MORNING BRIEFING
September 4, 2019

Industry Analysts' World Tour

See the collection of the individual charts linked below.

(1) Industry analysts remain upbeat on revenues despite depressing headline news. (2) Forward revenues are at record highs in both the US and overseas. (3) Forward revenues rising among developed economies, stalling at record high among emerging economies. (4) Latest US M-PMI is bad news for revenues growth, though consistent with 1.8% growth in real GDP. (5) A world of mostly sub-50.0 M-PMIs. (6) Based on MSCIs, forward earnings has been stalling in US and weakening overseas since early last year. (7) Unintended consequences beat intended ones from negative-interest-rate policies.

Strategy I: Global Revenues Remain on Uptrends. Previously, we've observed that global economic headlines have been increasingly depressing since early last year. We've also observed that notwithstanding the headlines, S&P 500 forward revenues—which is the time-weighted average of industry analysts' revenues estimates for the current and coming years—has remained on a solid uptrend in record-high territory (with some downside volatility late last year) (*Fig. 1*). It continued to set record highs during August.

The weekly S&P 500 forward revenues series tends to be a very good coincident indicator of the composite's actual quarterly revenues (*Fig. 2*). During the 8/22 week, industry analysts projected that S&P 500 revenues will grow 4.4% this year and 5.3% next year (*Fig. 3*). Those are upbeat estimates considering the headline news.

Now let's see whether the picture changes much when we go abroad. Are the industry analysts who are following companies outside the US more upbeat or less so about those companies' prospects? Here's the good news first, followed by the not-so-good:

(1) *US vs them.* When we compare the forward revenues of the US MSCI stock price index to that of the comparable All Country World Ex US index (in local currency), we see that both remain on uptrends that started in early 2016 following the 2015 downdraft resulting from the bursting of the commodity super-cycle bubble (*Fig. 4*). Astonishingly, both are in record-high territory, though the consensus expectations for revenues growth abroad are a bit lower than for the US, at 3.2% this year and 4.4% next year (*Fig. 5*).

(2) *Developed vs emerging.* Let's drill down some more. The forward revenues of the Developed Countries Ex-US MSCI (in local currency) isn't at a record high, but it has been making new cyclical highs since early last year (*Fig. 6*). The forward revenues of the Emerging Markets MSCI (also in local currency) has stalled at a record high since early 2018 (*Fig. 7*).

(3) *Comparative growth rates.* Here are the consensus revenues growth rates expected this

year and next for the major Developed Countries MSCI indexes around the world: Emerging Markets (5.1%, 7.3%), US (4.4, 5.4), EMU (2.4, 3.9), UK (1.6, 2.5), and Japan (1.7, 1.9). (See our *Annual Consensus MSCI Revenues & Earnings Growth*.)

(4) *US M-PMIs.* Now for the bad news: S&P 500 aggregate revenues growth is highly correlated with the US M-PMI, which fell below 50.0 during August for the first time since August 2016 (*Fig. 8*). It dropped to 49.1 from 51.2 during July and a recent peak of 60.8 during August 2018. Revenues rose 2.9% y/y during Q2-2019 and could weaken more based on the latest reading of the US M-PMI.

A silver lining is that the Institute for Supply Management, which compiles the M-PMI, reports that the US economy still isn't in a recession and is growing around 1.8% based on the past relationship of their index with real GDP.

Then again, the S&P 500 stock price index tends to stall on a y/y basis when the M-PMI is around 50.0 (*Fig. 9*). In any event, all of us recession-watchers now have another weak indicator to add to our worry list, including the yield curve, which inverted during the summer and is also highly correlated with the M-PMI (*Fig. 10*). Nevertheless, we still aren't in the recession camp.

Almost all the components of August's M-PMI were weaker than during July: M-PMI (49.1, down from 51.2), new orders (47.2, 50.8), production (49.5, 50.8), employment (47.4, 51.7), supplier deliveries (51.4, 53.3), inventories (49.9, 49.5). prices (46.0, 45.1), backlog of orders (46.3, 43.1), new export orders (43.3, 48.1), and imports (46.0, 47.0).

(5) *Overseas M-PMIs.* More bad news: The M-PMIs of the other major industrial economies have already been below 50.0 for several months (*Fig. 11*). Here are their August readings: China (49.5), Japan (49.3), US (49.1), Canada (49.1), UK (47.4), and Eurozone (47.0). Australia (50.9) is an exception.

Here are the M-PMIs for the Eurozone economies: France (51.1), Spain (48.8), Italy (48.7), Germany (43.5) (*Fig. 12*).

Among the emerging economies, we found only three with M-PMI readings above 50.0 during August: Brazil (52.5), India (51.4), and Vietnam (51.4).

Strategy II: Global Earnings Stalling or Weakening. The global forward earnings picture isn't as bright as the forward revenues based on the major MSCIs. Forward earnings for the US MSCI has stalled at a record high since mid-2018, while the series for the All Country World Ex US (in local currency) has been on a downward path over the same period (*Fig. 13*). The weakness overseas is visible in both Developed Countries Ex US and Emerging Economies. (See our *Global MSCI Comparisons of Forward Earnings*.)

Strategy III: Global Profit Margins. As we observed on Tuesday, earnings are weak relative to revenues around the world because profit margins are getting squeezed (*Fig. 14*). However, the US forward profit margin is near its 2018 record high of around 12.0% and holding up better than overseas margins, which on average have dropped from last year's peak of 8.3% during the 10/11 week to 7.8% currently.

Central Banks: Negative Consequences of Negative Rates. In late August, I discussed that the Minutes of the 7/30-31 FOMC meeting suggested that Fed policymakers might consider negative interest rates if and when the federal funds rate was lowered to the so-called "zero lower bound" (ELB). (See our 8/27 *Morning Briefing* titled "Fed's New Obsession with ELB.") Previously, Melissa and I made the case that such policies can have negative unintended effects on the economy. In our 2/24/16 *Morning Briefing*, we wrote:

"Negative interest rates are intended to stimulate the economy. But they might actually do the opposite ... Ultra-easy monetary policy 'could be the greatest failure of modern central banking' … economist Stephen Roach wrote in a 2/18 op-ed. He might be right. In any case, it's very hard to find the positives of negative rates. There's certainly lots of potential danger in these uncharted and troubled waters."

Negative policy rates already have been implemented in Japan (on 1/29/16) and in the Eurozone (on 6/5/14). Yet those policies have backfired, according to recent research. Nevertheless, there is no end in sight for the Bank of Japan's (BOJ) negative-rate policy, and the European Central Bank (ECB) stands ready to push rates further into negative territory at its next policy meeting this month (on 9/12).Consider the following:

(1) *The ECB's experience.* Central bankers believe that by lowering interest rates, they will stimulate economic growth and inflation. However, when interest rates go below zero, the opposite might happen. A 5/20 *WSJ* article titled "Negative Rates, Designed as a Short-Term Jolt, Have Become an Addiction" focused on the failure of negative interest rates to revive European economies:

"The negative-rate policy's ineffectualness is a sign of just how weak Europe's economic engines are, and how vulnerable. The policy threatens pensions, creates the risk of real-estate bubbles and doesn't fully quell the specter of deflation. European banks struggle with weak interest income and thin margins on loans, putting them behind American peers in profitability and making it harder for them to finance the economy."

During his 7/25 press conference, ECB President Mario Draghi was asked if businesses "might no longer invest or hurry up investing because" they anticipate "rates staying low" basically "forever." Draghi shrugged off the comment, responding that construction spending has been up. Draghi did not mention weakness in capital spending but did admit: "Certainly we have to ask ourselves: are all these instruments going to be effective forever? I think that's a legitimate question to ask." The latest batch of M-PMIs for the Eurozone suggests that negative interest rates have lost their effectiveness rather quickly.

(2) *The BOJ's experience.* Two Fed economists at the Federal Reserve Bank of San Francisco reviewed Japan's experience with negative interest rates in an 8/26 article titled "Negative Interest Rates and Inflation Expectations in Japan." They examined movements in yields on inflation-indexed and deflation-protected Japanese government bonds "to gauge changes in

the market's inflation expectations from the BOJ moving to negative policy rates." They found that "this movement resulted in decreased, rather than increased, immediate and medium-term expected inflation." Their conclusion: "This therefore suggests using caution when considering the efficacy of negative rates as expansionary policy tools under well-anchored inflation expectations."

Examined in the paper is an adjusted breakeven inflation rate (BEI). The adjusted measure accounts not only for nominal versus real Japanese government bond yields but also the value of deflation protection for Japanese inflation-index bonds. With deflation protection, bonds pay off their nominal principal at maturity even if there is price deflation. This protection has been highly valued by Japanese investors for extended periods. The authors noted: "This enhancement raises the value of inflation-indexed bonds, and hence pushes down real yields. This creates an upward bias in the measurement of inflation expectations from BEI rates."

On the BOJ's announcement day, the Japanese 10-year BEI (not accounting for deflation protection) rate increased 1bp. After accounting for deflation protection, the 10-year adjusted BEI rate declined an estimated 8bps, the researchers found. The paper noted: "Essentially, the market appeared to treat negative rates as bad news, perhaps because investors were concerned that the BOJ's unprecedented move meant that economic conditions were worse than they thought."

After its foray into negative rates, the BOJ was warned by lawmakers: "You have sent a message to the people that they had better watch out because Japan's economy is in trouble." Sure enough, the growth rates of private consumption and business investment in Japan have remained weak despite negative interest rates.

(3) *Bank-lending studies.* Negative interest rates on banks' excess reserves are supposed to encourage the banks to lend more. A 7/30 study based on data for 6558 banks from 33 OECD countries over 2012 through 2016 found that bank lending was weaker in countries that had adopted negative interest rates. A forthcoming follow-up study by the same researchers found that bank margins and profits fall in countries with negative interest rates compared to countries that did not adopt this policy.

A summary of the research titled "Negative interest rate policies are backfiring—new research," explained: "Negative interest rates are supposed to stimulate the domestic economy by facilitating an increase in the demand for bank loans. In theory this could increase new capital investment by firms and domestic consumption, via credit creation. But the research showed bank margins were being squeezed, curbing loan growth and damaging banking profits." Furthermore, negative interest rates seem to have negated the stimulative impact of other forms of unconventional monetary policy like quantitative easing.

(4) *Currency wars.* "In theory, negative rates discourage capital inflows and should depreciate the home currency, which should stimulate exports. In practice, devaluation is futile. There's only so far that currencies can weaken against others before they trigger competitive devaluations. Such 'currency wars' won't revive overall global economic growth. On the contrary, they might weigh on it instead. Negative interest rates and currency depreciation are

signs that monetary policy can't solve the world's economic problems," as we wrote in our 2/24/16 *Morning Briefing*. Yesterday, the euro slid to its lowest since 2017 as investors anticipated ECB rate cuts. Currencies around the globe are falling as the dollar strengthens, for now.

CALENDARS

US. Wed: Merchandise Trade Balance -$54.8b, Motor Vehicle Sales 16.9mu, MBA Mortgage Applications, Beige Book, Williams, Evans, Bowman, Bullard, Kashkar. **Thurs:** ADP Employment 140k, Jobless Claims, Productivity & Unit Labor Costs 2.2%/2.4%, Factory Orders 0.8%, C-PMI & NM-PMI, EIA Natural Gas Storage, DOE Crude Oil Inventories. (DailyFX estimates)

Global. Wed: Eurozone Retail Sales, Eurozone C-PMI & NM-PMI, UK C-PMI & NM-PMI, Japan C-PMI & NM-PMI, BOC Rate Decision 1.75%. **Thurs:** Germany Factory Orders -1.1%, Japan Household Spending, Guindos, Tenreyro. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings mostly took a step back again for these three indexes last week, but they remain in the uptrends that began during March. LargeCap's has risen during 24 of the past 29 weeks, MidCap's 16 of the past 25 weeks, and SmallCap's 13 of the past 23 weeks. LargeCap's has been at record highs since early June, while MidCap's and SmallCap's ticked down to 1.5% and 6.7% below their mid-October highs. At their bottoms earlier in 2019, 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 began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings edged down to a 34-month low of 2.2% y/y from 2.4%. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change fell to a 40-month low of 0.2% from 0.6%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -4.3% y/y change is down from -3.5% and is the lowest since December 2009. 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%, 1.7%, 11.4%), MidCap (22.7, -1.6, 13.7), and SmallCap (22.4, -0.9, 17.6).

S&P 500/400/600 Valuation (*link*): Valuations recovered last week from three-month lows for these three S&P market-cap indexes. LargeCap's forward P/E rose 0.4pt w/w to 16.5 and is down 0.7pt from a 17-month high of 17.2 at the end of July. That 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 gained 0.4pt to 15.3, down from a three-month high of 16.0 at the end of July. That's also 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 rose 0.5pt w/w to 16.0, which compares to an 11-week high of 16.7 at the end of July. 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 16th straight week, after being below for much of December for the first time since 2003.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs (*link*): Global manufacturing activity in August contracted for the fourth consecutive month, as new orders declined at the joint-fastest pace in nearly seven years—driven by the steepest contraction in international trade volumes since late 2012. The outlook also darkened, with business optimism sinking to its lowest level since that yardstick began in July 2012. JP Morgan's M-PMI (to 49.5 from 49.3) ticked up slightly from July's reading—which was the weakest reading since October 2012—matching its average reading over the past four months. It was at a seven-year high of 54.4 at the end of 2017. The emerging nation's M-PMI improved for the second month, to 50.4, after falling from 51.0 in March to 49.9 in June; it was at 49.5 in January—which was the first reading below 50.0 since mid-2016. Meanwhile, the M-PMI (48.7 from 48.6) for developed nations was in contractionary territory for the fourth month, after recovering to 50.2 in April, following a brief dip below 50.0 in March (to 49.9). Over half of the nations covered by the survey had M-PMI readings below the 50.0 breakeven point. The Eurozone (47.0 from 46.5) as a whole contracted, with activity declining in Germany (43.5 from 43.2), Austria (47.9 from 47.0), Ireland (48.6 from 48.7), Italy (48.7 from 48.5), and Spain (48.8 from 48.2), while growth in Greece (54.9 from 54.6), the Netherlands (51.6 from 50.7), and France (51.1 from 49.7) continued to expand. Japan (49.3 from 49.4) saw manufacturing activity contract for the sixth time this year. Meanwhile, IHS Markit's M-PMI for the US (50.3 from 50.4) remained just above 50.0—at odds with ISM's (49.1 from 51.2) measure, which sank below 50.0 for the first time in three years. Similarly, IHS Markit's M-PMI for China (50.3 from 49.9) was just above the 50.0 mark, while its official M-PMI (49.5 from 49.7) was below for the sixth time this year.

US Manufacturing PMIs (*link*): Manufacturing activity in August was the weakest since January 2016 and September 2009, respectively, according to the ISM and IHS Markit measures. The ISM M-PMI (to 49.1 from 51.2) remains on a steep downtrend—from its recent high of 60.8 just a year ago—falling below 50.0 for the first time in three years. (ISM notes that August's reading is consistent with roughly a 1.8% annualized increase in real GDP, based on the past relationship of the two measures.) The new orders (to 47.2 from 50.8) and production (49.5 from 50.8) indexes were the weakest since June 2012 and December 2015, respectively, while employment (47.4 from 51.7) was the weakest since March 2016. The remaining two index components showed that supplier deliveries (51.4 from 53.3) was heading back down to June's 35-month low of 50.7, while inventories climbed for the second month from 49.1 in June to 49.9 last month. Meanwhile, weak foreign demand pushed the new export orders (43.3 from 48.1) sub-index to its worst performance since April 2009. According to the report:

“Respondents expressed slightly more concern about U.S.-China trade turbulence, but trade remains the most significant issue, indicated by the strong contraction in new export orders. Respondents continued to note supply chain adjustments as a result of moving manufacturing from China.” IHS Markit’s M-PMI (50.3 from 50.4) hovered just above the breakeven point of 50.0 in August for the fourth month, down from 54.9 at the start of this year. Deteriorating exports are the key to the downturn, with new orders from foreign markets dropping at the fastest rate since 2009. Many companies blame slower global economic growth on rising trade-war tensions and tariffs.

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