MORNING BRIEFING
August 29, 2019

Running Out of Gas

The next *Morning Briefing* will be sent on Tuesday, September 3.

See the collection of the individual charts linked below.

(1) Setting the record straight on stock buybacks. (2) The Fed acknowledges that data on employee stock compensation plans are MIA. (3) Lots of traffic as car sales slow around the world. (4) Ridesharing is having an impact. (5) Why are German autos in a ditch? (6) Greener autos. (7) Chinese supply of autos accelerating, while Chinese demand is slowing. (8) Tougher emission standards. (9) Brexit again. (10) Carney has some thoughts on cryptocurrencies.

Stock Buybacks: Fed Seeking Missing Data. Joe and I have been working hard to set the record straight on buybacks. We wrote a 5/20 *Topical Study* titled "Stock Buybacks: The True Story." We summarized our findings in an 8/23 *Barron's* op-ed titled "Don't Blame Buybacks for Boosting Stock Prices—Or Promoting Inequality." Paperback and Kindle versions of our study are now also available on Amazon.

In our original study, we wrote: "We suspect that the Fed's accounts might not be accounting for the value of stocks issued by corporations to their employee stock compensation plans. We have reached out to the Fed and are awaiting guidance on this matter. Stay tuned." Well, sure enough, they recently sent us an email acknowledging that we might be right and are working to correct the problem!

Let's see if their fix corroborates our conclusion: "Hence, we again conclude that the impact of buybacks on earnings per share has been greatly exaggerated. That's because we found that roughly two-thirds of buybacks may be mostly offsetting stocks issued as labor compensation. Rather than boosting earnings per share, most buybacks are aimed at reducing the share-count dilution that results from compensating employees with stock."

Germany: Autobad. Labor Day typically means time with friends and family at the pool or beach, end-of-season barbeques, and of course traffic. Despite concerns that Americans are falling out of love with their cars, US vehicle miles traveled continued to climb in June, by 1.0% y/y, to new record highs, based on the 12-month sum (*Fig. 1*). And over the holiday weekend, driving times could spike by 85%-115% in metro areas, according to INRIX data quoted in an 8/17 *USA Today* article.

Despite the traffic, car sales in the US and in most major countries around the world have been declining for the past year. According to data from VDA reprinted by bestseillingcars.com, here's how some of the world's largest markets fared in terms of 1H-2019 sales growth (or

rather, lack thereof for most): China (-14.0% y/y), India (-10.3), Europe (-3.1), Russia (-2.4), US (-1.9), Japan (-0.3), and Brazil (10.9).

The reasons behind the declines vary. US tariffs typically are blamed for China's slowing economy and car sales. Europeans, too, are slogging through a slowing economy as they face Brexit, new car emissions rules, and potential US tariffs. The trade war is dampening US economic growth. Higher car prices have made car ownership more expensive, and ridesharing via Uber and Lyft has made it less hip worldwide. After multiple years of record or near-record car sales, it just may be time for the car market to take a breather now that many driveways have shiny, moderately new vehicles.

The economy of Germany, the world's Detroit, is among the most directly impacted by the global decline in the auto industry. German car manufacturers produced about one-fifth of cars sold globally last year and two-thirds of higher-margin premium cars, a 10/23 *Financial Times* article reported. Eight hundred auto suppliers operate in Germany, and a third of auto research occurs there. As a result, Germany's auto industry employs 834,000 and directly contributes around 5% to the country's GDP.

As you'd expect, the German auto market—and economy broadly—have felt the global auto industry's slowdown. Germany's passenger car production has been falling sharply since July 2018 and in July dropped to 4.7 million units (12-month sum), far below the 2016 peak of 5.8 million units and even below the 2009 Great Recession nadir of 4.8 million units (*Fig. 2*). The drop in production weighed on the country's GDP, which in Q2 fell 0.3% (saar) (*Fig. 3*). Q2 GDP was hurt most notably by a deterioration in net trade, as exports (-5.3% saar) fell more than imports (-1.1). Capital investment (-0.5) was also a drag on growth, with a drop in construction spending (-4.0) more than offsetting an increase in machinery & equipment investment (2.5) (*Fig. 4*).

Given these developments, I asked Jackie to take a closer look at Germany's economy in general and its auto industry in particular. Here are her findings:

(1) *Competition racing ahead*. While the global auto market has always been a tough competitive space, two new entrants have been disrupting it lately: electric car manufacturers and Chinese manufacturers seeking international growth.

Electric car sales have taken off as many countries have slapped the industry with tougher emissions rules, consumers have grown more environmentally aware, and price points have come down. Global electric vehicle sales reached 2.1 million units last year, up 64% y/y, according to an EVvolumes.com article. Some of the most aggressive electric car adopters include Norway, where 40% of new car sales were electric last year; Iceland (17.5%); and Sweden (7.2). In Asia, China leads the way (4.3). The country accounts for 56% of all electric cars sold last year.

German companies are aggressively rolling out their own electrified models, but others have a large head start. Tesla's Model 3 was the best-selling electric car worldwide last year, with a 7% market share, a 1/31 InsideEVs article reported. The Model 3 was followed by China's

BAIC EC-Series (4% market share), Nissan Leaf (4), the Tesla Model S (2), and Model X (2). Granted, these are early days, and as more German manufacturers roll out their offerings, the leader board could certainly change.

Meanwhile, Chinese auto manufacturers are looking abroad for growth as their domestic economy slows. Right now, their focus is primarily on emerging markets, but it's likely they'll continue to expand, targeting developed markets in the future, according to an 8/11 *WSJ* article.

"China's car manufacturers once struggled to sell their cars at home, let alone abroad. Now, the cars they are producing are much improved, analysts say, matching foreign rivals on quality and outflanking them on price," the article explained.

SAIC Motor is selling its sport-utility vehicle in India and has opened plants in Indonesia and Thailand to sell into Southeast Asia. Great Wall Motors opened its first overseas plant in Russia in June. And BAIC Motor started production in South Africa last year. Zhejiang Geely Holding Group opened a plant in Belarus in 2017 to serve Russia and Eastern Europe and entered the Southeast Asian Market in December.

(2) *China's slowing.* About a third of all vehicles sold globally are sold in China, and about a quarter of all cars sold in China are sold by German manufacturers, according to a 8/22 *WSJ* article. So when China's economy slows, it's likely that Germany's auto industry will catch a cold. Right now, it looks like it's time to buy some tissues.

Auto sales in China fell 9.6% y/y in June and 12.0% y/y during 1H-2019 to 12.3 million, the weakest result in four years. On a 12-month sum basis, the country sold 26.2 million automobiles, down from a peak of 29.6 million during June 2018 (*Fig. 5*).

(3) *Europe making life difficult.* In Europe, the auto industry is facing the double whammy of Brexit uncertainty and tougher auto emissions rules. Add to that a potential tariff war with the US, and you have numerous reasons for the economy to slow and consumers to postpone car purchases.

Brexit heated up Wednesday after UK Prime Minister Boris Johnson attempted to shut down Parliament temporarily to block lawmakers from voting against a no-deal Brexit. Melissa provides details on the Brexit drama below. The upshot is that UK real GDP fell 0.2% in Q2, hurt by sharp declines in manufacturing (-2.3%)—which is included in industrial output (-1.4)—and construction (-1.3); services showed no growth, its weakest performance since Q1-2010 (*Fig. 6* and *Fig. 7*).

In addition to Brexit, European car companies face the burden of reducing their vehicles' CO2 emissions. The EU has set initial targets for 2021 that get progressively tougher. For companies, that means more R&D spending to develop cars that can meet those standards.

The need to meet emissions standards was one of the reasons why Ford and Volkswagen expanded their global alliance last month. The companies agreed to collaborate on the

development of self-driving technology and electric vehicles, a 7/12 *Financial Times* article explained. VW will invest $2.6 billion in Ford's driverless technology startup company, and Ford will build an electric car in Europe using VW's manufacturing systems.

Brexit Update: Johnson's Prorogation. Members of Parliament (MPs) had their summer holiday recess rudely interrupted yesterday when PM Johnson invoked a procedure called "prorogation" to suspend parliamentary sessions for five weeks prior to the 10/31 Brexit deadline. His critics call it "a dirty trick." Next week, anti-no-deal Brexiters and Conservative rebel MPs will have to get their acts together quickly to stop Johnson from potentially allowing the UK to leave the EU without a deal.

In yesterday's *Morning Briefing*, we detailed the three different Brexit scenarios: deal, no-deal, or delay. Most MPs oppose a no-deal Brexit because it would impose a hard border between Northern Ireland (part of the UK) and the Republic of Ireland (an EU member state) overnight. That could send the UK's economy into a recession, with negative spillover effects to other countries.

What is prorogation, and can it be stopped? Prorogation ends a session of Parliament for a short time, so legislative discussions are halted and Parliament doesn't even sit. After the forced break, Parliament reopens with the Queen's speech. The process cannot be stopped by MPs, as they do not get to vote on it. (For more, see *The Guardian's* article titled "What is prorogation and why is Boris Johnson using it?")

Yesterday, Johnson said that he requested and gained approval from the Queen for a 10/14 speech to help focus on the public's priorities, including "helping the NHS, fighting violent crime, investing in infrastructure and science and cutting the cost of living," according to an article in the UK publication *Independent*.

Critics call the PM's act a deliberate move to shorten Parliament's Brexit debate time.

Johnson claims that there will be "ample" time for these discussions despite the prorogation. In fairness, the suspension curtails debate time by just over a week's worth of days given that Parliament has a three-week recess scheduled during the five-week suspension and doesn't sit on Fridays. The media hasn't focused on that fact.

The PM says that a debate over Northern Ireland would be held on 9/9. Further Brexit discussions would be held in the days before the European Council Summit on 10/17-18, leaving plenty of time for MPs to consider any breakthroughs with the EU on a withdrawal deal before vote in Parliament on 10/21-22.

Nevertheless, some say that shortening the discussion timeline gives the PM leverage to leave without a deal. Critics didn't look kindly on his move and may push anti-no-deal parties and Conservative rebels more quickly toward either a vote of no-confidence or the passing of legislation to delay the Brexit deadline date, both of which we covered yesterday.

Conservative rebel Dominic Grieve called the move in the "middle of a national crisis"

“outrageous” and “unprecedented.” It will “cause MPs to move very quickly to a vote of no-confidence in the government,” *Independent* reported he said. Our hunch is that there will indeed be a countermove by anti-no-dealers next week.

Crypto Update: Carney’s Currency. It’s one thing for Chinese officials to try to dethrone the dollar as the world’s reserve currency. It’s quite another thing for the head of the Bank of England (BOE) to suggest that the world’s financial system would be sounder without dollar dominance.

BOE Governor Mark Carney in his 8/23 speech at the Jackson Hole Symposium laid out such a case. The dollar, he argued, has an outsized impact on the global economy relative to the US economy’s size. The dollar is used in at least half of international trade invoices—representing value of about five times the US’s share of world goods imports and three times its share of world exports. The large amount of trade done in dollars encourages companies to use the dollar when issuing global securities and central banks to use the dollar in their foreign exchange reserves.

That forces foreign countries to focus monetary policy on stabilizing capital flows instead of using it to achieve domestic priorities related to output and inflation, Carney noted. To ensure stable capital flows, countries accumulate dollar-denominated reserves, creating the “global savings glut” that former Fed Chairman Ben Bernanke has pointed out can lead to extremely low global interest rates.

Because the dollar is dominant, every time the Fed acts to strengthen or weaken the US economy, the rest of the world’s economies feel it. In the current environment, that means the strong US economy and the strong dollar have muted the impact of loose monetary policy in countries with weak economies, making it difficult for their economies to revive.

Carney’s solution: Central banks around the world could join forces to create a virtual currency based on a basket of currencies. Trade could occur in that virtual currency. The private sector could also develop a virtual currency, along the lines of what Facebook’s doing with LIBRA. Either way, moving away from the dollar would give countries more control over their economies and perhaps mean that interest rates could rise from their basement levels.

CALENDARS

US. Thurs: GDP & PCE 2.0%/4.3%, GDP Price Index & PCE Core Index 2.4%/1.8%, Jobless Claims 215k, Advance Goods Trade Balance -$74.6b, Pending Home Sales 0.0%m/m/1.8%y/y, EIA Natural Gas Storage. **Fri:** Personal Income 0.3%, Real & Nominal PCE 0.5%/0.3%, Headline & Core PCED 1.4%/1.6% y/y, Consumer Sentiment 92.3, Chicago Purchasing Manager’s Index 47.9, Baker-Hughes Rig Count. (DailyFX estimates)

Global. Thurs: Eurozone Economic Sentiment 102.3, Germany CPI -0.1%m/m/1.5%y/y, Germany Unemployment Change & Unemployment Claims Rate 3.5k/5.0%, France GDP 0.2%q/q/1.3%y/y, UK Gfk Consumer Confidence -11, Japan Industrial Production -0.5%m/m/0.3%y/y, Japan Retail Trade 0.9%m/m/-0.6%y/y. **Fri:** Eurozone Headline & Core

CPI Flash Estimates 1.0%/1.0% y/y, Eurozone Unemployment Rate 7.5%, Germany Retail Sales -1.4%m/m/3.3%y/y, Italy GDP 0.0%q/q/0.0%y/y, Canada GDP (annualized) 3.0%, Japan Housing Starts 899k. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Bull/Bear Ratio (BBR) fell this week, after showing little change the prior two weeks, as bullish sentiment sank. The BBR fell to 2.35 this week from 2.74 and 2.73 the prior two weeks. Bullish sentiment (to 43.9% from 49.1%) tumbled 5.2ppts this week, to the fewest bulls' count since the 42.7% at the end of May. The majority of the move from the bullish camp, once again, went to the correction camp (37.4% from 33.0%), which jumped 4.4ppts; bearish sentiment (18.7 from 17.9) gained 0.8ppt—after three straight weeks near 18.0%. There have been wide swings between the bullish and correction camps since early June. The AAII Ratio climbed for the second week last week from 31.0% to 40.1% over the period, as bullish sentiment rose from 21.7% to 26.6% and bearish sentiment fell from 48.2% to 39.7%.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): Consensus S&P 500 forward revenues and earnings edged down w/w from their record highs. Analysts expect forward revenues growth of 5.3% and forward earnings growth of 7.9%, with each measure down 0.1ppt 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 9.0ppts 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 4.4% in 2019 and 5.3% in 2020. They're calling for earnings growth to slow sharply from 24.0% in 2018 to 2.0% in 2019 before improving to 10.2% 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 drop 0.3ppt y/y from 12.0% in 2018 to 11.7% in 2019 before improving to 12.2% in 2020. The S&P 500's forward P/E rose 0.5pt w/w to 16.8 from a 10-week low of 16.3 and compares to 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 rose w/w to 2.02 from an 11-week low of 1.96 and compares to an 11-month high of 2.10 in late July. 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 fell w/w for all 11 S&P 500 sectors last week, and forward earnings dropped for 8/11 sectors. 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 have declined from recent multi-year or record highs for four sectors: Communication Services, Real Estate, Tech, and Utilities. However, all sectors remain well above their multi-year lows during

December 2018. 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 (21.7%, down from 23.0%), Financials (18.6, down from 19.2), Real Estate (16.0, down from 17.0), Communication Services (14.9, down from 15.4), Utilities (13.0, matching its record high in May), S&P 500 (12.1, down from 12.4), Health Care (10.5, down from 11.2), Industrials (10.3, down from its record high of 10.4 in early July), Materials (10.1, down from 11.6), Consumer Discretionary (7.5, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (6.8, down from 8.0).

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