MORNING BRIEFING
September 18, 2018

Debt Roundup

See the pdf and the collection of the individual charts linked below.

(1) Debt worries making a comeback. (2) Record debt levels may matter again if inflation rebounds, which we don't expect. (3) Federal government interest payments soaring along with Treasury debt and rising interest rates. (4) Fed's rate hiking could push government interest payments over $500 billion by 2020. (5) Record bank loans in China. (6) Chinese government wants more babies. (7) Trump's trade war depressing Chinese stocks despite solid production growth. (8) China's real retail sales growth is weakening as aging demography weighs on consumer spending. (9) Getting less output bang per yuan of bank debt. (10) Beige Book has lots of green signals about growth, yellow signals about tight labor market, and a few red signals about price inflation.

Debt: Lots of It. As we observed yesterday, worrying about record amounts of debt is making a comeback. The calamity in the debt markets during 2007 and 2008 was the epicenter of the financial crisis that occurred back then. There was lots of talk about "deleveraging," which didn't play out as its proponents expected. The major central banks responded to the crisis with zero interest rates and QE bond purchasing programs. Ultra-easy monetary policies allowed borrowers to refinance their debts and to borrow more. Among the most profligate borrowers have been governments around the world. So their debts continue to rise to record highs.

That didn't matter as long as the Fed, the ECB, and BOJ were ballooning their balance sheets with lots of government bonds (*Fig. 1*). However, the Fed stopped doing so during October 2014, and started to taper its holdings last October (*Fig. 2*). The ECB is planning on halting its QE program by the end of this year. The BOJ has yet to announce similar plans to discontinue its QE program.

The answer to the question "Does debt matter?" was generally "No" since the start of the current bull market, with the obvious exception of Greek debt a few years ago, and Italian debt in recent months. It may matter if inflation makes a comeback, which we don't expect. We still aren't convinced that a supply/demand analysis of the debt markets has much usefulness in forecasting inflation and interest rates.

However, we are on alert given that more debt with less QE might push rates higher than we expect and pose more of a problem for stocks. Yesterday, we discussed the US debt outlook and focused on the surge in interest paid by the US government. We have a few more thoughts on this today and want to address the issue of Chinese debt. Consider the following:

(1) *US government interest expense soaring.* Since the Fed started raising the federal funds rate again at the end of 2015, net interest paid by the US government soared from $225.5 billion during the 12-months through December 2015 to a record high of $320.3 billion over the 12-months through August (*Fig. 3*). Over this same period, publicly-held US Treasuries jumped by $2.1 trillion to a record $15.8 trillion (*Fig. 4*).

We can use these two series to calculate the effective interest rate paid by the federal government (*Fig. 5*). We reckon it rose in August to 2.1%, up from 1.8% a year ago and the highest since August 2012. Keep in mind that the average maturity of the government's debt is around 70 months (*Fig. 6*). So the effective interest rate will move higher as maturing securities have to be refinanced at higher actual rates.

If the Fed succeeds in gradually normalizing monetary policy so that the federal funds rate rises to 3.00% by the end of next year, the current amount of debt outstanding would push the government's interest expense to over $500 billion annually by 2020 (*Fig. 7*).

(2) *Chinese bank loans swelling.* Chinese bank loans soared to a record high of 132 trillion yuan during August (*Fig. 8*). They've doubled since April 2013, tripled since May 2010, and quadrupled since February 2009. In US dollars, Chinese bank loans totaled $19.3 trillion during August, more than twice as much as US bank loans (*Fig. 9*). Over the past 12 months through August, Chinese bank loans are up $2.3 trillion (*Fig. 10*).

Trade: Braking China? China has clearly relied on lots of debt to finance its growth. The question is whether China may be getting less bang per yuan from all this debt. Another, more immediate concern is whether Trump's escalating trade war with China might depress Chinese growth and trigger a credit crisis? That worry seems to explain the awful performance of China's major stock indexes since the start of this year.

Here is the ytd performance derby through Monday's close of these Chinese indexes in yuan: Shanghai Shenzhen CSI 300 (-20.5%), Shanghai A-Share Stock Price (-19.8), China MSCI (-12.5), Hang Seng China Enterprises (-10.7), and Hong Kong Hang Seng (-10.0) (*Fig. 11*). Investors are likely anticipating that Chinese officials are running out of room to pump up economic growth, especially in the face of looming incremental tariffs from the US.

Disclosing the details of its latest Five-Year Plan during 2015, the Chinese government pledged to increase consumer spending to grow the economy. At this point, this pledge seems to be losing out to China's aging population and declining fertility rates despite the government having replaced the one-child per family limit with a two-child limit during 2015.

China's government more recently has discussed completely eliminating the limit on the number of children in a family, reported an 8/27 Bloomberg article. But that may come too late to restore economic growth anytime soon. The revised family planning guidance probably won't become effective until 2020. In the meantime, consider the following economic data:

(1) *Industrial production & real GDP*. So far, there isn't much evidence that Trump's trade war is depressing Chinese industrial production growth. Since 2015, it has hovered around 6.0% y/y. It was 6.1% during August (*Fig. 12*). Naturally, there is a good correlation between China's industrial production and real GDP. This suggests that real GDP growth is also continuing to hover around 6.5%, as it has since 2015.

(2) *Real retail sales*. The problem is that inflation-adjusted retail sales growth has been trending lower in recent years, and seems to have weakened more rapidly over the past year (*Fig. 13*). It was 6.7% y/y during August versus 8.3% a year ago. Aging demographics may be starting to weigh on Chinese consumer spending. So the government's goal of replacing export-led growth with consumer-led growth may be tough to achieve.

(3) *Industrial production & bank loans*. China has been getting less output bang per yuan of bank credit according to the ratio of industrial production to bank loans outstanding in yuan. Since early 2008, the ratio has been on a steep downward trajectory to a record low last month (*Fig. 14*).

We conclude that China's economy may be more vulnerable to Trump's trade war than widely recognized. If so, then the Chinese may work out a deal with Trump sooner than expected.

US Beige Book: Green, Yellow, and Red Signals. Business contacts surveyed by the 12 Federal Reserve Bank districts are mostly positive about the US economy. That's according to *The Beige Book* released on 9/12. This report collected anecdotal information about business activity on or before August 31, 2018.

While most contacts were optimistic about business activity, there was widespread concern about labor shortages constraining growth. Additionally, price pressures were noted as building, especially because of the trade dispute between the US and China and US labor shortages. Some firms are starting to pass input price increases along by increasing the price of their goods sold. However, there were some indications of a limit to the degree that higher input prices, especially labor costs, can be passed on without harming business activity.

The Beige Book is organized by Federal Reserve Districts. I asked Melissa to select excerpts from it and to reorganize them into macro categories: economic activity, employment and wages, prices, and tariffs (See Tables 1 to 4 here.) Here are a few key observations based on this exercise:

(1) *Green signals*. Most industry contacts within the 12 Fed Districts reported moderate to accelerating growth in economic activity. Retail demand generally improved with retailers expecting "continued positive momentum" for the remainder of the year. Manufacturers mostly indicated that activity continued to expand at a "brisk" pace. Some attributed increased demand to "a strong overall economy and pro-growth fiscal policy." On balance, residential and commercial real estate markets showed solid sales activity.

Service sector firms largely reported moderate growth in activity. Competition for small business customers in banking and finance was noted as particularly strong. Rising interest rates did not appear to be too much of a concern for the financial services sector. Energy activity reportedly remained steady. Agricultural reports were mixed with most of the downside attributable to weather conditions rather than economic ones.

(2) *Yellow signals*. Contacts in all the 12 Fed Districts cited the tightness of the labor market. One staffing contact said: "Companies are expanding or want to expand. Their challenge is finding enough workers." Labor shortages were observed across many occupations and skillsets, including restaurant workers, truck drivers, construction workers, skilled machinists, engineers, and IT workers. For firms in construction, the widespread labor shortage has prevented many companies from "being able to meet current levels" of demand.

Meanwhile, wage increases were moderate. Where wages did pickup, the growth was described as "inched up" or modest rather than intensified. Further moderate wage growth is widely expected in the coming months. Some staffing firms noted that companies are spending more to attract and retain talent. Most firms reported "rising benefit costs." To solve for the skills-gap reported in many industries, many firms are "boosting training efforts" and "forming partnerships with local high schools to prepare students" for careers. Some firms are offering flexible work arrangements.

Some contacts reported considering or finding alternatives to "alleviate" the worker shortage. Some business contacts “shared plans to move to locations with larger labor pools, to change/reduce personnel standards and requirements, or continue to pursue automation to replace workers.” Some firms unable to pay higher wages demanded by experienced job seekers decided to “wait it out” and not fill open positions.

(3) *Red signals*. Nonlabor price pressures are also building, but mostly modestly, according to many District business contacts. Input prices, especially for nonlabor costs like metals, lumber, concrete, and transportation, are generally rising faster than sales prices. Some firms reported beginning to pass price increases on to producers or consumers. Some construction firms said they were able to pass on price increases to preserve margins, but that rising prices were weighing on sales. Despite beginning to pass on nonlabor costs, some firms said that they were unable to pass higher labor costs to consumers.

Tariffs were noted among the District contacts as one of the major contributors to rising prices, particularly in the manufacturing sector. Many contacts explained that the uncertainty related to tariffs was also causing them to scale back capital investment plans a bit, or wait to make major business investment decisions. Melissa reports that the tariff commentary seemed a bit more alarming in the current book than the previous one. However, it wasn’t all bad this time as some contacts said they didn’t expect “too much damage” if the tariffs are expanded.

CALENDARS

US. **Tues:** Housing Market Index 67, Treasury International Capital. **Wed:** Housing Starts & Building Permits 1.240mu/1.320mu, MBA Mortgage Applications, Current Account Balance -$104.0b, EIA Petroleum Status Report. (Econoday estimates)

Global. **Tues:** Japan Trade Balance ¥483.2b, RBA Meeting Minutes, Draghi. **Wed:** UK Headline & Core CPI 2.4%/1.8% y/y, BOJ Rate Decision, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to record highs for all three of the market-cap indexes last week. Forward earnings activity has been relatively strong in the past 12 months: LargeCap’s and MidCap’s forward earnings have risen in 50 of the past 52 weeks, and SmallCap’s in 45. 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 22.9% y/y from 22.7%, which is the highest since April 2011 and compares to a six-year low of -1.8% in October 2015; MidCap’s improved to 24.1% from 24.0%, also the highest since April 2011 which compares to a six-year low of -1.3% in December 2015; and SmallCap’s edged down w/w to 33.9% from 34.1%, which compares to an eight-year high of 34.8% in mid-August and a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.9% and 10.2%, MidCap 21.6% and 12.5%, and SmallCap 28.1% and 15.8%.

S&P 500/400/600 Valuation (*link*): Forward P/E ratios rose last week to levels not much above their post-election lows in March. LargeCap’s weekly forward P/E was near a six-month high as it improved to 16.7 from 16.5 a week earlier. which compares to a post-election low of 16.0 in late March and is down from 18.6 on January 26—the highest since May 2002. That also 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 edged up to 16.6 from 16.5, down from a 10-week high of 16.7 at the end of August, which compares to a 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 has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E was steady at 18.0 last week, down from a 24-week high of 18.3, 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 the three indexes' daily forward price/sales (P/S) ratios, most were higher w/w but remain at levels well below January highs: LargeCap's P/S rose w/w to 2.09 from 2.08, and is down from a record high of 2.19 on January 26; MidCap's was steady at 1.33, which compares to its record high of 1.40, also on January 26; and SmallCap's edged up to 1.06 from 1.05, 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 two weeks left in the Q3 book, analysts usually turn their attention towards trimming forecasts. The S&P 500's Q3-2018 EPS forecast edged down two cents w/w to $40.62. That's down 1.1% since the end of Q2, but up 7.6% ytd and 8.3% since the passage of the TCJA. The $40.62 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 21.7%, down from 22.2% a week earlier and from 22.1% at the end of Q1. That compares to Q2-2018's blended 24.9%, Q1-2018's 26.6% (which is the strongest since Q4-2010 and likely to mark the peak of the current earnings cycle), 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, the Q3-2018 estimate has risen 0.3% for the Financial, and has fallen for the remaining 10 sectors. Real Estate is the biggest decliner, with its Q3-2018 forecast down 1.6% since the end of Q2, followed by Consumer Discretionary (-1.3), Energy (-0.8), Utilities (-0.6), Telecom (-0.5), Materials (-0.5), Consumer Staples (-0.4), Industrials (-0.2), Tech (-0.1), and Health Care (-0.1). The S&P 500's Q3-2018 forecasted earnings gain of 21.7% 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, with eight at a double-digit percentage rate. That compares to all 11 positive during Q2, when nine rose at a triple- or double-percentage rate. Five sectors are expected to beat the S&P 500's forecasted y/y earnings gain of 21.7% during Q3, matching Q2's measure. 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 (98.5% in Q3-2018 vs 123.1% in Q2-2018), Financials (41.6, 27.4), Materials (31.7, 40.0), S&P 500 (21.7, 24.9), Telecom (22.3, 16.4), Industrials (17.4, 20.3), Tech (16.9, 26.8), Consumer Discretionary (15.4, 23.1), Health Care (10.9, 18.1), Consumer Staples (7.2, 14.0), Utilities (5.1, 8.7), and Real Estate (4.4, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 18.8% y/y in Q3, down from a blended 21.9% 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

Regional M-PMI (*link*): The New York Fed—the first district to report on manufacturing for this month—says business activity eased this month, though remained at an elevated level. The composite index slipped to 19.0 in September after climbing to a 10-month high of 25.6 in August. Measures for both new orders (to 16.5 from 17.1) and shipments (14.3 from 25.7) showed a slower, but still solid, rate of growth, while labor market indicators continued to point to an increase in employment (13.3 from 13.1) and longer workweeks (11.5 from 8.9). Meanwhile, delivery times (6.5 from 10.4) continued to lengthen, while inventories (8.9 from 0.0) accumulated at their fastest pace in four months, after contracting in July. Price indexes remained high, suggesting ongoing significant increases in both input (46.3 from 45.2) prices and selling (16.3 from 20.0) prices. Looking ahead, firms remained moderately optimistic about the six-month outlook, though optimism in recent months has been more moderate than earlier this year, with the future business conditions (30.3 from 34.8) gauge slowing to a five-month low.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): August's CPI rate eased slightly after accelerating to its highest reading since the end of 2012 in July. August's rate matched its flash estimate, slipping to 2.0% y/y from 2.1% in July—above the ECB's target rate of just under 2.0% for the fourth month. Looking at the main components, energy (to 9.2% from 9.5% y/y) once again had the highest annual rate in August, though down from July's which was the highest since February 2012. Also moving lower, though modestly, were rates for food, alcohol & tobacco (2.4 from 2.5), services (1.3 from 1.4), and non-energy industrial goods (to 0.4 from 0.5). The core rate—which excludes energy, food, alcohol, and tobacco—edged down to 1.0% from July's 1.1%—which matched May's eight-month high. Of the top four Eurozone economies, inflation rates in France (2.6% y/y) and Spain (2.2) were above the Eurozone's 2.0% rate, while Germany's (1.9) and Italy's (1.6) were below. Ireland (0.9) and Greece (0.9) once again posted the lowest rates among the Eurozone countries.

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