



MORNING BRIEFING

July 30, 2019

The World According to Garp

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

(1) Global economic dysfunction isn't all about Trump's trade wars. (2) Low fertility rates around the world suggest voluntary self-extinction of the human race. (3) Debt financed fiscal spending on retirement benefits may be weighing on growth. (4) Central banks still doing whatever it takes, including enabling MMT. (5) Fiscal and monetary policies for geriatric economies. (6) Global manufacturing weighed down by trade wars and geriatric demographic profiles. (7) US economy seems less dysfunctional than many overseas economies.

Global Economy I: Dysfunctional Demographic Destiny. There is something wrong with the global economy. It's not functioning as it "should," or traditionally has. Actually, the world economy seems downright dysfunctional. This distortion relative to past norms reminds me of the skewed, tragicomic worldview of Garp in John Irving's best-selling novel *The World According to Garp* (1978), about a man born out of wedlock to a feminist icon.

The US economy is showing some signs of similarly unusual behavior, but it doesn't appear as abnormal as the rest of the global economy, so far. I am using the objective meaning of the word "abnormal" without drawing any subjective implications just yet. In other words, for us investors, the world is what it is—and our investment conclusions must be derived based on how it is, not on how it ought to be.

It's possible that many of the abnormalities are related to Trump's escalating trade wars with the rest of the world since early last year. The rest of the world is more dependent on exports, particularly to the US, than the US is on exports to the rest of the world. By disrupting US trade relations with the rest of the world, Trump does more economic damage over there than over here.

Nevertheless, I'm not convinced that it's all about Trump. Many overseas economies seem to have lost their dynamism in recent years. One possible explanation is that demographic profiles have turned increasingly geriatric around the world, led by Europe, Japan, and China ([Fig. 1](#), [Fig. 2](#), [Fig. 3](#), and [Fig. 4](#)). As I've discussed on numerous occasions, fertility rates have fallen below population replacement rates around the world, particularly in these three important regional and national economies ([Fig. 5](#), [Fig. 6](#), [Fig. 7](#), and [Fig. 8](#)). China's government exacerbated the situation with its one-child policy from 1979 through 2015.

Furthermore, almost everywhere, people are living longer. That is also making demographic profiles more geriatric around the world, which is putting pressure on governments to borrow more and accumulate more debt to provide retirement support programs for their rapidly

increasing cohort of senior citizens. Such government borrowing and mounting government debt are weighing on economic growth. In the past, debt financed government spending and tax cuts stimulated economic growth. That no longer seems to be the case.

The major central banks have joined in to help by providing ultra-easy monetary policies. They claim that their mandate is to avert deflation and to maintain inflation at around 2.0%. In addition, they are hoping that their policies will stimulate more economic growth. They've been struggling to do so for more than 10 years. Yet inflation remains mostly below their 2.0% target and economic growth remains lackluster at best. Actually, over the past year and a half or so, economic growth has been slowing around the world despite monetary and fiscal stimulus.

The result has been a mix of monetary and fiscal policies designed for geriatric economies. These policies have been offsetting the deflationary consequences of the voluntary self-extinction of the human race, which is the inevitable consequence of below-replacement fertility rates. Japan has been on this course for some time, which is why since 2011, more people died in Japan than were born. China is on course to displace Japan as the world's largest nursing home. Europe isn't that far behind. The US is in better demographic shape since the fertility rate remains around the population replacement rate.

The only areas where the prospects for population growth remain positive are Africa and India. But that could change for the worse as they continue to urbanize. In my opinion, it is urbanization that explains why fertility rates have fallen below replacement in much of the world. Children have an economic value in rural agricultural communities, but not in cities. Technological innovation has been boosting productivity in agriculture significantly in recent decades. The result has been migration from rural to urban areas, where children are all cost and no benefit in economic terms. Some may represent economic benefit to their parents in an urban setting, those that get jobs and support their parents in their old age. However, young adult children are less prone to do so the more that the elder care of their parents is outsourced to the government.

In Garp's world, Garp's mother had only one child. That's half as many as required for population replacement. In our similarly demographically dysfunctional world, fiscal and monetary authorities are deploying their policy tools on a whatever-it-takes basis to offset the consequences of the one-child or no-child policies that more and more couples (or single moms) are deploying in their personal lives. Some governments are starting to provide incentive for couples to have more babies, but without much success so far.

By the way, in our world, Modern Monetary Theory (MMT) isn't a theory. Instead, it is a description of the monetary and fiscal policies that governments increasingly have adopted to manage the voluntary self-extinction of the human race. MMT amounts to large government deficits enabled by a combination of near-zero interest rates and debt monetization provided by the central banks.

The proponents of MMT claim that it works very well as long as consumer price inflation remains subdued, as it has been for well over a decade. In theory, the flaw in the theory is that MMT is fueling asset price inflation as a result of widespread reaching for yield by investors.

That increases the risk of financial instability, with meltups in asset prices followed by meltdowns.

Global Economy II: Dysfunctional Manufacturing Data. Now let's turn to more mundane matters like assessing whether the latest batch of economic indicators confirms that something isn't quite right with the global economy. It's been easy to see in Japan for many years. Now it is becoming increasingly apparent in Europe. Consider the following latest developments:

(1) *Eurozone M-PMI.* The good news is that the NM-PMI remained solidly above 50.0 during July at 53.3, according to the flash estimate ([Fig. 9](#)). The really bad news is that the region's M-PMI fell to 46.4 during July, well below 55.1 a year ago.

(2) *Germany's Ifo.* The really bad news is that Germany's M-PMI fell to 43.1 during the month from 56.9 a year ago ([Fig. 10](#)). That weakness was confirmed by Germany's Ifo business confidence index, which fell to 95.7 during July, the lowest reading since April 2013, with the expectations component (92.2) the lowest since July 2009 ([Fig. 11](#)).

(3) *Japan's M-PMI.* During the first seven months of this year, Japan's M-PMI has been below 50.0 during five of those months ([Fig. 12](#)). It was 49.6 during July.

US Economy: Functioning More Normally. In the US, the growth rate of real GDP has been around 2.0% on a y/y basis since 2010. That once was considered to be the economy's stall speed. Whenever it fell to that rate on a y/y basis, it wasn't too long before it turned negative in a recession. Now since 2010, the 2.0% area has been the new normal for real economic growth in the US. Sure enough, the latest data for Q2 real GDP show that it was up 2.1% q/q (saar) and 2.3% y/y ([Fig. 13](#)). Let's examine the data more closely:

(1) *Real final sales and inventories.* Q2's 2.1% (saar) q/q increase in real GDP followed a gain of 3.1% during Q1. Inventories boosted Q1 and depressed Q2. Excluding inventory investment, real final sales rose 2.6% (saar) during Q1 and 3.0% during Q2 ([Fig. 14](#)).

(2) *Real consumption and capital spending.* Leading the gain in Q2's real final sales was a solid gain of 4.3% (saar) q/q in personal consumption expenditures, with spending on goods up 8.3% while services increased 2.5%.

Lagging was capital spending, with a decline of 0.6% (saar) during the quarter. Spending on structures declined 10.6% (saar), while intellectual property products rose 4.7%. Spending on capital equipment was up only 0.7% (saar), with transportation equipment down 9.2% while information technology equipment jumped 6.7% to a new record high.

Nondefense capital goods orders excluding civilian aircraft rose 1.9% m/m in June and 3.2% ytd, suggesting that spending on capital equipment may be starting to improve.

(3) *Trade.* Trump's trade wars may be weighing on both US exports and imports of goods and services in real GDP. The former fell 5.2% (saar) during Q2, while the latter was flat.

CALENDARS

US. Tues: Personal Income 0.3%, Nominal & Real PCE 0.3%/0.2%, Headline & Core PCE Deflator 1.5%/1.7% y/y, Consumer Confidence 125.0, Pending Home Sales 0.3%, Case-Shiller Home Price Index, FOMC Meeting Begins. **Wed:** ADP Employment Change 150k, Employment Cost Index 0.7%, Chicago Fed Purchasing Manager's Index 51.5, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Rate Decision 2.00%-2.25%, FOMC Excess Reserves Rate 2.10%, Powell. (DailyFX estimates)

Global. Tues: Eurozone Economic Confidence 102.7, Germany CPI 0.3%*m/m*/1.5%*y/y*, Germany Gfk Consumer Confidence 9.7, France GDP 0.3%*q/q*/1.3%*y/y*, UK Gfk Consumer Confidence -13, BOJ Rate Decision & 10-Year Yield Target -0.10%/0.00%, BOJ Outlook Report. **Wed:** Eurozone GDP 0.2%*q/q*/1.0%*y/y*, Eurozone Headline & Core CPI Flash Estimates 1.1%/1.0% y/y, Eurozone Unemployment Rate 7.5%, Germany Retail Sales 0.5%*m/m*/0.6%*y/y*, Germany Unemployment Change & Unemployment Claims Rate 2k/5.0%, Italy GDP -0.1%*q/q*/-0.1% y/y, Canada GDP 0.1%*m/m*/1.3%*y/y*, Japan Consumer Confidence 38.5, Japan Housing Starts 900k, Australia CPI 0.5%*m/m*/1.5%*y/y*, IHS Markit M-PMI & NM-PMI 49.6/54.0. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings mostly fell again last week for the S&P indexes, but remain in the uptrends that began during March. LargeCap's has risen during 20 of the past 24 weeks; MidCap's 14 of the past 20 weeks; and SmallCap's 11 of the past 18 weeks. LargeCap's was at a record high last week, while MidCap's and SmallCap's were 0.8% and 6.1% 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 edged down to a 32-month low of 3.1% y/y from 3.5%. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change slipped to a 35-month low of 2.7% from 2.9%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -3.2% 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%, 2.0%, 11.6%), MidCap (22.7, 0.2, 14.0), and SmallCap (22.4, 0.3, 19.4).

S&P 500/400/600 Valuation ([link](#)): Valuations moved higher last week for all three S&P market-cap indexes. LargeCap's forward P/E gained 0.3 point w/w to a 17-month high of 17.2 from 16.9. That's compares to a five-year low of 13.9 during December and 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 0.3 point to 16.0 from 15.7. 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 surged 0.5 point to an 11-week high of 16.7. That's still well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E was below LargeCap's P/E for a ninth 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 in high gear, the earnings hook took a pause following Boeing's poor results. Last week saw the S&P 500's blended Q2-2019 EPS forecast drop 17 cents w/w to \$40.20. That represents an earnings decline of 2.0% y/y, but should continue to improve as more companies report in the coming weeks; we forecast \$41.00 in Q2 EPS and flat earnings y/y. On a pro forma basis, the blended Q2 earnings growth rate is 0.5% y/y, which would be the 12th straight y/y rise and compares 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, versus six a week earlier, 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. Four sectors are expected to beat the S&P 500's Q2 growth rate, down from five during Q1. Communication Services and Financials are the only sectors currently posting better growth on a q/q basis during Q2. Here are the latest Q2-2019 earnings growth rates versus their Q1-2019 growth rates: Communication Services (18.2% in Q2-2019 versus -9.9% in Q1-2019), Financials (9.2, 8.0), Health Care (5.9, 10.3), Real Estate (2.2, 6.2), Consumer Staples (0.4, 1.0), Consumer Discretionary (-0.7, 8.1), Utilities (-0.9, -0.5), Information Technology (-4.0, -1.1), Industrials (-10.6, 6.9), Energy (-11.8, -26.1), and Materials (-32.9, -13.4). On an ex-Energy basis, S&P 500 earnings are expected to be up 1.2% 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. Looking ahead to the future, analysts as usual are trimming their forecasts for the next quarter. The S&P 500's Q3-2019 EPS forecast dropped 15 cents w/w to \$42.42. The consensus' \$42.57 estimate is down 1.3% in the four weeks since the start of the quarter, and now represents an earnings decline of 0.2% y/y. On a pro forma basis, the consensus Q3 estimate represents an earnings decline of 0.6% y/y, compared to a decline of 0.1% a week earlier and 0.8% at the end of Q2.

S&P 500 Q2 Earnings Season Monitor ([link](#)): With the Q2 earnings season over 44% complete for the S&P 500, the near-halfway results compared to the same point during Q1 show that revenues are beating by a greater amount and a higher percentage of companies are reporting positive revenue surprises and y/y revenue growth. The earnings surprise and y/y earnings growth metrics are about the same as Q1 despite Boeing's dismal Q2 results. Of the 222 S&P 500 companies that have reported through midday Monday, 76% exceeded industry analysts' earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 4.3% and exceeded forecasts by an impressive 6.3%. Ex-Boeing, y/y earnings growth improves 2.8ppts to 7.1%. On the revenue side, 62% of companies beat their Q2 sales estimates so far, with results coming in an impressive 1.1% above forecast and 4.1% higher

than a year earlier. Q2 earnings growth results are positive y/y for 69% of companies, versus a similar 69% at the same point in Q1, and Q2 revenues have risen y/y for 71% versus a slightly lower 69% during Q1. Looking at earnings during the same point in the Q1-2018 reporting period, a slightly higher percentage of companies (78%) in the S&P 500 had beaten consensus earnings estimates by a similar 6.3%, and earnings were up a tad higher 4.4% y/y. With respect to revenues at this point in the Q1 season, a lower 56% had exceeded revenue forecasts by a sharply lower 0.2%, and sales rose a slightly lower 3.8% y/y. Compared to 2018's stellar results, these mid-season 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. That has happened just five times in the 42 quarters since the bull market started in Q1-2009. As more companies have reported, it's looking less possible that Q2-2019 will make the sixth.

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): Five Fed districts have reported on manufacturing activity for July—Philadelphia, New York, Richmond, Kansas City, and Dallas—and indicate growth has moved from contraction to expansion, with the Philadelphia region accounting for the move up. The composite (to 1.4 from -3.7) index shows manufacturing activity expanding this month, though barely, after dipping into negative territory in June for the first time since August 2016. Philadelphia's composite (21.8 from 0.3) index revealed activity rebounded from a standstill in June to its best growth in 12 months in July, while activity in the New York (4.3 from -8.6) region paled in comparison, recovering only half of June's decline. Meanwhile, Kansas City's composite (-1.0 from 0.0) showed growth was basically flat, while Richmond's (-12.0 from 2.0) contracted at its fastest pace since January 2013; activity in the Dallas (-6.3 from -12.1) region continued to decline, though at half the pace of June. The new orders (unchanged at 0.6) gauge showed billings at a virtual standstill for the second month, as the strongest growth in Philadelphia orders (18.9 from 8.3) in a year, along with a slight acceleration in Dallas (5.5 from 3.7) orders, offset negative readings in New York (-1.5 from -12.0), Kansas City (-2.0 from 5.0), and Richmond (-18.0 from -2.0) billings—with latter's the weakest in 6.5 years. Meanwhile, the employment (5.5 from 5.9) measure showed hirings were the weakest since the end of 2016, though still positive. Manufacturers in the Philadelphia (30.0 from 15.4) region added to payrolls at their fastest pace since October 2017, while Dallas' (16.0 from 8.8) hired at double the pace of June—more than offsetting job cuts in the New York (-9.6 from -3.5), Kansas City (-6.0 from 5.0), and Richmond (-3.0 from 4.0) areas.

Regional Manufacturing Price Indexes ([link](#)): Available July data for the Philadelphia, New York, Richmond, Kansas City, and Dallas regions show pricing remains on a disinflationary trend, based on both the prices-paid and prices-received indexes—though prices-paid indexes in all regions but New York edged higher in July, while prices-received indexes in Philadelphia and Richmond accelerated. Here's a look at the prices-paid indexes for July versus their respective peaks during 2018: Philadelphia (to 16.2% from 60.0% y/y), New York (25.5 from 54.0), Dallas (17.0 from 54.0), Kansas City (15.0 from 52.0), and Richmond (3.0 from 5.7). Here are the same comparisons for the prices-received indexes: Philadelphia (9.5 from 35.0),

New York (5.8 from 23.3), Kansas City (2.0 from 27.0), Dallas (-1.7 from 26.2), and Richmond (2.5 from 2.8). (Note: Richmond prices are not diffusion indexes but rather average annualized inflation rates.)

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