



MORNING BRIEFING

August 19, 2019

Productivity Could Frustrate Endgamers

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

(1) Dueling leading indicators: The yield curve vs the S&P 500. (2) Trump doesn't like inverted yield curves. (3) Meetings in the Heartland. (4) No recession evident in retail sales or GDPNow estimate. (5) Predicting 10 out of 7 recessions. (6) No sign of a credit crunch. (7) The endgame doomsters love bad news. (8) Labor shortages should stimulate productivity. (9) The beginning of a major rebound in productivity growth? (10) Real compensation growth is really making a comeback. (11) Unit labor cost inflation based on ECI remains subdued, which is subduing price inflation. (12) Revisions don't change the productivity story. (13) Movie review: "One Child Nation" (+ + +).

US Economy I: The Short Story. The stock market tanked on Wednesday, 8/14 because the yield spread between the 10-year US Treasury bond and the 2-year Treasury note turned negative ([Fig. 1](#)). Such an inversion of the yield curve is widely viewed as a reliable leading indicator of economic recessions. Indeed, the spread between the 10-year Treasury bond yield and the federal funds rate is one of the 10 components of the Index of Leading Economic Indicators ([Fig. 2](#)).

The S&P 500 is also one of the components of the LEI. It remains just 4.5% below its July 26 record high but would fall sharply if stock investors become convinced that a recession is imminent ([Fig. 3](#)). We are adding last week's selloff to our list of panic attacks, making it #65 ([Table](#) and [Fig. 4](#)).

Not only did the stock market react badly to the latest yield-curve inversion but so did President Donald Trump, who tweeted: "CRAZY INVERTED YIELD CURVE! We should easily be reaping big Rewards & Gains, but the Fed is holding us back."

While this was all happening, I was visiting with our accounts in Kansas City at the end of last week. Of course, we discussed the recent inversion of the yield curve and the possibility that it is once again predicting an impending recession. There was certainly no sign of an imminent recession in Thursday's July retail sales press release. It jumped 0.7% m/m. Debbie reports that real retail sales rose 5.4% (saar) during the three months through July, based on the three-month average, matching its fastest pace since the end of 2017 ([Fig. 5](#)). As a result, the Atlanta Fed's [GDPNow](#) estimate for Q2 real GDP was raised from 1.8% to 2.2%.

In my meetings, I noted that an inverted yield curve has predicted 10 of the last 7 recessions. In other words, it isn't as accurate a predictor of economic downturns as widely believed. It can be misleading, having given three false signals of a recession. I also observed that inverted yield curves don't cause recessions. They've tended to predict financial crises, which morphed into economy-wide credit crunches and recessions ([Fig. 6](#)). There is certainly no sign of a

credit crunch in the yield spread between high-yield corporate bonds and the 10-year Treasury bond ([Fig. 7](#)).

The S&P 500 Diversified Banks stock price index dropped 3.2% last week on fears that an inverted yield curve would narrow the net interest margin of financial intermediaries ([Fig. 8](#)). This margin has remained between 2.8% and 4.3% since 1984 ([Fig. 9](#)). So in the past, it never inverted along with the yield curve! Financial crises that morphed into widespread credit crunches caused banks to cut their lending, not negative net interest margins.

US Economy II: The Long Story. The most widely hated bull market in history has been associated with the most widely anticipated recession of all times. In our opinion, the odds of a recession are reduced when so many people in business and finance are worrying about an impending recession. That fear of falling reduces excessive speculative behavior, which has typically set the stage for a recession. Join in with us to repeat our mantra: “No boom, no bust.” A corollary is our mantra: “No credit crunch, no recession.”

Nevertheless, as we saw once again last week, it doesn’t take much to cause panic attacks about recessions. The endgame doomsters have been predicting that “this will all end badly” ever since it ended badly in 2008. So they get very excited each time that something happens that might finally cause the next endgame.

Undoubtedly, one day in the future, there will be a recession, and it could be worse than the Great Recession. However, Debbie and I are thinking that the endgame scenario might be delayed, if not averted, by a secular rebound in productivity growth. Such a development would allow the economy to grow despite labor shortages.

In our opinion, a shortage of labor is the reason why productivity should rebound. If it does so, then real wages should rise along with productivity, which will give consumers more purchasing power to do what they do best, namely, go shopping. A productivity rebound would also keep a lid on inflation, which would reduce the risk of a recession caused by Fed tightening and a credit crunch. Let’s have a look at the latest data:

(1) *The long view.* Over the past 20 quarters (i.e., five years) through Q2-2019, nonfarm business productivity has increased by an average annual rate of 1.2% ([Fig. 10](#)). That’s up from a cyclical low of 0.5% during Q4-2015. That’s a good gain, but still well below previous cyclical peaks of 4.0% during Q4-2003, 2.5% during Q2-1987, 2.8% during Q1-1973, and 4.6% during Q1-1966.

(2) *The current view.* We are already getting closer to our happy scenario. Q2-2019 productivity data were released last Thursday. They show that productivity rose 1.8% y/y during the quarter, with real nonfarm business output up 2.6% and real GDP up 2.3% ([Fig. 11](#)). The increase in productivity was the best reading since Q1-2015. As Debbie reports below: “Nonfarm productivity for Q2 expanded 2.3% (saar) following an upwardly revised 3.5% (from 3.4%) advance during Q1.”

(3) *Compensation.* For the nonfarm business sector, the 20-quarter cycle in inflation-adjusted

hourly compensation is highly correlated with the comparable cycle in productivity ([Fig. 12](#)). During Q2-2019, the former was up at an average annual rate of 1.7%, the fastest pace since Q1-2008. As per microeconomic theory, we are using the nonfarm business price deflator rather than the CPI or personal consumption deflator to calculate real hourly compensation ([Fig. 13](#)).

(4) *Inflation*. In current dollars, nonfarm business hourly compensation is very volatile, even on a y/y basis and especially compared to average hourly earnings and the Employment Cost Index (ECI) ([Fig. 14](#)). During Q2-2019, hourly compensation rose 4.3% y/y, while the ECI rose 2.6%.

A good measure of unit labor costs can be derived by dividing the ECI (rather than hourly compensation) by nonfarm business productivity ([Fig. 15](#)). The yearly percent change in this measure tends to be in the same neighborhood as the inflation rate using the y/y percent change in the core PCE deflator. Our unit labor costs proxy rose just 0.8% during Q2, which is why price inflation remains so low.

(5) *Revisions*. The Bureau of Labor Statistics released its latest [Productivity and Costs](#) report last Thursday. It included revisions from Q1-2014 to Q1-2019. The revised data for productivity showed more of it from 2016-2018, but by Q1-2019, the revised level was identical to the preliminary estimate ([Fig. 16](#)).

Movie. “One Child Nation” (+ + +) ([link](#)) is an extremely disturbing documentary about China’s horrible one-child policy from 1979 to 2015. It resulted in the mass forced sterilization of women and involuntary late-term abortions. It led to human trafficking in babies, who were placed in overseas homes, many under the false pretense that they were orphans. The Orwellian government campaign to control the population’s growth rate was deemed necessary to avoid nationwide starvation. It included incessant propaganda, a widespread network of informants, and the conscription of medical professionals to execute the government’s dirty deeds. Among the people interviewed in the documentary, a few condoned it, but most did not and seemed to have been deeply traumatized by it. Everyone said they had no choice. The legacy of that policy is that China is rapidly turning into the world’s largest nursing home as the population ages without enough young adults to support the elderly. See the UN-compiled data in charts of China’s fertility rate ([Fig. 17](#)), elderly dependency ratio ([Fig. 18](#)), and young-vs-old population shares ([Fig. 19](#)).

CALENDARS

US. Mon: None. **Tues:** Quarles. (DailyFX estimates)

Global. Mon: Eurozone Headline & Core CPI 1.0%/0.9% y/y. **Tues:** RBA Minutes of August Policy Meeting. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance ([link](#)): Last week saw the US MSCI index fall 1.1% to

4.6% below its 7/27 record high. The AC World ex-US dropped 1.5% for the week and is nearing a bear market again at 18.3% below its record high in January 2018. The US MSCI's weekly performance ranked 16th among the 49 global stock markets we follow in a week when only three of the 49 countries rose in US dollar terms. That compares to the prior week's 20/49 ranking, when the US MSCI fell 0.5% as only 15 three markets rose. Among the regions, just two outperformed the AC World ex-US last week: EM Asia (0.1%) and BRIC (-0.5). The regions underperforming last week: EM Latin America (-5.7), EM Eastern Europe (-4.0), EMEA (-3.2), EAFE (-1.6), and EMU (-1.5). China was the best-performing country with a gain of 1.4%, followed by Denmark (0.8) and Egypt (0.3). Of the 28 countries that underperformed the AC World ex-US MSCI last week, Argentina fared the worst, tumbling 38.8%, followed by Greece (-8.3), Brazil (-5.6), Israel (-5.3), and Turkey (-5.2). The US MSCI's ytd ranking rose four places last week to 5/49, with its 15.5% ytd gain more than triple that of the AC World ex-US (4.7). All regions and 31/49 countries are in positive territory ytd. The regions that are outperforming the AC World ex-US ytd: EM Eastern Europe (6.2), EMU (6.1), and EAFE (5.3). EM Asia (0.5) is the biggest laggard ytd, followed by EM Latin America (1.7), EMEA (2.8), and BRIC (4.2). The best country performers ytd: Egypt (26.1), Switzerland (18.5), New Zealand (16.8), and Belgium (15.8). The worst-performing countries so far in 2019: Pakistan (-26.5), Argentina (-20.6), Poland (-14.0), Chile (-13.0), and Korea (-9.7).

S&P 1500/500/400/600 Performance ([link](#)): All of these indexes fell last week for the fourth time in five weeks. LargeCap's 1.0% fall was less than the drops recorded by SmallCap (-1.2%) and MidCap (-1.5). LargeCap ended the week 4.5% below its 7/26 record high of 3025.86, and MidCap weakened to 8.6% below its 8/29 record high. SmallCap slipped deeper into a correction at 16.3% below its 8/29 record after narrowly averting a bear market at the end of May. Just eight of the 33 sectors moved higher last week compared to 11 rising a week earlier. Last week's best performers: SmallCap Utilities (2.0), LargeCap Consumer Staples (1.6), MidCap Utilities (1.2), MidCap Consumer Staples (0.8), and LargeCap Utilities (0.5). SmallCap Energy (-4.1) was the biggest decliner, followed by LargeCap Energy (-3.9), MidCap Consumer Discretionary (-3.2), and MidCap Energy (-3.2). In terms of 2019's ytd performance, all three indexes are still positive, but SmallCap slipped to a single-digit percentage gain in the latest week. LargeCap leads with a gain of 15.2% ytd, 2.6ppts ahead of MidCap (12.6) and well ahead of SmallCap (8.8). Thirty of the 33 sectors are positive ytd, with the cyclical leading the top performers: LargeCap Tech (25.9), MidCap Tech (24.9), LargeCap Real Estate (24.2), SmallCap Tech (20.5), and SmallCap Utilities (19.2). MidCap Energy (-28.0) is the biggest decliner so far in 2019, followed by these underperformers: SmallCap Energy (-20.1), LargeCap Energy (-1.2), SmallCap Consumer Discretionary (2.2), and SmallCap Communication Services (2.5).

S&P 500 Sectors and Industries Performance ([link](#)): Three of the 11 S&P 500 sectors rose last week as five outperformed or matched the S&P 500's 1.0% decline. That compares to four rising a week earlier, when six outperformed the S&P 500's 0.5% drop. Consumer Staples was the best-performing sector with a gain of 1.6%, ahead of Utilities (0.5%), Real Estate (0.3), Tech (-0.3), and Communication Services (-1.0). Last week's underperformers: Energy (-3.9), Financials (-2.2), Materials (-2.0), Consumer Discretionary (-1.9), Industrials (-1.6), and Health Care (-1.1). Ten sectors are still higher so far in 2019, down from all 11 a week earlier and compared to just two sectors rising during 2018, when the S&P 500 fell 6.3%. These six

sectors have outperformed the S&P 500's 15.2% rise ytd: Information Technology (25.9), Real Estate (24.2), Consumer Staples (18.5), Communication Services (18.4), Consumer Discretionary (17.1), and Utilities (15.4). The ytd laggards: Energy (-1.2), Health Care (4.5), Financials (11.2), Materials (11.9), and Industrials (15.1).

Commodities Performance ([link](#)): Last week, the S&P GSCI index fell 1.0% as 10 of the 24 commodities moved higher. That compares to a 1.9% decline a week earlier when 14 commodities rose. The index had nearly climbed out of a correction during mid-April, recovering to a drop of 10.0% from its high in early October after being down as much as 26.9% from that high on 12/24. It's back in a bear market now at 21.2% below its October high. Nickel was the strongest performer for a third straight week as it rose 4.3%, ahead of Natural Gas (3.7) and Cotton (2.1). Corn was the biggest decliner, with a drop of 8.2%, followed by Live Cattle (-8.1) and Lean Hogs (-7.4). The S&P GSCI commodities index is up 5.8% ytd following a decline of 15.4% in 2018. The top-performing commodities so far in 2019: Nickel (52.2), Crude Oil (20.7), Gold (18.9), and Unleaded Gasoline (16.9). The biggest laggards in 2019: Natural Gas (-24.9), Live Cattle (-20.8), Cotton (-16.7), and Kansas Wheat (-16.2).

S&P 500 Technical Indicators ([link](#)): The S&P 500 price index fell 1.0% last week as it tested its short-term 50-day moving average (50-dma) for a third week and for the first time since the end of May. However, the index remains above its long-term 200-day moving average (200-dma). The index's 50-dma relative to its 200-dma rose for 26th time in 27 weeks to a 17-month high, forming a Golden Cross for a 21st week after 16 weeks in a Death Cross formation. The index had been in a Golden Cross for 137 weeks through late November, and its previous Death Cross lasted for 17 weeks through April 2016 (when its 50-dma bottomed at a then-four-year low of 4.5% below its 200-dma in March 2016). The current Golden Cross reading of 5.4% is up from 5.3% a week earlier and from -5.2% in early February, which had matched the lowest reading since November 2011. It's still down from a 55-month high of 7.2% in February 2018. The S&P 500's 50-dma rose at a snail's pace w/w as the price index fell to an 11-week low of 2.0% below its 50-dma from 0.8% below a week earlier. It had peaked recently during mid-July at a 19-week high of 4.3%. That was up from a 22-week low of 4.2% below its falling 50-dma at the end of May, but down from 6.6% above during mid-February, which was its highest since October 2011. The 200-dma rose for a tenth week, but also at a slower pace. It had been rising for 16 weeks through mid-May after falling from October to February in the first downtrend since May 2016 (when it had been slowly declining for nine months). The index traded above its 200-dma for an 11th week, but was down to an 11-week low of 3.3% above its rising 200-dma from 4.8% a week earlier and from a 17-month high of 8.8% at the end of July. That compares to 14.5% below its falling 200-dma on 12/24, which was the lowest since April 2009; the index remains well below the seven-year high of 13.5% above its rising 200-dma during January 2018.

S&P 500 Sectors Technical Indicators ([link](#)): Three of the 11 S&P 500 sectors traded above their 50-dmas last week, down from four a week earlier as Communication Services moved below. The three sectors still trading above their 50-dmas: Consumer Staples, Real Estate, and Utilities. All 11 sectors had been below their 50-dmas in early January. The longer-term picture—i.e., relative to 200-dmas—shows 10 sectors trading above currently, unchanged from a week earlier. Energy was below for a fifth week after being above—just for a week—for the

first time since early October. Ten sectors are in the Golden Cross club (with 50-dmas higher than 200-dmas), unchanged from a week earlier and compared to just two in February and all 11 in January 2018. Energy is the sole laggard, not having been in a Golden Cross for 39 straight weeks. Six sectors have rising 50-dmas now, down from all 11 a week earlier—with the deterioration signaling that the market's recent downturn has begun to weigh on the moving average. The sectors with falling 50-dmas: Energy, Financials, Health Care, Industrials, and Materials. Nine sectors have rising 200-dmas, down from 10 a week earlier, as Health Care slipped back into a downtrend that began in May. Energy has had a mostly falling 200-dma for more than eight months. That compares to just two sectors with rising 200-dmas in early January, in what was then the lowest count since all 11 sectors had falling 200-dmas two years before.

US ECONOMIC INDICATORS

Retail Sales ([link](#)): No sign of a slowdown in consumer spending last month. Both headline and core retail sales—which excludes autos, gasoline, building materials, and food services—posted strong gains last month, climbing to new record highs yet again. Total and core retail sales rose for the sixth time in seven months, jumping 0.7% and 1.0%, respectively, during July and 4.7% and 6.7% ytd. We estimate that real core retail sales (BEA uses the core retail sales measure to estimate personal consumption expenditures each month) advanced 0.6% in July, following gains of 0.9% and 0.8% the prior two months, while we estimate real total sales climbed 0.3% after increases of 0.5% in each of the prior two months. We calculate real core retail sales expanded 7.5% (saar) during the three months ending July, based on the three-month average, the strongest pace since March 2016—suggesting a strong start for Q3 real consumer spending in the GDP accounts. Meanwhile, real headline sales grew 5.4% (saar) over the comparable period—matching its fastest pace since the end of 2017. In July, 10 of the 13 major nominal sales categories rose, while only three fell—sporting goods & hobby (-1.1%), motor vehicles (-0.6), and health & personal care (-0.2). Leading July's advance were nonstore (2.8%), gasoline (1.8), food service & drinking, (1.1), electronic & appliance (0.9), and clothing (0.8) retailers; the remaining components posted gains from 0.2% to 0.6%.

Consumer Sentiment ([link](#)): Consumer sentiment sank in mid-August to its lowest level since the start of the year, with both the present situation and expectation components heading south. The Consumer Sentiment Index dropped from 98.4 to 92.1 this month; it was at a 19-month high of 100.0 during May. The present situation component (to 107.4 from 110.7) fell to its lowest level since November 2016, while the expectations component (82.3 from 90.5) was the lowest since January. Both remain at relatively high levels. According to the report, “Monetary and trade policies have heightened consumer uncertainty—but not pessimism—about their future financial prospects.” Consumers reacted strongly to the proposed September increase in tariffs on Chinese imports, which was spontaneously cited by 33% of consumers—not far from its recent peak of 37%. While the rescheduling of the tariffs until Christmas delays the negative impact on consumer prices, the report noted that it still heightens anxiety about future price increases. The consumers' main takeaway from the Fed's cutting interest rates for the first time in a decade last month was to raise concerns about a possible recession. Consumers showed some angst regarding the future pace of income and job gains.

Productivity & Labor Costs ([link](#)): Productivity is finally showing signs of life after growing below its historical average for too long. Nonfarm productivity for Q2 expanded 2.3% (saar) following an upwardly revised 3.5% (from 3.4%) advance during Q1. It was the best two-quarter performance since Q3-2014. Output (to 1.9% from 3.9%, saar) last quarter grew at a slower pace than Q1, while hours worked (-0.4 from 0.4) was slightly negative for the first time since Q3-2015. Unit labor costs (2.4 from 5.5) increased at less than half the pace of Q1 as hourly compensation (4.8 from 9.2) costs slowed considerably, though remained high. (Revisions to Q1 data were dramatic, with Q1 unit labor costs first reported down 1.6% and hourly comp up only 1.8%.) On a year-over-year basis, productivity growth accelerated 1.8% y/y—the strongest yearly increase since Q1-2015—while unit labor costs rose at a five-quarter high of 2.6%, boosted by a 4.3% jump in hourly comp. From 2011 to 2016, productivity averaged yearly gains of only 0.6%, moving slightly above 1.0% during 2017 and 2018.

Business Sales & Inventories ([link](#)): Both nominal and real business sales remain stalled at record highs. Nominal manufacturing & trade sales edged up 0.1% in June, while real business sales ticked up 0.2% in May; the former is within 0.2% of March's record high, the latter within 0.8% of January's record high. Real sales of retailers ascended to a new record high in May, while wholesalers' remained stalled just below March's record reading. Meanwhile, manufacturers' sales have dropped nearly 2.0% from January's cyclical high. June's nominal inventories-to-sales ratio (1.39) has fluctuated around its recent high of 1.40 through the first half of this year. Meanwhile, the real inventories-to-sales ratio is up from recent lows, holding at April's 1.46 in May—the highest since July 2016.

Industrial Production ([link](#)): The US industrial sector lacks momentum since reaching a new record high at the end of last year, with renewed trade tensions with China not helping. Headline production slipped 0.2% in July after climbing 0.2% in each of the prior two months; it's down 1.3% from December's record high. Both mining (-1.8%) and manufacturing (-0.4) production fell last month, with the former suffering a sharp, but temporary, loss due to Hurricane Barry; these declines were partially offset by a 3.1% jump in utilities output last month. So far this year, factory output has slumped 1.6% on widespread weakness. Output of business equipment has dropped 1.5% ytd, driven by declines in transit (-5.5% ytd) and industrial (-2.1) equipment. Meanwhile, production of information processing equipment (4.4) remains on a steep uptrend, setting yet another record high, and is an amazing 10.3% above its previous record high posted during April 2008. Consumer goods output is down 0.8% ytd, with both consumer durable (-1.8% ytd) and nondurable (-0.6) goods production in the red. Within durable goods, appliance & furniture (-3.2) and auto (-1.2) output fell, while production of computers, video & audio equipment (8.5) is up big.

Capacity Utilization ([link](#)): The headline capacity utilization rate fell for the sixth time in eight months, from a cyclical high of 79.6% in November to 77.5% in July—which is the lowest since October 2017. It was 2.3ppts below its long-run (1972-2018) average. Manufacturing's rate is moving sideways in recent months, registering 75.4% three of the last four months—its lowest percentage since September 2017; it was 2.9ppts below its long-run average. Meanwhile, the utilization rate for mining fell to 89.2%—which is about 2.0ppts above its long-run average—while the rate for utilities (to 76.6% from 74.5%) increased 2.1ppts but remained well below its long-run average.

Regional M-PMIs ([link](#)): Both Fed districts that have reported on manufacturing activity for August so far—Philadelphia and New York—show activity is expanding at a solid pace, with Philadelphia’s performance leading the way. The composite (to 10.8 from 13.1) index revealed manufacturing activity eased a bit from July’s pace this month but was much stronger than in June, when it dipped into negative territory for the first time since May 2016. Philadelphia’s composite (16.8 from 21.8) index showed activity remained at a healthy, though slower rate, while New York’s (4.8 from 4.3) matched July’s pace, after contracting at its fastest rate since October 2016 in June. New orders (16.3 from 8.7) this month grew at nearly double the pace of July, expanding at a 10-month high. Philadelphia (25.8 from 18.9) billings were the strongest since May 2018, while New York’s (6.7 from -1.5) swung from contraction to expansion. Meanwhile, employment (1.0 from 10.2) was at a standstill this month, as manufacturers in the Philadelphia (3.6 from 30.0) area hired at a considerably slower pace than last month; New York’s (-1.6 from -9.6) continued to cut payrolls, though at a slower pace.

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