



MORNING BRIEFING

June 19, 2019

Whatever It Takes, Again

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

(1) Can monetary policy fix all problems? (2) Pumping more liquidity. (3) Wealth Effect isn't trickling down. (4) NIRP in Europe and Japan. (5) Draghi ready to do more of whatever. (6) Modern Tether Theory of the US bond market. (7) Draghi as Sisyphus. (8) EU car sales hitting bottom? (9) Powell's new obsession: ELB. (10) Is ELB lower than ZLB? (11) The Fed doesn't have much powder left and should keep it dry. (12) Stocks after first rate cut.

Central Banks: Can They Do It? Could it be that the major central banks are trying to fix problems that can't be fixed with monetary policy? The answer, based on the experience of the past 10 years, is unambiguously "Yes!"

Yet the central bankers can't let go of their conceit that they are superheroes who can do whatever it takes with monetary policy to normalize economic activity by boosting economic growth and averting deflation. Occasionally, they will concede that the Financial Crisis of 2008 led to a "new normal" of subpar economic growth and near zero inflation and interest rates.

But rather than admit that monetary policy just can't seem to revive the old normal, they promise to do more to bring us back to normal economic times. So they pump more liquidity into the global economy, which is driving up asset prices. However, even the resulting positive Wealth Effect isn't trickling down to boost consumption and capital spending.

Of course, the Bank of Japan (BOJ) has led the way in unconventional monetary policies to revive Japan's economy during the 1990s with zero-interest rate policy (ZIRP) and Quantitative Easing ([Fig. 1](#) and [Fig. 2](#)). The Fed followed with similar policies since late 2008 ([Fig. 3](#) and [Fig. 4](#)). The European Central Bank (ECB) joined the ultra-easing party after ECB President Mario Draghi famously said in a bizarre off-the-cuff 7/26/2012 [speech](#) that the ECB would do "whatever it takes" to revive the Eurozone's economy including introducing negative interest rate policy (NIRP) during June 5, 2014, with the BOJ doing so on January 29, 2016 ([Fig. 5](#) and [Fig. 6](#)). Now consider the following related developments:

(1) *Draghi to the rescue again.* Mario Draghi is back with more of whatever it takes. On Tuesday, speaking at a forum in Sintra, Portugal, he said that if the economic situation deteriorates in the coming months, the ECB will announce further monetary stimulus including more interest rate cuts and another round of asset purchases. Earlier this month, the ECB announced that the first post-crisis rate hike will be postponed and is unlikely to happen until the second half of 2020 at the earliest.

The immediate effect of Draghi's latest dovish cooing was a sharp fall in the euro ([Fig. 7](#)). Bond yields dropped around the world. The 10-year German bund skidding to -0.30% for the first time ever. The

yield on the French 10-year note briefly traded in negative territory for the first time ever and was last seen at zero ([Fig. 8](#)). Our “Modern Tether Theory” (MTT) of the US bond yield was confirmed yet again as the US yield fell to 2.06% yesterday, the lowest since 9/8/17. Under MTT, US bond yields are strongly influenced by the gravitational pull of negative bond yields in Germany and Japan.

(2) *Draghi as Sisyphus*. Yesterday, both the need for and the futility of more ultra-easy monetary policy from the ECB was demonstrated by the release of May’s CPI for the Eurozone.

Final numbers showed that the CPI headline inflation rate in the region plunged to 1.2% y/y in May from 1.7% in April ([Fig. 9](#)). The core inflation rate fell from 1.3% to 0.8%. Driving the decline the most was a drop in services inflation to 1.0%, from 1.9%, though this might have been caused by volatility related to this year’s late Easter holidays. Core goods by contrast rose to 0.3%, from 0.2%. On the noncore front, energy inflation fell as expected on the back of base effects in oil prices, while food inflation held steady at 1.5%.

Since 2012, Draghi has been like Sisyphus. The ECB President has done whatever it takes to roll the inflation boulder up the hill, only to see it roll back down.

(3) *Eurozone economy remains mostly down and out*. Despite Draghi’s efforts, industrial production in the Eurozone was down 2.7% since its most recent peak during November 2017 through April ([Fig. 10](#)). Leading the way lower has been the region’s largest economy. German manufacturing production is down 5.8% over this period to the lowest since January 2017 ([Fig. 11](#)).

European auto production was hard hit since last September by the introduction of the Worldwide Harmonized Light Vehicle Test Procedure (WLTP). EU passenger car registrations (a proxy for sales) fell on a y/y basis from September through April, though flattened out during the 12 months through May ([Fig. 12](#)). The fairly steady improvement in the yearly percent change from September’s -23.5% y/y to 0.1% last month, suggests that the worst is over and that pent up demand could kick in soon.

The good news is that the ECB has managed to revive lending activity in the Eurozone ([Fig. 13](#)). On the other hand, the EMU Financials Sector MSCI stock price index is down 26.8% since early last year ([Fig. 14](#)).

(4) *Powell’s ELB obsession*. Apparently, Draghi’s latest dovish pronouncement was in response to the potential negative impact of Trump’s escalating trade war with China on global economic growth, and its spillover into the Eurozone’s economy. Fed Chairman Jerome Powell was equally dovish in a 6/4 [speech](#) for the same reason:

“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.”

Powell’s speech suggested that he and his colleagues are totally obsessed with the “Effective Lower Bound” (ELB) for the federal funds rate. Indeed, the acronym ELB appears 26 times in his speech. Interestingly, Powell never explicitly defines ELB. In the past, Fed officials were more explicit calling it the “Zero Lower Bound” (ZLB). In a 3/8 [speech](#), Powell stated: “Just over 10 years ago, the Federal Open Market Committee (FOMC, or the Committee) lowered the federal funds rate close to zero, which we refer to as the effective lower bound, or ELB. Unable to lower rates further, the Committee turned to two novel tools to promote the recovery.”

In his latest speech, the undefined term “ELB” seems to open up the possibility of negative interest rates. Powell is very concerned that the federal funds rate is too close to the ELB. He is also worried about what the Fed can do when the federal funds rate falls to the ELB:

“The next time policy rates hit the ELB—and there will be a next time—it will not be a surprise. We are now well aware of the challenges the ELB presents, and we have the painful experience of the Global Financial Crisis and its aftermath to guide us. Our obligation to the public we serve is to take those measures now that will put us in the best position deal with our next encounter with the ELB.”

Leaving no doubt about his concern, Powell said: “In short, the proximity of interest rates to the ELB has become the preeminent monetary policy challenge of our time, tainting all manner of issues with ELB risk and imbuing many old challenges with greater significance.”

(5) *Keeping the powder dry in the Fed's armory.* Melissa and I expect that the FOMC will remain patient at today's meeting and leave the federal funds rate unchanged. Powell is likely to follow up with a dovish statement that will reiterate the Fed's willingness to ease if the US-China trade war escalates.

Given Powell's obsession with the ELB, he should be in no rush to move the federal funds rate closer to it as long as there is no compelling case for doing so. The latest recession scare was blown away by last week's strong retail sales report and yesterday's solid housing starts report, which caused the Atlanta Fed's [GDPNow](#) model to boost projected Q2 real GDP growth to 2.0% with real consumer spending now up 3.9% ([Fig. 15](#)).

Private residential investment in real GDP has been a negative contributor to growth for the past five quarters ([Fig. 16](#)). It could be a positive one during Q2.

(6) *Trump's game.* President Donald Trump may be playing a game with all of us. If there is no deal announced following next week's G20 meeting, he might very well slap the 25% tariff on all goods imported from China. The stock market would tank. The Fed might respond at the July 30-31 meeting of the FOMC by lowering the federal funds rate. Then Trump might announce that a deal with China is in the works, sending stock prices soaring—that's after getting what he wanted from the Fed, i.e., a rate cut!

Then again, Trump might not escalate the trade war with China. He said on Tuesday that he had a positive phone conversation with his Chinese counterpart Xi Jinping and that they will hold an “extended meeting” next week at the G20 summit. As a result, the S&P 500 was back in record high territory yesterday. Is this fun, or what?

Strategy: Stocks After First Rate Cut. Given widespread expectations that the Fed might cut the federal funds rate soon, Joe recently created a new publication titled [S&P 500 Sector & Industry Performance After First Fed Funds Rate Cut](#). Since the Fed last embarked on easing in 2007, S&P and MSCI changed their classification scheme with pricing back to 1989. So some data are not available for the newer industries and the Real Estate sector. Joe's analysis covers the current S&P 500 sector and industry lineup during each of the four easing cycles that began on 7/6/1995, 9/29/1998, 1/3/2001, and 9/18/2007. For each cycle, he calculates the one-, three-, six-, and 12-month price returns. He also provides their average returns for the four cycles.

Because the easing cycles of 2001 and 2007 were followed by brutal compressions in valuations and deep recessions, the S&P 500's negative return over the ensuing 12-months during those cycles depressed the four-cycle average. If you believe, as we do, that we're not likely to repeat the horrible returns of 2001 and 2007, it may be better to focus instead on the average of the 1995 and 1998

cycles, which we discuss below. Here's what Joe found:

(1) In the three months following the first of the 1995 and 1998 rate cuts, eight of the 10 sectors were higher as the S&P 500 soared an average of 11.8%. Here's how the sectors ranked: Communication Services (20.0%), Financials (16.7), Information Technology (15.3), Consumer Staples (14.7), Health Care (14.3), Consumer Discretionary (12.4), Industrials (7.6), Utilities (2.9), Energy (0.0), and Materials (-2.5).

(2) Six months after the first rate cut, returns continued to improve, but at a slower pace than during the first three months. All 10 sectors were higher as the S&P 500 was up an average of 18.1%. Here's how the sectors ranked after six months: Communication Services (27.5%), Financials (21.7), Consumer Discretionary (21.6), Information Technology (21.2), Health Care (20.9), Industrials (15.6), Consumer Staples (15.4), Energy (9.1), Utilities (3.0), and Materials (0.4).

(3) In the 12 months following the 1995 and 1998 rate cuts, all 10 sectors were positive as the S&P 500 rose an average of 19.8%. Here's how the sectors ranked: Information Technology (39.8%), Communication Services (24.3), Industrials (22.9), Consumer Discretionary (19.7), Financials (17.0), Energy (15.5), Health Care (15.3), Consumer Staples (11.6), Materials (5.1), and Utilities (0.4).

(4) The best performing industries in the 12 months following the 1995 and 1998 rate cuts: Computer & Electronics Retail (97.2%), Casinos & Gaming (80.2), Semiconductor Equipment (75.5), Biotechnology (73.0), Communications Equipment (67.2), Footwear (64.7), Electronic Equipment & Instruments (60.1), IT Consulting & Other Services (49.2), and Oil & Gas Drilling (43.9).

CALENDARS

US. Wed: MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Rate Decision Upper & Lower Bounds 2.25% to 2.50%, Rate on Excess Reserves 2.35%, Powell. **Thurs:** Leading Indicators 0.1%, Jobless Claims 220k, Philadelphia Fed Manufacturing Index 10.4, EIA Natural Gas Report. (DailyFX estimates)

Global. Wed: UK Headline & Core CPI 2.0%/1.7% y/y, Canada Headline & Core CPI 2.1%/1.9% y/y, Draghi, Juncker. **Thurs:** Eurozone Consumer Confidence -6.5, UK Retail Sales Including & Excluding Fuel 2.7%/2.4% y/y, Japan All Industry Activity Index 0.70%, Japan CPI Total, Core, and Core-Core 0.7%/0.7%/0.5% y/y, ECB Publishes Economic Bulletin, BOE Bank Rate 0.75%, BOE Asset Purchase Target £435b, BOJ Rate Decision, Carney, Lowes. (DailyFX estimates)

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): May housing starts fell less than expected, while gains the prior two months were stronger than previously reported; building permits moved higher for the second month. Housing starts dipped 0.9% last month to 1.269mu (saar) after upwardly revised gains of 6.8% (from 5.7%) and 4.3% (1.7), in April and March, respectively. Single-family starts sank 6.4% to 820,000 units (saar) after jumping a revised 10.6% (from 7.8%) during the two months through April, while multi-family starts have soared 36.9% during the five months through May to a 16-month high of 449,000 units (saar). Building permits edged higher for the second month, by a total of 0.5% to 1.294mu (saar), after sliding 2.9% the first three months of 2019. Single-family permits rose for the first time in six months, rebounding 3.7% to 815,000 units (saar) in May, after plunging 7.3% the previous five months. Meanwhile, multi-family permits dropped 5.0% to 479,000 units (saar) after a 6.8% rebound in April; May's decline was the fourth this year. The National Association of Home Builders Housing Market Index (HMI) for June shows homebuilders' confidence took a small step back, to 64, after climbing 10

points the first five months of this year to 66. All three components ticked lower this month, though are still up noticeably over the first half of this year: current sales conditions (to 71 from 61), expected sales (70 from 61), and buyer traffic (48 from 43).

GLOBAL ECONOMIC INDICATORS

Eurozone CPI ([link](#)): May's CPI rate confirmed the flash estimate, remaining below 2.0% for the sixth consecutive month, while the core rate moved back below 1.0%. The headline rate eased to 13-month low of 1.2% y/y last month, after accelerating from 1.4% to 1.7% in April; it was at a recent peak of 2.2% in October. Looking at the main components, energy (to 3.8% from 5.3% y/y) once again recorded the highest annual rate in May, though slowed from April's pace, while services (1.0 from 1.9) inflation also decelerated. Meanwhile, the rate for non-energy industrial goods (0.3 from 0.2) accelerated only slightly, while the rate for food, alcohol & tobacco was unchanged at 1.5%. The core rate—which excludes energy, food, alcohol, and tobacco—made a round trip, slowing to 0.8% y/y after accelerating from 0.8% in March to 1.3% in April. Of the top four Eurozone economies, only Germany's (1.3% y/y) rate was above May's 1.2% headline rate, while rates in France (1.1), Spain (0.9), and Italy (0.9) were below. Cyprus (0.2), Portugal (0.3), and Greece (0.6) had the lowest inflation rates in the Eurozone.

European Car Sales ([link](#)): EU passenger car registrations (a proxy for sales) left negative territory in May (y/y) for the first time in nine months, after the introduction of the Worldwide Harmonized Light Vehicle Test Procedure (WLTP) last September, push sales growth below zero the prior eight months. Demand in the Central European countries drove May's growth rate, rising 6.2% y/y, while the five major European markets were a mixed bag: Germany (9.1% y/y) and France (1.2), were the only two in the plus column, while sales in Spain (-7.3), the UK (-4.6), and Italy (-1.2) were in the red. Sales during the first five months of 2019 fell 2.1% y/y, compared to the same period a year ago—with four of the big five posting slight declines, while only German (1.7% y/y) sales were up ytd.

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