



MORNING BRIEFING

June 6, 2019

Big Government vs Big FANGs

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

(1) Is Powell ready to pull the trigger for a rate cut? (2) Fed's latest word game. (3) What does "appropriate" mean? (4) Is Powell ready to fly with the doves? (5) The debate about a "makeup" strategy for inflation targeting. (6) Rate-cutting risks causing financial instability. (7) Comparing 2019 to 1999. (8) Willy Sutton and the FANGs. (9) Bullish for lobbyists and lawyers. (10) Remember what happened to Microsoft. (11) Growth is scarce. FANGs have it.

Fed: Powell Put, or Pause? In a Tuesday 6/4 [speech](#) at the *Fed Listens* event in Chicago, Federal Reserve Chairman Jerome Powell seemed to suggest that he is ready to cut interest rates. In the second paragraph of his talk, he said:

"I'd like first to say a word about recent developments involving trade negotiations and other matters. We do not know how or when these issues will be resolved. We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective."

The financial markets and press jumped on that statement as a clear signal that Powell is getting ready to lower rates. The 2-year Treasury note yield was down to 1.83% on Wednesday, well below the federal funds rate range of 2.25% to 2.50%. The S&P 500 rose 3.0% from Monday's close through Wednesday. The following are just a few headlines that appeared in MarketWatch, NYT, and Bloomberg, respectively: "[Dow rallies over 500 points after Powell seen to leave door open to rate cut](#)," "[Stocks Jump as Fed's Powell Suggests Rates Could Come Down](#)," and "[Powell Signals Openness to Rate Cut If Needed Over Trade Tensions](#)." We aren't convinced that Powell is ready to pull the trigger for a rate cut. Let's review what he said in the rest of his speech:

(1) *Powell's word play.* The key words he used were "as appropriate." What "appropriate" means is up for interpretation, with the markets and the media assuming he was implying openness to a rate cut. Melissa and I believe that Powell continues to advocate for patience on interest rates, neither pursuing an interest-rate hike, or a knee-jerk cut, as US-China trade negotiations continue.

(2) *Powell the contrarian?* Some also may have assumed that Powell was hinting at a rate cut because several dovish Fed officials—including FRB-SL President James Bullard (in a 6/3 [speech](#)) as well as Fed Governors Richard Clarida (in a 5/30 [speech](#)) and Lael Brainard (in a 5/16 [speech](#))—have said in recent weeks either that they wouldn't be opposed to rate cuts or that they wouldn't mind an inflation overshoot. However, given comments that Powell made at his last press conference that low inflation readings may be "transient," as well as evidence from his latest speech, we think he may not be ready to fly with the doves. (For example, see our [5/20](#) and [2/25 Morning Briefings](#).)

(3) *Powell doesn't like it hot.* Importantly, Powell seems unconvinced that an inflation overshoot is a good idea. One of the primary solutions to the low inflation problem that has been discussed as a part

of the *Fed Listens* series is an inflation “makeup” strategy, whereby Fed officials would commit to allow the rate of inflation to run beyond the Fed’s stated 2.0% target so that price levels may catch up on “missed” increases when rates fell below 2.0%.

During his latest speech, Powell seemed unconvinced about the effectiveness of implementing such a strategy: “For makeup strategies to work, households and businesses must go out on a limb ... raising spending in the midst of a downturn ... based on their confidence that the central bank will deliver the makeup stimulus at some point. ... But important questions remain. To achieve buy-in by households and businesses, a comprehensible, credible, and actionable makeup strategy will need to be followed by years of central bank policy consistent with that strategy.”

Aside from the challenge in successfully implementing a makeup strategy, Powell is also concerned about the risks to financial stability from keeping interest rates too low: “Using monetary policy to push sufficiently hard on labor markets to lift inflation could pose risks of destabilizing excesses in financial markets or elsewhere.”

(4) *Powell fears the ELB.* Powell called the Effective Lower Bound (ELB), or the lowest possible federal funds rate that could effectively stimulate the economy, the “preeminent monetary policy challenge of our time.” It seems to us that Powell’s fear of the ELB is one of the primary reasons that he would not be in favor of a rate cut unless it is absolutely necessary.

But once again, his comments are up for interpretation. He said: “The next time policy rates hit the ELB—and there will be a next time—it will not be a surprise.” Some might have taken that to mean that the Fed is on course to cut rates. But our take is that Powell feels the Fed will have no choice but to hit the ELB during the next downturn simply because we are so close to it. Powell added: “The combination of lower real interest rates and low inflation translates into lower nominal rates and a much higher likelihood that rates will fall to the ELB in a downturn.”

Powell compared today’s US economy to a similar period in 1999 when inflation was at 1.4% with unemployment 4.1%. But the difference, he said was that the federal funds rate was at 5.2%, which was 20 quarter-point rate cuts away from the ELB. Powell stated that “a low-side surprise of a few tenths on inflation did not raise the specter of the ELB” when nominal interest rates were around 4% to 5%. “But the world has changed.” Today, “a similar low-side surprise” would “bring us uncomfortably closer to the ELB.”

That brings us full circle back to why the Fed is so concerned about low inflation in a low-interest-rate world: The Fed simply doesn’t have much room to stimulate the US economy in a downturn with its primary interest-rate tool. Solutions will continue to be debated at future *Fed Listens* events. (For background on *Fed Listens*, see our 4/15 [Morning Briefing](#).)

Technology: Fang Bite. Willy Sutton robbed banks “because that’s where the money is.” America’s big government is going after the country’s big tech companies because that’s where the money is.

The Department of Justice called dibs on investigating Apple and Alphabet (parent of Google), leaving Amazon and Facebook for the Federal Trade Commission (FTC). Anti-trust investigations haven’t formally been announced yet. And we are months—perhaps years—away from court cases, assuming any are even forthcoming.

In any event, the four companies will have to hire more Washington lobbyists and corporate lawyers to defend themselves. They’ll have to contribute more money to both parties. The latest iteration of antitrust efforts is mostly populist pandering, not an existential threat to the companies. If there are

grounds for doing anything, it will turn out mostly to be a fine or a slap on the wrist. It's hard to make a case for breaking the companies up, since their customers love their products and services and the low prices (if any) they must pay for them. If you were to tell most people they can't use Google, they'd probably freak out. Same goes for Amazon, Apple, and Facebook.

Our friends at Capital Alpha Partners suggest we all take a deep breath before joining the frenzy surrounding this week's news. "Across all of the companies, we have not seen anything specific that shows that the government knows what they are looking for or what the problem is. As such, we think it is premature to speculate on what the solutions would be," wrote Robert Kaminski of Capital Alpha Partners. Even if the feds do find reason to act, he adds, they're unlikely to disrupt the companies' business models and more likely to request behavioral remedies to correct one-off problems.

That said, the frenzy continues to escalate, particularly among politicians. The House of Representatives' Judiciary Committee is investigating digital markets and the tech giants. President Trump has called for additional scrutiny of social media companies because he believes they don't fairly present conservative views. On the other side of the aisle, presidential candidate Senator Elizabeth Warren (D-MA) plans to break up big tech companies like Amazon, Facebook, and Google if she ends up in the White House. And if you're still not convinced, a Google search of the term "techlash" returns 90,900 results.

Many areas could be targeted for investigation. "Amazon is accused of using data from its online platform to gain an unfair advantage over other sellers. Google's manipulation of search results to favor its own businesses has already been punished by the EU. Apple's fighting a private lawsuit which alleges its 30% take on apps sold in its apps store is an abuse of monopoly power. And Facebook dominates the digital ad market together with Google," a 6/3 [article](#) in *MIT Technology Review* states. There are also the privacy-related criticisms of Facebook. I asked Jackie to take a quick look backward at the Microsoft antitrust case, followed by a look at where today's tech giants stand. Here is her report:

(1) *Mr. Gates went to Washington.* Microsoft's antitrust case was long and painful: 12 years from the first FTC investigation through the approval of the company's settlement with the government. During that time, the company's reputation was raked through the mud, employee morale fell, and a small competitor, Google, was founded (1998), a 6/3 *NYT* [article](#) reported.

The government had to prove that Microsoft was preventing competition even though it was not raising prices and thereby harming consumers. The lack of higher prices will be an issue again if the government decides to bring antitrust cases against today's tech giants. Consumer prices have fallen for retail goods thanks to Amazon's market entrance, Google doesn't charge consumers searching the Internet, and connecting with friends is free on Facebook.

In the Microsoft case, the government argued that Microsoft stifled competition by requiring PC manufacturers to sell PCs with Microsoft's operating system and with its web browser, Internet Explorer, which was free. The judge ruled that Microsoft was a monopoly and decided that the company should be split into one company that produced the operating system and one that produced other software. The ruling was overruled on appeal, and the government and Microsoft ultimately settled in 2001. The company remained intact, but Microsoft did share its application programming interfaces with other companies, making it easier for other software/Internet browsers to work with the Microsoft operating system.

(2) *Similarities and differences.* Because the FTC investigation occurred during the tech bubble, it's tough to parse how much Microsoft's stock was affected by the general market environment and economy and how much it was hurt by the antitrust case. Microsoft's stock price peaked in December

1999 at \$58.38, while the antitrust case was making headlines and one month after the judge in the case found that Microsoft held monopoly power, according to a *Wired* [timeline](#) published on 11/4/02. The stock subsequently fell to a low of \$21.68 in December 2000. It didn't revisit its high-water mark until 2016. That said, almost all stocks were falling as the tech bubble burst in 2000. The Nasdaq peaked in 2000, tumbled sharply, and didn't make a new high until 2014.

Today's antitrust targets may have already anticipated a good chunk of the potential risk. Through Tuesday's close, Amazon is 14.0% off its peak hit in August 2018, Google is 18.2% off its April 2019 high, Apple is 21.1% below its August 2018 level, and Facebook has lost 23.0% since topping out in July 2018.

In 1998 and 1999, Microsoft had the largest market capitalization in the S&P 500, according to Joe's data. Ironically, the company once again has the largest market cap, at \$918.3 billion. But not far behind are Amazon (\$833.4 billion), Apple (\$797.4 billion), and Google (\$719.4 billion). Further behind is Facebook (\$468.5 billion).

(3) *Reasonable valuations*. In 2000, Microsoft shares traded at a 60 P/E, which wasn't extreme during the tech bubble time period, according to a CNBC [graphic](#) from 2015. Most of today's tech giants trade at reasonable P/Es relative to today's market and are much less expensive than Microsoft was at the turn of the century. Using 2019 earnings-per-share estimates and Tuesday's closing share prices, Facebook trades at a P/E of 23.0, Amazon at 63.2, Apple at 15.7, and Google at 22.7. Those P/Es are higher than the S&P 500's 16.8 P/E, but those four companies are also expected to grow earnings faster than the S&P 500. Facebook's earnings are forecast to grow by 27.5% in 2020 y/y, Amazon's by 40.6%, Apple's by 10.5%, and Google's by 15.0%.

(4) *Fascinating FANGs*. Facebook, Amazon, and Google are members of the so-called FANG group, along with Netflix, which is not under the regulatory microscope. Joe has put together a great chart book, [Industry Indicators: FANGs](#) that tracks the progress of the fabulous FANGs. They've dramatically outperformed the S&P 500 over the past six years ([Fig. 1](#)). The four companies represent 10.0% of the S&P 500's market capitalization but only kick in 3.5% of its earnings ([Fig. 2](#)). And because two of the four FANG members trade at lofty P/Es relative to the broader market, the FANGs inflate the S&P 500's P/E by 1.1 points, to 16.1 ([Fig. 3](#)). With a forward P/E of 46.1, the FANG stocks have rarely been this "inexpensive" ([Fig. 4](#)). The FANG multiple has come down over the past three years thanks to Amazon, Facebook, and Netflix ([Fig. 5](#)).

CALENDARS

US. Thurs: Nonfarm Productivity & Unit Labor Costs 3.5%/-0.9%, Jobless Claims 215k, Merchandise Trade Balance -\$50.6b, Challenger Job Cuts Reports, EIA Natural Gas Report, Williams, Kaplan. **Fri:** Payroll Employment Total, Private, and Manufacturing 180k/174k/5k, Unemployment Rate 3.6%, Average Hourly Earnings 0.3%/m/3.2%/y/y, Average Weekly Hours 34.5, Consumer Credit \$13.0b, Baker-Hughes Rig Count. (DailyFX estimates)

Global. Thurs: Eurozone GDP 0.4%/q/1.2%/y/y, Germany Factory Orders 0.0%/m/-5.9%/y/y, Japan Household Spending 2.7% y/y, ECB Rate Decision 0.00%, ECB Marginal Lending Facility & Deposit Facility Rates 0.25%/-0.40%, Draghi, Carney, Kuroda. **Fri:** Germany Industrial Production -0.5%/m/-0.4%/y/y, Germany Trade Balance €19.5b, BOE/TNS Inflation Next 12 Months, Canada Net Change In Employment & Unemployment Rate -5.5k/5.7%, Japan Leading & Coincident Indicators 96.0/100.2. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) sank further below 3.00 this week, as bullish sentiment continued to slide—tumbling 6.3ppts just this week. The BBR slumped for the fifth week to 2.31 (lowest since mid-February) from 3.16 five weeks ago—which was the first reading above 3.00 since October. Bullish sentiment plunged 13.7ppts the past five weeks, from 56.4% to 42.7%—which was the fewest bulls since the first week of this year, when it was expanding from their low of 29.9% during the final week of 2018. Virtually all the bulls fled to the correction camp over the past five weeks, with the correction count jumping 13.0ppts—from 25.8% to 38.8%—the highest percentage since just before Christmas. Bearish sentiment climbed 1.2ppts to 18.5% this week, though was up only 0.7ppt the past five weeks, fluctuating in a very narrow range from 17.2% to 17.8% the prior four weeks. The AAI Ratio declined for the third week last week to 38.2% after increasing the prior two weeks from 62.4% to 65.0%. Bullish sentiment ticked up to 24.8% last week after falling from 43.1% to 24.7% the prior two weeks, while bearish sentiment climbed four of the prior five weeks, from 20.2% to 40.1%.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues remain stalled near a record high for an eighth week, and forward earnings rose for a seventh week to less than 0.1% below its record high in early December. Analysts expect forward revenues growth of 5.4% and forward earnings growth of 7.1%. Forward revenues growth is down 0.9ppt from a seven-year high of 6.3% in February 2018, but is up from a 31-month low of 5.0% in mid-February. Forward earnings growth is down 9.8ppts from a six-year high of 16.9% last February, but that's up from a 34-month low of 5.9% in late February. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenues growth was 5.5% and forward earnings growth was 11.1%. Turning to the annual growth expectations, analysts expect revenues growth to slow from 8.3% in 2018 to 4.9% in 2019 and 5.2% in 2020. They're calling for earnings growth to slow sharply from 24.1% in 2018 to 3.3% in 2019 before improving to 11.1% in 2020. The forward profit margin was steady w/w at 12.1%, but is down 0.3ppt from a record high of 12.4% in mid-September. Still, that's up from 11.1% prior to the passage of the TCJA in December and compares to a 24-month low of 10.4% in March 2016. The S&P 500's forward P/E has moved lower in four of the past five weeks after peaking at an eight-month high of 17.0 in late April. It fell 0.4 points w/w to a 16-week low of 16.1. That's up from 14.3 during December, which was the lowest reading since October 2013 and down 23% from the 16-year high of 18.6 at the market's valuation peak in January 2018. The S&P 500 price-to-sales ratio of 1.95 is also at a 16-week low. But that's still up from 1.75 during December, when it was the lowest since November 2016, and down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins ([link](#)): Consensus forward revenues rose w/w for four of the 11 S&P 500 sectors and forward earnings for 4/11 sectors. Utilities was the only sector to have both measures rise w/w. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Energy's forward earnings is beginning to move higher now after tumbling about 25% from November to February. Forward P/S and P/E ratios are now well above their multi-year lows during December 2018 for all sectors, and are near or above their 2018 highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. Due to the TCJA, the profit margin for 2018 was higher y/y for all sectors but Real Estate. The outlook for 2019 shows higher margins are expected y/y for just 4/11 sectors: Consumer Discretionary, Financials, Industrials, and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since then, it has moved lower for nearly all of the sectors, but early signs of a bottom are appearing. During the latest week, the forward profit margin rose 0.1ppt for Real Estate and remained steady for the remaining 10 sectors. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.2%, down from 23.0%), Financials (18.7, down from 19.2), Real Estate (15.7, down from 17.0), Communication Services (14.8, down from 15.4), Utilities (12.9, down from a

record high of 13.0 in mid-May), S&P 500 (12.1, down from 12.4), Health Care (10.5, down from 11.2), Materials (10.3, down from 11.6), Industrials (10.2, down from a record high of 10.4 in mid-March), Consumer Discretionary (7.6, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (7.2, down from 8.0).

US ECONOMIC INDICATORS

ADP Employment ([link](#)): Private industries added only 27,000 to payrolls in May—the smallest number since the expansion began—following a strong April. According to the report, “Job growth is moderating. Labor shortages are impeding job growth, particularly at small companies, and layoffs at brick-and-mortar retailers are hurting.” There were minor revisions to April (to 271,000 from 275,000) and March (158,000 from 151,000) payrolls, for a net gain of 3,000. In May, service-providing industries added only 71,000 to payrolls, the least since September 2017, while goods-producing industries cut payrolls by 43,000—the weakest performance since May 2010. Growth in service-providing employment slowed in nearly all industries, with the largest advances posted by health care/social assistance (34,000), professional & business services (22,000), and leisure & hospitality (16,000) last month. Meanwhile, the decline in goods-producing industries was across the board, though led by construction (-36,000), while natural resource (-4,000) and manufacturing (-3,000) companies recorded small declines. Large companies (68,000), which are better equipped to compete for labor in a tight labor market, posted the best job growth last month, while small businesses (-52,000) cut payrolls at the fastest pace since March 2010—led by goods-producing companies. Medium-sized companies added only 11,000 to payrolls last month, the least in over nine years.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs ([link](#)): Global economic activity in May was the weakest since June 2016, as manufacturing stagnated and services saw a marked growth slowdown. The JP Morgan Global Composite Output Index (C-PMI) sank for the second month, to 51.2 in May from 52.8 in March; it peaked at 54.8 in February 2018. Global PMIs show the service (51.6 from 52.7) sector continued to outpace the manufacturing sector (49.8 from 50.4), though the former was the weakest since August 2016 while the latter contracted for the first time since February 2016. Looking at C-PMIs, growth in the emerging (51.3 from 52.4) and developed (51.1 from 52.0) economies are growing at virtually the same pace, down from their peaks of 53.5 and 55.4, respectively, during January and February of last year. May’s slowdown was mainly centered in the US, with slower growth in both the manufacturing and service sectors pushing its C-PMI (50.9 from 53.0) down to a three-year low. Slower growth was also recorded by China (51.5 from 52.7), Japan (50.7 from 50.8), and Russia (51.5 from 53.0), while growth held steady in both the UK (50.9) and India (51.7) last month. Meanwhile, mild accelerations were recorded in both the Eurozone (51.8 from 51.5) and Australia (51.5 from 50.0).

Global Non-Manufacturing PMIs ([link](#)): May saw the rate of expansion in the global services economy slow to a 33-month low. JP Morgan’s Global NM-PMI (to 51.6 from 52.7) eased further, along with the NM-PMIs for both the emerging (51.7 from 53.2) and developed (51.5 from 52.6) economies. The report notes that the seeds of the global service sector slowdown were planted in the US (50.9 from 53.0) and China (52.7 from 54.5)—as the former posted its lowest rate of expansion during the current 39-month sequence of increase, while growth in China eased to a three-month low. Brazil (47.8 from 49.9) was the only nation to register a contraction in May, posting its weakest performance since last September. Growth accelerated in the Eurozone (52.9 from 52.8), the UK (51.0 from 50.4), and Australia (51.5 from 50.1), but decelerated in Japan (51.7 from 51.8), India (50.2 from 51.0), and Russia (52.0 from 52.6). Within the Eurozone, France’s NM-PMI (51.5 from 50.5) saw output accelerate modestly, while Germany’s (55.4 from 55.7) and Spain’s (52.8 from 53.1) showed growth easing a bit—though remaining above France’s pace. Meanwhile, Italy’s NM-PMI (50.0 from 50.4) fell to the

breakeven point between expansion and contraction.

US Non-Manufacturing PMIs ([link](#)): A tale of two surveys: ISM's May survey reveals lots of strength in the service sector, while IHS Markit's shows growth falling toward the breakeven point of 50.0. ISM's NM-PMI (to 56.9 from 55.5) remains at a relatively high level, though is down from September's peak of 60.8. Three of the four components improved in May, with the business activity (61.2 from 59.5) gauge moving back above 60.0, while the new orders (58.6 from 58.1) and employment (58.1 from 53.7) measures were not far behind—the latter showing the best hiring pace in seven months. Meanwhile, the supplier deliveries (49.5 from 50.5) gauge deteriorated for the third month, dropping below 50.0 for the first time since the end of 2015. IHS Markit's NM-PMI (50.9 from 53.0) indicates service activity is now expanding at its slowest pace since March 2016, while firms expressed the lowest degree of confidence since mid-2016—reflecting the uncertainty around the ongoing global trade tensions. Both output and new orders grew at only marginal rates last month, as the steepest fall in demand for manufactured goods since 2009 was accompanied by a further marked slowdown in orders for services. According to the report, "The slowdown has also seen inflationary pressures fade rapidly. Despite upward pressure on prices from tariffs, the rate of increase of average prices charged for goods and services barely rose in May, in marked contrast to the strong rises seen earlier in the year, as increasing numbers of companies competed on price amid weak demand."

Eurozone Retail Sales ([link](#)): Retail sales in April fell for the first time this year, following a strong showing at the start of the year. Sales contracted 0.4% after holding steady at its record high in March; sales expanded 1.5% during the two months ending February. In April, sales of food, drinks & tobacco dipped 0.4% after climbing three of the prior four months by nearly 1.0% while sales of non-food products (excluding fuel) sank 0.6% during the two months ending April, following a 2.7% surge during the first two months of the year. Automotive fuel sales ticked up 0.1% in April after declines of 0.7% and 0.5% the prior two months. April sales are available for three of the four largest Eurozone economies: France saw sales expand for the third time in four months, by 0.4% in April and 1.2% ytd, to a new record high. Meanwhile, German sales (-2.0%) posted the largest decline among the Eurozone economies in April, following no change in March and a 3.3% jump the first to months of the year, while sales in Spain dropped 0.7% m/m after climbing 1.5% during the three months through March. Aside from Germany, Portugal (-1.0) and Spain (-0.7) recorded the largest decreases during April, while Slovenia (2.0) and Malta (1.7) posted the biggest increases. On a y/y basis, Slovenia (12.7), Lithuania (10.2) and Ireland (10.1) were the top performers, while Germany (-0.9) was the only nation to post a decline.

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