



MORNING BRIEFING

July 17, 2019

Central Bankers' Ballet

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

(1) Meet ballerina Alexandra MacDonald. (2) Draghi & Powell: From pirouette to pas de deux. (3) June ECB minutes confirm broad support for easing. (4) Draghi's latest "whatever-it-takes" speech. (5) Both ECB and Fed have second thoughts about normalizing. (6) Why are ECB and Fed officials freaking out? (7) Powell's speech yesterday was a feather less dovish than last Thursday's testimony. (8) The delusion of central bankers.

Central Banks I: Pirouette Lessons. Fed Chair Jerome Powell and European Central Bank (ECB) President Mario Draghi have been taking ballet lessons. They've both mastered the pirouette. They might have learned to do so from a YouTube [video](#) titled "How to Pirouette" with Alexandra MacDonald, the first soloist of the National Ballet of Canada. The problem with this maneuver is that after all that effort to execute a perfect turn, you remain exactly where you were before! Let's review the recent performances of these two remarkably agile central bankers.

Central Banks II: Draghi's Dance. Last Thursday (7/11), the ECB released the [minutes](#) of the 6/5-6/6 meeting of the central bank's Governing Council. ECB officials were in "broad agreement" at their June meeting that the bank should "be ready and prepared to ease the monetary policy stance further by adjusting all of its instruments," according to the minutes. The 7/11 *WSJ* [explained](#):

"While the exact timing of any ECB action remains unclear, analysts said the bank could cut its key interest rate, currently set at minus 0.4%, as soon as its next policy meeting on July 25. More likely, the ECB could clearly signal a rate cut at its July meeting, and follow through on Sept. 12, when policy makers will have fresh economic forecasts for growth and inflation."

This wasn't a big surprise since ECB President Mario Draghi in a 6/18 speech in Sintra, Portugal refreshed his "whatever-it-takes" approach to central banking by saying: "In the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required."

In his speech, as [reported](#) by CNBC, Draghi declared: "The (European) Treaty requires that our actions are both necessary and proportionate to fulfil our mandate and achieve our objective, which implies that the limits we establish on our tools are specific to the contingencies we face. If the crisis has shown anything, it is that we will use all the flexibility within our mandate to fulfil our mandate—and we will do so again to answer any challenges to price stability in the future."

He also said: “We remain able to enhance our forward guidance by adjusting its bias and its conditionality to account for variations in the adjustment path of inflation. This applies to all instruments of our monetary policy stance.” He added: “Further cuts in policy interest rates and mitigating measures to contain any side effects remain part of our tools. And the APP [Asset Purchase Program] still has considerable headroom.”

The ECB has had a negative deposit facility rate since 6/11/14 ([Fig. 1](#)). The central bank started its APP on 1/22/15 and terminated it at the end of 2018 ([Fig. 2](#)).

The surprise is that the minutes showed broad support at the June meeting for an aggressive approach. Officials noted that they should be ready to use all policy tools, including interest-rate cuts and fresh bond purchases, “in the light of the heightened uncertainty which was likely to extend further into the future.”

This was all quite a reversal from the ECB’s plans to start normalizing its monetary policy, as expected earlier this year. The ECB had previously been moving to phase out its extraordinary policy tools, including negative interest rates, and had been guiding investors to expect a future interest-rate hike. The central bank phased out its €2.6 trillion bond-buying program, a.k.a. quantitative easing, at the end of 2018.

But then the ECB rolled out fresh stimulus in March, pushing back the timing of an interest-rate rise—which was further extended on 6/6—and unveiling a new batch of cheap long-term loans for banks. At his post-meeting 6/6 [press conference](#), Draghi announced that in response to rapidly deteriorating inflation expectations, the ECB would keep interest rates at their current, record-low level at least through the first half of 2020, instead of the end of this year as stated in March. Also, he said banks would be allowed to borrow from the ECB at a rate just 10 basis points above its minus 0.4% deposit rate provided that they beat the ECB’s lending benchmarks in a new targeted longer-term refinancing operation, or TLTRO.

In the Q&A session after that 6/6 press conference, Draghi said several members of the Governing Council raised the possibility of rate cuts in the meeting, while others mentioned restarting asset purchases. The minutes confirmed that there actually was broad support for these actions, as noted above. Here’s a quick review of Draghi’s pirouette based on his press conferences since the spring of 2018:

(1) [4/26/18 presser](#). Draghi confirmed that APP would continue at a pace of €30 billion until the end of September 2018, “or beyond, if necessary.”

(2) [6/14/18 presser](#). Draghi announced that the pace of APP purchases would be cut to €15 billion per month from October to December 2018, and then purchases would stop.

(3) [12/13/18 presser](#). Draghi confirmed that APP will be terminated by the end of the year and reiterated that “we intend to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when we start raising the key ECB interest rates...”

(4) [3/7/19 presser](#). Draghi said that interest rates would remain unchanged “at least through the end of 2019.”

(5) [6/6/19 presser](#). Draghi said that interest rates now would remain unchanged “at least through the first half of 2020.” He also strongly suggested that the next rate move would be a cut rather than a hike, and that APP might be reactivated.

It’s not so obvious why ECB officials are freaking out about the need for another round of easing. Granted: The headline and core CPI rose just 1.2% and 1.1%, respectively, over the past year through June, based on the flash estimates ([Fig. 3](#)). But both rates, particularly the core rate, have been mostly below the ECB’s 2.0% target since the Great Recession, notwithstanding ultra-easy monetary policy. Why would another round of it work any better?

Granted: The Eurozone’s economic indicators have been weak, especially the ones for manufacturing. But the region’s industrial production (excluding construction) rose 0.9% m/m during May, suggesting that the sector may be bottoming ([Fig. 4](#)).

Central Banks III: Powell’s Turn. Fed Chair Powell has also been working on his pirouette since the start of this year. Last year, his hawkish off-the-cuff comments in an [interview](#) on 10/3/18 sent stock prices reeling, resulting in a 19.8% plunge in the S&P 500 from 9/20/18 through 12/24/18 ([Fig. 5](#) and [Fig. 6](#)). Then in a 1/4/19 [panel discussion](#), he walked back his hawkish talk with dovish comments. This time, he read from a script to avoid making another bearish gaff. He said that the Fed would be “patient,” implying a long pause in rate-hiking. Melissa and I dubbed it “Patient Powell’s Put” in our 1/7/19 [Morning Briefing](#).

Sure enough, the stock market loved what has also widely been called “Powell’s Pivot,” sending the S&P 500 soaring 25.3% from the 12/24/18 low to a new record high on 4/30/19. Like the three Fed chairs before him, Powell was stress-tested by the stock market and delivered the obligatory put, just as Greenspan, Bernanke, and Yellen had done.

The escalation of the US-China trade war in early May sent stock prices down sharply again, by 6.8% through 6/3/19. Once again, the Fed chair revived the market with even more dovish talk in the second paragraph of his prepared 6/4/19 [remarks](#). He said that monetary policy would “act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective,” implying rate-cutting ahead. The S&P 500 soared 9.2% to yet another new record high on 7/3 thanks to “Powell’s Pirouette.”

Last Thursday (7/11), Powell told the Senate Banking Committee: “The relationship between unemployment and inflation became weak” about 20 years ago “It’s become weaker and weaker and weaker.” He also told the senators that the so-called “neutral rate,” or policy rate that keeps the economy on an even keel, is lower than past estimates have put it—meaning monetary policy has been too restrictive. “We’re learning that interest rates—that the neutral interest rate—is lower than we had thought, and I think we’re learning that the natural rate of unemployment is lower than we thought,” he said. “So monetary policy hasn’t been as accommodative as we had thought.”

It's also not obvious why Fed officials are freaking out over the need to lower interest rates after spending so much time and effort getting us acclimated to normalizing monetary policy in the US. Granted: The latest Atlanta Fed's [GDPNow](#) is showing real GDP rising just 1.6% during Q2. But yesterday's reading for real consumer spending in real GDP was raised to 4.2% from 3.8% following the release of June's solid retail sales report ([Fig. 7](#))! Manufacturing output rose 0.4% during June, following a 0.2% gain in May, the first back-to-back monthly increases since the end of last year ([Fig. 8](#)).

Granted: The headline and core PCE deflator rose just 1.5% and 1.6% y/y through May ([Fig. 9](#)). But didn't Powell say at his 5/1 presser that some of the recent weakness was likely transitory?

In his testimony last Thursday, Powell left no doubt that he is ready to cut the federal funds rate at the end of this month to boost the economy. He implied as much in his congressional testimony on Wednesday before a House committee. He was more emphatic about it on Thursday during his [Q&A](#) before a Senate committee.

Yesterday, Powell showed off his pirouette in Paris. He gave a [speech](#) titled "Monetary Policy in the Post-Crisis Era" at a conference organized by the Banque de France. He pulled back a bit from the ready-to-ease tone of his Thursday testimony, saying:

"In our baseline outlook, we expect growth in the United States to remain solid, labor markets to stay strong, and inflation to move back up and run near 2 percent. Uncertainties about this outlook have increased, however, particularly regarding trade developments and global growth. In addition, issues such as the U.S. federal debt ceiling and Brexit remain unresolved. FOMC participants have also raised concerns about a more prolonged shortfall in inflation below our 2 percent target. Market-based measures of inflation compensation have shifted down, and some survey-based expectations measures are near the bottom of their historical ranges.

"Many FOMC participants judged at the time of our most recent meeting in June that the combination of these factors strengthens the case for a somewhat more accommodative stance of policy. We are carefully monitoring these developments and assessing their implications for the U.S economic outlook and inflation, and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective."

Central Banks IV: The Great Delusion. Central bankers tend to be macroeconomists who were taught in graduate school that inflation is a monetary phenomenon. They were also taught to hate deflation as much as inflation. That's why the major central banks have all pegged 2.0% as their Goldilocks inflation target, not too hotly inflationary or frigidly deflationary.

But surely, they must have learned over the past 11 years that inflation isn't a monetary phenomenon after all. They must realize that there are four powerful forces of deflation that are microeconomic in nature. I've dubbed them the "4Ds," D  tente, Demographics, Disruption, and

Debt.

In his speech in Paris yesterday, Powell (sort of) mentioned them in passing: “Many factors are contributing to these changes—well-anchored inflation expectations in the context of improved monetary policy, demographics, globalization, slower productivity growth, greater demand for safe assets, and weaker links between unemployment and inflation. And these factors seem likely to persist.”

He has been worrying a great deal recently that these factors collectively may continue to keep the “neutral rate of interest low,” i.e., too close to zero, which is the dreaded “effective lower bound.” He concluded: “This proximity to the lower bound poses new complications for central banks and calls for new ideas.”

The problem is that the central bankers have run out of new ideas (and policy tools), so they keep trying the same old ones. Their delusion is that doing more of the same (i.e., ultra-easy monetary policy) should boost inflation to 2.0%. Maybe they should just give up on the notion that deflation is a bad outcome of the 4Ds and admit that they are trying to fix a problem that monetary policy cannot fix.

If they persist in their delusion and their ultra-easy monetary policies, the outcome will continue to be asset price inflation, especially in global equity markets. That’s fine, until it isn’t.

CALENDARS

US. Wed: Housing Starts & Building Permits 1.260mu/1.300mu, MBA Mortgage Applications, DOE Crude Oil Inventories, Beige Book. **Thurs:** Leading Indicators 0.1%, Jobless Claims 216k, Philly Fed Manufacturing Index 5.0, EIA Natural Gas Report, Williams. (DailyFX estimates)

Global. Wed: European Car Sales, Eurozone Headline & Core CPI 1.2%/1.1% y/y, UK Headline & Core CPI 2.0/1.8 y/y, Canada CPI -0.3%/m/m/2.0%/y/y. **Thurs:** UK Retail Sales Ex Auto Fuel 2.6% y/y, Canada Employment Report, Japan Headline, Core, and Core-Core CPI 0.7%/0.6%/0.5% y/y, Australia Employment Change & Unemployment Rate 9k/5.2%, BOE Bank Liabilities and Credit Conditions Surveys. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q2 Earnings Season Monitor ([link](#)): With the major finance firms now releasing results for Q2-2019, the aggregate surprise and y/y earnings growth rate for the S&P 500 has improved since yesterday. A sharply higher percentage of companies is reporting positive revenue surprises and y/y revenue growth than during the same point in Q1, and the revenue and earnings beats are slightly larger too. However, these figures will continue to change as more Q2-2019 results are reported in the coming weeks. Of the 33 S&P 500 companies (nearly 7% of the total) that have reported through midday Tuesday, 82% exceeded industry analysts’ earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 4.4%, and exceeded forecasts by an average of 5.7%. On the revenue side, 73% of

companies beat their Q2 sales estimates so far, with results coming in 1.4% above forecast and 2.6% higher than a year earlier. Q2 earnings growth results are positive y/y for 67% of companies, vs a slightly higher 69% at the same point in Q1, but Q2 revenues have risen y/y for 88% vs a much lower 76% during Q1. Looking at earnings during the same point in the Q1-2018 reporting period, a slightly lower percentage of companies (81%) in the S&P 500 had beaten consensus earnings estimates by a slightly lower 5.5%, and earnings were up a similar 4.3% y/y. With respect to revenues at this point in the Q1 season, a sharply lower 45% had exceeded revenue forecasts by a much lower 0.5%, but sales rose a greater 4.0% y/y. Compared to 2018's stellar results, these early readings for Q2 indicate a continuation of a marked slowdown in revenue and earnings growth and a slight deterioration in profit margins. But that should come as no surprise to investors. Q1-2019 had marked the 11th straight quarter of positive y/y earnings growth and the 12th of positive revenue growth. However, earnings growth trailed revenue growth during Q1-2019 for the first time since Q2-2016, which has happened just five times in the 42 quarters since the bull market started in Q1-2009; it's quite possible it will happen for a sixth time in Q2-2019.

US ECONOMIC INDICATORS

Retail Sales ([link](#)): Consumers continue to spend! Both headline and core retail sales—which excludes autos, gasoline, building materials, and food services—climbed to new record highs again in June, while there were mostly upward revisions to prior months. Core retail sales advanced 0.7% last month, following slight upward revisions to both May (to 0.6% from 0.5%) and April (0.5 from 0.4), while total sales rose 0.4% after a slight downward revision to May (0.4 from 0.5) and a slight upward revision to April (0.4 from 0.3) sales. Both measures increased five of the first six months of this year for gains of 5.4% and 4.0%, respectively. (The BEA uses the core retail sales measure to estimate personal consumption expenditures each month.) We estimate core retail sales accelerated 0.9% in June after advances of 0.6% and 0.1% the prior two months, while our estimates for real total sales climbed 0.6% in June after a 0.4% increase in May and no change in April. We calculate core retail sales expanded 4.0% (saar) during Q2, slightly below Q1's 5.8%—which was the strongest quarterly gain since Q2-2017, while headline sales grew 3.9% (saar) last quarter, up from Q1's 3.0%, and the fastest quarterly increase since Q4-2017. In June, 10 of the 13 major nominal sales categories rose, while only two fell—gasoline service stations (-2.8%) and electronic & appliance stores (-0.3)—and sporting goods & hobby stores was unchanged. Leading June's advance were nonstore (1.7), restaurants (0.9), motor vehicle (0.7), and miscellaneous store (0.6) retailers, while furniture, building materials, food & beverage, health & personal care, and clothing retailers all posted sales gains of 0.5% during the month; general merchandise sales ticked up 0.2%.

Business Sales & Inventories ([link](#)): Nominal business sales in May remained stalled at record highs, while real business sales slipped in April after reaching a new record high in March. Nominal manufacturing & trade sales (MTS) edged up 0.2% in May after edging down 0.2% in April; sales expanded 1.9% the first three months of this year to a new record high. Meanwhile, real business sales contracted 0.9% after increasing four of the prior five months by 1.8% to a new high. Real sales of both wholesalers and retailers were stalled just below March's record high in April, while manufacturers' sales are down 2.1% since reaching a new cyclical high at the start of the year. May's nominal inventories-to-sales ratio remained at 1.39,

just below its recent high of 1.40, recorded in February. Meanwhile, the real inventories-to-sales ratio is up from recent lows, climbing to 1.45 in April—the highest since November 2016.

Industrial Production ([link](#)): Industrial production in June was flat, though the manufacturing sector is showing signs of life after falling the first four months of this year. Headline production was unchanged last month, after a 0.4% gain and a 0.5% loss the prior two months, as a 3.6% drop in utilities output offset gains in both manufacturing (0.4%) and mining (0.2) production last month. June's 0.4% increase in factory output followed a 0.2% advance in May, not a lot though a promising sign after the 1.3% drop during the four months through April. (The manufacturing sector has faced challenges from trade tensions and a global slowdown.) Looking at production by market group, consumer durable goods production led gains, rebounding 3.1% during the two months through June—boosted by a 5.9% surge in automotive products; consumer nondurable goods production showed little change over the period. Meanwhile, business equipment production posted its first back-to-back gain this year, rising 0.9% during the two months through June. Information processing equipment output continued to set new highs (not posting a decline in eight months), climbing 0.9% in June and 5.3% during the seven months through June. Transit equipment production rebounded 1.6% last month after falling to a 12-month low in May, while industrial equipment output remains on a volatile downtrend, though may be finding a bottom—retaining nearly all of May's 1.4% rebound.

Capacity Utilization ([link](#)): The headline capacity utilization rate fell for the sixth time in seven months, from a cyclical high of 79.6% in November to 77.9% in June—matching April's 14-month low. It was 1.9ppt below its long-run (1972-2018) average of 77.9%. Manufacturing's rate ticked up 75.9% from 75.6% the prior two months—which was the lowest rate since the start of 2018; it was 2.4ppts below its long-run average. Meanwhile, the utilization rate for mining edged down from 91.7% to 91.5%, still more than 4.0ppts higher than its long-run average, while the operating rate for utilities sank 3.0ppts to 74.6%—the lowest since February 2017—and well below its long-run average.

Import Prices ([link](#)): Import prices in June fell for the first time this year, on widespread declines, as May's decrease was revised to unchanged. Prices sank 0.9% last month, the first decline since December, after climbing 1.9% the first four months of this year. Petroleum prices tumbled 6.2% last month following a five-month spike of 35.2%, while nonpetroleum prices fell for the fourth time this year, by 0.4% m/m and 1.6% ytd. Versus a year ago, import prices fell 2.0% y/y, recording its largest decline since August 2016. The yearly rate for petroleum prices is negative again, dropping 7.4% y/y, after turning positive in March for the first time since November. The rate for nonpetroleum prices was -1.4% y/y in June, matching May's rate, which was the steepest decrease since June 2016. The rate for capital goods imports (-1.3% y/y) remained in negative territory in June for the ninth month, while the rate for industrial materials & supplies (-5.8) fell further below zero, posting its biggest decline since August 2016. Prices for consumer goods ex autos (-0.6) remained below year-ago levels, while the yearly change in auto prices was fractionally below zero for the sixth month. The rate for food prices (1.0) was above zero for only the second time in 14 months. Looking at our Asian trading partners, we're importing deflation, with import prices for goods from China (-1.5) and the NICs (-2.0) falling, while Japan's were flat with a year ago. Meanwhile, there's no sign

of inflation in EU (-0.3) import prices, decelerating sharply from last May's 4.1%, while import prices for goods from Latin America (-2.4) were negative for the seventh month.

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