



MORNING BRIEFING

July 17, 2018

Happy Sales

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

(1) Retail sales boosted by solid employment gains and tax cuts. (2) GDPNow now at 4.5%. (3) Business sales jump to record high, remaining bullish for S&P 500 revenues. (4) No sign of supply-chain worries in real inventory-to-sales (I/S) ratios. (5) Remarkable decline in retailing I/S ratio attributable to Amazon. (6) Big divergence between real GDP outlook at the Fed and the White House. (7) Kudlow crosses the line. (8) Will tighter monetary policy offset stimulative fiscal policy? (9) Powell skirts trade policy issues. (10) Known unknown: Fiscal multiplier in bad vs good times.

Business Cycle I: Record Business Sales. Yesterday's report on June retail sales was a strong one, confirming that solid employment gains and tax cuts are trumping concerns about protectionism and weakening gains in inflation-adjusted wages. Debbie discusses the report below. We aren't surprised, since our Earned Income Proxy for private-sector wages and salaries is growing at a solid pace, up 5.0% y/y through June ([Fig. 1](#)). Retail sales is up 6.6% over the same period, and 5.4% excluding gasoline sales.

As a result, the Atlanta Fed's [GDPNow](#) estimate for real GDP growth in Q2-2018 was raised to 4.5% yesterday from 3.9% on July 11. The estimate for real consumer spending growth increased from 2.7% to 3.1% after yesterday's retail sales report. Real federal government spending growth jumped from 1.4% to 5.6% after the Monthly Treasury Statement release on Thursday, July 12.

We actually spend more time analyzing the companion report that is always released at the same time as retail sales, i.e., the one on total manufacturing and trade sales of goods, which is lagged by a month. Here's why:

(1) *Level at record high.* May's business sales jumped 1.4% m/m and 8.6% y/y—the largest yearly gain since November 2011 ([Fig. 2](#)). This series is highly correlated with aggregate S&P 500 revenues. So the latest business sales figure augurs well for revenues during Q2.

(2) *Solid growth rates.* Not surprisingly, the growth rates of S&P 500 aggregate revenues and business sales are highly correlated ([Fig. 3](#)). Both are up 8.6% y/y. Excluding petroleum sales, which have continued to rebound from the lows of early 2016, business sales is still up impressively by 5.8% y/y, while S&P 500 aggregate revenues excluding energy is up 7.6% ([Fig. 4](#)).

(3) *Bottom line.* You may be wondering why business sales of goods (\$17.4 trillion, saar) is almost as large as nominal GDP of goods and services (\$20.0 trillion during Q1 saar). The former includes intermediate goods, while the latter includes just finished ones. You might also be wondering why business sales of goods is so highly correlated with S&P revenues, which includes sales of goods *and* services. The answer is that the cycle in goods tends to fluctuate with more amplitude than the cycle in services.

One more thing: S&P 500 revenues also includes overseas sales of goods and services. However, the US business cycle tends to dominate or lead the overseas business cycle. The bottom line is that it works: Business sales is a great coincident monthly indicator of the growth in quarterly S&P 500 revenues, and it remains bullish.

Business Cycle II: Inventory Trends. There is no sign yet that Trump's "America First" protectionism is depressing business sales. Nor is there any evidence, so far, that companies are scrambling to build their inventories in the event that their global supply chains are disrupted by Trump's fair-trade campaign. Here is what the data show:

(1) *Total business inventories.* The inflation-adjusted inventories-to-sales (I/S) ratio for business as a whole has been on a downtrend since recently peaking at 1.47 during January 2016 ([Fig. 5](#)). It was down to 1.41 in April.

(2) *Manufacturing & trade inventories.* The same can be said of the I/S ratio for manufacturing, which has declined from a recent peak of 1.66 during July 2016 to 1.60 during April, holding at its lowest reading since April 2015 ([Fig. 6](#)).

The I/S ratio for wholesalers has been a bit more volatile, but is down from a recent peak of 1.39 during January 2016 to 1.33 during April.

(3) *Impact of online retailing.* The most interesting development is the ongoing plunge in the I/S ratio for retailing. It was at 1.28 in April, little changed from March's record low of 1.27. However, the data are only available since January 1997. Nevertheless, there has been a discernable plunge in this ratio since its record high (for this series) at 1.56 during October 2008.

This extraordinary development is attributable to the extraordinary increase in online retailing led by Amazon, which has revolutionized inventory management in the retailing industry. Amazon went public during 1997. At the beginning of that year, online shopping accounted for just 8.4% of the sum of in-store (GAFO) sales plus online sales ([Fig. 7](#) and [Fig. 8](#)). It was up to 30.8% of this total by May of this year.

(4) *Driving trucks and trains.* With real business inventories rising in record-high territory this year, it's not surprising to see that intermodal railcar loadings and truck tonnage are also at record highs ([Fig. 9](#) and [Fig. 10](#)).

The Fed I: Circular Reasoning. "Tax Law May Stimulate Economy Less Than Expected, or Maybe Not at All, S.F. Fed Economists Say." That's the startling headline of a *WSJ* [article](#), which discussed the FRB-SF's 7/9 [Economic Letter](#) with the less provocative title "Fiscal Policy in Good Times and Bad."

The letter's authors, Tim Mahedy and Daniel J. Wilson, concluded that fiscal stimulus tends to be less stimulative during economic expansions than downturns and estimate the TCJA's "true boost" to 2018 GDP growth at well below the percentage point expected by "a number of macroeconomic forecasters"—maybe "as small as zero." So the fiscal multiplier may be zero during good times!

Of course, the TCJA is providing fiscal stimulus with tax cuts rather than spending increases. The Fed economists obviously aren't buying the supply-siders' optimistic spin on the TCJA's impact on GDP. Neither are the members of the FOMC. According to the June [Summary of Economic Projections](#) (SEP) of the Fed governors and district presidents, the rate of real GDP growth will slow over the next few years. At the same time, they are forecasting further increases in the federal funds rate. The implication is that Fed officials expect to be raising interest rates to dampen the fiscal stimulus! In other words,

monetary and fiscal policy would be working at cross-purposes.

Oddly, the FRB-SF economists didn't touch on the role of monetary policy in their analysis. It seems logical to Melissa and me that one reason that stimulative fiscal policy may not be as stimulative during periods of economic growth is because monetary policy tends to be a counter-cyclical force during good times. Such logic may explain the observations of the FRB-SF economists as well as the Fed's subdued projections for growth. Consider the following:

(1) *Growth not so fast.* The White House has been promoting the supply-side impact of the TCJA. The Council of Economic Advisers (CEA) [projects](#) that economic growth will accelerate to above 3.0% y/y, on average, through the next decade, boosted by Trump's economic agenda. In contrast, Fed officials are expecting real GDP growth to slow over the next three years. According to the June SEP, the median projections for real GDP growth in 2018, 2019, and 2020 are 2.8%, 2.4%, and 2.0% on a Q4/Q4 basis, respectively. For the longer run, the FOMC's projection is just 1.8%, a full percentage point below the committee's 2018 projection and 1.2 percentage points below the CEA's long-run projection.

(2) *Trade not in the numbers.* Could the trade dispute between the US and China be weighing on the Fed's growth projections? We doubt it. During his 6/13 [press conference](#) following the release of the June SEP release, Fed Chairman Jerome Powell said: "We really don't see [trade] in the numbers. It's just not there." He added: "[S]o I would put it down as more of a risk."

Even though the trade dispute has escalated since then, Powell continues to see the outcome as unknown. He said so in a radio interview last Thursday, according to a 7/12 [WSJ article](#), which concluded: "Federal Reserve Chairman Jerome Powell said a strong economy should allow the central bank to keep raising interest rates gradually and it was premature to judge how recent trade policy actions could alter those plans." The article also quoted Powell on the impacts of various trade scenarios:

"If the Trump administration is successful over time in lowering trade tariffs, 'then that'll be a good thing for our economy,' Mr. Powell said. 'If it works out other ways, so that we wind up having high tariffs on a lot of products ... and that they become sustained for a long period of time, then yes, that could be a negative for our economy.'" Also: "In his most direct comments on the issue to date, Mr. Powell highlighted a worse-case scenario, of sorts, for the Fed. 'You can imagine situations which would be very challenging, where inflation is going up and the economy is weakening,' he said." That would be the stagflation scenario mentioned in yesterday's [Morning Briefing](#). As for his opinion on Trump's trade policies, Powell said: "When we don't make policy, we don't praise it; we don't criticize it."

(3) *Fiscal stimulus in the numbers.* On the other hand, fiscal stimulus is reflected in the Fed's projections, Powell said during his press conference: "Fiscal policy is boosting the economy, ongoing job gains are raising incomes and confidence, foreign economies continue to expand, and overall financial conditions remain accommodative. These observations are consistent with the projections that Committee participants submitted for this meeting." The fact the Fed is projecting such subdued growth when factors in addition to the fiscal stimulus are expected to boost it implies that the Fed expects insignificant effects from stimulus. Maybe that's because it is accounting for a significant offsetting factor, namely rising interest rates!

(4) *Breaking precedent.* Perhaps the divergence between the projections of the White House and those of the Fed reflects different expectations for monetary policy? That could explain why the White House recently reversed a 25-year precedent of refraining from commenting on monetary policy, according to a 6/29 [WSJ article](#). Larry Kudlow, the director of the National Economic Council, said he hopes that

Powell recognizes that “more people working and faster economic growth do not cause inflation” and that the Fed “will move very slowly.” Those were some of Larry’s first public comments since he (thankfully) recovered from a mild heart attack. So the Fed’s approach must be at the top of Larry’s mind, which is probably because his office’s growth projections depend on it.

(5) *Fed funds rising.* Over the same time that the Fed projects slowing US economic growth, the median federal funds rate is projected to increase to 2.40% for 2018, 3.10% for 2019, and 3.40% for 2020. That isn’t a steep path of increases, but the jumps aren’t insignificant.

Last September, the Fed projected the federal funds rate for 2020 at 2.90%. It was increased to 3.10% in December and again to 3.40% in March, then maintained for the June projection. This progression clearly corresponds to the timing of the TCJA passage at the end of last year. As of June, the Fed expects the federal funds rate to settle around 2.90% over the longer run. Perhaps officials are anticipating that they’ll need to tap on the brakes to keep the US economy from overheating in the short term due to the anticipated effects of the stimulus.

(6) *Reading between the lines.* During Powell’s press conference, CNBC’s Steve Liesman asked Powell to explain how he personally would forecast the impact of the fiscal stimulus on real GDP. Powell evaded the question, focusing on the participants’ range of expectations: “I think we’re looking at a reasonable range of estimates and ... different participants are putting different estimates in and we’re going to be waiting and seeing.” The range of participant projections in the June SEP is 1.7%-2.1% for the longer run. If Powell is saying that this range is “reasonable,” isn’t he also suggesting that the higher White House expectation isn’t reasonable?

Powell’s response seemed out of character. So far during his tenure as Fed chairman (i.e., since February 5), he has been quite direct in his speeches and public comments. In this instance, Powell was either dodging the question or indicating that the answer isn’t so simple.

(7) *It’s complicated.* It’s easy to see how complicated the Fed’s projections can get. A SEP footnote states: “Each participant’s projections are based on his or her assessment of appropriate monetary policy.” So the Fed’s projections for real GDP growth depend on future monetary policy—with what that means differing by forecaster—and monetary policy of course depends on the forecast for real GDP growth as well as the rate of inflation.

Therefore, the best answer to the question “How will fiscal stimulus impact real GDP growth?” may be: “It depends.” It depends on whether the stimulus gives rise to inflation. It depends on how trade issues play out—and play into growth and inflation. And it also depends on how Fed officials react to all of these effects!

The Fed II: No Precedent. The economic letter discussed above doesn’t really add much to the existing literature on the effectiveness of fiscal policy. And the existing literature isn’t very useful in measuring the effects of fiscal policy during various stages of the business cycle. The authors do present new data characterizing the context for fiscal policy—i.e., showing that fiscal stimulus is pouring into an already “hot economy” for the first time since the Vietnam War. But they don’t weigh in on how the current stimulus may influence tomorrow’s output, limiting their discussion to studies of fiscal multipliers.

The authors stated that “[t]he predominant research finding is that the fiscal multiplier is smaller during expansions than during recessions.” Weakening that conclusion, however, they admitted that estimating the fiscal multiplier is challenging, especially “given the historical rarity of stimulative fiscal policy in good times or contractionary fiscal policy in bad times at the federal level. Therefore,

researchers have typically turned to data at the state level or from other countries to estimate separate fiscal multipliers for procyclical and countercyclical stimulus.” Further: “There has been scant empirical research on the link between the state of the economy and the macroeconomic impacts of tax changes.”

Our assessment is that the evidence presented only very loosely supports its key finding. None of the three studies cited by the authors examines the fiscal multiplier for the US at a national level. Two focus on state-level data, and the third estimates the national GDP multiplier on government spending using a panel of OECD countries. The additional evidence presented is what we call “loose evidence,” derived from microeconomic theory based on the marginal propensity to consume.

The authors also mention a “prominent” contrary [study](#) titled “Government Spending Multipliers in Good Times and in Bad: Evidence from US Historical Data.” But its conclusion is inconclusive. That paper’s researchers comprehensively investigated “whether government spending multipliers in the United States differ according to two potentially important features” of the economy: (i) the amount of slack in the economy, and (ii) whether interest rates are near the zero lower bound. Their research yielded mixed results using different methodologies.

Our point is that economic models for the fiscal multiplier aren’t very helpful right now because there really isn’t much precedent for fiscal stimulus in an economy with today’s features. So far, the fiscal package appears to be boosting growth while inflation remains relatively subdued. Assuming that continues for a while, as we do, the Fed will likely continue its gradual path of interest rate increases, as discussed above.

CALENDARS

US. Tues: Headline & Manufacturing Industrial Production 0.6%/0.7%, Capacity Utilization Rate 78.3%, Housing Market Index 69, Treasury International Capital, Fed Chair Powell’s Semiannual Monetary Policy Testimony Before the Senate Banking Committee. **Wed:** Housing Starts & Building Permits 1.320mu/1.333mu, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Fed Chair Powell Appears Before House Panel. (*Wall Street Journal* estimates)

Global. Tues: European Car Registrations, UK Jobless Claims Change & Claimant Count Rate, UK Employment Change & Unemployment Rate (3-month) 115k/4.2%, RBA July Meeting Minutes, BOE’s Carney, Cunliffe, and Stheeman Speak on Financial Stability. **Wed:** Eurozone Headline & Core CPI 2.0%/1.0% y/y, UK Headline & Core CPI 2.6%/2.1% y/y, Japan Merchandise Trade Balance ¥155.0b. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose to record highs for all three of these indexes last week. Forward earnings activity has been relatively strong in the past 11 months, as LargeCap’s forward earnings has risen in 49 of the past 50 weeks, MidCap’s is up in 44 of the past 46 weeks, and SmallCap’s is up in 43 of the past 46. Earnings momentum remains healthy, 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 an eight-week high of 21.6% y/y from 21.4%, which compares to a seven-year high of 21.7% in mid-May and a six-year low of -1.8% in October 2015; MidCap’s rose to 23.4% from 23.2%, which compares to a seven-year high of 24.0% in early June and a six-year low of -1.3% in December 2015; and SmallCap’s increased w/w to 31.6% from 31.5%, which compares to 32.0% in late June, which was the highest since October 2010, and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018

and 2019: LargeCap 22.1% and 9.9%, MidCap 20.6% and 12.7%, and SmallCap 29.7% and 15.1%.

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios were mixed last week after rising broadly a week earlier for the first time in four weeks. They remain down from 12-week highs in early June to levels that are not much above their recent post-election lows. LargeCap's weekly forward P/E rose to 16.5 from 16.3, which is up from a post-election low of 16.0 in late March and down from 18.6 on January 26—the highest since May 2002. That compares to the post-Lehman-meltdown P/E of 9.3 in October 2008, but is well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E was steady at 16.6, which is up from its 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E had mostly been at or below LargeCap's P/E from August to March for the first time since 2009. SmallCap's P/E edged down to 17.7 from 17.8, which compares to a post-election low of 17.0 in mid-March. That's 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 daily forward price/sales (P/S) ratios, they also improved w/w for all three indexes, but remain at levels well below January highs: LargeCap's P/S of 2.04 is down from a record high of 2.19 on January 26; MidCap's 1.34 compares to its record high of 1.40, also on January 26; and SmallCap's 1.02 is down from 1.05 then, 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 books closed on Q2 results, analysts and investors are awaiting Q2 results and guidance about the future. The S&P 500's Q3-2018 EPS forecast was steady w/w at \$41.02. That's down 0.1% since the end of Q2, but up 8.7% ytd, and 9.4% since the passage of the TCJA. The \$41.02 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 23.2%, down from 23.3% a week earlier and at the end of Q2, but up from 22.1% at the end of Q1. That compares to Q2-2018's blended 20.9%, Q1-2018's 26.6% (which is the strongest since Q4-2010), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q2, Q3-2018 estimates are higher for two sectors, down for six, and steady for three. The Q3 forecast has risen 0.4% for Energy and Materials. Consumer Staples, Industrials, and Telecom are the biggest decliners, with their Q3-2018 forecast down 0.5% since the end of Q2, followed by 0.1% declines for Consumer Discretionary, Financials, and Tech. The S&P 500's Q3-2018 forecasted earnings gain of 23.2% y/y would be its ninth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q3-2018, but nine are expected to rise at a double- or triple-digit percentage rate compared to seven during Q2. However, just three are expected to beat the S&P 500's forecasted y/y earnings gain of 23.2% compared to four during Q2. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace and four outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q3 relative to very low earnings a year ago, with the pace slowing from Q2. The latest forecasted Q3-2018 earnings growth rates vs their blended Q2-2018 growth rates: Energy (103.7% in Q3-2018 vs 145.1% in Q2-2018), Financials (44.5, 22.0), Materials (33.4, 33.5), S&P 500 (23.2, 20.9), Telecom (20.3, 9.5), Consumer Discretionary (19.4, 16.1), Industrials (18.8, 15.3), Tech (17.0, 25.5), Consumer Staples (10.5, 9.9), Health Care (10.9, 11.2), Utilities (7.1, 1.6), and Real Estate (4.8, 2.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 20.0% y/y in Q3, up from a blended 17.1% in Q2; that compares to 24.5% in Q1-2018, 12.7% in Q4-2017, and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

US ECONOMIC INDICATORS

Retail Sales ([link](#)): Consumers continued their shopping spree in June, pushing retail sales up to yet another new record high. Sales expanded 0.5% last month, following an upwardly revised gain (to 1.3%

from 0.8%) during May. It was the fifth consecutive advance in sales, which had stalled in December and January. Meanwhile, core retail sales were unchanged at their record high last month, while May's 0.5% increase was revised up to a 0.8% gain. (The BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) Real retail sales climbed for the fourth time in five months, according to our estimates, advancing 0.4% in June after a 1.2% jump in May. These sales accelerated 7.3% (saar) last quarter—the best quarterly advance since Q1-2015—after contracting -2.1% during Q1. We estimate real core retail sales fell for the first time in five months, by a negligible -0.1% last month, while the quarterly gain accelerated 5.9% (saar) after falling -1.8% during Q1. Eight of the 13 major nominal sales categories rose in June, boosted by gains of 1.0% or more by health & personal care (2.2%), food service & drinking (1.5), nonstore (1.3), and gasoline (1.0) retailers; auto (0.9) and building material (0.8) increases were just below 1.0%. Major offsets to these gains were recorded by sharp declines in sales of sporting goods (-3.2) and clothing (-2.5) stores. It was the third straight decline in sales for the former, but just the first contraction in six months for the latter—which is up 3.5% ytd.

Business Sales & Inventories ([link](#)): Nominal business sales in May climbed to another new record high, while real sales in April remained stalled at its record high. The details: Nominal manufacturing & trade sales (MTS) advanced for the 11th time in 12 months, jumping 1.4% m/m and 8.6% y/y—the best yearly growth rate since November 2011. Inflation-adjusted MTS has been moving sideways since reaching a new record high at the end of last year. April sales fell for the second time this year, down -0.1% m/m and -0.3% ytd. Still, these sales are up 3.6% y/y. The real sales of retailers reached a new record high in April, while wholesalers' sales climbed for the third month, heading back toward November's record high; real manufacturers' sales remained stalled at their cyclical high. April's real inventories-to-sales ratio remained at 1.41; it's been on a fairly steady downtrend since reaching a cyclical high of 1.47 at the start of 2016. May's nominal inventories-to-sales ratio continues to fall, dropping to 1.34—the lowest since the end of 2014 and considerably below the seven-year high of 1.43 posted two years ago.

Regional M-PMI ([link](#)): The New York Fed—the first district to report on manufacturing for this month—says business activity continued at a fairly brisk, though slightly slower pace. The composite index slipped to 22.6, after climbing from 15.8 in April to 25.0 in June. Still, this month's reading is within 5.5 points of October's 37-month high of 28.1. Both the new orders (to 18.2 from 21.3) and shipments (to 14.6 from 23.5) components fell back below 20.0 this month, posting a modest pullback. Labor market indicators pointed to continued sturdy growth in employment (17.2 from 19.0), which held near June's high for this year, and a modest increase in the workweek (5.6 from 12.0). Meanwhile, delivery times (6.0 from 13.2) continued to lengthen, though by a narrower margin than in recent months, while inventories (-4.3 from 5.4) contracted for the first time since last October. The prices paid index (42.7 from 52.7) retreated ten points but remained elevated, while the prices received index (22.2 from 23.2) was little changed, signaling ongoing moderate increases in selling prices. Looking ahead, the index for future business conditions reversed June's gain, falling to 31.1 this month after rising from 31.1 to 38.9 last month.

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