



MORNING BRIEFING

April 18, 2018

Lots of Debt

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

(1) China's engine running on bank loans. (2) No credit crunch for China as long as inflation remains subdued. (3) Chinese bank loans funded by Chinese depositors. (4) Less and less bang per yuan? (5) CBO projecting \$1.2 trillion per year, on average, in federal budget deficit through 2028. (6) Public debt set to double again over next 10 years. (7) CBO not drinking supply-side Kool-Aid. (8) Interest paid by federal government set to triple over next 10 years. (9) Will tax cuts lift potential GDP's growth rate? (10) Budget deficit may or may not matter when inflation is low, but will definitely matter if inflation rises.

China: Lots of Bank Lending. China remains a powerful engine of global economic growth. That engine has been and continues to be fueled by massive injections of bank loans into the economy. So far, China has avoided a credit crunch. Such events typically occur when a country's central bank slams on the monetary brakes to halt a significant increase in the inflation rate. That hasn't been a problem in China so far.

Another credit crunch scenario can occur if a country borrows too much from overseas lenders. Various events might unfold to stop the lenders from renewing their loans, especially if they have short-term maturities. Once again, the result is a credit crunch. The Chinese tend to borrow from their own banks, which are mostly funded by Chinese depositors who have a very high savings rate. Consider the following:

(1) *Inflation.* China's CPI inflation rate, on a y/y basis, has been hovering around 2.0% since the start of 2014 ([Fig. 1](#)). The Chinese economy was showing signs of deflation in recent years, as evidenced by the 14.4% drop in the PPI from August 2011 through February 2016 ([Fig. 2](#)). The y/y PPI inflation rate turned positive during October 2016 and has remained so since then, with the latest reading at 3.1% during March. China had a problem with excess capacity that seems to have been resolved.

(2) *Bank loans.* China's bank loans increased by a record \$2.1 trillion over the 12-month period through March ([Fig. 3](#)). Some of that strength was offset by weakness in shadow bank lending, which dropped from a peak of \$1.65 trillion during May 2013 to \$592 billion over the past 12 months through March ([Fig. 4](#)). Over this same period, shadow banking's share of "social financing" has dropped from a peak of 55% to 22% currently ([Fig. 5](#)).

(3) *M2.* While it is disturbing to see that bank loans have quadrupled to a record \$19.8 trillion since February 2009, M2 well exceeds bank loans and has also been rising rapidly. The ratio of M2 to bank loans hovered around 1.55 from 2006 through 2014, before dropping to 1.39 in March of this year ([Fig. 6](#)).

(4) *Economic activity.* While M2 growth has moderated to 8.2% during March from around 10.0% during 2015 and 2016, retail sales growth has been hovering around 10.0% over this same period ([Fig. 7](#)). It was 10.1% in March. Somewhat disconcerting is that the ratio of bank loans to industrial production in

China has increased from a low of 94 at the end of 2007 to a record high of 178 during March ([Fig. 8](#)). This suggests that the Chinese are getting less bang per yuan for their economy. On the other hand, China's services economy is growing faster than the manufacturing sector, so the ratio may be misleading.

US: Lots More Treasury Financing Ahead. Last week, the Congressional Budget Office (CBO) released [The Budget and Economic Outlook: 2018 to 2028](#). The bottom line is that the US is set to run federal budget deficits averaging \$1.2 trillion per year over the next 10 years through 2028. Federal debt will increase faster than GDP. In other words, the CBO isn't drinking the supply-siders' Kool-Aid. The CBO doesn't buy the notion that the Trump administration's tax cuts will boost growth sufficiently to pay for themselves. Here are a few of the report's key points:

(1) *Deficits.* During the current economic expansion, the federal budget deficit bottomed at \$1,477 billion ([Fig. 9](#)). It narrowed back to \$666 billion during fiscal 2017, which ended last September. According to the CBO, it is on track to widen to \$804 billion during the current fiscal year (Table 2 in the CBO report). Then over the next 10 years, from fiscal 2019 to fiscal 2028, the cumulative deficit is projected to be \$12.4 trillion.

(2) *Debt.* Publicly held US Treasury debt is projected to double from \$14.7 trillion at the end of fiscal 2017 to \$28.7 trillion by 2028 ([Fig. 10](#)). That's after it doubled from fiscal 2009 through fiscal 2017. The CBO projects the federal government debt-to-GDP ratio will rise from 77% last year to 96% during 2028.

(3) *New laws.* The CBO report notes: "Projected deficits over the 2018–2027 period have increased markedly since June 2017, when CBO issued its previous projections. The increase stems primarily from tax and spending legislation enacted since then..." The Tax Cuts and Jobs Act (TCJA) was enacted December 22, 2017. It was followed early this year by the Bipartisan Budget Act and then the Consolidated Appropriations Act. These acts collectively "significantly reduced revenues and increased outlays anticipated under current law." To avert a bitter partisan shutdown of the government, the Republicans and Democrats came up with a perfect bipartisan solution, i.e., spend lots more money on the programs that satisfy their respective partisan constituencies!

(4) *Revenues & outlays.* The 12-month sum of federal government outlays rose to a record \$4.1 trillion during March ([Fig. 11](#)). The CBO projects that this will grow 71% to \$7.0 trillion by 2028. The 12-month sum of federal government receipts rose to \$3.3 trillion through March. It has flattened out over the past two years, and is projected to increase by 67% over the next 10 years to \$5.5 trillion.

Federal government receipts have averaged 17.4% of GDP over the past 50 years ([Fig. 12](#) and [Fig. 13](#)). The CBO expects receipts to be about 16.6% of GDP from 2018 through 2022 before rising to 18.5% by 2028 after many of the provisions of the 2017 tax act expire.

Federal government outlays have averaged 20.3% of GDP over the past 50 years ([Fig. 14](#)). The CBO is projecting that outlays will remain near 21.0% over the next three years, and then rise to 23.3% by 2028. The CBO explains: "That increase reflects significant growth in mandatory spending—mainly because the aging of the population and rising health care costs per beneficiary are projected to increase spending for Social Security and Medicare, among other programs."

(5) *Interest costs.* The CBO also warns that interest costs "are projected to grow more quickly than any other major component of the budget, the result of rising interest rates and mounting debt. By 2028, net outlays for interest are projected to be roughly triple what they are this year in nominal terms...." Over the past 12 months through March, federal government net interest paid rose to a record \$283 billion,

which means that the CBO is projecting it will increase to \$850 billion in 10 years ([Fig. 15](#))!

It's hard to fathom why the US Treasury didn't issue only 30-year bonds in recent years, when the yield fell to as low as 2.11% on July 8, 2016 ([Fig. 16](#)).

(6) *Economic growth*. The CBO is acknowledging that the recently legislated cuts in tax rates and increases in spending will provide some fiscal stimulus to economic growth that will lift real GDP growth above its potential, which is determined by the growth in the labor force and in productivity. However, the CBO isn't increasing its projection of the potential growth rate of the economy, unlike supply-siders who believe that the tax cuts will do just that, presumably mostly by boosting productivity.

In the CBO's projections, real GDP growth and real potential GDP growth average 1.9% over the 2018-2028 period, even though real GDP grows more rapidly at first. In the CBO's projections, real GDP expands by 3.3% this year and by 2.4% in 2019. Here is the CBO's spin on potential output:

"Potential output is projected to grow more quickly than it has since the start of the 2007–2009 recession, as the growth of productivity increases to nearly its average over the past 25 years and as the recent changes in fiscal policy boost incentives to work, save, and invest. Nonetheless, potential output is projected to grow more slowly than it did in earlier decades, held down by slower growth of the labor force (which results partly from the ongoing retirement of baby boomers)."

(7) *So what?* The 30-year Treasury bond yield did increase from the record low of 2.11% on July 8, 2016 to a recent high of 3.22% on February 21. That occurred mostly as a result first of Trump's election victory in late 2016 and then in response to the passage of the TCJA in late 2017. Since then, the yield hovered listlessly around 3.00%. There's been almost an eerie dead calm in the bond waters.

On the other hand, there has been mounting chatter about whether federal budget deficits matter or not. Our take is they don't matter much as long as inflation remains subdued, as we expect it will. However, we will have more to say on this important subject in coming days and weeks.

CALENDARS

US. **Wed:** MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Dudley. **Thurs:** Leading Indicators 0.3%, Jobless Claims 230k, Philadelphia Fed Manufacturing Index 20.1, Weekly Consumer Comfort Index, EIA Natural Gas Report, Quarles. (*Wall Street Journal* estimates)

Global. **Wed:** Eurozone Headline & Core CPI 1.4%/1.0% y/y, UK Headline & Core CPI 2.7%/2.5% y/y, BOC Rate Decision 1.25%. **Thurs:** UK Retail Sales -0.4%/m/m/1.4%/y/y, Japan Headline, Core, and Core-Core CPI 1.0%/0.9%/0.5% y/y, Australia Employment Change & Unemployment Rate 20k/5.5%. (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—fell for the fourth week since reaching a new record high during the week of March 10. Since then, the WLI is down 1.5% during the four weeks ending April 7, after climbing eight of the prior nine weeks by a total of 8.2%. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB contracted 3.0% over the four-week period, following a nine-week jump of 13.0%. Jobless claims, one of the components of our BBB, rose for the fourth week to 230,000 (4-wa), not far from the 222,750 reading four weeks ago—which was the lowest level since 1973. Meanwhile, the CRB raw industrial

spot price index, another BBB component, remains in a volatile flat trend around recent highs. The WCCI is at its highest reading since 2001.

S&P 500 Q1 Earnings Season Monitor ([link](#)): With nearly 9% of S&P 500 companies finished reporting earnings and revenues for Q1-2018, the percentage of companies with positive surprise results are lower compared to the same point during the Q4 earnings season, but their overall surprise and y/y growth metrics are stronger. Of the 43 companies in the S&P 500 that have reported through mid-day Tuesday, 74% exceeded industry analysts' earnings estimates by an average of 5.4%; they have averaged a y/y earnings gain of 31.6%. At the same point during the Q4-2017 reporting period, a higher percentage of companies (77%) in the S&P 500 had beaten consensus earnings estimates by a lower 2.9%, and earnings were up a lower 18.4% y/y. On the revenue side, 81% beat sales estimates so far, with results coming in 1.7% above forecast and 10.9% higher than a year earlier. At this point in the Q4 season, a higher 87% had exceeded revenue forecasts by a lower 1.3%, and sales rose a lower 8.8% y/y. Q1 earnings results are higher y/y for 93% of companies, vs a lower 80% at the same point in Q4, and Q1 revenues also are higher y/y for 93% vs a similar 93% a quarter ago. These figures will change markedly as more Q1-2018 results are reported in the coming weeks. The early results on revenues are very encouraging, particularly the percentage of companies growing revenues y/y. Q1-2018 should mark the seventh straight quarter of positive y/y earnings growth and the strongest since Q4-2010 in part due to lower tax rates.

US ECONOMIC INDICATORS

Industrial Production ([link](#)): Headline production hit a new record high in March, while factory output reached a new cyclical high, though growth in the latter slowed last month. Headline production rose for the fifth time in six months, up 0.5% in March and 3.9% over the period—with factory output up 0.1% and 2.9% over the comparable periods. Business equipment production expanded for the seventh time in eight months, advancing 0.5% in March and 2.8% over the period. Production of information processing equipment has been very strong the first three months of this year, expanding 3.0% to a new record high, while transit equipment output was 3.6% higher over the three-month period, to its highest level since the start of 2016. Production of industrial machinery is stalled around recent highs so far this year. Meanwhile, utilities usage jumped 3.0% in March after unseasonably warm weather cut February usage by 5.0%; mining production rose 3.9% during the two months through March.

Capacity Utilization ([link](#)): The headline capacity utilization rate in March climbed for the second month from 77.1% in January to 78.0% in March—the highest reading since March 2015. Still, it's 1.8ppts below its long-run (1972-2017) average, but closing the gap. Manufacturing's capacity utilization rate edged down to 75.9% after rebounding from 74.9% to 76.0% in February—which was its highest reading since August 2015—March's rate was 2.4ppts below its long-run average. The utilization rate for mining rose for the second month from 87.3% in January to 90.1% in March, which is 3.1ppts above its long-run average though 1.5ppts below its high in 2014. The capacity utilization rate for utilities jumped 2.2ppts to 79.0% last month, remaining below its long-run average.

Regional M-PMI ([link](#)): Activity in the New York Fed district, the first to report on manufacturing for this month, remained firmly in positive territory during April, but optimism tumbled. The composite index eased to 15.8 this month after rebounding from 13.1 in February to 22.5 during March (which was near October's 37-month high of 28.1). Both shipments (to 17.5 from 27.0) and new orders (9.0 from 16.8) showed more measured growth than last month, while delivery times (15.6 from 16.2) continued to lengthen and inventory levels (8.1 from 5.6) moved higher. As for labor conditions, the employment (6.0 from 9.5) measure showed hirings expanded at a slower pace for the second month, while the average workweek (16.9 from 5.9) was significantly longer. Both input (47.4 from 50.3) and output (20.7 from 22.4) prices remained elevated. Looking ahead, the index for future business conditions (18.3 from

44.1) sank to its lowest level in more than two years.

Housing Starts & Building Permits ([link](#)): Housing starts surprised on the upside in March, with a double-digit rebound in the volatile multi-family starts. Total starts climbed 1.9% last month to 1.319mu (saar), while February's (to -3.3% from -7.0%) loss was less negative and January's (10.9 from 10.0) gain more positive. Last month, multi-family starts advanced 14.4% after a 10.2% decrease and a 22.2% increase the prior two months, though these starts are trending higher—with March's 452,000 units (saar) the highest since the end of 2016. Meanwhile, builders broke ground on less single-family homes, slumping 3.7% to 867,000 units (saar) after climbing 6.3% the first two months of the year. These starts remain in a volatile flat trend around recent highs, hindered by shortages of skilled labor and lots along with rising materials' costs. Building permits jumped 2.5% to 1.354mu (saar)—near its cyclical high—after a 4.1% loss and a 5.9% gain the previous two months. Multi-family units also accounted for the gain in overall building permits last month, rebounding 19.0% to 514,000 units (saar) after a 13.6% drop in February. Single-family permits tumbled 5.5% in March to 840,000 units (saar) after reaching a new cyclical high of 889,000 units in February. Meanwhile, April builder confidence remained on solid footing, though eased for the fourth month. The NAHB Housing Market Index declined from an 18-year high of 74 in December to 69 this month, as builders remained hampered by a shortage of buildable lots. All three components are down from December highs: sales expectations (to 77 from 79 in December), current sales (75 from 80), and traffic (51 from 55), though the former held close to December's reading.

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