



MORNING BRIEFING

September 10, 2019

More Easing

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

(1) Try, try again. (2) PBOC cuts reserve requirements again. (3) BOJ concerned about strong yen, thinking negative thoughts again. (4) Fed acting appropriately as usual. (5) Draghi's last act. (6) A package deal coming from the ECB. (7) Germans finding it harder to criticize ECB's easy money. (8) Lagarde is in Draghi's camp. (9) Lots of low-octane fuel not working well in global economic engine. (10) Dull Beige Book with weak spots. (11) Lots of uncertainty about trade. (12) Lots of labor shortages.

Central Banks I: More of the Same. The major central banks are providing yet another round of monetary easing. They are doing their best to stimulate their economies and boost inflation closer to their 2.0% targets. However, their ultra-easy monetary policies haven't worked as expected, so they keep doing more of the same. Let's start with the central banks of China, Japan, and the US before moving on to the Eurozone's central bank:

(1) **PBOC.** Last Friday, the People's Bank of China (PBOC) said it was lowering bank reserve requirement ratios (RRR) for the third time this year, freeing up \$126 billion in liquidity. This follows an announcement in early June by China's central bank that it will use various policy tools to keep liquidity in the market reasonably ample and to provide targeted liquidity support to small and mid-sized banks. Chinese markets were rattled in late May after the government took over troubled regional lender Baoshang Bank.

The PBOC said it will cut RRR on 9/16 by 50bps for all banks, with an additional 100bps cut for qualified city commercial banks. The RRR for large banks will be lowered to 13.0% ([Fig. 1](#)). This makes seven times that the PBOC has slashed the ratio since early 2018.

The central bank is widely expected to cut the loan prime rate as well in mid-September, for the first time in four years, in an effort to reduce corporate funding costs ([Fig. 2](#)).

(2) **BOJ.** Also on Friday, according to an interview with the *Nikkei* newspaper, Bank of Japan (BOJ) Governor Haruhiko Kuroda said cutting interest rates further into negative territory is among the bank's policy options. The official deposit rate for bank reserves was cut to -0.10% on 1/29/16 and remains there for now ([Fig. 3](#)). But Kurado stressed that if the BOJ were to ease, the central bank would take into account the impact such a move could have on Japan's banking system and financial market functions.

There's lots of market chatter suggesting that the BOJ could ease policy this month to take pressure off the yen, which has been trending higher recently as a result of the expected monetary easing steps by the Fed and the European Central Bank (ECB) ([Fig. 4](#)).

(3) *The Fed*. Also on Friday, just before the FOMC's pre-meeting blackout for Fed officials, Fed Chair Jerome Powell spoke at a forum in Zurich. He claimed that the Fed's pivot this year to lower interest rates has helped sustain US economic growth. He noted that there are multiple challenges for sustaining growth, including weakness in Europe and elsewhere, as well as the tariff war between the US and China. He said that trade uncertainty is weighing on US capital spending.

The FOMC lowered the federal funds rate range on 7/31 from 2.25%-2.50% to 2.00%-2.25%. It is widely expected to do so again at the 9/16-17 meeting next week. Powell bolstered those expectations by pledging once again that the Fed will "continue to act as appropriate to sustain this expansion," a phrase he has used before that the market has taken to mean that the Fed is likely to cut interest rates.

On Friday, the 12-month futures federal funds rate was down to just 1.11% ([Fig. 5](#)). The 2-year US Treasury note yield was down to 1.53% ([Fig. 6](#)).

Central Banks II: Draghi's Swan Song. ECB President Mario Draghi will leave the ECB on 10/31 when his term expires. He will be replaced by Christine Lagarde. Before passing the baton, Draghi is expected to stay true to his dovish 2012 words to "do whatever it takes" to support the eurozone economy. The bank's next meeting, scheduled for 9/12, could be one of the most interesting since the ECB decided to delve into negative-interest-rate policy during June 2014. Discordant political and economic factors are converging at this meeting just as Draghi sings his swan song. Consider the following:

(1) *A spoon full of sugar*. During his 7/25 [press conference](#), Draghi suggested that more stimulus is coming. Minutes from the 7/25 meeting of the ECB's Governing Council backed up this message. Officials discussed that a broad stimulus "package" would be more effective than a series of actions, [observed](#) the 8/22 *WSJ*. Sources [told](#) Reuters last week that the ECB is leaning toward a rate cut, reinforcement of the bank's pledge to keep rates low for longer, and aid for banks to compensate for negative rates. It is also possible that the bank will revisit its asset purchase program (APP).

The ECB's official deposit rate on bank reserves is currently -0.40% ([Fig. 7](#)). It is expected to be cut by 10-20bps at the next meeting. The APP program, which was terminated on 12/31/18, is expected to be restarted at the next meeting as well ([Fig. 8](#)).

(2) *Germany's vocal chorus*. However, some hawkish ECB officials have downplayed the possibility of further stimulus, [reported](#) CNBC yesterday. Some hope, as Draghi has previously discussed, that fiscal stimulus will save the day. But in the absence of that, the ECB may need to step in. Yesterday, Bloomberg [observed](#): "It's notable that the hawks' complaints have been about restarting QE only, with barely a squeak against cutting rates. This is no doubt an acknowledgement that something has to be done to stop the euro from rising."

The central bank's APP is a controversial issue in Germany, where "the country's constitutional court is embroiled in an ongoing case centering on whether the ECB's bond-buying constitutes

so-called ‘monetary financing,’ which is prohibited under EU law,” the CNBC article recalled. Critics have long claimed that the bank’s policies have led to low returns for savers and reduced the incentive for political reforms throughout the euro region. However, especially weak German manufacturing data may drown out the chorus of critics.

(3) *Lagarde singing Draghi’s song*. As she prepares to take the reins, Christine Lagarde sided with the central bank’s unconventional policies, defending low rates and supporting the APP, during her nomination hearing in the European Parliament last week, [reported Time](#). Without such measures, “the crisis would have been a lot worse,” she said. Lagarde also said that she agrees with the bank’s perspective that accommodation will be necessary “for an extended period of time.”

(4) *La commedia è finite*. Draghi noted during his prior presser that, despite further employment gains and increasing wages, softening global growth dynamics and weak international trade weigh on the eurozone’s outlook. Uncertainties related to geopolitical factors, including the rising threat of protectionism, particularly the threat of a hard Brexit, and vulnerabilities in emerging markets, have dampened economic sentiment, especially in the manufacturing sector. With inflationary pressures remaining muted, “a significant degree of monetary stimulus continues to be necessary to ensure that financial conditions remain very favourable and support the euro area expansion” as well as prices. Nevertheless, he reassured the public that the risk of a recession in the broader eurozone remains “pretty low.” Let’s hope Draghi’s swan song isn’t off key.

Global Economy: Low-Octane Fuel. As the major central banks have been pumping fuel—i.e., liquidity—into the global economy’s tank, we can’t help remembering how lower-octane fuels can damage a car’s engine.

Where has all the liquidity been going? Lots of it seems to be offsetting deflationary pressures resulting from the four forces of deflation, or what we call the “4Ds”: détente, disruption, demography, and debt. Lots of it also has been boosting asset prices in stock, bond, and real estate markets. Neither effect represents high-octane economic stimulus.

Now consider the following economic developments:

(1) *Commodity prices*. The forces of deflation are so powerful that all the central bank liquidity has failed to boost commodity prices and inflation. The CRB raw industrials spot price index is down 16% from last year’s peak on 6/12 ([Fig. 9](#)). The CPI inflation rate among the G7 economies remained subdued during July, at 1.6% on a headline basis and 1.8% on a core basis ([Fig. 10](#)).

(2) *OECD leading indicators*. As Debbie discusses below, the OECD leading indicators composite fell from the most recent peak of 100.7 during February 2018 to 99.0 during July, the lowest reading since September 2009. Weakness is widespread, with Japan (99.3), the Eurozone (99.0), and US (98.7) all below 100.0 ([Fig. 11](#)).

(3) *German orders and production*. During July, German manufacturing orders and output

were down 5.6% and 4.8% y/y ([Fig. 12](#)). On the other hand, merchandise exports were up 0.7% in July and 2.0% the past three months. This suggests to us that Germany's economic problems may be largely homegrown, contrary to the popular tale that the country is facing weak demand for its exports.

(4) *US durable goods orders*. Powell is half right about US capital spending being depressed by uncertainty. The full story is that nondefense capital goods orders excluding aircraft has stalled for the past year, but at a cyclical high that matches previous cyclical and record highs ([Fig. 13](#)).

(5) *China trade*. Also stalling at record highs for the past year have been both Chinese exports and imports (on a seasonally adjusted annual rate basis) ([Fig. 14](#)).

US Economy: Beige Beige Book. Beige is dull; so was the Fed's September *Beige Book* economic survey, showing the economy nationwide growing at a modest pace. The publication captures qualitative business commentary on issues pertinent to the US economy through the end of August for the 12 Federal Reserve districts. Seven Federal Reserve districts reported modest or moderate growth, two reported steady growth, two said growth picked up slightly, and one reported that growth was unchanged.

Business commentary was mixed. On the plus side, employment, wage growth, and prices grew modestly, and real estate activity held steady. Concerns about tariffs and trade notwithstanding, generally optimistic outlooks nationwide were reported across many industries. Some districts anticipated that the actual effects of the recent tariff hikes would not be felt for a few months. However, the uncertainty related to international trade disputes already has showed up in manufacturing activity, as discussed below. Consumer-spending reports were mixed. Among the negatives, home sales were reported as restrained by low inventory.

The biggest challenges identified in the report were soft manufacturing activity and the labor shortage. Let's focus on these areas of weakness:

(1) *Soft manufacturing activity*. Manufacturing showed signs of slowing or softening among most districts but not across all industries. Bright spots included semiconductors and metals production in the San Francisco area.

Nevertheless, as new orders have declined, manufacturers in several districts noted rising finished inventories despite decreased capacity utilization and production levels. The St. Louis Fed observed that slowing growth in manufacturing has been reported for the past few quarters, "but this is the first time that [respondents] have reported declines for all three of these measures [new orders, production, and capacity utilization] since 2016."

Many manufacturing contacts expressed concern about geopolitical and international trade uncertainties going forward. The word "uncertainty" was used 29 times (up from 21 in the previous *Beige Book*), most often related to trade or implied trade tensions. For example, Philadelphia district manufacturing contacts "noted a slightly more cautious outlook given trade

and market uncertainty.”

Cleveland manufacturers attributed weak demand to customers delaying capital spending as a result of stiff international competition. Richmond contacts had similar complaints. The 9/8 *WSJ* ran an insightful [article](#) on this phenomenon titled “Manufacturers Cut Spending as Trade War Dents Confidence” after surveying their own manufacturing contacts.

(2) *Labor shortage*. Yesterday, Debbie and I discussed the recent weak employment data, attributing it to tight labor supply, not weak labor demand. The latest *Beige Book* confirmed our thinking: Labor shortages, reported in nearly all districts, are continuing to constrain growth. Only Cleveland’s labor pool was characterized in mixed to upbeat terms. In most districts, finding qualified applicants topped employers’ challenges.

In the Boston district, labor supply was reported as scarce and matching skill sets to open positions as difficult—requiring less-than-ideally qualified workers to be hired at higher pay. In New York, “trouble finding qualified workers in a variety of roles” and a wide gap between salary demands and employment offers were reported, slowing hiring.

Richmond, Chicago, St. Louis, Kansas City, Dallas, and San Francisco firms similarly reported difficulty finding qualified workers across job categories and experience levels. Sought-after workers spanned from retail and food-service clerks, truck drivers, construction workers, auto technicians, and production workers to teachers, financial services and IT professionals, engineers, pilots, and physicians.

A few Minneapolis employers said they will have to close or move if workers cannot be found. In Atlanta’s district, the “inability to secure labor was holding back growth, encouraging investments in automation and pushing a few firms to acquire competitors as a means of gaining labor resources.” Philadelphia district contacts said that the labor pool was nearly “nonexistent.”

CALENDARS

US. Tues: NFIB Small Business Optimism Index 103.4, JOLTS. **Wed:** PPI Final Demand 1.7% y/y, Wholesale Inventories 0.2%, MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

Global. Tues: UK Employment Change & Unemployment Rate 15k3m/3m/3.9%3m, Japan Machine Tool Orders, China CPI & PPI 2.6%/-0.9% y/y. **Wed:** Japan Machine Orders - 8.1% m/m/-43.5y/y, Mexico Industrial Production. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings were mixed for these three indexes last week, but they remain in the uptrends that began during March. LargeCap’s has risen during 25 of the past 30 weeks, MidCap’s 16 of the past 26 weeks, and SmallCap’s 14 of the past 24 weeks. LargeCap’s has been at record highs since early June, while MidCap’s and

SmallCap's are 1.6% and 6.4% 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 2.0% y/y from 2.2%. 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 -0.3% from 0.2%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -4.4% y/y change is down from -4.3% 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%, 1.6%, 11.2%), MidCap (22.7, -1.9, 13.6), and SmallCap (22.4, -0.9, 17.6).

S&P 500/400/600 Valuation ([link](#)): Valuations recovered for a second straight week from three-month lows for these three S&P market-cap indexes. LargeCap's forward P/E rose 0.3pt w/w to 16.8 and is down 0.4pt 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 0.3pt to 15.6, 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 0.2pt w/w to 16.2, 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 17th straight week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With less than a month left before the Q3 books are closed, analysts will soon take a closer look at their forecasts for the quarter. The S&P 500's Q3-2019 EPS forecast dropped 3 cents w/w to \$41.48. That represents an earnings decline of 2.8% y/y compared to the prior week's forecasted earnings drop of 2.7%. The consensus' \$41.48 estimate is down 3.5% in the 10 weeks since the start of the quarter, which compares to a 1.6% drop for Q2 over the similar 10 weeks. While the consensus Q3 EPS estimate is below our forecast of \$43.00 and nearly below the \$41.45 reported for Q2, we are expecting slightly positive y/y earnings growth of 0.8%. On a pro forma basis, Q3 earnings are expected to decline 2.0% y/y, which would be the first drop in 13 quarters and compares to 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Six of the 11 sectors are expected to record positive y/y earnings growth in Q3-2019, with none rising at a double-digit percentage rate. That compares to seven positive during Q2, when three rose at a double-digit percentage rate. However, eight sectors

are expected to beat the S&P 500's Q3 growth rate, up sharply from just three during Q2. Industrials, Materials, Real Estate, and Utilities are the only sectors to post better (or less worse) growth on a q/q basis during Q3. The consensus expects earnings to fall 0.3% y/y in Q3 on an ex-Energy basis. That compares to ex-Energy gains of 3.9% in Q2 and 3.0% in Q1, and is well below the 14.2% y/y gain in Q4-2018. Here are the latest Q3-2019 earnings growth rates versus their Q2-2019 growth rates: Financials (4.4% in Q3-2019 versus 10.0% in Q2-2019), Real Estate (3.4, 3.1), Health Care (2.4, 10.4), Utilities (1.7, 1.1), Industrials (1.7, -9.1), Consumer Discretionary (0.7, 2.6), Consumer Staples (-0.5, 1.6), Communication Services (-0.5, 17.8), Information Technology (-7.6, -2.2), Materials (-9.3, -12.7), and Energy (-27.0, -9.0).

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators ([link](#)): In July, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—maintained June's assessment of stable growth momentum in the OECD area as a whole, which was an upgrade from May's signs of stabilizing growth momentum and April's assessment of easing growth momentum. July's OECD's CLI was at 99.0—which was the lowest since September 2009. Among the major OECD economies, CLIs for both France (99.2) and Canada (98.9) continue to point to stable growth momentum, while stabilizing growth momentum remains the assessment for Japan (99.3) and Italy (99.1). Brexit uncertainties makes the UK's direction harder to predict, but July's survey shows growth momentum is expected to remain stable—though at historically low trend rates. Meanwhile, the US (98.7) and the Eurozone (99.0) as a whole, particularly Germany (98.6), continue to anticipate easing growth momentum. Among the major emerging economies, stable growth momentum is still the assessment for Brazil (102.2), Russia (99.6), and China's (98.8) industrial sector, while signs of easing growth momentum are emerging in India (99.8)—with its auto industry in sharp decline.

Eurozone GDP ([link](#)): Real GDP in the Eurozone expanded only 0.8% (saar) during Q2—half Q1's 1.7% rate—and matching its slowest pace since mid-2014. Real domestic demand (1.2%, saar) improved from Q1's 0.6% (which was the weakest performance since contracting during Q3-2017), while trade was a drag on growth as imports (0.9) expanded at a faster pace than exports (0.1)—which were at a standstill. Meanwhile, real gross fixed capital formation (2.2%) accelerated at nearly triple the rate of Q1, while real household spending (0.8) was half the 1.6% pace recorded in each of the prior two quarters; government spending (1.3) was in line with prior quarters' rates. Of the four largest economies, Spain's (1.9%, saar) and France's (1.3) economies exceeded the Eurozone's 0.8% rate last quarter, while Italy's showed no growth and Germany's (-0.3) economy contracted—posting the weakest growth among all the Eurozone economies.

UK GDP ([link](#)): GDP began Q3 on an up note in July, after contracting during Q2 for the first time since Q4-2012, easing fears that the UK will fall into recession. Monthly data show real GDP rebounded 0.3% in July—the strongest monthly increase since the 0.5% gain at the start of this year. All three of the major industry groupings improved during the month: services (to 0.3% from 0.0%), construction (0.5 from -0.7), and production (0.1 from -0.1); the latter includes manufacturing (0.3 from -0.2), which drove its rebound. Meanwhile, real GDP was flat,

based on the rolling three-month average, after contracting 0.2% in June. Services output (which accounts for roughly 80% of the UK economy) accelerated 0.2% over the comparable three-month period, from 0.1% during June, with the service sector the only positive contributor to GDP growth over the time span. Production industries (-0.5%) continued to contract—though at roughly a third of June’s 1.4% loss—with the decline in manufacturing narrowing to -1.1% from -2.3%; construction declined 0.8% after sliding 1.3% during the three months through June.

UK Industrial Production ([link](#)): Output has lost momentum since reaching a cyclical high in March. Headline production edged up 0.1% in July after edging down 0.1% in June. Since peaking in March, output is down 1.9%, with manufacturing contracting 2.9%. The main industrial groupings show the decline was led by consumer nondurable (-3.7%), intermediate (-2.9), and capital (-2.2) goods over the four-month period, with output of consumer durable goods (-0.7) slightly below zero and energy (0.4) slightly above. IHS Markit’s M-PMI in August dropped to 47.4—its weakest reading since July 2012. According to the report, “The high levels of economic and political uncertainty pervasive across domestic and global markets continued to weigh heavily on the performance of UK manufacturing during August.” Output volumes fell as new work contracted at the fastest pace in over seven years, while business optimism dropped to a series low.

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