



MORNING BRIEFING

March 12, 2019

Following the Money

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

(1) The Fed's cornucopia of data. (2) US direct investment abroad turns negative in reaction to Trump's trade policies. (3) Last year, foreigners were sellers of US stocks and corporate bonds. They bought some Treasuries. (4) Bears have more corporate debt to be bearish about. (5) Leveraged loans at record high. (6) Lots of private equity available to purchase distressed assets. (7) Supply-and-demand credit analysis not very rewarding for predicting bond yield. (8) The truth about households.

Flow of Funds I: Key Takeaways. Last Thursday, the Fed updated its [Financial Accounts of the United States](#) through Q4-2018. While the data are a bit stale, they do provide some important insights into some of the key economic and financial developments last year. They therefore are relevant to thinking about this year. There are lots of issues that the data might help us resolve about the performance of the economy and financial markets last year and so far this year. Key takeaways:

(1) While the accounts focus on flow of funds in the US, there's plenty of information that relates to the global economy. Below, Melissa and I find some evidence that Trump's trade wars depressed US direct investment abroad, which might explain some of the weakness in the global economy since early last year.

(2) The US Treasury bond yield remained around 3.00% last year despite lots of forecasts that it should head higher. I surmised that perhaps foreign investors were buying US bonds because their yields were well above comparable yields in Japan and Europe. The Fed's data show that foreigners were buying US Treasuries, but not corporate bonds.

(3) Corporate debt continued to rise to record highs last year. Below, we review some of the points we've previously made about why we aren't overly concerned. In particular, we found some Fed data that support our view that distressed asset funds may be a new shock absorber in the credit market.

(4) Once again, the Fed's data confirm our opinion that a supply-and-demand analysis of the flow of funds isn't very useful for predicting interest rates. That doesn't mean the data are useless since they provide lots of insights into the workings of the financial markets. We are always on the lookout for signs of a credit bubble in the form of debt series that are going up exponentially. The standout currently is the series for leveraged loans. But it remains relatively small.

(5) Finally, we find evidence in the Fed's accounts that many Americans may have a bigger stake in the stock market than widely believed. Now let's take a deep dive into the data.

Flow of Funds II: World View. Let's start with what the accounts show about the flows that occurred between the US and the rest of the world (ROW). There is some evidence that Trump's policies had a significant impact on these flows:

(1) *US direct investment abroad has plummeted.* There's some evidence in the Fed's accounts that US investors significantly reduced their direct investment activity last year, which might have contributed to the global economic slowdown that intensified during H2-2018.

Table F.230 of the Fed's accounts shows direct investment flows between the US and ROW. US direct investment abroad plunged to *minus* \$131 billion last year, down from *plus* \$317 billion the year before and the lowest on record ([Fig. 1](#)). Foreign direct investment in the US remained robust at \$292 billion. The plunge in US activity abroad is starkly different than the relatively steady pace of roughly \$350 billion per year from 2008-2017.

Trump's trade policies may have convinced American CEOs to reduce their direct investments abroad, while their overseas counterparts concluded that investing more than, or at least the same as, before Trump might please the Tweeter-In-Chief.

(2) *Foreigners had a modest impact on US bond markets last year.* During 2018, I disagreed with the bond bears who predicted that the 10-year Treasury yield was heading toward 4.00%. While it did rise slightly above 3.00%, it ended the year below that level and was down to 2.62% on Friday. I argued that inflation would remain low, which would keep yields down. I also suggested that foreign investors might be buying our bonds given that comparable yields in Germany and Japan were around zero.

Table F.133 shows that foreign investors, on balance, purchased a total of only \$175.4 billion of US bonds (including Treasuries, agencies, and corporates) last year ([Fig. 2](#)). They purchased a net total of almost nothing (-\$3.0 billion) in the corporate bond market, down from \$320.9 billion during 2017 ([Fig. 3](#)). They were modestly active buyers of US Treasury bonds (\$83.9 billion) and agencies (\$94.5 billion) ([Fig. 4](#)).

(3) *Foreigners were modest sellers of equities last year.* With all due respect to our overseas accounts, foreigners' net flows in the US equity market tend to be contrary indicators. Table F.133 shows that, on balance, they sold \$94 billion in US equities last year ([Fig. 5](#)). The year before, they purchased \$125 billion. They contributed greatly to the stock market's selloff during 2015 and early 2016.

(By the way, the Fed's accounts show ROW activity in mutual funds but don't distinguish between equity and bond funds. The accounts do not include a series for ROW net purchases of ETFs.)

Flow of Funds III: US Corporate Finance. The bears have been growling about corporate debt for quite a while. They will continue to do so given that bonds issued by nonfinancial corporations (NFC) rose to yet another record high, totaling \$5.5 trillion, at the end of last year ([Fig. 6](#)).

Also at a record high at the end of last year was loans to NFCs, at \$3.5 trillion, led by a big increase over the past couple of years in "other loans," which includes leveraged loans extended by the shadow banking system. These loans rose to a record \$1.7 trillion at the end of last year, up \$0.4 trillion since the end of 2016.

Here are a few happy thoughts for worriers about this issue:

(1) *Corporate bonds have been refinanced at low interest rates.* Melissa and I have addressed the concerns about corporate debt several times last year. We observed that there has been a widening spread between gross and net issuance of bonds in recent years ([Fig. 7](#) and [Fig. 8](#)). This implies that a significant portion of outstanding corporate bonds have been refinanced at historically low interest rates.

(2) *Shadow banks can absorb hits better than banks can.* Leveraged loans are financed by the shadow banking system, which includes lots of institutional investors. If some of the loans they own default, that will reduce the rates of return on their portfolios. The losses shouldn't trigger a credit crisis that turns into a credit crunch (shutting off lending to even good borrowers), which is what happened in the past when the capital of banks was depleted by loan losses.

By the way, the 2/18 *WSJ* [reported](#): “Norinchukin Bank, a 95-year-old bank that holds around \$600 billion in deposits from Japan’s agricultural and fishing collectives, has amassed a significant share of the estimated \$700 billion global market for collateralized loan obligations, or CLOs—complex investment vehicles that buy more than half of U.S. loans to junk-rated companies.”

(3) *Huge amount of private equity has been looking for distressed assets.* Last year, we introduced the notion that there is now an important shock absorber in the US credit market. There are numerous distressed asset funds with plenty of cash ready to be deployed when a financial crisis starts to depress certain asset prices. The managers of these funds quickly pounce when opportunities open up to buy distressed assets, thus reducing the magnitude and the shock waves of any crisis.

When Melissa and I researched our recent stories on buybacks, we found that the Fed compiles a series for gross NFC equity issuance that includes initial public offerings (IPOs), secondary equity offerings (SEOs), and private equity ([Fig. 9](#)). The Fed maintains separate series for IPOs and SEOs ([Fig. 10](#)).

Gross equity issuance rose to a record high of \$482 billion last year, while the 12-month sum of IPOs and SEOs continued to meander around \$100 billion, as it has been doing for the past few years. The implication is that private equity flows rose to a record \$388 billion last year ([Fig. 11](#)).

Flow of Funds IV: US Government. As noted above, one of the biggest surprises of 2018 was that the bond yield ended the year below 3.00%, at 2.69%, only slightly higher than the rate it began the year (2.40%). Trump’s tax cuts, implemented at the beginning of last year, were projected to boost economic growth and inflation, with the federal budget deficit ballooning. The Fed was expected to raise the federal funds rate three or four times and to pare its balance sheet by \$50 billion per month for the foreseeable future.

Let’s see what the Fed’s data show about the supply and demand for Treasury securities last year:

(1) *Supply of Treasuries.* Table F.210 shows that the net issuance of marketable US Treasury securities ballooned from \$554 billion during 2017 to \$1,132 billion last year ([Fig. 12](#)).

(2) *Demand for Treasuries.* The biggest buyer of these securities was the household sector, which scooped up \$580 billion ([Fig. 13](#)). Mutual funds and ETFs purchased \$327 billion last year. The ROW dropped from \$307 billion to \$84 billion. The Fed unloaded \$232 billion in Treasuries as it reduced the size of its balance sheet.

As I’ve observed before, supply and demand analysis based on the flow of funds hasn’t been a very useful way to predict bond yields during the first 40 years of my career. Inflation and the Fed’s reaction to this key variable have been much more important.

Flow of Funds V: Households. Above, we noted that households were the biggest buyers of Treasuries last year. Who are these people? Nobody knows, which explains why it’s important to know that in the Fed’s accounts most items associated with the household sector are calculated as residuals. The Fed does note that in addition to actual households, the sector includes domestic hedge funds,

private equity funds, and personal trusts.

With that hedge clause, let's see what the Fed's data show about the widespread notion that only a few fat cats own stocks and have been getting fatter during the current bull market:

(1) *Net worth*. The net worth of the household sector rose to a record high of \$108.1 trillion during Q3-2018. It took a hit of \$3.8 trillion during Q4, falling to \$104.3 trillion as a result of the stock market selloff. We know that consumer confidence fell late last year. That suggests that lots of people were in pain from the stock market's mini-debacle.

(2) *Equities*. The Fed's data show that the biggest asset in the household sector's balance sheet is pension fund entitlements ([Fig. 14](#)). A lot of cats have this asset, not just the fat ones. It dropped \$0.8 trillion to \$25.6 trillion at the end of last year.

The household sector is also exposed to stocks through mutual funds, which totaled \$7.8 trillion at the end of last year, down \$1.2 trillion. The sector also holds equities directly in brokerage accounts. This item dropped \$2.7 trillion to \$16.1 trillion.

Keep in mind that both the mutual fund and pension categories also include funds invested by the household sector in bonds, which have performed nicely over the past 10 years.

(3) *Less mortgage debt burden*. By the way, the ratio of home mortgages outstanding to disposable personal income fell to 0.65 at the end of last year, the lowest since Q1-2001 ([Fig. 15](#)). We conclude that overall consumers are in good financial shape.

CALENDARS

US. Tues: NFIB Small Business Optimism Index 102.8, Headline & Core CPI 1.6%/2.2% y/y. **Wed:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods -0.8%/0.1%/0.1%, PPI-FD Headline, Core, and Core Less Trade Services 0.2%/0.2%/0.2%, Construction Spending 0.3%, Atlanta Fed Business Inflation Expectations, E-Commerce Retail Sales, EIA Petroleum Status Report.(Econoday estimates)

Global. Tues: UK Headline & Manufacturing Industrial Production -1.3%/-1.9% y/y, UK Trade Balance -£3500m. **Wed:** Eurozone Industrial Production 1.0%/m/m/-2.1%/y/y, Mexico Industrial Production -2.0% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): LargeCap's forward earnings rose last week, for a second week for the first time in three months, but those of MidCap and SmallCap fell. All three of these indexes are still on the downtrend that began in late October. LargeCap's forward EPS is now 2.1% below its record high of \$175.48 in late October, while MidCap's and SmallCap's are now 2.8% and 7.2% below their mid-October highs, respectively. LargeCap's forward EPS had been the most below its record high since June 2016, while MidCap and SmallCap have not been this far below since February 2016 and November 2010, respectively. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but is tumbling now as y/y comparisons become more difficult. In the latest week, the rate of change in LargeCap's forward earnings fell to a 26-month low of 6.6% y/y from 6.8%. 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 25-month low of 7.3% from 7.9%, 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 17-month low of 8.6% from 10.1%, 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 have been dropping since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.5%, 3.9%, 12.0%), MidCap (22.5, 3.7, 12.5), and SmallCap (21.4, 7.6, 17.1).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios dropped sharply w/w for these indexes, but remain well above their multi-year lows in late December. LargeCap's weekly forward P/E dropped to a four-week low of 16.0 from 16.3, and is up from a five-year low of 13.9 during December. That compares to a six-month high of 16.8 in mid-September and 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 was also at a four-week low of 15.4, down from 15.9 a week earlier. 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. However, 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 tumbled w/w to a four-week low of 16.4 from 17.1, but is up from 13.6 during December, which had 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). SmallCap's P/E was higher than LargeCap's P/E for a ninth week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q4 earnings season nearly finished, analysts are essentially done revising their Q1 forecasts. Last week saw the S&P 500's Q1-2019 EPS forecast drop 10 cents w/w to \$37.55. That's down 9.3% since the end of Q3. The \$37.55 estimate represents a forecasted pro forma earnings decline for Q1-2019 of 1.4%, compared to -1.1% a week earlier and 5.3% at the end of Q4. If it comes to pass, Q1's y/y decline would be its first after 10 straight gains, and down from 16.7% in Q4 and 28.4% in Q3 (which marked the peak of the current earnings cycle). Just four of the 11 sectors are expected to record positive y/y earnings growth in Q1-2019, with none rising at a double-digit percentage rate. That compares to 10 positive during Q4, when six rose at a double-percentage rate. Five sectors are expected to beat the S&P 500's Q1 growth rate, compared to just four during Q4. Utilities is the only sector expected to post better growth on a q/q basis during Q1. Here are the latest forecasted Q1-2019 earnings growth rates versus their blended Q4-2018 growth rates: Industrials (5.4% in Q1-2019 versus 27.1% in Q4-2018), Health Care (4.9, 13.3), Financials (3.7, 15.6), Real Estate (2.3, 6.2), Utilities (-0.4, -10.4), Consumer Staples (-2.0, 4.6), Consumer Discretionary (-3.2, 17.3), Communication Services (-5.4, 26.3), Information Technology (-6.5, 10.1), Materials (-13.5, 3.9), and Energy (-16.4, 81.5). On an ex-Energy basis, analysts expect S&P 500 earnings to drop 0.6% y/y in Q1, well below the 14.0% y/y gain in Q4.

US ECONOMIC INDICATORS

Retail Sales ([link](#)): Core retail sales—which exclude autos, gasoline, building materials, and food services—rebounded 1.1% in January after a revised 2.3% drop in December—which was steeper than the 1.7% initial decline and the biggest since January 2000. (The BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) Meanwhile, headline retail sales eked out a 0.2% gain after contracting a revised 1.6% in December, which was also larger than its preliminary loss of 1.2%. We estimate January real core retail sales jumped 1.4% following a 1.7% loss and a 1.2% gain the prior two months, while real retail sales climbed 0.5% after a 1.1% decrease and a 0.4% increase during December and November, respectively. We calculate that real core retail sales

accelerated 2.1% (saar) during the three months ending January (based on the 3-month average), up from 1.1% at the end of last year; real retail sales growth slowed to 0.8% (saar) over the comparable period, the weakest since April 2018—slowing steadily from July's 6.2%. In January, eight of the 13 major nominal sales categories rose, led by sporting goods (4.8%), building materials & supplies (3.3), and nonstore (2.6) retailers. Meanwhile, declines in motor vehicle (-2.4), gasoline (-2.0), clothing (-1.3), and furniture (-1.2) store sales were a major drag during the month.

Business Sales & Inventories ([link](#)): Nominal business sales in December continued to decline from October's record high, while real business sales reached a new record high at the end of 2018. Nominal manufacturing & trade sales (MTS) sank 1.5% during the two months ending December, while inflation-adjusted MTS rose 0.6% over the same period. Real sales of both retailers and wholesalers were stalled around record highs in December, while manufacturers' reached a new cyclical high. Except for a temporary blip in early 2018, the real inventories-to-sales ratio was on a fairly steady downtrend since reaching a cyclical high of 1.47 in early 2016, though appears to have found a bottom, at 1.42, during Q3, climbing to 1.43 during Q4. December's nominal inventories-to-sales ratio has jumped to 1.38 since dropping to 1.33 in June—which was the lowest since November 2014.

Housing Starts & Building Permits ([link](#)): Housing starts rebounded sharply in January, virtually erasing the sharp decline during the final four months of 2018, while building permits advanced for the fourth time in five months—to within striking distance of a new cyclical high. Housing starts soared 18.6% to 1.230mu (saar) in January, after a four-month slide of 19.0% to 1.037mu—the lowest since March 2015. Single-family starts posted their biggest monthly gain in the history of the series, surging 25.1% to an eight-month high of 926,000 units (saar), more than reversing the 16.9% drop during the four months ending December. Volatile multi-family starts remained around recent lows, edging up 2.4% to 304,000 units (saar) after plunging 25.4% in December. Building permits climbed 1.4% in January, and 7.7% during the five months through January, to 1.345mu (saar), 2.3% below last March's cyclical peak of 1.377mu. Multi-family permits strengthened for the fourth consecutive month, by 7.2% in January and 28.1% over the period, to 533,000 units (saar)—the highest since June 2015. Meanwhile, single-family permits fell three of the past four months, by a total of 4.9%, to a 17-month low of 812,000 (saar).

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators ([link](#)): In January, 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 anticipate an easing of growth momentum in most major economies, with the OECD's CLI (99.1) sinking to its lowest level since October 2009. Easing growth momentum remained the assessment for the US (99.0), Canada (98.9), the UK (98.4), and the Eurozone (99.3) as a whole—including Germany (99.4) and Italy (99.2), while France's CLI (99.1) indicated signs of stabilizing growth momentum (from easing growth)—driven by improvements in consumer confidence, car registrations, and slower inflation. Meanwhile, Japan's (99.8) assessment has been downgraded from stable growth momentum to signs of easing growth momentum—reflecting declines in the stock market, expected sales of small business, and manufacturing hours. Among emerging economies, in Brazil (102.6) the tentative signs of growth gaining momentum—flagged in the last assessment—have now been confirmed, while China's (98.3) assessment has improved to stable growth momentum from an easing of growth in the prior report. Meanwhile, stable growth momentum remains the assessment for India (100.7), while Russia's CLI (99.6) continues to point to an easing of growth.

Germany Manufacturing Orders ([link](#)): German factory orders posted the biggest monthly decline in seven months at the start of this year, though the steep decline reported at the end of last year was revised to a solid gain. Orders contracted 2.6% in January, after a revised 0.9% advance in December

(first reported as a 1.6% decline), on a slump in both foreign (-3.6%) and domestic (-1.2) billings. Foreign orders from outside the Eurozone plunged 4.2% following a 0.2% downtick in December—driven by a sharp drop in capital goods (-7.6) billings, while consumer goods orders soared for the second month, by 8.5% m/m and 14.7% over the period; these intermediate goods orders expanded 2.6% in January after a two-month slide of 8.8%. Foreign orders from within the Eurozone have been very volatile, contracting 2.6% in January after a 4.1% increase and a 9.9% decrease the prior two months. Both consumer (-10.9% after 4.9%) and intermediate (-4.7, 5.8) goods orders fell sharply in January from solid gains in December, while capital goods orders increased 2.9% during the two months through January after plummeting 12.4% in November. As for domestic goods orders, intermediate goods billings have been in a virtual freefall since peaking during August 2017, sinking 11.6% through January, while capital goods orders are volatile around recent highs and consumer goods orders volatile around recent lows. Meanwhile, February's IHS Markit M-PMI suggests further downside for Germany's manufacturing sector, sinking further into contraction territory, falling to 47.6, after falling below the 50.0 breakeven point in January (49.7) for the first time in more than four years. February's reading was the lowest since December 2012.

Germany Industrial Production ([link](#)): Germany's industrial sector continued to fight major headwinds in January, with output falling to its lowest reading since March 2017. Germany's headline production—which includes construction—contracted for the fourth time in five months, by 0.8% m/m and 2.1% over the period. (Excluding construction, output fell 0.9% and 2.5% over the comparable periods.) Since its recent peak in May 2018, manufacturing output has tanked 4.5% to a 22-month low. Here's how the main industrial groupings performed over the same period, with consumer nondurable (-8.7%), capital (-4.5), intermediate (-3.2), and consumer durable (-2.8) goods output all in the red—though both consumer nondurable (1.7) and durable (0.6) goods output rose in January. Looking ahead, IHS Markit notes continued weakness in February: "Output decreased for the first time in almost six years in February. The contraction was the most marked since December 2012 and reflected the intermediate and capital goods sectors, with makers of consumer goods recording the only increase in output."

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