



MORNING BRIEFING

August 1, 2018

New York, Tokyo, and Mumbai

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

(1) Earnings hotter than expected. (2) Forward revenues and earnings of S&P 500/400/600 rising to fresh record highs at end of July. (3) Lots of good reasons to be bearish on bonds, yet yield of 10-year Treasury remains calm just under 3.00%. (4) US bond yield is tethered to near-zero yields in Germany and Japan. (5) Trade uncertainties depressing Germany. (6) BOJ keeps priming inflation pump, which continues to run dry. (7) Inflation remains relatively subdued in US. (8) One person's debt is another's asset. (9) A guided tour of the latest developments in India.

US Stocks: Earnings on a Hot Tin Roof. The Q2 earnings season is coming to a close. Remarkably, the result for the S&P 500 once again is turning out better than industry analysts had expected at the start of the season ([Fig. 1](#)). That happens regularly, but it's surprising so soon after industry analysts scrambled to raise their Q2 earnings estimates at the beginning of this year to reflect the slashing of corporate taxes by the Tax Cuts and Jobs Act (TCJA) late last year. It suggests either that they underestimated the impact of the TCJA or that earnings are getting a bigger boost than expected from the strong US economy. Consider the following:

(1) *Earnings.* The earnings season has also brought some upside surprises for the S&P 400 and S&P 600. Interestingly, industry analysts have continued to increase their Q4 estimates for all three stock price composites, as they have been doing since the beginning of the year. The result is that the 2018 estimates for all three continue to rise, as do the comparable estimates for 2019 ([Fig. 2](#)). Consequently, the forward earnings of the S&P 500/400/600 all rose to record highs at the end of July.

(2) *Revenues.* Just as impressive is that the 2018, 2019, and forward revenues estimates of the S&P 500/400/600 also all have continued rising in record-high territory ([Fig. 3](#)). That's truly remarkable, since by all accounts the global economy is slowing, partly in response to Trump's escalating trade war. Then again, his tax cuts have boosted the US economy.

(3) *Valuation.* Despite the recent rally in stock prices, valuation multiples remain in fair-value territory for the S&P 500/400/600, as rising earnings have offset rising stock prices. The forward P/Es of the S&P 500/400/600 at the end of July were 16.4, 16.3, and 17.4 ([Fig. 4](#)).

US Bonds: Yields Made in Japan. Helping stocks to recover from the year's lows in early February is the eerie calm in the US bond market. The Bond Vigilante Model suggests that the 10-year Treasury bond yield tends to trade around the growth rate in nominal GDP on a y/y basis ([Fig. 5](#)). It has been trading consistently below nominal GDP growth since mid-2010. The current spread is among the widest since then, with nominal GDP growing 5.4% while the bond yield is just below 3.00% ([Fig. 6](#)).

Why isn't the bond yield closer to 4.00% or even 5.00%? After all, the TCJA and additional fiscal spending passed by Congress earlier this year are projected by the Congressional Budget Office to result in federal budget deficits averaging about \$1 trillion per year for the next 10 years ([Fig. 7](#)).

Furthermore, the FOMC commenced tapering its balance sheet last October and plans to continue doing so through the end of 2024 ([Fig. 8](#)). The Fed is on track to slash its holdings of Treasuries and MBSs by \$2.5 trillion and \$1.7 trillion, respectively, over the next seven years! Oh and by the way, the FOMC is on track to raising the federal funds rate to 3.00% by the end of next year from 1.75%-2.00% currently.

Let's review some possible explanations for the nonchalant performance of the bond market. Is it the calm before the storm or the calm that calmly continues? Consider the following bullish offsets to the bearish factors just mentioned above:

(1) *Near-zero yields in Germany and Japan.* The 10-year German government bond yield has dropped from this year's high of 0.77% on February 2 to 0.44% yesterday ([Fig. 9](#)). Germany may have been hit by uncertainty created by Trump's trade war. The IFO Business Confidence Index has been falling all year, with its expectations component the lowest since March 2016 ([Fig. 10](#)). In any event, the ECB has indicated that the bank's key interest rates will remain at historical lows at least through the summer of next year!

Meanwhile, there was some anxiety last week about a rumored change of course by the BOJ. The 10-year Japanese bond yield jumped from 0.035% on Friday, July 20, to 0.104% on Monday of this week. It was back down to 0.048% yesterday after the BOJ kept its policy steady. It maintained its target for the 10-year government bond yield at around 0.00% and the short-term interest rate target at minus 0.1%. The bank announced one minor tweak: In a statement, it explained that the yields may move up or down "to some extent mainly depending on developments in economic activity and prices."

Wow, lots of agita about nothing! The BOJ also acknowledged that it will take "more time than expected" to achieve its inflation target of 2%. You think? The BOJ's monetary base has more than quadrupled since April 2013, when Haruhiko Kuroda, the new head of the bank back then, slammed on the monetary accelerator and never took his foot off of it ([Fig. 11](#)). Most of the time since then, through June of this year, Japan's CPI inflation rate has remained closer to zero than 2.0% (with the exception of 2014, when the sales tax was raised significantly) ([Fig. 12](#)).

(2) *Subdued inflation.* Back in the USA, the latest inflation figures remain relatively benign: Not too hot, not too cold, just warm enough to allow the Fed to proceed with the gradual normalization of monetary policy. The headline PCED rose 2.2% y/y through June, while the core increased 1.9% over the same period ([Fig. 13](#)).

The wage component of the Employment Cost Index held at 2.9% y/y during Q2 ([Fig. 14](#)). That's the highest pace since Q3-2008, but still relatively low given the tightness of the labor market.

(3) *Record wealth, with lots set on risk off.* That still leaves an important question: Why aren't bond yields rising in anticipation of all the debt that will need to be financed? There is already a record amount of debt everywhere, and more coming can't be good for bonds. There is also a record amount of wealth in the world. Some of it tends to be managed with a risk-off bent. Ironically, people who expect that "this will all end badly" tend to buy government bonds because they are deemed to be among the safest assets.

India I: Hotter and Hotter. India boasts the hottest big economy in the world at the moment, and its stock market is hitting record highs. In some ways, it's the financial equivalent of a Bollywood movie, exuberant and over the top, minus the music and dancing. One thing that's different: Investors aren't assured of the happy ending that movie goers can expect. A weak rupee and rising oil prices are seen as threats. I asked Sandra Ward, our contributing editor, to look behind the scenes, to see what's been

driving the growth in the economy and the stock market and whether it's sustainable. Here's what she found:

(1) *Shaking off demons*. India's GDP grew at a 7.7% y/y clip during Q1, compared with 7.2% growth the prior quarter and 6.1% in Q1-2017 ([Fig. 15](#)). It was the highest rate of growth in seven quarters. The Reserve Bank of India expects full-year growth of 7.4%, a 4/28 [piece](#) on Reuters reported. The International Monetary Fund concurred until a few weeks ago, when it cut its growth outlook for India in 2018 by 0.10% to 7.3%, citing higher oil costs and higher interest rates, according to a 7/16 [article](#) in *The Hindu*. Significantly, India's Q1 economic growth eclipsed that of China's 6.8% by nearly a full percentage point. China's growth came in slightly ahead of expectations but was flat with the previous two quarters.

All core segments of India's economy contributed to growth, and the construction sector showed exceptionally strong performance, according to a 5/31 [article](#) in *The Hindu*. One concern: Government spending is still the biggest driver of GDP at 16.8% growth, but that figure is down significantly from the 31.9% contribution posted in Q1-2017 when we wrote about India in the 7/20/17 [Morning Briefing](#) ([Fig. 16](#)).

India is recovering, at last, from the initial negative effects of economic reforms enacted by Prime Minister Narendra Modi. First, common bank notes in circulation were eliminated in a demonetization process in 2016, creating a lot of uncertainty and subsequent disruption to the economy. Then in 2017, a goods and services tax designed to simplify the tax code, boost efficiencies, and increase the competitiveness of Indian goods was imposed, and the confusion that resulted also interfered with business activity.

(2) *Manufacturing PMI*. India's manufacturing improved in June at the fastest rate since December, extending the period of expansion to 11 months, according to the 7/2 Nikkei India Manufacturing PMI [report](#). The M-PMI index rose to 53.1 in June from 51.2 in May ([Fig. 17](#)). July's M-PMI is being released this morning.

Input costs rose at the fastest rate since July 2014 on higher steel and oil prices. Growth in output charges exceeded that pace as firms raised their prices at the fastest rate since February. New orders from overseas posted the eighth straight month of gains, with the rate of expansion the fastest since February.

(3) *Services PMI*. After contracting slightly in May, the Indian service sector returned to a growth trajectory in June. The strongest rise in new business in a year led to the fastest rate of expansion since June 2017, according to the 7/4 Nikkei India Services PMI [report](#). The Nikkei Business Service Activity Index rose to 52.6 in June from 49.6 in May. Service providers weren't able to fully pass on their higher input costs to India's famously price-sensitive consumers.

(4) *Inflation*. Wholesale prices rose by 5.8% in June, accelerating at the fastest pace in four and a half years on surging food and fuel prices, according to a [story](#) in the 7/16 *Economic Times*. Consumer prices rose 5.0% on higher fuel and housing costs ([Fig. 18](#)).

(5) *Rate hike*. In a surprise move, the Reserve Bank of India raised its benchmark interest rate by 0.25% in June for the first time since 2014, citing the pressures from higher oil prices and the weakening rupee, a 6/6 [article](#) in the *FT* pointed out ([Fig. 19](#)). India relies on foreign sources for 80% of its oil.

India II: Higher and Higher. India is the best performing of the emerging markets and Asian countries

so far this year. The MSCI India Share Price Index is up 4.4% ytd (in rupees) compared with a loss of 2.5% in the MSCI Emerging Market Share Index (local currency), while the MSCI Emerging Asia Share Index (local currency) is down 3.1% ytd ([Fig. 20](#)).

(1) *Higher earnings.* The MSCI India index companies are projected to increase earnings this year at a 28.0% rate, compared with 15.7% for the MSCI Emerging Market index companies and 14.9% for the companies in the MSCI Emerging Asia index. Yet the MSCI India index is trading at a forward P/E of 18.1 ([Fig. 21](#)).

Investors are betting that stronger economic growth will lead to higher profits. They also see India somewhat as a safe haven in the tit-for-tat trade war between the US and China. In addition, more and more domestic investors have been drawn to the equities market by the strong performance of Indian equities over the past few years. Many, too, have turned increasingly to mutual funds and insurance products as demonetization discouraged folks from investing in physical assets such as gold and real estate, according to a 6/27/17 [piece](#) on LiveMint.com.

Other emerging markets have sold off as higher interest rates in the US have driven the US dollar higher, but the S&P BSE Sensex has bucked the trend, rising 10.1% ytd through Monday. The Sensex set a new high on Tuesday, closing at 37,606.58. Still, comparatively few companies are driving the benchmark higher. The *WSJ* reports that the bulk of the gains can be credited to outsourcing companies and banks, with Tata Consultancy Services and Infosys advancing the most, according to a 7/26 [piece](#).

(2) *Bad loan resolution.* Financial companies make up 41% of the Sensex. Kotak Mahindra Bank and Yes Bank are among the top five performers so far this year, as investors expect the new bankruptcy code will help break up the logjam of bad loans on bank balance sheets and free up lending. State Bank of India, the largest by assets of the state-owned banks, reported a \$1.1 billion loss in the quarter ended March. Yet the bank also signaled that the worst of its non-performing loan problem was behind it and that it is on track for recovery, according to a 5/22 [article](#) on Reuters. More recently, more than 20 Indian banks signed an agreement aimed at speeding up bad-loan resolution, according to a 7/23 Reuters [story](#).

(3) *Foreign direct investment.* A spate of high-profile deals could mark a new spurt of growth for foreign inflows into India, which grew at a rate of 3% last year, a five-year low.

In May, Walmart announced a \$16 billion investment in Flipkart, giving it a 77% stake in India's largest online retailer, which was started by two former Amazon employees, according to a 5/9 *FT* [piece](#).

Sweden's home-furnishing giant Ikea is preparing to open its first megastore in India, after more than a decade of delays and setbacks and an estimated \$750 million to acquire land and permissions for four stores. It plans to spend about the same over the next few years, says a 6/10 *FT* [article](#).

The entertainment company and streaming service Netflix just launched its first Indian-produced series, *Sacred Games*, lured by the country's 500 million Internet users. Netflix views India as its next major source of revenue growth and expects to add 100 million Indian subscribers to its existing base of 125 million global subscribers, according to a 7/16 [report](#) in the *FT*.

And French industrial group Schneider Electric agreed to buy India's Larsen & Toubro for \$2.1 billion, which will make India the third-largest market for Schneider. "It's a bet on India and a growing economy with favorable government policies," a Schneider spokesperson told the *FT* for a 5/1 [piece](#).

(4) *Demographic dividend*. On track to become the world's most populous country by 2024, India has a highly desirable demographic profile. More than 50% of its population is below the age of 25, and more than 65% is under 35. A growing workforce population should help drive economic growth ([Fig. 22](#)). Of course, all those folks are going to need jobs, and that will be Modi's next challenge, especially as he faces reelection in 2019.

CALENDARS

US. Wed: ADP Employment 172k, Motor Vehicle Sales Total & Domestic 17.1mu/12.9mu, Construction Spending 0.3%. ISM & IHS Markit M-PMIs 59.4/55.5, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Announcement 1.875% (1.75% to 2.00%). **Thurs:** Jobless Claims 218k, Challenger Job-Cut Report, Factory Orders 0.9%, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: Eurozone, Germany, France & Italy M-PMIs 55.1/57.3/53.1/53.0, UK M-PMI 54.2. **Thurs:** BOE Bank Rate 0.75%, BOE Asset Purchase Target 435b, BOE Inflation Report, BOJ Minutes of June Policy Meeting. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q2 Earnings Season Monitor ([link](#)): With Q2 results in hand for over 60% of S&P 500 companies, we find a higher percentage of companies reporting positive surprises than at the same point during the Q1 earnings season but a lower overall percentage surprise. Year-over-year growth rate metrics for the Q2 reporters to date are close to Q1's historically high levels. More specifically, of the 302 companies in the S&P 500 that have reported through mid-day Tuesday, 82% exceeded industry analysts' earnings estimates by an average of 5.2%; they have averaged a y/y earnings gain of 26.2%. At the same point during the Q1-2018 reporting period, a lower percentage of companies (81%) in the S&P 500 had beaten consensus earnings estimates by a higher 7.9%, and earnings were up a lower 25.7% y/y. On the revenue side, 73% of companies beat their Q2 sales estimates so far, with results coming in 1.2% above forecast and 10.1% higher than a year earlier. At this point in the Q1 season, a higher 75% of reporting companies had exceeded revenue forecasts by a higher 1.5%, and sales had risen by a lower 9.7% y/y. Q2 earnings results are higher y/y for 86% of companies, vs a higher 88% at the same point in Q1, and Q2 revenues are higher y/y for 87% vs a higher 91% a quarter ago. These results are very encouraging, particularly the percentage of companies growing revenues y/y. Q2-2018 should mark the eighth straight quarter of positive y/y earnings growth and among the highest growth since Q4-2010. The strong results are mostly due to lower tax rates and improved business conditions.

US ECONOMIC INDICATORS

Personal Income & Consumption ([link](#)): The latest monthly data show real consumer spending was strong throughout Q2, boosted by tax cuts. Real personal consumption expenditures (PCE) climbed 0.3% in June, matching May's pace—which was revised up from the initial estimate of unchanged. For the quarter, real PCE accelerated 4.0% (saar), the strongest since Q4-2014 and considerably faster than Q1's nearly five-year low of 0.5%. Last quarter's pickup was broad-based, with both goods (5.9%, saar) and services (3.1) consumption accelerating—the latter the fastest in just over three years. Within goods consumption, both durable (9.3) and nondurable (4.2) goods spending were robust. Real disposable income advanced for the 12th straight month, up 2.6% over the period to a new record high, while real wages & salaries rose 2.5% over the same period, also to a new record high. Meanwhile, the NIPA annual benchmark revision revealed that the savings rate was much higher than previously reported because of an IRS report that found billions of dollars in unreported income. That finding

caused the government to sharply boost its previous estimates of the saving rate. So while June's 6.8% rate matched May's, the latter's was more than double its pre-revision rate of 3.2%.

Consumer Confidence ([link](#)): Consumer confidence unexpectedly edged up in July to one of its highest readings in 18 years. Overall confidence rose to 127.4 last month—after falling from 128.8 in May to 127.1 in June—and now is not far from February's 130.0 reading, which was the highest since November 2000. "Consumers' assessment of present-day conditions improved, suggesting that economic growth is still strong," said Lynn Franco, director of economic indicators at The Conference Board. "However, while expectations continue to reflect optimism in the short-term economic outlook, back-to-back declines suggest consumers do not foresee growth accelerating," she added. July's present situation component climbed for the third month, from 157.5 in April to 165.9—its highest reading since March 2001. Meanwhile, the expectations component slipped for the second month, from 107.2 in May to a low for this year of 101.7 in July. The current jobs outlook continued to remain very favorable last month: Jobs plentiful (to 43.1% from 40.4%) rose to a new cyclical high, while jobs hard to get (15.0 from 15.1) was at its lowest percentage since July 2001. The six-month jobs outlook was mixed, with those reporting more jobs (22.5, up from 22.0) rising to a 16-month high, while those expecting fewer jobs (15.7 from 13.1) climbed to a seven-year high. The spread between the two remained favorable, at 6.8ppts, holding among one of the highest percentages during the past couple of years.

Employment Cost Index ([link](#)): Labor costs in the private sector rose at a slightly slower pace during Q2, while the yearly rate continued to accelerate, though remained relatively subdued below 3.0%. Total compensation costs rose 0.6% last quarter, following a 1.0% jump during Q1, which was the highest in 14 years. The quarterly slowdown reflected an easing in the wages & salaries (to 0.6% from 1.0%) gain; the increase in benefits costs (0.8) matched Q1's pace—which was the highest since Q2-2014. Meanwhile, compensation costs rose 2.9% y/y, the fastest in a decade. Benefits costs have accelerated steadily since Q1-2016, more than doubling over the period from 1.2% to 2.8% y/y, the highest rate since the start of 2012. Wages & salaries rose 2.9% y/y during Q2, matching Q1's rate, which was the fastest since Q3-2008.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI Flash Estimate ([link](#)): July's CPI rate is expected to accelerate to its highest reading since the end of 2012, according to the flash estimate. Yesterday's report shows the rate climbing to 2.1% y/y—above the ECB's target rate of just under 2.0%. Looking at the main components, energy (to 9.4% from 8.0% y/y) is once again expected to have the highest annual rate in July—nearly quintuple March's recent low of 2.0%. Also expected to move higher, though modestly, are rates for non-energy industrial goods (to 0.5 from 0.4) and services, while the rate for food, alcohol & tobacco (2.5 from 2.7) is presumed to move lower. The core rate—which excludes energy, food, alcohol, and tobacco—is calculated to edge up from 0.9% to 1.1%, matching May's eight-month high.

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