



## MORNING BRIEFING

June 25, 2019

### Lots of Central Bank Liquidity

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

(1) Normalization will have to wait. (2) Powell, Draghi, and Draghi. (3) Bears are still fighting the central banks. (4) The bears' favorite chart has been mostly bullish. (5) The Powell Pivot has turned into the Powell Pirouette. (6) QT set to end in US. QE might be back on in Eurozone soon. (7) Kuroda, like Peter Pan, taking the BOJ to Neverland. (8) PBOC's assets flatten, but cuts in required reserves boosting bank loans. (9) Clash of the titans: central banks vs the 4Ds. (10) Central banks are dependent on (weak) data.

**Central Banks I: Rolling in Dough.** The normalization of monetary policy has been postponed. Fed Chairman Jerome Powell promised at the start of this month (6/4 [speech](#)) and again last week (6/19 [presser](#)) to take "appropriate" measures to revive economic growth if necessary. So did European Central Bank (ECB) President Mario (Whatever-It-Takes) Draghi in a 6/18 forum. The Fed had been normalizing monetary policy from the end of 2015 through late 2018. The ECB had been signaling since last year that normalization might start this fall. Both Powell and Draghi recently suggested that easing rather than tightening is likely in coming months.

Bank of Japan (BOJ) President Haruhiko Kuroda never took his foot off the monetary accelerator since he came into office on 3/20/13. The People's Bank of China's (PBOC) central bankers continue to take appropriate measures to revive economic growth every time the country's economy shows signs of slowing too fast. In other words, none of the major central bankers are in any rush to normalize their monetary policies any longer. That certainly explains why the S&P 500 is back in record-high territory.

The stock market's bears have warned, almost since the start of the bull market, that once the major central banks start normalizing their monetary policies, stock prices will tumble. They've consistently maintained that the global bull market in stocks was rigged by all the liquidity provided by the central bankers. I've countered: "So what's your point? As long as the central monetary planners are pumping liquidity into the global economy and financial markets, that's a great reason to be bullish rather than bearish!"

Meanwhile, the bears have remained obsessed with a chart showing a good (not great) correlation between the S&P 500 and the assets on the Fed's balance sheet ([Fig. 1](#)). They were licking their chops when the Fed terminated QE3 at the start of October 2014. Sure enough, stock prices hit a rough patch in 2015. Much to the chagrin of the bears, the S&P 500 resumed climbing to record highs during the second half of 2016. They got their bearish hopes up again when the Fed starting paring its balance sheet at the start of October 2017. Yet here we are at yet another record high in the S&P 500.

Their fallback position was that when QE3 was terminated in the US, the ECB and the BOJ continued to expand their balance sheets ([Fig. 2](#)). Indeed, the combined assets of the Fed, the ECB, and BOJ (in US dollars) soared 55% from \$9.6 trillion, when QE3 was terminated, to a record \$14.9 trillion during March 2018. Since then, this total is down 5% to \$14.2 trillion during May of this year. Yet here we are at yet another record high in the S&P 500!

Now let's review the latest related developments:

(1) *The Fed is ready to ease if necessary.* The Fed did start normalizing monetary policy at the 12/16/2015 meeting of the FOMC with the first hike in the federal funds rate since the Great Recession and Financial Crisis of 2008, when the official rate was lowered to almost zero at the 12/16/2008 meeting ([Fig. 3](#)). There have been nine quarter-point rate hikes since then through the end of 2018, bringing the federal funds rate up to 2.25%-2.50% ([Fig. 4](#)).

Last year's 19.8% stock market plunge from 9/20 through Christmas Eve must have brought joy to the bears. But it also convinced Fed officials to pause normalizing monetary policy in the new year for a while. Sure enough, Powell used the word "patient" to describe monetary policy in scripted comments for the first time in a 1/4 panel discussion with his predecessors Janet Yellen and Ben Bernanke at the American Economic Association's annual meeting in Atlanta. This will forever be remembered as the "Powell Pivot."

On the panel, Powell also indicated flexibility on paring the balance sheet, reversing his 12/19/2018 comment that it was on "autopilot." The Fed announced on 3/20 that it would stop paring its balance sheet by the end of September. Powell's soothing words certainly helped rapidly to reverse the stock market's fall, triggered by his 10/3/18 gaff ("[W]e're a long way from neutral" interest rates.) ([Fig. 5](#)).

The 12-month federal funds rate futures peaked at 2.88% on 11/8/2018 ([Fig. 6](#)). It fell to 2.41% by the end of the year. It was down to 1.70% by the end of May. It fell to 1.47% last Friday after Powell's 6/19 presser that reiterated his 6/4 message suggesting that the Fed was ready to move from pause mode to easing. The word "patient" was dropped from the June FOMC statement. The new "it" word is now "appropriate," as in the FOMC "will act as appropriate to sustain the expansion." The Powell Pivot has turned into the Powell Pirouette.

(2) *The ECB is ready to do more of whatever it takes.* As Melissa and I observed yesterday, Mario Draghi, on Tuesday (6/18) 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 ECB implemented negative-interest-rate policy (NIRP) on 6/11/2014, when its official rate was lowered to -0.10%. There have been three additional cuts since then, with the latest one on 3/16/2016, lowering the rate to -0.40% ([Fig. 7](#)).

On 6/14/2018, the ECB announced that the "Governing Council will continue to make net purchases under the asset purchase programme (APP) at the current monthly pace of €30 billion until the end of September 2018. The Governing Council anticipates that, after September 2018, subject to incoming data confirming the Governing Council's medium-term inflation outlook, the monthly pace of the net asset purchases will be reduced to €15 billion until the end of December 2018 and that net purchases will then end."

The ECB's holdings of securities of euro area residents soared from €588 billion at the start of 2015 to a record high of €2.91 trillion during the 12/21/2018 week ([Fig. 8](#)). It edged down to €2.85 trillion during the 6/14 week. Draghi's recent comments suggest that APP could make a comeback.

(3) *The BOJ is in Neverland.* In his opening remarks at a conference in Tokyo on 6/4/15, BOJ President Kuroda said: "I trust that many of you are familiar with the story of Peter Pan, in which it says, 'The

moment you doubt whether you can fly, you cease forever to be able to do it.” A 6/4/15 WSJ [blog post](#) observed: “Japan’s central bank chief invoked the boy who can fly to emphasize the need for global central bankers to believe in their ability to solve a range of vexing issues, whether stubbornly sluggish growth or entrenched expectations of price declines.” The author says that Kuroda added: “Yes, what we need is a positive attitude and conviction.”

On 1/21/16, Kuroda emphatically ruled out negative interest rates: “We are not considering a cut in interest on bank reserves,” he told the parliament. The BOJ feared that negative rates would make banks reluctant to sell their Japanese government bonds, thus undermining its asset purchase program. On 1/29/17, the BOJ surprised everyone by lowering the official rate on new bank reserve deposits to -0.10% ([Fig. 9](#)). Japan’s Peter Pan was up to his old tricks.

In May, the BOJ’s assets rose to a record-high 567 billion yen, up 224% from 175 yen during April 2013, when Kuroda became the head of the BOJ ([Fig. 10](#)). Kuroda continues to sprinkle the fairy dust.

(4) *The PBOC is pumping bank lending.* The PBOC’s balance sheet (in US dollars) stopped growing in early 2015 ([Fig. 11](#)). It’s been hovering around \$5.2 trillion since then. That coincided with a decline in its foreign exchange reserves from a peak of \$4.4 trillion during early 2015 to \$3.1 trillion during May. Capital outflows have been offsetting China’s trade surplus in recent years ([Fig. 12](#)).

That hasn’t stopped the PBOC from providing lots of credit to the Chinese economy by slashing required reserve ratios for the banks ([Fig. 13](#)). China’s banks have responded by providing a whopping \$2.5 trillion in loans over the 12 months through May ([Fig. 14](#)). However, the PBOC seems to be getting less and less bang per yuan.

**Central Banks II: Pushing on a Noodle.** The central bankers are fighting powerful forces of deflation. With all the liquidity they’ve provided, they have succeeded in averting outright deflation. However, the Fed, the ECB, and the BOJ haven’t succeeded in pushing inflation in their countries up to their 2.0% targets. Inflation remains awfully close to zero and too close to its border with deflation.

In our opinion, the central bankers are trying to fix problems that can’t be fixed with ultra-easy monetary policies. Previously, we’ve discussed the “4Ds,” i.e., the forces of deflation. They are D  tente, Demography, Disruption, and Debt. Consider the following:

(1) *D  tente:* D  tente occurs after wars. Such periods of peacetime lead to globalization with freer trade, which means more global competition in markets for labor, capital, goods, and services. Wars, in effect, are trade barriers. The end of the Cold War marked the beginning of the current period of globalization.

Competition is inherently deflationary. No one can raise their price in a competitive market because it is set by the intersection of aggregate supply and demand. However, anyone can lower their price if they can cut their costs by boosting productivity. The incentives to do so are great because that’s a sure way to increase market share and profits.

(2) *Demography:* Demographic profiles are turning increasingly geriatric around the world. People are living longer. They are having fewer children. As a result of widespread urbanization, children no longer provide the benefit of labor in rural economies. Instead, they are a significant cost in urban settings. Economies with aging demographic trends are likely to grow more slowly and have less inflation.

(3) *Disruption:* Competitive markets facing worker shortages will tend to stimulate productivity via technological innovation. Technology is inherently disruptive across a wide range of businesses. That’s all very deflationary.

(4) *Debt*: Governments with aging populations are bound to borrow more. Governments challenged by rising dependence ratios—with the number of retiring seniors outpacing the number of young adult workers—don't have much choice but to borrow money to meet their funding gaps. Debt accumulated for this purpose is likely to weigh on economic growth rather than to stimulate it.

**Central Banks III: Dependent on Weak Data.** Central bankers like to say that their policies are “data dependent.” The 4Ds combined tend to weigh on economic growth and are inherently deflationary. This explains why unconventional ultra-easy monetary policies have become conventional over the past 10 years. The central bankers are doing more of the same and getting the same disappointing result. Like Sisyphus of ancient Greek mythology, they are stuck between a rock and a hard place. Every time they push the boulder up the hill, it comes rolling back down.

The latest batch of global economic indicators confirms that the central bankers remain dependent on weak data.

## CALENDARS

**US. Tues:** Consumer Confidence 131.0, New Home Sales 645k, Richmond Fed Manufacturing Index 2, S&P Case-Shiller Composite 20-City 2.5% y/y, Powell Economic Outlook & Monetary Policy Review, Williams, Bullard. **Wed:** Durable Goods Orders Total & Ex Transportation -0.1%/0.1%, Core Capital Goods Orders & Shipments 0.1%/-0.2%, Advanced Merchandise Trade Balance -\$71.9b, Wholesale Inventories 0.5%, DOE Crude Oil Inventories.(DailyFX estimates)

**Global. Tues:** None. **Wed:** Germany Gfk Consumer Confidence 10, Japan Retail Trade 0.6% m/m/1.2% y/y, Carney. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings ([link](#)):** Forward earnings rose last week for all three S&P indexes, continuing their rebounds that began during March. LargeCap's has risen during 16 of the past 19 weeks; MidCap's 11 of the past 15 weeks; and SmallCap's 10 of the past 13 weeks. LargeCap's was at a record high for a third week for the first time since late October, while MidCap's and SmallCap's are 1.2% and 5.8% below their mid-October highs. 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. In the latest week, the rate of change in LargeCap's forward earnings was steady at a 30-month low of 4.3% y/y. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change improved to 3.5% from a 34-month low of 3.0%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -1.4% y/y is the lowest since January 2010. That compares to 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%, 2.8%, 11.7%), MidCap (22.7, 0.9, 14.3), and SmallCap (22.4, 2.7, 18.7).

**S&P 500/400/600 Valuation ([link](#)):** Forward P/E ratios were higher for all three indexes last week. LargeCap's forward P/E rose 0.4 point w/w to 16.8, a tad below its 13-month high of 16.9 in early May and 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 rose to a seven-week high of 15.7 from 15.4. 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 improved to 16.2 from 16.0 and 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](#)): With the Q2 earnings season set to begin in several weeks, analysts no doubt are contemplating the trade war's impact on earnings. However, revisions activity remains light for the current quarter: last week saw the S&P 500's Q2-2019 EPS forecast drop three cents w/w to \$40.46. 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' \$40.46 estimate is down 2.1% since the start of the quarter, which represents an earnings decline of 1.3% y/y. On a pro forma basis, it represents an earnings gain of 0.2% y/y, compared to 0.3% a week earlier and 2.9% at the end of Q1. If Q2 earnings growth is positive, it would be the 12th straight y/y rise, compared to 1.6% in Q1, 16.9% in Q4, and 28.4% in Q3 (which marked the peak of the current earnings cycle). Five 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-digit 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 (16.5% in Q2-2019 versus -9.9% in Q1-2019), Financials (5.7, 8.0), Health Care (2.9, 10.3), Utilities (2.2, -0.5), Real Estate (1.1, 6.3), Consumer Discretionary (0.0, 8.1), Industrials (-0.3, 6.9), Energy (-1.2, -26.1), Consumer Staples (-1.4, 0.9), Information Technology (-8.3, -1.1), and Materials (-29.3, -13.4). On an ex-Energy basis, S&P 500 earnings are expected to rise 0.3% y/y in Q2, down from 3.0% 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

**Regional M-PMIs** ([link](#)): Three Fed districts have reported on manufacturing activity for June so far—Philadelphia, New York, and Dallas—and show growth contracted for the first time since October 2016, as activity in all three regions deteriorated. We average the composite, orders, and employment measures as data become available. The composite (to -6.8 from 9.7) index showed growth slipped into negative territory this month after expanding last month at its best pace in six months. The New York regions' composite (to -8.6 from 17.8) index denoted activity contracted for the first time since October 2016, plunging 26.4 points in June (its biggest monthly decline on record), while Dallas' (-12.1 from -5.3) contracted at its fastest pace since June 2016; Philadelphia's (0.3 from 16.6) showed activity in that region was at a standstill. The new orders gauge (0.0 from 7.7) was the weakest since September 2016, showing no growth, driven by a sizable decline in billings in the New York (-12.0 from 9.7) region. Meanwhile, Philadelphia (8.3 from 11.0) manufacturers showed a slight slowing in orders growth, while Dallas' (3.7 from 2.4) showed a slight acceleration—though was weaker than Philly's pace. The employment index (6.9 from 11.5) revealed factories hired at a slower pace than in May—and the weakest since February 2017. Manufacturers in the Philadelphia (15.4 from 18.2) region continued to add to payrolls at a healthy pace, while New York's (-3.5 from 4.7) cut jobs for the first time since January 2017;



Dallas' (8.8 from 11.6) have been hiring at a fairly steady rate through the first half of this year.

## GLOBAL ECONOMIC INDICATORS

**Germany Ifo Business Climate Index ([link](#)):** German business confidence sank again this month, to its lowest level since November 2014, as the buildup in global trade tensions remains a major headwind. Sentiment dropped to 97.4 in June, deteriorating every month except March since reaching its recent high of 104.2 last August. However, the quarterly average for Q2 remained in line with Q1's, indicating the economy remained broadly stable during H1. The expectations component dipped from 95.2 to 94.2 this month, though has been in a relative flat trend the past four months. Meanwhile, the present situation component ticked up to 100.8 from 100.7 in May—which was the lowest since August 2016. Manufacturers remain the most pessimistic, with their sentiment sliding from a record high of 34.2 in November 2017 to 1.5 this month—its worst reading since the end of 2012. The slowdown in manufacturing has spilled into the service sector, with its sentiment sinking to 20.0—the lowest since November 2014—from 33.6 just nine months ago. Sentiment in the construction industry (to 22.9 from 24.3) took a step back this month, though remains at a relatively high level. Meanwhile, the business climate for trade improved, with its index climbing from 5.4 to 7.9—bouncing in a relative flat trend during the first half of this year.

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