



MORNING BRIEFING

January 16, 2019

European Tour

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

(1) Lots of woes in Eurozone. (2) Rapidly decelerating real GDP growth. (3) Underperforming stocks. (4) ECB drops QE and starts looking for other easing tools. (5) Bad batch of leading indicators, sentiment readings, and industrial production. (6) Germany teetering on the edge of recession as auto sales weaken. (7) Not enough Rhine water. (8) Social unrest in France weighing on economy. (9) Hard or soft Brexit? (10) Some good news out of Europe. (11) Draghi sees need for more easy money.

YRI Video Podcast. Has the stock market discounted all the bad news? That's the implication of the recent plunge in the Bull-Bear Ratio. In my latest [video podcast](#) I observe that it is very bearish, which is bullish if you happen to be a contrarian.

Europe I: Significant Slowdown in Eurozone. The European Central Bank (ECB) ended its four-year-old bond-buying stimulus program in December, but it may yet have to reach into its bag of easy-money tricks.

Weakness persists across the Eurozone in the early days of 2019 as heightened trade tensions, a slowdown in China, uncertainty surrounding the UK's Brexit plan, political unrest in France, and lingering concerns over Italy's debt levels depress business and consumer confidence. After Eurozone growth reached the highest pace in a decade during 2017, it slowed markedly in 2018. Eurozone GDP barely grew, rising by just 0.6% q/q (saar) in Q3-2018, its slowest pace in four years ([Fig. 1](#)). Forecasts put Eurozone GDP growth at below 1.6% this year, compared with expected growth of 1.9% in 2018 and 2.4% in 2017, noted a 1/7 *FT* [piece](#).

The MSCI EMU share price index decline of 14.7% (in euro) in 2018 was the second-worst performance of the 11 major market indexes we track, with the bulk of the bad performance coming in Q4, when it dropped 12.9%. Only EM Asia's drop of 15.0% was worse in 2018. The woes continue for MSCI's EMU index in 2019: Its ytd gain of 3.0% (local currency) is the third-worst performance among the pack, slightly ahead of EM's 2.8% and EM Asia's 2.3%. In dollar terms, the EMU index was the worst performer of 2018, dropping 18.8%. Much of the decline occurred in Q4, when again the index's 14.3% skid put it at the bottom of the pack ([Fig. 2](#)).

Newly released [minutes](#) from the ECB's December 12-13 policy meeting reveal officials understood the risks to the economy, which remained "fragile and fluid" when they ended their quantitative easing program at year-end. Publicly, they referred to the risks as "balanced" and "moving to the downside," while behind closed doors they voiced greater concern that "risks could quickly regain prominence or new uncertainties could emerge," according to a 1/10 Reuters [report](#). The bankers recognized that by cutting their 2019 growth forecast for the region, they were tacitly acknowledging the increased risks, noted a 1/10 Bloomberg [article](#).

There was talk, too, of adding a new targeted longer-term refinancing operation (TLTRO) to the monetary tool kit. TLTROs inject liquidity into the system by giving incentives to commercial banks to lend to businesses and consumers. The ECB has undertaken two rounds of TLTROs, in 2014 and 2016. Loans made under the previous four-year TLTRO expire in 2020, Reuters observed in an [11/2 piece](#).

Cushioning the blow of the bond-buying program's end, the ECB said in December it will reinvest the proceeds from maturing debt back into bonds to alleviate potential volatility that could raise borrowing costs. While the central bank said it will raise interest rates in 2019 sometime after summer, it left itself room to be flexible.

Let's review the latest information on the risks facing the Eurozone:

(1) *Slowdown continuing.* Leading indicators released Monday by the Paris-based Organization of Economic Cooperation and Development (OECD) suggest the Eurozone slowdown will continue, according to a 1/14 [WSJ article](#). The Eurozone leading indicator fell below 100 for the fourth straight month in November and marked its 11th straight decline ([Fig. 3](#) and [Fig. 4](#)). The leading indicators are designed to signal turning points in an economy six to nine months in advance.

(2) *Sentiment softening.* The latest (1/8) [release](#) of the European Commission's (EC) Economic Sentiment Indicator (ESI) showed increasing pessimism in December. The ESI fell 2.2 points to 107.3, its lowest level in two years. The industry, construction, services, and consumer sectors all showed declines in confidence. The lone exception was retail, which showed a tiny gain ([Fig. 5](#) and [Fig. 6](#)). The ESI weakened in the Eurozone's five largest economies: Spain (-3.0), France (-2.0), Germany (-1.9), Italy (-1.4), and the Netherlands (-0.3).

(3) *Industrial production down sharply.* Industrial production in the Eurozone fell by 1.7% m/m (sa) in November, and 3.2% y/y, according to a 1/14 [release](#) from Eurostat, the statistical office of the EC. It marked the steepest drop since February 2016, and cast doubt on any chance of a rebound in Q4, noted a 1/14 [piece](#) in the *FT* ([Fig. 7](#) and [Fig. 8](#)). Production was down m/m across the board in capital goods (-2.3%), durable goods (-1.7), intermediate goods (-1.2), non-durable consumer goods (-1.0), and energy (0.0, or more specifically -0.06). Hardest hit m/m were Ireland (-7.5), Portugal (-2.5), and Germany and Lithuania (both -1.9).

Compared with a year earlier, energy production fell 5.2%, capital goods dropped 4.5%, durable consumer goods fell 3.5%, intermediate goods declined 3.0%, and non-durable goods dropped by 0.1%. The member states showing the steepest y/y declines in industrial production were Ireland (-9.1%), Germany (-5.1), Portugal (-2.9), and Spain (-2.8).

(4) *Germany's economy teetering.* Weighing heavily on the region is the possibility that Germany, the region's biggest economy, is close to entering a recession after three straight months of declining industrial production. A 1/15 [report](#) by Germany's federal statistics office said Tuesday GDP grew 1.5% in 2018, the weakest rate of growth since 2013. In the two prior years, the economy expanded by 2.2%.

Still, the number suggests growth in Q4 was positive, following Q3's 0.2% contraction. Robust domestic demand buoyed by a strong labor market offset weak export sales in the quarter, according to a 1/15 [piece](#) in the *FT*. Unless the figures are revised when the Q4 figures are released next month, Germany appears to have narrowly averted meeting the technical definition of a recession: two consecutive quarters of negative growth. Trouble for Germany is trouble for the entire region. Germany accounts for one-third of total economic output in the Eurozone ([Fig. 9](#)).

German industrial production fell 1.9% m/m in November, well below consensus expectations for growth of 0.3%. Declines were broad-based across all industries, suggesting Germany's problems extend beyond the automotive sector, which has been plagued by quality-control issues as carmakers struggle to comply with new stricter emissions standards that went into effect September 1. On a y/y basis, output fell 4.7% ([Fig. 10](#) and [Fig. 11](#)). "There is more to it than just cars," ING Chief Economist Carsten Brzeski told CNBC in a 1/8 [report](#). "The last significant quarterly surge in industrial production dates to the fourth quarter of 2017. Since then, industrial production has been treading water."

There's no question of the importance of the German auto industry to the health of its economy and that of the Eurozone. It's the largest industry in Germany, accounting for 20% of total industry revenue according to Germany Trade and Invest (GTAI), the country's economic development agency. It is Europe's No. 1 auto market. More than 30% of all passenger vehicles in the region are made in Germany, and about 20% of all new car registrations occur in Germany, according to a GTAI [report](#).

December proved to be a dismal month for German automakers and followed a poor November. The number of newly registered passenger cars in Germany dropped 7% y/y in December to 237,100, according to [statistics](#) from VDA, the trade group for German automakers. German car makers made 18% fewer vehicles, or 296,000, in December and saw exports drop to 246,800, a 20% y/y decline ([Fig. 12](#)).

Last summer's drought and subsequent drop in water level on the Rhine River also wreaked havoc with industrial production, as shipping was disrupted and supplies limited. The waterway, on which 80% of the 223 million tons of cargo shipped by water in Germany travels, was impassable for much of the summer, creating logistical bottlenecks for important raw materials such as coal, oil, and gas, according to an 11/4 NYT [article](#).

(5) *France's political travails depressing production.* Industrial production in France slid by an unexpected 1.3% m/m in November, following gains in two of the prior three months; the result was well below expectations for no change, a 1/10 FT [piece](#) pointed out. Manufacturing output fell 1.4% m/m. Blame it on the so-called "yellow-vest" demonstrators who took to the streets to protest the government's economic policies, forcing business shutdowns ([Fig. 13](#)).

In light of the economic weakness, France's top central banker urged the ECB to take a "gradual and pragmatic" approach as it winds down its stimulus programs. François Villeroy de Galhau, a member of the ECB's governing council, cautioned the ECB to "keep its options open in the face of current uncertainty," a 1/10 FT [article](#) reported.

Europe II: The Brexit Question. The English punk rock group The Clash famously asked the question, "Should I stay or should I go?" in its hit song from 1981. UK citizens answered that question definitively in a referendum more than two and half years ago when they voted to leave the EU, but their government wrestled endlessly with the question of how best to go about executing such a wrenching split.

Lurching toward a deadline of March 29 without any agreed-upon plan has created huge uncertainty in financial markets and helped to drive down the British pound as well as the euro to levels approached following the Brexit vote in June 2016 ([Fig. 14](#) and [Fig. 15](#)). Fearing the worst, companies began triggering contingency plans in December when Prime Minister Theresa May postponed a critical vote, as her agreement with the EU appeared doomed to defeat and her job imperiled.

The "meaningful vote" occurred last night in the House of Commons, and May's withdrawal agreement

was soundly defeated, 432-202. With no Plan B and 10 weeks to go until the end of March, lawmakers in the UK will have to decide quickly on a path forward: negotiating a softer Brexit agreement, holding a second referendum, or facing the chaos of a hard Brexit. Labor Leader Jeremy Corbyn has called for a vote of “no confidence” in May, which could lead to a general election. A 1/15 NYT [story](#) reported that few analysts thought Corbyn could get enough votes for such a move.

Europe III: The Good News. Not all is doom and gloom in the Eurozone. Let's look at some bright spots:

(1) *Jobs.* The seasonally adjusted unemployment rate in the Eurozone registered 7.9% in November, the first time it has fallen below 8% since October 2008, according to a 1/9 [release](#) from Eurostat ([Fig. 16](#)). Unemployment was down from October's 8.0% level and the 8.7% recorded in November 2017. Germany's 3.3% unemployment rate is the second-lowest in the region, behind the Czech Republic's 1.9%. Germany's tight labor market drove stronger domestic demand in Q4, helping to produce positive growth and avert a technical recession.

The picture brightened meaningfully for even those countries plagued by high unemployment. Greece's 18.6% rate as of September 2018 ranks as the highest, but that is meaningfully down from 21.0% during September 2017. Spain's unemployment rate is next highest, at 14.7% in November but down from 16.5% a year ago.

(2) *Inflation.* Inflation in the Eurozone for December is forecast at 1.6%, the lowest level in eight months, thanks to a slower pace of growth in energy costs, according to a 1/4 Eurostat flash [estimate](#) ([Fig. 17](#)).

(3) *Sovereign debt in demand.* Investors showed strong appetite for Eurozone sovereign bonds last week, the first sale in the post-QE period, according to a 1/14 [piece](#) in the WSJ. More than €37 billion in bonds sold during the first week of 2019, placing the week among the strongest issuances since 2010. Some issuers were urged to come to market ahead of the UK's Brexit vote. Yields closed lower, and spreads tightened. There was some concern that investors were turning to less risky assets to protect themselves from an economic slowdown.

(4) *Whatever it takes.* Mario “Whatever-It-Takes” Draghi is still the president of the ECB until October 31. Yesterday, speaking to the European Parliament in Strasbourg, he acknowledged the Eurozone economy is weaker than expected and noted, “a significant amount of monetary policy stimulus is still needed,” according to a 1/15 CNBC [report](#).

CALENDARS

US. Wed: Import & Export Prices -0.9%/-0.3%, Housing Market Index 57, Treasury International Capital, Beige Book. **Thurs:** Jobless Claims 221k, Philly Fed Manufacturing Index 10.0, EIA Natural Gas Report, EIA Natural Gas Report. (Econoday estimates)

Global. Wed: European Car Sales, Germany CPI 0.1%/m/1.7%/y/y, UK Headline & Core CPI 2.1%/1.8% y/y. **Thurs:** Eurozone Headline & Core CPI 1.6%/1.0% y/y, Japan Headline, Core, and Core-Core CPI 0.3%/0.8%/0.3% y/y, BOE Credit Conditions & Bank Liabilities Surveys, Kuroda, Amamiya. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q4 Earnings Season Monitor ([link](#)): With just over 5% of S&P 500 companies finished

reporting earnings and revenues for Q4-2018, y/y revenue and earnings growth remains strong, but the surprise metrics have weakened relative to Q3's results due to Q4's trading turmoil and rising loan loss provisions in the Financials sector. Of the 27 companies in the S&P 500 that have reported through mid-day Tuesday, 85% exceeded industry analysts' earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 18.6%, but missed forecasts by an average of 1.2%. On the revenue side, just 59% of companies beat their Q4 sales estimates so far, with results coming in 0.1% below forecast and 8.3% higher than a year earlier. Q4 earnings growth results are positive y/y for 96% of companies, vs a higher 98% at the same point in Q3, and Q4 revenues have risen y/y for 89% vs a higher 95% during Q3. These figures will change markedly as more Q4-2018 results are reported in the coming weeks. Looking at earnings during the same point in the Q3-2018 reporting period, a higher percentage of companies (88%) in the S&P 500 had beaten consensus earnings estimates by a higher 4.3%, and earnings were up a higher 24.3% y/y. With respect to revenues at this point in the Q3 season, a higher 71% had exceeded revenue forecasts by a higher 0.5%, and sales rose a tad lower 7.9% y/y. The early results for Q4 indicate a slowdown in revenue and earnings growth from Q3, but that comes as no surprise to investors. Q4-2018 should mark the tenth straight quarter of positive y/y earnings growth and the 11th for revenue growth. Looking at the Q4 results ex-Financials and Real Estate, the earnings surprise improves to 2.9% from -1.2% and growth rises to 21.6% from 18.6%. The ex-Financials and Real Estate revenue surprise would be 0.4% instead of -0.1%, with revenue growth improving to 10.3% from 8.4%.

US ECONOMIC INDICATORS

PPI ([link](#)): The Producer Price Index for final demand in December fell for the first time since February 2017, with prices for both goods and services declining. Prices fell -0.2% last month after a 0.1% gain in November and a 0.6% spike in October; prices had only increased 0.1% during the three months through September. Prices for final demand goods contracted -0.4% for the second month, posting its biggest two-month (-0.9%) drop since February 2016. Once again gasoline prices drove the decline, falling -13.6% in December after a similar decline in November. The comparable services measure saw a -0.1% downtick after gains of 0.3% and 0.7% the prior two months. The December decrease in prices was led by margins for food retailing, which fell -2.5%; indexes for cellular phone and other wireless telecommunication services, automotive fuels & lubricants retailing, and airline passenger services also moved lower. The yearly inflation rate for the headline series was unchanged at 2.5% y/y—its smallest rate last year and down from 3.4% in July. The yearly rate for final demand goods has eased steadily from 4.4% in July to a 25-month low of 1.7% last month. Meanwhile, the yearly rate for final demand services accelerated 2.8% y/y in December, back up at March's high, which was the largest in the history of the series going back to late 2010. The rate for finished goods less food, energy & trade services remained just below 3.0%, at 2.8% y/y for the third straight month.

Regional M-PMI ([link](#)): The New York Fed—the first district to report on manufacturing for 2019—reveals business activity slowed for the second month—to its lowest reading since May 2017. Business sentiment has slumped due to the trade fight with China and the partial government shutdown. The composite index sank to 3.9 in January, from 11.5 in December and 21.4 in November. The new orders measure dropped -17.3 points the past three months to a 20-month low of 3.5; the shipment gauge fell from 26.1 to 17.9 the past two months—still a robust reading. Delivery times (-2.1 from 3.2) were shorter this month, while inventories (-7.6 from 7.1) contracted for the first time in six months. Meanwhile, the employment measures reveal hirings (to 7.4 from 17.5) at manufacturing companies were less than half December's pace, while hours worked (6.8 from 6.7) virtually matched the pace at the end of last year. The prices paid index continued to ease from its recent peak of 54.0 in May, though remained at an elevated level of 35.9; the prices-received measure eased from 23.0 to 13.1 over the same time period—though has shown little movement the past three months. As for the six-month outlook, its index dropped -15.1 points the past two months to 17.8—its lowest reading since

February 2016. The new orders and shipments measures sank -17.0 points and -13.2 points, respectively, over the same period to 19.5 and 22.4—still respectable readings, though roughly half the pace of this time last year. The employment measure slumped to a 29-month low of 8.5—down from 27.0 last January.

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