



## MORNING BRIEFING

January 15, 2019

### Liquidity: Plenty or Not Enough?

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

(1) An ugly scenario much loved by the bears. (2) From QE to QT. (3) Is it all about central bank liquidity? (4) Is the ebb and flow of liquidity like looking in the rear-view mirror? (5) International reserves aren't growing. (6) Other measures of liquidity showing lots of personal saving, lots of buybacks and dividends, and lots of bank loans. (7) Commercial banks buying Treasuries. (8) 2016: Déjà vu all over again? (9) Global economic indicators are mixed, but mostly weak. (10) Movie review: "Mary Queen of Scots" (+).

**Strategy: Beauty & Liquidity.** Liquidity, like beauty, is in the eye of the beholder. The stock market's bears have been anticipating a very ugly scenario for a very long time. They've claimed that the bull market has been mostly driven by the excessive amounts of liquidity provided by the Fed's various QE (a.k.a. quantitative easing) programs. They've noted a strong correlation between the S&P 500's performance and the Fed's holdings of bonds ([Fig. 1](#)). They've said that once the Fed terminated the provision of additional liquidity through QE net bond purchases, stock prices would take a dive. The Fed did so on October 29, 2014, when its holdings plateaued around \$4.2 trillion, yet the bull market proceeded apace, with the S&P 500 rising to a record 2,931 on September 20, 2018.

Then the bears said that the next bear market would start once the Fed pared its holdings of bonds. The Fed began to do so on October 1, 2017. The Fed announced a schedule of QT (a.k.a. quantitative tightening) that would reduce its holdings of bonds from \$4.2 trillion to \$750 billion by the end of 2023, matching the level just before the adoption of ultra-easy monetary policies during late 2008 ([Fig. 2](#)).

The bears also warned that the European Central Bank was likely to terminate its QE program this year, which is what the central bank announced at the end of last year ([Fig. 3](#)). The Bank of Japan hasn't made any such announcement, but reserve balances didn't rise as rapidly last year as they did from 2013-2016, suggesting that Japan's central bank may be running out of securities to buy ([Fig. 4](#)).

Needless to say, after the sharp selloff in stock prices around the world during the final three months of 2018, the bears are doing high-fives and telling the bulls, "We told you so." The drying up of central bank liquidity has triggered a bear market, in their estimation.

If liquidity suddenly dried up late last year, why did stocks rebound so strongly since December 24 through last Friday's close, with the S&P 500 up 10.4% and the Nasdaq up 12.6% over this period? Did liquidity suddenly reappear? If it didn't, then stocks should resume their slide into bear-market territory.

Then again, I'm not a big fan of liquidity, which makes conceptual sense but is hard to measure and is less useful for predicting markets than for explaining what they've already done. By definition, liquidity always flows when asset prices are rising and ebbs when asset prices are falling. In other words, we know this once it has happened. For now, Debbie and I believe the data show that there is plenty of liquidity based on several measures other than the balance sheets of the central banks:

(1) *International reserves.* One of the few measures of global liquidity is the data series compiled by the International Monetary Fund for the non-gold international reserves of the world's central banks. The yearly percent change in this variable is very cyclical and tends to be highly correlated with the growth rate of the value of world exports, also on a y/y basis ([Fig. 5](#)). Debbie and I think that the reserves indicator is a proxy for the strength of the global economy, especially relative to the US. When the global economy is strong (weak), commodity prices tend rise (fall) and commodity exporting countries tend to accumulate more (fewer) reserves ([Fig. 6](#)).

The global economy has been relatively weak over the past year. So international reserves growth was zero in November. That might be bearish for stocks overseas. However, the US economy and corporate earnings are still growing, which should make US stocks relatively attractive for global investors. The absence of a global boom is also helping to keep both inflation and interest rates subdued, which should boost valuation multiples that were beaten down last year on exaggerated fears of a global recession.

(2) *US savings flows and liquid assets.* Last year, the Bureau of Economic Analysis revised both personal saving and the personal saving rate significantly higher. The 12-month sum of personal saving has averaged \$895 billion since the start of 2009, more than double the average from 1990-2008 ([Fig. 7](#)). Over the past 12 months through November, Americans saved \$1.0 trillion.

Much of their savings have been pouring into mutual funds, ETFs, and savings deposits ([Fig. 8](#)). The total liquid assets held by individuals and institutions soared to a record \$12.6 trillion dollars at the end of last year, up from \$9.1 trillion at the end of 2008 ([Fig. 9](#)). Considering that money market and bank deposit rates remain historically low, could it be that Americans remain overly cautious and their financial holdings atypically liquid as a result of their traumatic experiences during the financial crisis of 2008?

(3) *Stock buybacks and dividends.* It's hard to blame the stock market rout at the end of last year on a liquidity drought when stock buybacks plus dividends jumped to a record \$1.3 trillion at an annual rate during Q3 ([Fig. 10](#)). Buybacks might have been temporarily boosted by repatriated earnings, as they rose to a record high of \$815 billion at an annual rate—but should remain high—while dividends rose to yet another record high of \$461 billion at an annual rate during Q4.

(4) *Commercial bank assets.* While Fed watchers have been blaming the Fed's QT program for some of the stock market's rout late last year, they've been missing that US commercial banks and foreign central banks continue to buy and hold US Treasury and agency securities ([Fig. 11](#)). So while the Fed's portfolio of these securities is down \$385 billion since the start of October 2017, the holdings of commercial banks and foreign central banks are up \$240 billion and \$20 billion, respectively, over the same period.

Meanwhile, commercial and industrial loans held by all US commercial banks soared to a record \$2.34 trillion at the start of this year ([Fig. 12](#)). That's up \$221 billion y/y.

(5) *Mutual funds and ETFs.* Perhaps last year's selloff had more to do with a massive shift to risk-off investing from risk-on rather than a sudden shortage of liquidity. That would certainly explain the recent rebound so far in risk-on asset prices around the world. Late last year, exaggerated fears of a recession caused significant slowdowns in the 12-month net inflows to equity and bond mutual funds and ETFs ([Fig. 13](#)).

(6) *Credit spreads and distressed asset funds.* The risk-off nature of last year's selloff was reflected in

the plunge in stock market valuation multiples. It was also reflected in the widening yield spread between high-yield corporate bonds and the US Treasury bond, which is closely correlated with the S&P 500 VIX ([Fig. 14](#)).

The spread recently jumped to 530bps. That was still below the 844bps peak in the spike that occurred in early 2016. Back then, the collapse in oil prices and weakness in other commodity prices raised the risks of a global credit crunch and recession led by commodity-related industries.

That scenario was averted because the Fed backed off from raising the federal funds rate until the end of 2016. In addition, OPEC producers cut production to boost oil prices. So it could be déjà vu all over again this year. Also during 2016, distressed asset funds acted as shock absorbers in the credit markets. They could do so again this year if distress shows up in corporate credits, including leveraged loans and junk bonds.

(7) *Treasury bonds & the yield curve*. There's certainly plenty of liquidity in the Treasury bond market. When the 10-year Treasury bond yield rose to last year's high of 3.24% on November 8, there was much chatter about it going to 4.00% and even to 5.00%. That made sense when the Fed seemed to be on a set course to raise the federal funds rate and taper its balance sheet at the same time as the US federal budget was swollen by Trump's tax cuts. Yet here it is below 3.00%, at 2.70% yesterday.

As I've often observed and reviewed in my book [Predicting the Markets](#), flow-of-funds analysis doesn't have a good forecasting record for the bond yield. More useful is an analysis of how the Fed is likely to respond to actual and expected inflation. The same can be said for the shape of the yield curve, which is currently relatively flat. That may be signaling an impending recession. More likely, in our view, is that it is consistent with our prediction that inflation is dead. If so, then the Fed may be done raising interest rates for the foreseeable future.

In our opinion, the drop in Treasury yields and the widening of credit-quality spreads late last year reflected a shift from risk-on to risk-off, rather than a shortage of liquidity. There have been several such shifts during the current bull market. By our count, there have been 62 panic attacks including the latest one. They were all followed by risk-back-on relief rallies. So far so good for #62, but it remains the latest challenge to our bullish stance on the market.

(8) *HFT and algos*. The promoters of high-frequency trading (HFT) claim that it increases the stock market's liquidity. That's a controversial issue, of course. Less controversial is that algorithm computer trading increases the stock market's volatility. Long-only investors tend to complain about that during meltdown days rather than melt-up ones. The jury is out on HFT and algos. In any event, computer-driven trading isn't going away, and probably does contribute to volatility. Humans will just have to adjust to this reality and focus on the fundamentals with a longer-term time horizon.

**Global Economy: Falling Into a Recession?** While the US economy continues to grow, there seems to be mounting anxiety about the outlook for the global economy. If the latter is falling into a recession, it is hard to imagine that the US can decouple sufficiently from the rest of the world's woes. Then again, the data show that while the global economy may be slowing, it isn't contracting. Muddling along is our outlook for the global economy. Let's review the muddle:

(1) *Global indicators are mixed*. As Debbie discusses below, the OECD Leading Indicators dipped below 100.0 last year during June and has continued to fall, down to 99.3 during November—the lowest since October 2012 ([Fig. 15](#)).

Confirming the slowdown in the global economy last year was the sharp drop in the Goldman Sachs

Commodity Index, which is heavily weighted with oil. The CRB raw industrials index was weak during the first half of 2018, but stabilized during the second half of the year ([Fig. 16](#)). The plunge in the price of oil had to do with too much supply rather than a shortfall of demand, similar to the situation during the second half of 2014 through early 2016.

The resilience of the global economy is reflected in forward revenues, which is analysts' consensus expectation for revenues over the coming 52 weeks using the time-weighted average of their current-year and coming-year estimates. The MSCI forward revenues for the US, Developed World ex-US, and Emerging Markets are still on uptrends, though they may be starting to flatten ([Fig. 17](#)).

(2) *China is maturing.* Rapidly growing small companies tend to become big companies. As they mature, their growth rates naturally slow. The same can be said of China's economy. It is maturing and slowing. This natural process was exacerbated by China's one-child policy, as we have previously observed.

In recent months, stock markets around the world have been much more sensitive to China's economic indicators than in the past. Investors seem to be realizing that they can no longer count on China to be a major engine of global growth. We agree with that assessment, but don't want to exaggerate the negative magnitude of this development.

For example, global stock prices took a hit on news that China's exports dropped sharply during December. CNBC [reported](#) yesterday: "China's exports unexpectedly dropped 4.4 percent, defying projections of a 3 percent gain. The news appeared to reinforce worries that U.S. tariffs on Chinese goods were starting to take a heavy toll on the world's second-largest economy." That's based on the official data, which are not seasonally adjusted and are volatile from month to month.

Seasonally adjusted data show that China's exports fell even more, by 7.7% m/m ([Fig. 18](#)). A much bigger drop of 16.1% occurred for imports, partly because the price of crude oil dropped at the end of last year. Belying the weakness in the trade data is the railways freight traffic measure, which remained high during November ([Fig. 19](#)). We will be watching out for the December figure.

(3) *Europe is weakening.* The latest batch of European data has been awfully weak, if not downright awful. However, the volume of retail sales excluding autos rose to a record high during November ([Fig. 20](#)). That's about all the good news we can find for Europe. The OECD Leading Indicators for Europe all moved below 100.0 last year through November ([Fig. 21](#)). The Eurozone's Economic Sentiment Indicator also declined all last year, auguring a slowdown in the region's real GDP growth ([Fig. 22](#)).

By the way, today British lawmakers are poised to vote on Prime Minister Theresa May's Brexit deal, with less than 75 days to go before the country leaves the European Union. Her plan is widely expected to be defeated. As CNBC noted in the story cited above: "That leaves the prospect of a complete collapse of government, a disorderly exit from the bloc or even the entire Brexit process being scrapped altogether over the coming weeks." Or Brexit will happen, which will still make for a messy situation in Europe.

**Movie.** "Mary Queen of Scots" (+) ([link](#)) has a great cast working with a disappointing script that is rife with historical inaccuracies. Top-notch performances are delivered by Saoirse Ronan as Mary Stuart and Margot Robbie as Elizabeth I. There's lots of bad blood in the relationship of these two royal sisters, especially since Mary was a Catholic and Elizabeth was a Protestant. The movie does remind us that as awfully uncivil as our political divisions have become in the US today, it was often much worse in the past when monarchs reigned supreme. There was constant intrigue, deception, and backstabbing both in and among their courts. It hasn't gotten that bad yet in our nation's capital. Then

again, as George Santayana observed, “Those who cannot remember the past are condemned to repeat it.” *Note: Best (+ + +) to worst (- - -).*

## CALENDARS

**US. Tues:** PPI-FD Total, Core, and Core Ex Trade Services -0.1%/0.2%/0.2%, Empire State Manufacturing Index 12.0, George. **Wed:** Import & Export Prices -0.9%/-0.3%, Housing Market Index 57, Treasury International Capital, Beige Book.(Econoday estimates)

**Global. Tues:** Eurozone GDP 1.5% y/y, Eurozone Trade Balance €12.8b, Japan Machine Orders 3.0%~~m/m~~/0.1%~~y/y~~. **Wed:** European Car Sales, Germany CPI 0.1%~~m/m~~/1.7%~~y/y~~, UK Headline & Core CPI 2.1%/1.8% 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, accelerating the declines that began during October. Indeed, LargeCap and MidCap dropped w/w at the fastest pace since February 2016. LargeCap's forward EPS is now 1.5% below its record high of \$175.48 in late October, while MidCap and SmallCap are now 1.0% and 3.8% below their mid-October highs, respectively. LargeCap's forward EPS is the most below its record high since July 2016, while MidCap and SmallCap have not been this far below since April 2016. 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 a 12-month low of 14.6% y/y from 17.3%. 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 a 14-month low of 15.6% from 18.8%, 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 an 11-month low of 21.8% from 25.4%, 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 (22.5%, 6.4%, 11.2%), MidCap (21.5, 8.6, 11.1), and SmallCap (22.1, 13.9, 15.4).

**S&P 500/400/600 Valuation** ([link](#)): Forward P/E ratios rose for a third straight week from multi-year lows to six-week highs. LargeCap's weekly forward P/E of 15.0 is up from 14.6 a week earlier and a five-year low of 13.9 during December. 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. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E gained 0.7 points to 14.3 last week from 13.6. That's up from 13.0 during December, which was the lowest reading since November 2011. 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 rose 0.8 points to 15.3 last week from 14.5. That's up from 13.6 during December, which had also marked its lowest reading since November 2011. 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 moved back above LargeCap's P/E for the first time in five weeks after being below during December for the first time since 2003.

**S&P 500 Sectors Quarterly Earnings Outlook** ([link](#)): Analysts continued cutting Q4 forecasts last week. The S&P 500's blended Q4-2018 EPS forecast of \$40.51 is down 4.8% since the end of Q3, but remains 5.1% higher since the passage of the TCJA. The \$40.51 estimate represents a forecasted pro forma earnings gain for Q4-2018 of 14.5%, down from 15.1% 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 28.4% 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 28.4%, 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 15.1% 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 six 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 15.8% during Q4, compared to four beating the S&P 500's 28.4% 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 (61.8% in Q4-2018 versus 114.2% in Q3-2018), Industrials (24.7, 18.9), Financials (19.4, 44.8), Communication Services (17.8, 26.1), S&P 500 (14.5, 28.4), Consumer Discretionary (12.9, 25.4), Health Care (11.1, 16.5), Tech (8.5, 29.1), Real Estate (6.6, 5.3), Materials (5.6, 30.1), Consumer Staples (3.1, 11.4), and Utilities (-9.1, 10.9). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 12.5% 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 all 11 sectors since the end of Q3. Materials is the biggest decliner, with its Q4-2018 forecast down 14.8% since the end of Q3, followed by Utilities (-8.5), Real Estate (-7.3), Industrials (-5.4), Energy (-4.7), Consumer Staples (-4.5), Financials (-4.2), Consumer Discretionary (-4.0), Communication Services (-4.0), Tech (-3.5), Financials (-2.9), and Health Care (-1.2).

**S&P 500 Q4 Earnings vs Past Quarters Trend** ([link](#)): Earnings estimate revisions activity for Q4-2018 has returned to the usual pattern of falling just before the earnings reporting season. This follows the unusual pre-reporting estimate increases seen for Q1- and Q2-2018 due to the TCJA. With the December-quarter books closed, the current Q4-2018 EPS forecast of \$40.86 is down 4.8% over the 15 weeks since the quarter's start, well below the 1.4% drop for Q3 over a similar period. In the 98 quarters dating back to 1994, forecasts declined an average of 4.0% over the 13 weeks since the start of the quarter. Analysts expect EPS for Q4-2018 to be up 12.5% y/y on a frozen actual basis, down from 13.4% a week earlier. However, it's still expected to mark the tenth straight quarter of higher EPS on a y/y basis and the fifth straight quarter of double-digit percentage growth. Since 1994, the Q4 earnings surprise has been positive in 16/24 years, with the last miss occurring in 2008. Q4 should mark the S&P 500's record 40th straight quarter of positive surprises—a streak dating back to Q1-2009.

## GLOBAL ECONOMIC INDICATORS

**Global Leading Indicators** ([link](#)): In November, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—continued to point to an easing of growth momentum in most major economies, with the OECD's CLI (99.3) sinking to its lowest level since October 2012. The US (99.6) and Germany (99.8) are the latest to join the easing growth momentum camp—after being flagged in the prior assessment as showing tentative signs of easing growth. Meanwhile, easing growth momentum remained the assessment for the UK (98.6), Canada (99.1), and the Eurozone (99.4) as a whole—including France (99.1) and Italy (99.4). Among the major emerging economies, CLIs continued to show stable growth momentum for China's (98.8) industrial sector and India (101.0), while CLIs for both Brazil (102.1) and Russia (100.0) continued to anticipate easing growth.

**Eurozone Industrial Production** ([link](#)): November output in the Eurozone fell for the second time in three months—to its lowest level since June 2017—posting its biggest monthly decline since February 2016. Industrial production (excluding construction) sank -1.7% in November, following a 0.1% uptick in October and a -0.6% drop in September. All the main industrial groupings recorded declines in output on both a monthly and three-month basis; here's a tally: capital goods (-2.3% m/m & -1.8% past 3 months), consumer durable goods (-1.7 & -1.4), intermediate goods (-1.2 & -1.5), consumer nondurable goods (-1.0 & -2.6), and energy (-0.6 & -4.0). November production data are available for the top four Eurozone economies, and all posted declines over the comparable periods: Germany (-1.9% & -3.0%), Italy (-1.6 & -1.8), Spain (-1.6 & -1.4), and France (-1.3 & -1.8). Among other Eurozone economies for which data are available, the largest decreases in industrial production were observed in Ireland (-7.5%), Portugal (-2.5), and Lithuania (-1.9). The highest increases were registered in Estonia (4.5), Greece (3.1), and Malta (2.6).

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