



MORNING BRIEFING

June 4, 2019

Uncharted Waters

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

(1) One more month to go to US economy's 10-year jubilee. (2) LEI does look topky. (3) More record highs ahead for CEI. (4) No boom, no bust. But what about protectionism? (5) Jury is out on Trump's helter-skelter approach to trade. (6) Some misgivings about LEI signals during the longest expansion on record. (7) Some cyclical indicators (like jobless claims) simply can't get much better. (8) Business loans at record high. (9) Borrowing by NFCs in the bond market cooled off dramatically last year. Why?

US Economy: The Longest Expansion. The US economic expansion should make it through July and beyond, despite all the chatter about a recession. Granted, the yield curve has inverted recently, heightening fears of an impending, if not imminent, recession ([Fig. 1](#)).

However, as Debbie and I have observed before, the yield curve is just one of the 10 components of the Index of Leading Economic Indicators (LEI). The LEI stalled at a record high over the past seven months through April. It probably declined in May as stock prices swooned and the yield curve inverted. However, recessions are usually preceded by three or more consecutive months of declines in the LEI. During the previous seven expansions, the LEI peaked 13.7 months on average before the first month of recession ([Fig. 2](#)).

In our opinion, this means that the Index of Coincident Economic Indicators (CEI) is likely to continue rising into record-high territory at least through July, and probably beyond. If so, then this expansion will be the longest on record next month ([Fig. 3](#)). All the way back in 2014, we concluded that it might last at least this long. We based our analysis on the history of the CEI.

Since the start of the CEI series during 1959, the economy always has regained all that was lost during recessions ([Fig. 4](#)). That's because the economy is wired to grow along with the labor force and productivity. In any case, once the CEI is back rising into record-high territory, there's a tendency for the economy's "animal spirits" to turn more manic, or at least more optimistic. After all, by that time the last recession has been over for a while.

The past six recovery periods lasted 33.3 months on average, with the shortest at 19 months and the longest at 68 months. During the recoveries, lost ground was regained, and the situations proved not to be as bad as had been widely feared. Most people kept their jobs during the downturn, while relatively few lost their jobs. Most companies stayed in business, though many had to fire some workers and postpone some spending plans.

Expansion (i.e., post-recovery) periods tend to last longer than recovery periods. The previous five expansion periods lasted 65.4 months on average, with the shortest at 30 months and the longest at 104 months.

During the current business cycle, the recovery phase ended and the expansion phase started during

November 2013. Adding 65.4 months for the average length of the previous expansions puts the end of the current expansion around May 2019.

Previous expansions ended with the Fed raising interest rates to cool the speculative fire caused by the late-cycle boom. Higher interest rates invariably triggered a financial crisis, which turned into a credit crunch and a recession. This time, there are few signs of a speculative boom. The Fed has paused its rate-hiking since the start of this year, and the markets are anticipating that the next move might be a rate cut.

This is our long-held no-boom-no-bust scenario, which has kept us optimistic on the prospects for a long expansion. The question is whether Trump's escalating trade war (rather than Fed tightening) might cause a recession. We have plenty of experience with the traditional boom-bust business cycle just described above. The only experiences we have with protectionism are the Smoot-Hawley and Reagan tariffs and the voluntary export restrictions on the Japanese. The former triggered a global depression, the latter might have boosted the US economy by forcing foreign manufacturers to produce more in the US.

The jury is out on Trump's helter-skelter approach to trade wheeling-and-dealing, as we discussed yesterday. We are sticking with our position that all sides in the various trade disputes need deals, so some will probably be struck. For now, let's have a closer look at various leading indicators:

(1) *Index of Leading Economic Indicators*. Debbie and I have some misgivings about the LEI. Many of its components are cyclical. That makes sense in the context of forecasting the business cycle. However, many have run out of room to improve given that this has turned out to be the longest economic expansion on record ([Fig. 5](#)).

For example, the average workweek has been fluctuating around its cyclical high since 2014. Jobless claims are so low that they probably can't go much lower. Building permits have also been moving sideways at their cyclical high since 2017.

So far, we know that three of the 10 LEI components fell in May: the S&P 500, ISM New Orders Index, and the interest-rate spread.

(2) *Weekly leading indicators*. We track three weekly leading indicators ([Fig. 6](#)). One is produced by the Economic Cycle Research Institute (ECRI). Another is compiled by the Foundation of International Business & Economic Research (FIBER). The third is our very own open-source Boom-Bust Barometer (BBB).

All took a dive late last year and recovered earlier this year. All remain on uptrends. The ECRI and FIBER are proprietary, but our hunch is that they include the obvious weekly components, such as initial unemployment claims, the S&P 500, and a credit-quality spread.

Our BBB is simply the ratio of the CRB raw industrials spot price index to jobless claims. Our indicator has recently reversed most of its gain at the beginning of this year. The problem with it is that jobless claims probably can't go much lower, so it will be dominated by the commodity price index, which can be volatile.

(3) *Other leading indicators*. We are always on the lookout for other stray cats and dogs that might be able to predict the business cycle. We've found that payroll employment in truck transportation and in temporary help services are highly correlated with the LEI ([Fig. 7](#) and [Fig. 8](#)). Both remain on uptrends, but have stalled at their record highs in recent months.

Is that a sign that the economy is slowing, or merely that it is getting harder to find truckers and temps? If the latter, then a shortage of workers could also slow the economy, though it is very unlikely to cause a recession.

Corporate Bonds: Looking for Distress Signals. The bears are very distressed by what they see in the corporate debt markets. They see too many leveraged loans and too many corporate bonds. Melissa and I addressed this issue several times last year and this year. Our conclusion is that neither is likely to trigger a financial crisis, though both could exacerbate a downturn caused by other distressing events, e.g., a bloody trade war. Now consider the following:

(1) *Leveraged loans.* There's no sign of a credit crunch in the business loans market. Commercial and industrial loans rose to a record \$2.35 trillion during the 5/22 week at all commercial banks in the US ([Fig. 9](#)).

In the Financial Accounts of the US, the Fed disaggregates the loans data into those held by depository institutions and "other loans," which are mostly leveraged loans that are sold to investors either directly or through CLOs. During Q4-2018, the former was at a record \$1.2 trillion, while the latter was at a record-high \$1.7 trillion ([Fig. 10](#)).

2) *Nonfinancial corporate bonds.* At the end of last year, nonfinancial corporate (NFC) bonds outstanding rose to a record \$5.5 trillion, doubling since Q4-2006 ([Fig. 11](#)). On the other hand, the bonds of the financial sector totaled \$4.8 trillion at the end of last year, down from the record high of \$6.3 trillion during Q1-2009.

The good news is that the pace of NFC bond borrowing last year fell to only \$116 billion, the lowest since 2008, and well below the record high of \$462 billion during the four quarters through Q3-2015 ([Fig. 12](#)). The questions are: Why the slowdown? Is the economy slowing? Is capital spending slowing? Did Trump's tax reform reduce the incentive to raise money in the bond market? Did repatriated earnings reduce the need to raise money in the capital markets for buybacks?

We aren't sure. The answer could be "all of the above." In any event, it should be a relief to see NFCs cooling their bond issuance. Let's see what they do in 2019 that might give us a better handle on whether the borrowing slowdown was temporary or longer lasting.

CALENDARS

US. Tues: Factory Orders -0.9%, Powell, Williams, Brainard. **Wed:** ADP Employment Change 183k, ISM & IHS Markit NM-PMIs 55.5/50.9, MBA Mortgage Applications, DOE Crude Oil Inventories, Beige Book, Bowman, Clarida. (DailyFX estimates)

Global. Tues: Eurozone Headline & Core CPI Flash Estimates 1.3%/0.9% y/y, Eurozone Unemployment Rate 7.7%, RBA Cash Target 1.25%. **Wed:** Eurozone Retail Sales -0.5% m/m/1.5% y/y, Eurozone, Germany, France, and Italy C-PMIs 51.6/52.4/51.3/49.3, Eurozone, Germany, France, and Italy NM-PMIs 52.5/55.0/51.7/49.8, UK C-PMI & NM-PMI 51.0/50.6, China NM-PMI 54.2, Australia GDP 0.4% q/q/1.8% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): LargeCap's forward earnings rose w/w for a seventh straight week, and MidCap's and SmallCap's were higher after falling for two straight weeks. The recent

trend remains positive, though: LargeCap's has risen during 13 of the past 16 weeks; MidCap's nine of the past 12 weeks; and SmallCap's seven of the past 10 weeks. LargeCap's forward EPS is less than 0.1% below its record high of \$175.48 in late October; MidCap's is 1.2% below its mid-October high; and SmallCap's is 6.5% below its mid-October high. At their bottoms, LargeCap's forward EPS had been the most below its record high since June 2016, and MidCap's was the lowest since May 2015. SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but tumbled as y/y comparisons became more difficult. But that may be ending soon too. In the latest week, the rate of change in LargeCap's forward earnings edged down to 4.6% y/y from 4.7%, just above the 29-month low of 4.5% in mid-May. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change dropped to 4.4% from 4.5%, which compares to a 30-month low of 4.2% in mid-May and 24.1% in mid-September (the highest since April 2011). SmallCap's fell to 1.8% from 2.0%, which compares to a 40-month low of 1.6% in mid-May and is down from an eight-year high of 35.3% in early October. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 3.2%, 11.8%), MidCap (22.7, 1.8, 13.9), and SmallCap (22.4, 2.9, 18.6).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios fell for a fourth week for all these indexes, but they remain above their multi-year lows in late December. LargeCap's weekly forward P/E dropped to an 18-week low of 15.7 from 16.1, which compares to a 13-month high of 16.9 in early May and is up from a five-year low of 13.9 during December. That also compares to a 16-year high of 18.6 during January 2018—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 dropped 0.5pt to a 20-week low of 14.7. That's down from a seven-month high of 16.3 in early April, but 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 of 15.5 was also down 0.5pt to a 20-week low, which is well above its seven-year low of 13.6 during December. That's still 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 a tad below LargeCap's P/E for a third straight week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q1 earnings season essentially complete, analysts are no doubt contemplating the trade war's impact on earnings. While revisions activity remains light, last week saw the S&P 500's Q2-2019 EPS forecast slip another 7 cents w/w to \$40.60. That's still in line with our forecast of \$41.00, which assumes there will be yet another earnings hook during the reporting season. The consensus' \$40.60 estimate is down 1.8% since the start of the quarter, which represents a forecasted pro forma earnings gain of 0.9% y/y, compared to 1.0% a week earlier and 2.9% at the end of Q1. If it comes to pass, Q2's gain would be the 12th straight y/y rise, but down from 1.5% in Q1, 16.8% in Q4, and 28.4% in Q3 (which marked the peak of the current earnings cycle). Seven of the 11 sectors are expected to record positive y/y earnings growth in Q2-2019, with only one rising at a double-digit percentage rate. That compares to six positive during Q1, when one also rose at a double-percentage rate. Five sectors are expected beat the S&P 500's Q2 growth rate, the same as during Q1. However, Communication Services and Utilities are the only sectors to post better growth on a q/q basis during Q2, just as they did during Q1. Here are the latest Q2-2019 earnings growth rates versus their Q1-2019 growth rates: Communication Services (16.3% in Q2-2019 versus -9.9% in Q1-2019), Financials (6.1, 8.0), Health Care (2.8, 10.3), Utilities (2.0, -0.5), Real Estate (1.2, 6.3), Consumer Discretionary (0.6, 8.2), Energy

(0.1, -26.1), Industrials (-0.1, 6.9), Consumer Staples (-1.1, 0.6), Information Technology (-7.9, -1.5), and Materials (-18.5, -13.4). On an ex-Energy basis, S&P 500 earnings are expected to rise 0.9% y/y in Q2, down from 2.9% in Q1 and well below the 14.2% y/y gain in Q4. Q2's forecasted gain would mark the lowest ex-Energy growth rate since Q2-2016.

US ECONOMIC INDICATORS

Construction Spending ([link](#)): Construction spending in April remains stalled around record highs as public construction investment continued to surge, while private investment continued to slide. Overall spending ticked down 0.1% in April, while March's (to 0.1% from -0.9%) decrease was revised to a slight increase—pushing its ytd gain up to 1.8%. Public investment skyrocketed 4.8% in April and 15.9% ytd to a new record high—with spending on office, commercial, health care, highways & streets, sewage & waste, and water supply projects all posting double-digit ytd advances. Meanwhile, spending on private construction projects sank to the lowest level since January 2017, dropping 1.7% in April and 2.5% ytd; it's plunged 6.2% since peaking last May. Within private construction, residential investment has contracted 11.4% from last April's cyclical high, as home-improvement and single-family investment plunged 21.7% and 7.6% y/y, while multi-family investment climbed 7.9%. Meanwhile, private nonresidential building slumped 2.9% in April, after jumping 4.4% during the four months through March to a new record high.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs ([link](#)): Global manufacturing activity was the weakest since October 2012, while business optimism fell to its lowest level since the data were first collected in July 2012. JP Morgan's M-PMI fell below the breakeven point of 50.0 for the first time since February 2016, declining steadily from December 2017's seven-year high of 54.4 to 49.8 in May—as trade tensions continued to weigh on the sector, with new export orders contracting for the ninth consecutive month. The emerging nation's M-PMI (to 50.4 from 50.5) deteriorated slightly for the second month, after improving the prior two months from January's 49.5 (which was the first reading below 50.0 since mid-2016) to 51.0 in March. Meanwhile, the M-PMI for the developed nations fell to 49.2 last month after recovering to 50.2 in April, following a brief dip below 50.0 in March (to 49.9). National PMI data signaled deteriorating business conditions in several major industrial regions including the Eurozone (to 47.7 from 47.9), Japan (49.8 from 50.2), the UK (49.4 from 53.1), Canada (49.1 from 49.7), South Korea (48.4 from 50.2), and Taiwan (48.4 from 48.2). Within the Eurozone, Germany (44.3) recorded the sharpest deterioration in operating conditions, followed by Austria (47.8)—which saw its manufacturing activity contract at the sharpest rate in over four years. Meanwhile, Italy's PMI (49.5) remained slightly below 50.0, while only marginal growth was seen in M-PMIs for France (50.6) and Spain (50.2); Greece (54.5) remained the best-performing country in terms of manufacturing activity. Meanwhile, PMIs for the US (50.5), China (50.2), and Brazil (50.2) were only a few ticks above the benchmark 50.0 no-change mark. The downshift in growth in the US was the main driver of the slowdown in global manufacturing, as the US PMI slipped to its lowest level in almost a decade (September 2009).

US Manufacturing PMIs ([link](#)): US Manufacturing PMIs ([link](#)): Manufacturing activity eased further in May, according to both the ISM and IHS Markit M-PMIs, expanding at the slowest rates since October 2016 and September 2009, respectively. The ISM M-PMI (to 52.1 from 52.8) remains on a steep downtrend from its recent high of 60.8 just nine months ago—driven by the escalating trade tensions between the US and China. (Note: ISM survey was taken before President Trump's latest warnings of imposing tariffs on Mexican goods.) Two of the five components that comprise the M-PMI show that the production (51.3 from 52.3) measure sank to its weakest reading since August 2016, while the orders (52.7 from 51.7) gauge improved only slightly. Meanwhile, the sub-index for the backlog of orders (47.2 from 53.9) contracted for the first time since the start of 2017 last month, while the new export orders'

(51.0 from 49.5) sub-index moved back into expansionary territory. The remaining three components of the M-PMI show the employment (53.7 from 52.4) gauge moved higher, while the inventory (50.9 from 52.9) and supplier deliveries' (52.0 from 54.6) measures moved lower—with the latter plummeting from its cyclical high of 67.6 last July. The IHS Markit's M-PMI (50.5 from 52.6) in May continued to slide from its reading of 54.9 at the start of the year—indicating a marked slowdown in growth compared to Q1. According to the report, “New orders are falling at a rate not seen since 2009, causing increasing numbers of firms to cut production and employment. At current levels, the survey is consistent with the official measure of manufacturing output falling at an increased rate in the second quarter, meaning production is set to act as a further drag on GDP, with factory payroll numbers likewise in decline.”

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