homes, up from a record low of 36.2% during Q1-2009 and the best since Q1-2006 ([Fig. 9](#)).

(5) *Liabilities*. Despite the significant rebound in real estate values, home mortgage debt has been essentially flat since 2007 ([Fig. 10](#)). As a result, home mortgage debt as a percentage of total household liabilities has dropped from a record high of 74.9% during Q1-2009 to 64.4% at the end of last year, the lowest reading since Q4-1987 ([Fig. 11](#)). The ratio of home mortgage debt to disposable personal income has dropped from a record high of 1.00 during Q3-2007 to 0.69 at the end of last year, the lowest since Q1-2002 ([Fig. 12](#)).

CALENDARS

US. Tues: NFIB Small Business Optimism Index 107.1, Headline & Core CPI 2.2%/1.0% y/y. **Wed:** Retail Sales Total, Ex Autos, Ex Autos & Gas, Control Group 0.4%/0.4%/0.4%/0.5%, Business Inventories 0.5%, PPI-FD Total, Core, Core Less Services 0.2%/0.2%/0.3%, MBA Mortgage Applications, Atlanta Fed Business Inflation Expectations, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. Tues: Japan Machine Orders 5.2%/m/m/-0.5%/y/y, BOJ Minutes of Policy Meeting, Poloz. **Wed:** Eurozone Industrial Production -0.4%/m/m/4.7%/y/y, Eurozone Employment, Germany CPI 0.5%/m/m/1.4%/y/y, China Retail Sales (ytd) 10.0% y/y, China Industrial Production (ytd) 6.2% y/y, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose to record highs last week for all three indexes, albeit at slower pace for LargeCap and MidCap. LargeCap's forward earnings was higher for a 33rd straight week, its longest streak since mid-2011; MidCap's was higher for a 29th

week, which matches its prior record streak, ended in mid-2002; and SmallCap's was up for a 13th week in a row. Momentum remains strong, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap's forward earnings rose to 20.2% y/y from 20.1%, which is its highest since May 2011 and compares to a six-year low of -1.8% in October 2015; MidCap's dropped to 23.1% from 23.4%, and is down from late February's 23.9%, which had been the highest since April 2011 and compares to a six-year low of -1.3% in December 2015; and SmallCap's jumped to 23.7% from 22.1%, which was the highest since July 2011 and compares to a six-year low of 0.3% in December 2015. Consensus expected earnings for 2018 and 2019 were slightly higher w/w for all three indexes. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 19.4% and 10.0%, MidCap 20.6% and 12.4%, and SmallCap 24.0% and 15.3%.

S&P 500/400/600 Forward Valuation ([link](#)): Last week saw forward P/E ratios surge to five-week highs for all three indexes after taking a hit in the prior week. LargeCap's weekly forward P/E rose to 17.3 from 16.7. That compares to 18.6 on January 26—the highest since May 2002—but is up from its post-election low of 16.3 in early February. Looking back further, that's up from 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. MidCap's forward P/E rose to 17.3 from 16.7, which is up from the panic attack's 23-month low of 16.2. MidCap's P/E has been at or below LargeCap's P/E since August for the first time since 2009. It's down from a 15-year high of 19.2 in February 2017, when the Energy sector's earnings were depressed, 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 P/E was up w/w to 18.5 from 18.0, which compares to a post-election low of 17.6. SmallCap's P/E remains well below its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed), but is comfortably above its three-year low of 15.5 in February 2016. Looking at their daily forward price/sales (P/S) ratios on Friday relative to their panic attack lows on February 8 and their recent highs, valuations have recovered somewhat for the three indexes: LargeCap's P/S of 2.09 is up from the panic low of 1.95, but down from a record high of 2.19 on January 26; MidCap's 1.38 is up from 1.28, but remains below its record high of 1.40 then; and SmallCap's 1.06 is up from 0.99, which compares to its record high of 1.17 in November 2013 when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q4 earnings season and post-TCJA guidance essentially complete, the Q1-2018 earnings forecast dropped w/w for the first time in 13 weeks. The S&P 500's Q1-2018 EPS forecast was down to \$36.21 from \$36.24 a week earlier. Still, that's up 5.2% since the end of Q4 and 5.9% since the passage of the TCJA. The \$36.21 estimate represents a forecasted pro forma earnings gain for Q1-2018 of 18.1%, down from 18.2% a week earlier, and compares to Q4-2017's blended 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3% (which then was the strongest growth since Q3-2011 owing mostly to easier comps for Energy). Since the end of Q4, Q1-2018 estimates are higher for 10 sectors and down for one. Energy's Q1 forecast has jumped 21.1%, followed by the forecasts for Telecom (up 14.4%), Financials (12.3%), and Utilities (5.4). Real Estate is the sole decliner, with its Q1-2018 forecast down 6.0%, followed by small gains for Materials (0.5), Consumer Staples (0.6), Tech (1.9), Consumer Discretionary (4.1), Industrials (4.2), and Health Care (4.7). The S&P 500's Q1-2018 forecasted earnings gain of 18.1% y/y would be its seventh straight gain after four declines and its strongest since Q1-2011. All 11 sectors are expected to record positive y/y earnings growth in Q1-2018—with seven rising at a double-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 18.1%. That's better than the 10 sectors rising y/y during Q4-2017, when seven also rose at a double-digit pace or better. Analysts expect Energy to report another large profit jump in Q1 relative to very low earnings a year ago, but the pace will slow from triple digits in Q4. All 11 sectors last rose y/y during Q2-2017, which was the first time that had happened since Q3-2011. The latest forecasted Q1-2018 earnings growth rates vs their blended Q4-2017 growth rates: Energy (74.7% in Q1-2018 vs 123.4% in Q4-2017),

Materials (27.5, 35.9), Financials (24.3, 13.5), Tech (22.3, 20.1), S&P 500 (18.1, 14.8), Industrials (14.3, 1.8), Telecom (13.2, 4.8), Health Care (10.4, 9.0), Utilities (9.7, 13.0), Consumer Staples (9.5, 11.9), Consumer Discretionary (9.0, 10.5), and Real Estate (3.2, -4.0). On an ex-Energy basis, S&P 500 earnings are expected to rise 16.2% y/y in Q1, up from a blended 12.6% in Q4 and 6.1% in Q3 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

GLOBAL ECONOMIC INDICATORS

France Industrial Production ([link](#)): Industrial production fell unexpectedly in January after a strong performance the last half of 2017. Headline production, which excludes construction, sank 2.0% in January after climbing five of the last six months of 2017, by 3.1%, to a new cyclical high. Unseasonably warm weather caused a sharp drop in electricity output during the month. Meanwhile, manufacturing production declined for the third month, by 1.1% in January and 1.9% from October's cyclical high. January's weakness was widespread, with consumer durable (-3.3%), intermediate (-2.0), and consumer nondurable (-1.8) goods production all contracting sharply, while capital goods production was flat. February's IHS Markit M-PMI slowed for the second month from 58.8 to 55.9 over the period, though remained at an elevated level. Both new orders and output rose at slower rates, but both foreign and domestic demand remained robust. Manufacturers remained optimistic—business confidence hit a new record high.

Spain Industrial Production ([link](#)): Output fell in January for the first times in six months. Production, excluding construction, sank 2.6%—the steepest decline August 2015—after soaring 4.2% during the final five months of 2017, to a new cyclical high. Factory output fell 0.8% after advancing seven of the last eight month of 2017, by nearly 4.0%, to its highest reading since November 2008. January's setback was broad-based, with capital (-2.3%), consumer durable (-2.0), intermediate (-0.8), and consumer nondurable (-0.7) goods production all moving lower, though capital and intermediate goods levels were just south of their cyclical highs. Manufacturing activity improved in February, with its M-PMI climbing from 55.2 to 56.0—as both new orders and production accelerated, boosting employment further.

UK Industrial Production ([link](#)): UK industrial output in January rebounded 1.3%—driven by North Sea oil after the reopening of a pipeline that had been shut down temporarily, causing a 1.3% contraction in December. Prior to the recent volatility, production had increased for eight months by a total of 3.2%. Manufacturing production advanced for the ninth straight month—the longest sustained period of expansion since records began—climbing 3.6% to a new cyclical high. (The latest surge has factory output within a percentage point of its record high recorded at the start of 2007.) The recent move up in manufacturing production was led by gains of 8.1% and 7.4%, respectively, in production of consumer durable and capital goods production over the nine-month period—the latter to yet another new record high. IHS Markit's M-PMI for February slipped to an eight-month low of 55.2, as manufacturing production increased at its slowest pace in 11 months; brighter news was provided by the trend in new orders, which accelerated during the month.

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