MORNING BRIEFING
December 18, 2018

The True Story

See the collection of the individual charts linked below.

(1) Druckenmiller and Warsh speak for the Dow Vigilantes. (2) Jerome, Virginia, and Santa. (3) Yield curve has a good track record excluding the false alarms. (4) Focusing on bank net interest margin. (5) No credit crunch in banking sector. (6) Capital spending is at a record high despite record buybacks plus dividends. (7) Net bond borrowing by nonfinancial corporations is falling fast. (8) Fed vice chair is a folk-rock singer and about to take the Fed on a magical mystery tour of monetary policy. (9) Alternative ways to target inflation under Fed consideration.

True Story I: Dow Vigilantes & Santa. If you had any doubts about the existence of the Dow Vigilantes, two have stepped forward to identify themselves as such. The 12/16 *WSJ* included an op-ed by Stanley F. Druckenmiller and Kevin Warsh titled "Fed Tightening? Not Now." They warn that the combination of quantitative tightening and interest-rate hiking could cause serious damage to the global economy and financial markets. They conclude:

"This is a time for choosing. We believe the U.S. economy can sustain strong performance next year, but it can ill afford a major policy error, either from the Fed or the rest of the administration. Given recent economic and market developments, the Fed should cease—for now—its double-barreled blitz of higher interest rates and tighter liquidity."

The recent selloff in stock prices shows that the Dow Vigilantes are screaming "*no mas!*" We will find out tomorrow whether the Fed will take their advice, during Fed Chairman Jerome Powell's press conference following the FOMC's two-day meeting. Let's see if he will be wearing a Santa suit. The odds are increasing that the FOMC might vote to hold off on another hike this year. In any event, Powell will certainly signal that the process of raising interest rates will be even more gradual than previously indicated by the Fed's dot plot. Yes Virginia, there is a Santa Claus—we hope.

True Story II: Banks Are Very Profitable. Why does the yield curve have such a good track record of forecasting recessions when it inverts? Prior to the last six recessions, it inverted for 56 weeks, on average, before the downturns (*Fig. 1*). That's the widely accepted story. However, a closer look at the weekly spread between the 10-year US Treasury yield and the federal funds rate (which is the "official" version of the spread in the monthly Index of Leading Economic Indicators) shows that it has also inverted in the past prematurely, giving false alarms. For example, during the longest economic expansion to date, it turned negative a couple of times during 1995 and again during 1998. The recession actually started in March 2001.

Notwithstanding the false alarms, the question of why the yield curve has consistently inverted prior to recessions remains. One widely held view is that banks stop lending when the rates they pay in the money markets on their deposits and their borrowings exceed the rates they charge on the loans they make to businesses and households. So an inverted yield curve heralds a credit crunch, which inevitably causes a recession.

In a 12/5 post on Eaton Vance's Advisory Blog, Andrew Szczurowski convincingly argues that "the market is looking at the wrong curve. It's not an inverted 2s-10s, or 2s-30s, or 2s-5s curve that matters. What really matters, in my mind, is what is happening to the curves at banks." He observes:

"At the same time, the rates banks are charging for a mortgage are up 150 basis points from their lows. This is the first hiking cycle where banks' margins are actually increasing as the Fed is hiking rates. The reason being, they aren't paying their depositors much more today than they were over the past few years."

So what really matters is the net interest margin of the banks. Consider the following:

(1) *Interest margin.* Data available for all FDIC-insured financial institutions show that the margin has increased from a recent low of 3.0% during Q1-2015 to 3.5% during Q3-2018 (*Fig. 2*). That has coincided with the Fed's program to normalize the federal funds rate (*Fig. 3*). It is up 200bps from 0.00%-0.25% in late 2015 to 2.00%-2.25% currently. Yet the net interest income of FDIC-insured institutions rose to a record $137 billion during Q3-2018 (*Fig. 4*).

(2) *Charge-offs and dividends.* There's no sign of distress, or even stress, in the FDIC data. Net charge-offs have been relatively stable around $10 billion per quarter for the past few years (*Fig. 5*). Provisions for loan losses have matched the charge-offs. Cash dividends rose to a record $43.8 billion last quarter (*Fig. 6*).

(3) *Business loans.* Remember the scare about the near-zero slowdown in the growth of commercial and industrial loans at the beginning of this year (*Fig. 7*)? Fuhgeddaboudit: Loan growth has picked up since then, rising 8.9% y/y to a record $2.3 trillion through the 12/5 week (*Fig. 8*).

(4) *Bottom line*. Despite this year's flattening of the yield curve, there's no sign of a credit crunch at the banks.

True Story III: Capital Spending at Record High. Another widely held view is that corporations aren't spending enough on plant and equipment because they're spending too much on buying back their shares with too much money borrowed in the bond market. *Au contraire*: The GDP data show that nominal capital spending rose to a record high of $2.8 trillion (saar) during Q3-2018 (*Fig. 9*). Over the past year through Q2-2018, S&P 500 buybacks totaled $646 billion. That's a lot, but it wasn't enough to slow capital spending. Consider the following:

(1) *Buybacks and dividends.* It's true that the sum of buybacks and dividends paid by S&P 500 companies has equaled close to 100% of their operating income over the past few years (*Fig. 10*). Specifically, buybacks plus dividends equaled $1.08 trillion over the past year through Q2, while operating income totaled $1.20 trillion. "What a waste of money that could have been used to expand capacity and boost labor compensation," say progressive do-gooders.

(2) *Capital spending and cash flow.* So how did capital spending rise to a record high if most of corporate profits were used for buybacks and dividends? Corporate Accounting 101 teaches that corporate cash flow is the driver of corporate income statements. Data collected by the Fed for nonfinancial corporations show that internal cash flow fully covered gross fixed investment—which rose to a record $2.0 trillion—over the past year through Q3 (*Fig. 11*). The overwhelming majority of cash flow is attributable to the capital consumption allowance, i.e., depreciation, which in effect serves as a huge tax shelter for corporate income (*Fig. 12*).

(3) *Corporate bond borrowing.* It's true that nonfinancial corporate bond debt rose to a record $5.5 trillion during Q3 (*Fig. 13*). However, the y/y change in this series shows that the pace of net borrowing has fallen from a record $462 billion during Q3-2015 to $125 billion during Q3 (*Fig. 14*). Gross issuance typically well exceeds net issuance, as it has during the current expansion, suggesting that lots of bonds have been refinanced at relatively low interest rates (*Fig. 15*).

The Fed: Magical Mystery Tour. While I've been moonlighting as a movie reviewer for several years, Fed Vice Chairman Richard Clarida has been moonlighting as a folk-rock singer. The former PIMCO executive was sworn into his starring role at the Fed during September of this year. We found some of his musical tracks here on YouTube.

Clarida is about to lead the Fed on a magical mystery tour over the coming year to reassess the making of monetary policy. The idea was proposed by Clarida on behalf of the Fed's Subcommittee on Communications and mentioned in the minutes of the 11/7-8 FOMC meeting, which stated: "The goal of these discussions would be to identify possible ways to improve the Committee's current strategic policy framework in order to ensure that the Federal Reserve is best positioned going forward to achieve its statutory mandate."

The Fed is open to suggestions, as suggested by its 11/15 press release, "Federal Reserve to review strategies, tools, and communication practices it uses to pursue its mandate of maximum employment and price stability." It stated that the district "Reserve Banks will host a series of public events around the country to hear from a wide range of stakeholders" over the coming year. The Chicago Fed will sponsor a research conference on June 4-5 next year with speakers and panelists from outside the Fed system. Then, around the middle of 2019, "Federal Reserve policymakers will discuss the perspectives offered during the outreach events as part of their review of how to best pursue the Fed's statutory mandate. At the end of the process, policymakers will assess the information and perspectives gathered during the year of review and will report their findings."

That's all that the announcement said. So I asked Melissa to dig around for more specifics about what is likely to be discussed at these events. Her findings suggest that members of the Fed are seriously considering alternative options to inflation targeting. The Fed's dual mandate as dictated by Congress is to achieve maximum employment and stable prices. Currently, the Fed aims to achieve a 2.0% inflation target. In an 11/27 speech, Clarida outlined the Fed's challenge in meeting its objectives with a question: "What might explain why inflation is running at or close to the Federal Reserve's long-run objective of 2 percent, and not well above it, when growth is strong and the labor market robust?"

To solve for this problem, Fed members are considering new monetary policy tactics that we discuss below. Most involve purposefully overshooting this target in "good" times to offset expected undershoots during "bad" times. To us, it seems Fed members are searching for ways to justify holding interest rates lower for longer. Consider the following:

(1) *Embarking on the journey*. Clarida seems to be spearheading the pursuit to reset the Fed's framework. Supporting the effort is New York Fed President John Williams. In June, Williams was promoted to his current post from his former position as the San Francisco Fed President. The Fed vice chairman and head of the New York Fed are the most influential policymakers after the Fed chairman. The head of the New York Fed serves as the vice chairman of the Federal Open Market Committee (FOMC) and is a permanent (versus rotating) voter at policy meetings.

In a 12/3 video interview with Bloomberg, Clarida gave a nod to Williams' 11/30 speech. In it, Williams provided some clues as to what sort of monetary policy tools the heads of the Fed are most interested in reevaluating. It was titled "Monetary Policy Strategies for a Low-Neutral-Interest-Rate World."

Williams explained that the reason the Fed is embarking on this journey is that low interest rates are likely here to stay. Factors contributing to historically low interest rates are structural and outside of the Fed's control, including aging demographics, low productivity, and the demand for safe assets.

Structurally low interest rates are a problem for monetary policymakers. If a recession hits, "central banks may not be able to reduce interest rates well below their neutral level to stimulate the economy as warranted because of the effective lower bound on nominal interest rates. This shortfall of monetary accommodation would result in less desirable economic outcomes during the recession and recovery. In particular, inflation would typically undershoot its desired target during these episodes."

(2) *Alternative ways to target inflation*. Williams proposes three solutions to the problem, which are sure to be extensively discussed during the Fed's strategic review process. The first option is for the Fed to continue to target 2.0% inflation. When economic downturns hit, the Fed will be forced to use a combination of "aggressive conventional and unconventional policy actions" to offset the effects of being limited by a low-interest-rate floor. But doing so carries the "risk that inflation expectations become anchored at too low a level."

The second option is for the Fed to move to "average-inflation targeting." With that, the central bank intentionally aims to overshoot the inflation rate in "good" times. That can offset inflation rates below desired levels during "bad" times, ensuring that the longer-run average inflation rate and inflation expectations stay in line with the target.

The third option is "price-level targeting," as well as its "various offshoots" such as nominal GDP targeting and temporary price-level targeting. With price-level targeting, the central bank "commits to keep the price level near a steadily growing target path." Like average-inflation targeting, an overshoot of the target inflation rate in "good" times purposefully offsets an undershoot of inflation "when policy is constrained" under price-level targeting.

By the way, Williams didn't specifically mention it, but FRB-SL President James Bullard, a non-voter on the FOMC this year, recently suggested another alternative to policy-setting. Bullard argued that the Fed should modernize the Taylor Rule, a policy-setting tool first introduced by John Taylor in 1993. In a 12/7 speech, Bullard recommended lowering the values of two of the key variables in the Taylor Rule equation: inflation and the natural rate of interest (i.e., the rate that keeps the economy moving at an even keel). Bullard concludes that this modernized rule would suggest that the Fed should maintain the current policy rate for longer, whereas the original version of the rule would suggest raising it.

(3) *Ex Fed heads weigh in*. Two former Fed chairs have recently discussed different approaches to inflation targeting. In a 10/12 opinion piece for Brookings, former Fed Chair Ben Bernanke proposed "an option for an alternative monetary framework" that he calls a "temporary price-level target—temporary, because it would apply only at times when short-term interest rates are at or very near zero." Bernanke describes the approach in detail. The gist is that the Fed would pursue an overshoot during times when the Fed perceives structurally low interest rates as a challenge. When interest rates are behaving more normally, then the Fed would return to its 2.0% target.

In a 12/6 opinion piece for *Yale Insights*, former Fed Chair Janet Yellen advocated for average-inflation targeting. She wrote: "I frankly think it's appropriate after a long period when inflation's run shy of 2% to then allow inflation to run above 2%. I would be inclined to establish as a target something like 2% on average over the business cycle."

CALENDARS

US. Tues: Housing Starts & Building Permits 1.221mu/1.257mu, FOMC Begins. **Wed:** Existing Home Sales 5.190mu, MBA Mortgage Applications, Current Account -$124.9b, EIA Petroleum Status Report, FOMC Announcement 2.375% (2.25% to 2.50%), Powell. (Econoday estimates)

Global. Tues: Germany Ifo Business Climate, Current Assessment & Expectations Indexes 101.7/104.9/98.3, Japan Trade Balance -¥630b, RBA Meeting Minutes. **Wed:** UK Headline & Core CPI 2.3%/1.8% y/y, Canada Headline & Core CPI 1.8%/1.9% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings fell last week for all three of these indexes following a brief pause a week earlier from the declines that began in mid-October. The w/w declines for LargeCap and SmallCap were their biggest since February 2017, while MidCap fell the most since February 2016. LargeCap's forward EPS fell 0.2% w/w to $175.10 and is now 0.2% below its record high of $175.48 eight weeks ago. That's about the same as MidCap's, which dropped 0.4% w/w to 0.4% below its record high of $124.62 on October 19. However, SmallCap's fell 0.7% w/w to 2.9% below its October 26 record high of $61.42. Forward earnings momentum remains healthy compared to the past due to the boost from the Tax Cuts and Jobs Act (TCJA), as the yearly change in forward earnings is up from six-year lows in early 2016, but has clearly peaked. In the latest week, the rate of change in LargeCap's forward earnings fell to an eight-month low of 20.2% y/y from 20.7%. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's y/y change was down to an 11-month low of 20.4% from 21.1%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's dropped to a seven-month low of 28.4% from 29.7%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts are dropping now. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (23.2%, 8.0%, 10.6%), MidCap (21.7, 9.9, 11.6), and SmallCap (22.9, 15.5, 15.0).

S&P 500/400/600 Valuation (*link*): Forward P/E ratios reversed broadly lower again last week. LargeCap's weekly forward P/E fell w/w to 14.8 from 15.0, breaching its prior low of 14.9 in January 2016 to the lowest level since October 2014. That compares to a six-month high of 16.8 in mid-September, a multi-year high of 18.6 on January 26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. However, last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E dropped to 14.0 last week from 14.3, and is at the lowest reading since November 2012. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. 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 slipped to 14.7 last week from 15.1, and is also at its lowest reading since November 2012. That's well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). Furthermore, SmallCap's P/E is now below LargeCap's P/E for the first time since 2003. Looking at the three indexes' daily forward price/sales (P/S) ratios, all fell w/w: LargeCap's P/S fell w/w to 1.84 from 1.86, which is the lowest since December 2016 and down from a record high of 2.19 on January 26; MidCap's decreased to 1.10 from 1.15, which is the lowest since June 2016 and compares to its record high of 1.40, also on January 26; and SmallCap's dropped to 0.84 from 0.87, which is the lowest since November 2012 and compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Analysts resumed cutting Q4 forecasts last week, particularly for the commodities-related sectors. The S&P 500's blended Q4-2018 EPS forecast of $41.23 is down 3.1% since the end of Q3, up 6.0% ytd, and up 6.8% since the passage of the TCJA. The $41.23 estimate represents a forecasted pro forma earnings gain for Q4-2018 of 16.1%, down from 16.8% a week earlier and from 20.1% at the end of Q3. That would mark the slowest growth since Q4-2017 and comes on heels of 28.3% y/y growth in Q3, which is sure to mark the peak of the current earnings cycle. The blended Q4-2018 growth rate compares to Q3-2018's 28.3%, Q2-2018's 24.9%, Q1-2018's 26.6%, Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. The S&P 500's Q4-2018 forecasted earnings gain of 16.1% y/y would be its tenth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q4-2018, with seven rising at a double-digit percentage rate due to the lower corporate tax rate. That compares to all 11 positive during Q3, when 10 rose at a triple- or double-percentage rate. Four sectors are expected to beat the S&P 500's blended y/y earnings gain of 16.1% during Q4, compared to four beating the S&P 500's 28.3% gain during Q3. Analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago, with the pace slowing substantially from Q3. The latest forecasted blended Q4-2018 earnings growth rates versus their Q3-2018 growth rates: Energy (70.8% in Q4-2018 versus 114.6% in Q3-2018), Financials (23.2, 44.7), Industrials (24.6, 19.0), Communication Services (17.6, 26.2), S&P 500 (16.1, 28.3), Consumer Discretionary (12.9, 25.4), Health Care (11.5, 16.6), Tech (11.7, 29.1), Real Estate (7.1, 5.3), Materials (5.8, 29.2), Consumer Staples (2.5, 11.4), and Utilities (-9.5, 10.9). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 13.9% y/y in Q4, well below the 25.0% in Q3; that compares to 21.9% in Q2-2018, 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). The Q4 estimate has fallen for 10/11 sectors since the end of Q3, and remained steady for Health Care versus a 3.1% decline for the S&P 500. Materials is the biggest decliner, with its Q4-2018 forecast down 15.5% since the end of Q3, followed by Utilities (-8.1), Real Estate (-6.6), Industrials (-5.6), Consumer Discretionary (-4.2), Communication Services (-4.0), Consumer Staples (-4.0), Financials (-2.9), Tech (-2.4), Consumer Staples (-4.0), and Energy (-1.5).

US ECONOMIC INDICATORS

Regional M-PMIs (*link*): The New York Fed—the first district to report on manufacturing for this month—reveals business activity has slowed to a 19-month low. The composite index decelerated to 10.9 this month, roughly half November's 23.3 pace as well as half the May-to-November average of 22.4; it was at a 10-month high of 25.6 in August. Measures for both new orders (to 14.5 from 20.4) and shipments (21.0 from 28.0) slowed, after accelerating sharply in November, though remain at respectable levels. Delivery times (3.2 from 4.4) continue to lengthen, while inventories (7.1 from 10.9) are still moving higher, though at a slower pace. Meanwhile, the employment measures reveal hirings (26.1 from 14.1) this month accelerated at the strongest rate in the history of the series going back to July 2001, while hours worked (8.0 from 9.2) continued to increase modestly. The prices paid gauge continued to ease from its recent peak of 54.0 in May, though remained at an elevated level of 39.7 this month, while the prices-received measure eased from 23.0 to 12.8 over the same time period. As for the six-month (30.6 from 33.6) outlook, firms remained fairly optimistic, though not as optimistic as early this year when the future business conditions index peaked at 50.5. Still, measures for both future new orders and shipments pointed to continued solid growth at 34.2 and 34.3, respectively.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI (*link*): The Eurozone's CPI rate eased in November after accelerating in October to its highest reading since the end of 2012. November's rate slowed to 1.9% y/y, below the flash estimate of 2.0%, after accelerating the previous two months from 2.0% in August to 2.2% in October—remaining above the ECB's target rate of just under 2.0% for the seventh month. Looking at the main components, energy (to 9.1% from 10.7% y/y) once again recorded the highest annual rate, though slowed for the first time since August. Also moving lower were rates for food, alcohol & tobacco (1.9 from 2.2) and services (1.3 from 1.5), with the former slowing to its lowest rate since February; the rate for non-energy industrial goods remained at 0.4%. Meanwhile, the core rate—which excludes energy, food, alcohol, and tobacco—ticked down to 1.0% y/y after accelerating from 0.9% to 1.1% in October, which had matched its high for the year posted in both July and May. Of the top four Eurozone economies, inflation rates in Germany (2.2% y/y) and France (2.2) were above the Eurozone's 1.9% rate, while Spain's (1.7) and Italy's (1.6) were below. Ireland (0.8) and Portugal (0.9) recorded the lowest CPI rates, coming in below 1.0%.

US PMI Flash Estimates (*link*): US private-sector growth eased in December, for the sixth time in seven months, according to flash estimates, though still expanded at a respectable rate—above the 50.0 no-growth threshold. The C-PMI had peaked back in May at a 37-month high of 56.6 before sliding to a 19-month low of 53.6 this month; the NM-PMI dropped from a three-year high of 56.8 to an 11-month low of 53.4 over the same period. Meanwhile, the M-PMI slipped from a 43-month high of 56.5 in April to a 13-month low of 53.9 this month. According to the report, manufacturing production volumes increased solidly in December—unchanged from November's pace—though new order growth was the weakest in just over a year and job creation was the slowest since August 2017. As for the service sector, the latest data signaled a further slowdown in new business growth at service-sector firms (which was the weakest since April 2017), contributing to a fall in unfinished business for the first time in four months. While price pressures have eased, they remain a concern for both sectors.

Eurozone PMI Flash Estimates (*link*): Eurozone business activity this month grew at the weakest rate in 49 months, according to preliminary estimates, as an undercurrent of slowing economic growth was exacerbated by protests in France. According to the report, "Companies are worried about the global economic and political climate, with trade wars and Brexit adding to increased political tensions within the euro area. The surveys also point to further signs that the struggling autos sector continued to act as a drag on the region's economy." The Eurozone's C-PMI slowed for the ninth time since reaching a 139-month high of 58.8 at the start of this year, slumping to a 49-month low of 51.3 by the end of the year. The M-PMI sank to a 34-month low of 51.4, as export orders continued to contact this month, falling at the fastest pace in the four-year history of the series. Service-sector growth is now on par with that of the manufacturing sector, after outpacing it the prior three months. The Eurozone's NM-PMI dropped to a 49-month low of 51.4 (from 53.4 in November); it had peaked at 58.0 at the start of this year. Across the region, C-PMIs show that growth in Germany (to 52.2 from 52.3) expanded at the slowest pace in 48 months, while France's (49.3 from 54.2) was the weakest in 30 months—contracting for the first time since June 2016—with panelists blaming the "gilets jaunes" movement's protests for the decline. Germany's economy showed a slowing of growth in both the manufacturing and services sectors, though the latter continues to outperform the former. This month's M-PMI (51.5 from 51.8) fell to a 33-month low, while the month's NM-PMI (52.5 from 53.3) was at a seven-month low. In France, the NM-PMI (49.6 from 55.1) posted its weakest performance in 34 months, while the M-PMI (49.7 from 50.8) measure was the weakest in 27 months. Meanwhile, aside from the two largest Eurozone economies, growth ran slightly above the Eurozone average for the first time since May, but nevertheless deteriorated to the weakest in just over five years.

Japan M-PMI Flash Estimate (*link*): Japan's manufacturing sector this month held steady, according the flash estimate, though business confidence was the weakest since October 2016—falling for the seventh straight month. The M-PMI edged up to 52.4 this month after falling to a 15-month low of 52.2 last month. According to the report, new orders expanded at a faster pace this month despite the sharpest decline in export orders in over two years, while production grew at its fastest pace since April. The report noted: "There appears to be no lagged impact on output from the strong contraction in capex spending during Q3"; however, it warns "the prospects heading into 2019 ahead of the sales tax hike still appear skewed to the downside."

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