MORNING BRIEFING
August 8, 2019

World Woe I

See the collection of the individual charts linked below.

(1) Trump is a disruptor. (2) Trump may outsmart himself. (3) Lots of huffing and puffing. (4) Trump needs the Fed to lower interest rates to offset delayed China deal. (5) Commodity prices falling. (6) Germany is the gasping canary in the factory. (7) Energy is the biggest loser. (8) China has lots of dollar-denominated debt. (9) Technology continues to disrupt.

Global Economy: Will Trump Trump Trump? According to his many detractors, President Donald Trump is the cause of all the world's woes. I've had a more balanced view. The world has lots of problems that aren't attributable to Trump. I've discussed the homegrown problems in China, Europe, and Japan. They all have too many old people, not enough young people, too much debt, and out-of-control central banks. However, Trump's escalating trade wars since early 2018 have exacerbated the world's woes. That's most apparent in global manufacturing indicators, which have been weakening since early last year, as we reviewed in Tuesday's *Morning Briefing*.

Trump is a disruptor, for sure. He has upended the post-WWII multilateral world order. His goal is a more bilateral world where the US can use its economic clout for the benefit of the US economy. As I discussed yesterday, his endgame with China may be more about forcing companies to move their supply chains out of China than to get a trade deal.

In any event, he now doesn't see a deal with China until after he wins next year's presidential election. But he won't win if all of his huffing and puffing (H&P) over trade continues to weaken global growth and harms the US economy. So he is doing more and more H&P about the need for the Fed to lower interest rates more aggressively. Since late last week, the stock market's reaction to his latest round of H&P has been decidedly negative. The mounting risk is that Trump may trump Trump as he unleashes his deal-making skills on the world.

The world's woes are easy to monitor via the CRB raw industrials spot price index, which is down 14% since the start of last year through Monday to the lowest level since 4/6/16 (*Fig. 1*). That has leveled out our Boom-Bust Barometer (which is the ratio of the CRB index to initial unemployment claims) since early last year (*Fig. 2*). This indicator tends to be highly correlated with the S&P 500, which nevertheless managed to rise to a new record high on 7/26 as S&P 500 forward earnings rose to a record high in early August (*Fig. 3*).

Another recent example of the world's woes is Germany's industrial production (excluding construction). It plunged 1.8% m/m during June and is down 6.2% y/y, to the lowest level since December 2016 (*Fig. 4*). Auto production on a 12-month sum basis fell again during July, to

4.7 million units, slightly below the 2009 trough (*Fig. 5*). I seriously doubt that Germany's woes all are attributable to Trump, though his policies clearly are weighing on China's economy, which means fewer Chinese imports of German cars.

Energy: For Whom the Tariffs Toll. To see the impact of Trump's tariffs on the S&P 500, we measured performance from 4/3/18, the day the Trump administration released its $50 billion list of 1,333 Chinese products under consideration for 25% tariffs.

As you'd expect, S&P 500 Industrials, Materials, and Energy sectors were hit hardest. A bit more surprising was the Financials sector's appearance near the bottom of the list and Real Estate's location at the top. Here's the performance derby for the S&P 500 sectors from 4/3/18 through Tuesday's close: Real Estate (22.4%), Information Technology (21.4), Utilities (19.4), Consumer Discretionary (17.5), Consumer Staples (13.2), Health Care (13.0), S&P 500 (11.6), Communication Services (9.9), Industrials (2.9), Materials (1.2), Financials (0.3), and Energy (-11.5) (*Table 1*).

The Energy sector has been hurt by the drop in demand growth from a slowing global economy. The price of Brent crude oil per barrel has fallen 17% since 4/3/18 (*Fig. 6*).

The Energy Information Administration trimmed its forecast for the growth in global oil consumption during 2019 to 1.0% as of 8/6 from 1.1% on 7/9, making August the seventh consecutive month the estimate was reduced. World consumption, at 100.91mbd, is projected to be slightly below global production of 101.02mbd—an estimate that also was trimmed slightly this month, to 0.3% growth from 0.4%.

The US fracking miracle continues to change the industry's dynamics (*Fig. 7*). And others are looking to emulate our success. Vista Oil & Gas is tapping into Argentina's shale oil and gas basin, Vaca Murta, which is estimated to have about 27 billion barrels of potential resources, an 8/6 *FT* article reported. Argentina hopes to double its oil production to 1mbd by 2023, and some of the major oil companies have announced plans to boost production in the area.

The S&P 500 Energy sector's 11.5% decline since the trade war began fails to reflect the deeper damage borne by some of its component industries: Oil & Gas Equipment & Services (-42.2%), Oil & Gas Drilling (-32.1), Oil & Gas Exploration & Production (-19.8), and Oil & Gas Refining & Marketing (-13.1).

China: A Fist Full of Dollar-Denominated Debt. There's an old saying in the world of bankruptcy workouts that's attributed to JP Getty: "If you owe the bank $100, that's your problem. If you owe the bank $100 million, that's the bank's problem." We're not quite sure who owns the debt that China's corporations and state-run companies have outstanding (stay tuned!). But there's certainly an awful lot of it.

Jackie took a look at China's $4 trillion corporate bond market and $21 trillion bank loan market in the 7/25 *Morning Briefing*. Her focus was some of the issuers who were defaulting on their obligations. China's weakening of the yuan, presumably in retaliation for President Trump's tariffs, made us explore another avenue: the amount of dollar-denominated debt

Chinese organizations have outstanding.

The Bank of International Settlements' Q1 report breaks Chinese dollar-denominated debt down among resident issuers (those that are incorporated in China) and national issuers (those who have a Chinese parent company). Here's Q1 debt among the former: banks ($68.6 billion), other financial corporations ($71.0 billion), non-financial corporations ($27.4 billion), and general government ($5.2 billion). Among national issuers, the figures are: banks ($272.3 billion), other financial corporations ($149.4 billion), and non-financial corporations ($444.0 billion).

Together, that equates to $1.0 trillion of dollar-denominated debt, though it's unclear whether there's overlap among the two categories. It's also unclear whether the data being reported is accurate. "According to analysts at Nomura, the amount of offshore dollar bonds issued by Chinese corporations was $841.6 billion at the end of June," an 8/7 *WSJ* article reported. That's almost twice the BIS figure.

President Donald Trump should be eternally grateful to those who lent to Chinese entities in dollars because the burden of repaying that debt may prevent the Chinese government from sharply devaluing its currency. The country has been manipulating the yuan around the edges, letting it settle slightly above 7 yuan per US dollar this week (*Fig. 8*). But it's unlikely the country can seriously devalue its debt because doing so would put more pressure on the issuers of dollar-denominated paper.

Here's some more news on dollar-denominated Chinese debt:

(1) *New issue market has been on fire*. Asian dollar-denominated, high-yield debt issuance has been at a record pace this year, with Chinese issuers leading the way. Of the $59 billion of dollar-denominated Asian debt sold ytd through 7/26, Chinese companies represented about $38 billion, according to a 7/28 *WSJ* article. Higher yields helped sell the debt. On average, Chinese junk issues were yielding 7.9% by the end of July, compared to 6.0% for US junk bonds and 3.1% for euro-denominated, high-yield debt.

(2) *Developers were big borrowers.* Chinese real estate developers were the largest issuers of dollar-denominated debt. They have $114 billion of offshore high-yield bonds outstanding, up from $8.9 billion in 2010. About $21 billion of that debt will be due in 2020 and $29 billion in 2021, the 7/28 *WSJ* article stated, crediting Fitch.

An 8/5 *WSJ* article citing Moody's said $33.8 billion of onshore and $19.3 billion in offshore bonds issued by developers either mature or are subject to put options in the next year. The article continued: "Several hundred minor players have already been bankrupted this year: wider failures could have a knock-on impact through an already fragile financial system, parts of which are short of dollars already. Last month, the government restrained the ability of developers to issue offshore bonds for anything other than refinancing maturing dollar debt, perhaps in anticipation of currency weakness. All of that suggests that even if seven is no longer the magic number for the PBOC, policy makers will want to prevent the yuan from weakening too far."

(3) *Running short on dollars?* The Chinese dollar issue may be bigger than just the need to meet dollar-debt maturities. Kyle Bass, CEO of Hayman Capital Management, who's known for betting against subprime mortgages during the financial crisis, told CNBC on 8/5 that the Chinese need dollars to buy oil, food, and basic materials. The country is running both a current account and a fiscal deficit. And while China says it is 15% of the world's economy, less than 1% of global transactions settle in yuan.

Kevin Lai, chief economist for Asia excluding Japan at Daiwa Capital Markets, is also on alert. He believes that China's growing external US dollar leverage is being underestimated, and it could possibly trigger a major financial crisis, according to a 11/16/18 *South China Morning Post* article. Lai noted that China's dollar debt makes it vulnerable because of tightening US dollar liquidity, a weakening yuan, and the US-China trade war. Stay tuned.

Disruptive Technology Review. It may be the hazy, lazy days of summer, but disruptive technology is moving faster than ever. Here's an update looking at new delivery methods, robots in stores, and tech firms invading the world of finance:

(1) *Delivery without the guy*. Meet Scout, Amazon's six-wheeled, sidewalk-driving delivery robot. Looking a bit like a beach cooler on wheels, Scout has begun making deliveries in the Irvine, California area. It'll work during daylight hours, accompanied by an "Amazon Scout Ambassador"—a.k.a. a human making sure it doesn't get lost and answering questions from people in the neighborhood, according to an 8/6 Techcrunch article.

Scout has been operating in the Seattle area "over the past few months" and has navigated both rain and snow. In a video about Scout on Amazon, Scout rolls up the sidewalk and stops in front of a house. The homeowner then comes out to Scout to retrieve the package.

At first glance, Scout doesn't seem able to climb front steps or ring a doorbell. It's unclear what it would do if the homeowner wasn't home. Wouldn't it be great if they could teach Scout to walk our dogs?

(2) *Marty arrives at Stop & Shop.* Imagine our surprise as we were racing through Stop & Shop and saw in the distance a beeping, moving object with large eyes. Could it be one of the robots we've been writing about all these many months?

Yes! Marty has arrived on Long Island! He's 6 feet, 8 inches tall and goofy enough looking to make you smile. The Marty we saw did cause some congestion in the aisles (he moves very slowly), but most people who encountered Marty chuckled and moved on.

Marty's job is to monitor the aisles for any spills or items that could harm customers. When he spots something amiss, he sends a message over the public address system asking for an employee's help. Five-hundred Martys are being put to work this year at Stop & Shops in New York, Massachusetts, Connecticut, Rhode Island, and New Jersey, a 8/6 *Newsday* article reported.

(3) *Banks under siege*. Banks are facing competition from two very large entities: Apple and the Federal Reserve.

Apple has started rolling out its new consumer credit card with Goldman Sachs. Here are some of the details from an 8/7 MarketWatch article: "People will be able to sign up for the card direct from their iPhone—to do so, they will need to have the latest version of the iOS software. They will be prompted to provide personal information including age, address and the latest four digits of the Social Security number. That information will be then sent to Goldman Sachs for approval, which should take less than a minute. If approved, people will be able to start using their card almost immediately with the Wallet app and Apple Pay. A physical card will also be mailed to these customers." This is great news for Apple and Goldman and bad news for any other credit card issuer.

Were that not enough, the Federal Reserve has announced plans to develop a faster payment system for banks to exchange money. The catch: There's another real-time money exchange network set up by big banks. "The new [Federal Reserve] system would allow bill payments, paychecks and other common consumer or business transfers to be available instantly and round-the-clock, a change from the government's current system that is closed on weekends and can at times take days to settle a transaction. The Fed said it anticipates that the new service will be available in 2023 or 2024, and will support payments of up to $25,000," the 8/5 *WSJ* article reported.

Big banks—including Citigroup, US Bancorp, and JPMorgan Chase—already have invested about $1 billion in their own clearing system. The Fed has decided to build a second system because it believes the competition would lower costs, improve efficiency, and reduce the vulnerability of the financial system while creating redundancy.

CALENDARS

US. Thurs: Jobless Claims 215k, Wholesale Inventories 0.2%, EIA Natural Gas Report. **Fri:** PPI Final Demand Headline & Core 1.7%/2.3% y/y Baker-Hughes Rig Count. (DailyFX estimates)

Global. Thurs: OECD Leading Indicators, Japan GDP (annualized) 0.6% q/q, China Trade Balance $44.3b, Mexico CPI, ECB Publishes Monthly Bulletin, Lowe. **Fri:** Germany Trade Balance €19.8b, UK GDP 0.1%m/m/0.0%q/q/1.4%y/y, Headline & Manufacturing Industrial Production -0.3%/-1.1% y/y, UK Trade Balance – £2600m, China New Yuan Loans ¥1300b, China Aggregate Financing ¥1650b, China CPI & PPI 2.7%/0.0% y/y, RBA Statement of Monetary Policy. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) dropped back below 3.00 this week as bullish sentiment plunged. The BBR sank to 2.69 after climbing seven of the prior eight weeks from 2.31 (lowest since mid-February) to 3.35. Bullish sentiment (to 48.1% from 57.2%) tumbled 9.1ppts this week, back toward its recent low of 42.7% nine weeks ago—

which was the fewest bulls since mid-January. Nearly all of this week's move out of the bullish camp went to the correction (34.0 from 25.7) camp, which jumped 8.3ppts. Over the prior eight-week period, bullish sentiment (57.2 from 42.7) jumped 14.5ppts, while the correction count (25.7 from 38.8) sank 13.1ppts. Bearish sentiment rose for the second week to 17.9% from 16.8% two weeks ago; it had fluctuated in a small band from 18.0% to 18.5% from early June through early July. The AAII Ratio rebounded last week to 61.5%, after falling the prior week, for the first time in seven weeks, from 55.6% to 49.8%. Bullish sentiment climbed from 31.7% to 38.4% last week, while bearish sentiment fell from 32.0% to 24.1%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues and earnings rose w/w back to new record highs. Analysts expect forward revenues growth of 5.3% and forward earnings growth of 8.1%, up 0.1ppt and 0.5ppt, respectively, from a week earlier. Forward revenues growth is now down 1.0ppt 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 8.8ppts from a six-year high of 16.9% last February, but has improved steadily 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 8.5% in 2018 to 4.3% in 2019 and 5.3% in 2020. They're calling for earnings growth to slow sharply from 24.1% in 2018 to 2.2% in 2019 before improving to 10.4% in 2020. The forward profit margin was steady w/w at 12.1%, and is down just 0.3ppt from a record high of 12.4% in mid-September. That compares to 11.1% prior to the passage of the TCJA in December 2017 and a 24-month low of 10.4% in March 2016. Analysts are expecting the profit margin to fall from 12.0% in 2018 to 11.7% in 2019 before rising to 12.3% in 2020. The S&P 500's forward P/E was down to 16.3 based on Tuesday's close from an 18-month high of 17.4 in late July. 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. Similarly, the S&P 500 price-to-sales ratio was down to 1.99 from an 11-month high of 2.10. That's 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 ten of the 11 S&P 500 sectors and forward earnings for 9/11 sectors. Materials was the only sector to have both measures fall w/w. Forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward P/S and P/E ratios are now well above their multi-year lows during December 2018 for all sectors, but have declined from recent multi-year or record 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 one sector now: Financials. 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. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.0%, down from 23.0%), Financials (18.6, down from 19.2), Real Estate (15.8, down from 17.0), Communication Services (15.0, down from 15.4), Utilities (12.9, down from its record high of 13.0 in May), S&P 500 (12.1, down from 12.4), Materials

(10.1, down from 11.6), Health Care (10.5, down from 11.2), Industrials (10.3, down from its record high of 10.4 in early July), Consumer Discretionary (7.5, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (7.0, down from 8.0).

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2 earnings season over 85% complete for the S&P 500, the results compared to the same point during Q1 show that revenues are beating by a greater amount; a higher percentage of companies is reporting positive revenue surprises; the earnings surprise is a tad smaller; and y/y earnings growth is only 1.4ppts lower despite Boeing's dismal Q2 results. Of the 426 S&P 500 companies that have reported through midday Wednesday, 74% exceeded industry analysts' earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 1.9% and exceeded forecasts by an impressive 6.0%. Ex-Boeing, Q2's y/y earnings growth improves 1.7ppts to 3.6%. On the revenue side, 58% of companies beat their Q2 sales estimates so far, with results coming in an impressive 1.4% above forecast and 4.3% higher than a year earlier. Q2 earnings growth results are positive y/y for 66% of companies, versus a lower 65% at the same point in Q1, and Q2 revenues have risen y/y for 68% versus a similar 68% during Q1. Looking at earnings during the same point in the Q1-2019 reporting period, a higher percentage of companies (76%) in the S&P 500 had beaten consensus earnings estimates by a higher 6.8%, and earnings were up a higher 3.3% y/y. With respect to revenues at this point in the Q1 season, a similar 58% had exceeded revenue forecasts by a sharply lower 0.2%, and sales rose a higher 5.2% 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 now looking more possible that Q2-2019 will make the sixth.

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production (*link*): Factory output in June dropped to its lowest level since December 2016. Germany's headline production—which includes construction—posted its second sizeable decline in three months, falling 1.5% in June and 3.3% over the period. Excluding construction, output tumbled 1.8% and 3.4% over the comparable periods. Manufacturing output sank 1.8% m/m and 3.2% during the three months through June, to its lowest reading since the end of 2016, as trade uncertainties and slowing global growth continue to weigh on Germany's manufacturing sector. Industrial production contracted 5.2% y/y in June—the steepest yearly decline since late 2009. Factory output sank 6.1% y/y, with production in all main industrial groupings—consumer (-6.9% y/y), capital (-6.1), and intermediate (-5.8) goods—below a year ago. Looking ahead, IHS Markit's M-PMI (to 43.2 from 45.0) for July contracted for the seventh time this year, posting its poorest performance since mid-2012, led by the steepest drop in new export orders since 2009. Output also fell at an accelerating pace, with manufacturers making more aggressive cuts to employment and purchasing activity. According to the report, "Over the past year-and-a-half, the combination of trade tensions, the Brexit saga, upheaval in the car industry, and a slowing Chinese economy has been a toxic mix for manufacturers globally, but particularly for those in Germany."

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