



MORNING BRIEFING

September 17, 2019

More on Inflation

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

(1) Truth or dare in the Middle East. (2) Robert Hardy weighs in on latest attack on Saudi oil assets. (3) It was a professional hit job. (4) Plenty of oil reserves to cushion the blow if Saudi production is restored quickly. (5) Growing bank loans to business discredit inverted-yield-curve scare. (6) Over-weighted rent biasing CPI measures of inflation higher vs PCED measures. (7) Despite higher tariffs, import price inflation remains muted. (8) Surveys of pricing pressure showing less of it. (9) PPI inflation for trucking stuff taking a dive.

Geopolitics: Iran vs Saudi Arabia. Anything is possible in the Middle East, where truth or dare is played with weapons. There is already some chatter suggesting that Iran didn't attack Saudi Arabia over the weekend. Rather, some third party in the neighborhood with an interest in a full-out war between the two sent the drones that badly damaged the Saudi's oil infrastructure. The truly frightening development is that hard-to-detect and hard-to-stop drones rigged with explosives can be deadly.

The truly ironic development is that Israel has developed anti-drone technology that could protect Saudi Arabia from more drone attacks. An 8/20 [article](#) in *US News & World Report* observed that Israel has numerous companies making technology to detect drones. For example: "Vorpai [Ltd. In Israel] has built a system that uses sensors to identify drones in a specific geographic area, then sends a live feed of a map with the locations to a customer's phone or computer screen, Raz said. The company has partnerships with Microsoft and AT&T, and its global customers include law enforcement and intelligence agencies, militaries and civilian companies."

While I've learned a lot about the Middle East over the years, I often turn to Robert Hardy, the proprietor of [The Geostrat](#), for deeper insights into the latest geopolitical developments in the region and around the world. Robert kindly agreed to let me excerpt some of his comments from a special report he issued yesterday:

(1) *Location of attack.* "[Abqaiq] is located in Saudi Arabia's Eastern Province, which has the Kingdom's largest Shia [minority] population. [It] is the most important facility for the Kingdom's oil sector; more important than its Gulf export terminals at Ju'aymah and Ras Tanura. For that matter, it is more important that the Strait of Hormuz or the Bab el-Mandeb Strait at the southern entrance to the Red Sea. Oil can be diverted away from the above choke points by pumping it across the country via the East-West pipeline to the Yanbu or Yenbo export terminal on the Red Sea, but it cannot bypass Abqaiq because the East-West pipeline begins at Abqaiq, and all the production from the three [main oil] fields ... is processed there."

(2) *False claims?* "There were...glaring anomalies about the Houthi claim [that they launched the attack]. The Houthis [who are Iran's allies in the war in Yemen] have always rushed out claims before the Saudis; this time they waited almost two hours after the official Saudi report. Unlike prior attacks, the screen did not show anything about the drones' path or the targets."

(4) *Damage*. “The processing facility contains very advanced distilling columns packed with ‘spiroids.’ If the distilling chamber was destroyed—worse case up to two years to rebuild. If not, the Saudis will have dodged a bullet.” It all adds up to a carefully crafted professional hit job.

(5) *Defenseless*. “Most of the Saudi’s billions of dollars air defenses are designed to intercept traditional ballistic missiles. They will have to acquire a low-level air defense system, but the best one the Israeli Iron Dome system is probably politically off limits. The next best choice is the Russian Pantsir S1M, a point defense anti-aircraft, anti-rocket anti-missile combined artillery and missile system.”

(6) *Oil supply*. “IEA members are required to have a 90-day stockpile of crude. Japan and South Korea are members, China and India are not. The latter two are estimated to have between 30 and 40-days of supply. The world is awash in potential supply, while the global slowdown had reduced demand, seen in OPEC and Russia’s agreement to reduce supplies.”

Credit: Loans Expand When Yield Curve Inverts! Last week’s backup in bond yields was partly attributable to abating recession fears on news of better-than-expected retail sales and higher-than-expected core CPI inflation both for August. The former continues to outpace the increase in the goods component of CPI inflation. So inflation-adjusted core retail sales (excluding autos, gasoline, building materials, and food services) rose at a solid 7.5% (saar) over the three months through August ([Fig. 1](#)). Consumers are in great shape and continue to drive the economic expansion.

What about the widely held notion that the slight inversion of the yield curve during the late summer might depress bank lending and push the economy into a recession? As Melissa and I explained in our 4/7 study “[The Yield Curve: What Is It Really Predicting?](#),” inverted yield curves don’t cause recessions. Rather, they predict that if monetary policy remains tight or continues to tighten, a financial crisis is likely to happen. That event tends to morph into an economywide credit crunch and a recession. Financial crises cause credit crunches, not inverted yield curves.

We can see this by tracking the relationship of the yield-curve spread between the federal funds rate and the 10-year US Treasury bond (which is a component of the Index of Leading Indicators) and the growth rate of commercial and industrial (C&I) bank loans ([Fig. 2](#)). It shows that these bank loans tend to grow when the yield curve is flattening and inverting. When the yield-curve spread is widening, bank loans tend to be falling. That’s exactly the opposite of the popular notion that inverted yield curves are associated with declining bank lending!

Recent developments bear this out. The yield-curve spread turned slightly negative in late June. Meanwhile, C&I bank loans are up 6.2% y/y through 9/4.

In our study, we wrote: “The widely held notion that a flat or an inverted yield curve causes banks to stop lending doesn’t make much sense. The net interest margin, which is reported quarterly by the Federal Deposit Insurance Corporation (FDIC), has been solidly positive for banks since the start of the data in 1984” ([Fig. 3](#)). The net interest income of FDIC-insured institutions rose to a record \$140.2 billion during Q4-2018 and remained near that figure, at \$139.0 billion, during Q2-2019 ([Fig. 4](#)).

US Inflation: More or Less? Debbie, Melissa, and I are spending more of our research efforts on inflation these days. In recent years, we’ve stuck our necks out by declaring that inflation is dead, or at least in a coma. So we are scrutinizing any signs of life on the inflation front.

August’s core CPI data showed the index rose 2.4% y/y and 3.4% (saar) over the past three months. As we noted yesterday, while we are not alarmed, we are on alert. In the 9/11 [Morning Briefing](#), we

reviewed alternative measures of CPI inflation, which are mostly showing more of it. Yesterday, we sliced and diced the CPI and compared it to the PCED, which is the Fed's preferred measure of headline and core inflation. The latter remained subdued at 1.4% y/y and 1.6%, respectively, during July. August data for the PCED will be out on 9/27 in the personal income press release.

Today, let's examine more measures of inflationary pressures:

(1) *Rent in CPI, again.* First, let's have another look at the exaggerated impact that rent has on the CPI. A few of our readers were surprised by the following observation in our commentary yesterday on this subject: "Rent of shelter accounts for 33% of the CPI and only 16% of the PCED, with comparable weight discrepancies for tenant rent (8% vs 4%) and owner-occupied rent (24% vs 12%). Since rent has been rising relatively faster than most other components of inflation, its bigger weight in the CPI gives the CPI another upward bias compared to the PCED."

The bias is even worse for the core CPI. Debbie reports that rent of shelter accounts for 42% of the core CPI and only 18% of the core PCED, with comparable weight discrepancies for tenant rent (10% vs 5%) and owner-occupied rent (30% vs 13%).

Rent of shelter in the CPI rose 3.4% y/y during August. It has consistently exceeded 3.0% since July 2015 ([Fig. 5](#)). So rent inflation biases the CPI inflation rate higher relative to the PCED measure. We suspect it is doing so for the alternative CPI measures as well.

(2) *CPI and PPI.* Goods inflation remained subdued during August, with the CPI up just 0.2% y/y and PPI (final demand for goods) down 0.1% y/y ([Fig. 6](#)). Services inflation was higher for both, with the CPI and PPI (final demand for services) up 2.7% y/y ([Fig. 7](#)).

(3) *PPI and import prices.* Notwithstanding the US-China trade war's result of higher tariffs on US goods imported from China, import-price inflation remains subdued, which is keeping a lid on PPI goods inflation. During August, import prices fell 2.0% y/y ([Fig. 8](#)). Excluding petroleum, they were down by 1.0%, the eighth consecutive decline on this basis.

During August, import prices from China fell 1.6% y/y ([Fig. 9](#)). That might seem surprising given that tariffs have been increased on some of those goods. However, keep in mind that China's PPI inflation rate has been falling from a recent peak of 7.8% during February 2017 to -0.8% during August.

(4) *Surveys of pricing.* The prices-paid index in the US M-PMI survey has tumbled from a recent peak of 79.5 during May 2018 to 46.0 during August ([Fig. 10](#)). It has been below 50.0 for three consecutive months. The similar index in the NM-PMI survey has been hovering around 57.0 since the start of this year, after hovering around 62.0 most of last year.

Significantly, the percentage of small business owners planning to raise their average selling prices dropped from a recent peak of 29% last November to 17% during August, according to the latest survey conducted by the National Federation of Independent Business ([Fig. 11](#)).

Debbie and I average the survey results of the five Federal Reserve banks that conduct these surveys monthly. The average prices-paid index, which tends to track the comparable M-PMI index, fell from a recent peak of 47.7 during July 2018 to 14.1 during August, the lowest since October 2016 ([Fig. 12](#)). The average prices-received index for the five districts surveyed by the Fed banks fell from a recent peak of 25.4 to 5.7 during August.

(5) *Truck transportation.* Last year, there was some angst concerning a shortage of truck drivers

pushing up labor costs and prices in the trucking industry, which would push up retail prices. Wage inflation remains relatively high in the industry, at 5.6% y/y through July ([Fig. 13](#)). But the PPI for truck transportation of freight was up only 1.2% y/y during August, down from a recent peak of 8.2% ([Fig. 14](#)).

(6) *Bottom line on inflation.* We continue to believe that powerful forces of deflation (a.k.a. the 4Ds—détente, disruption, demographics, and debt) are keeping a tight lid on inflation, frustrating the efforts of the major central banks to push it higher with their ultra-easy, unconventional monetary policies.

CALENDARS

US. Tues: Headline & Manufacturing Industrial Production 0.2%/0.1%, Capacity Utilization 77.6%, NAHB Housing Market Index 66, Treasury International Capital Flows FOMC Meeting. **Wed:** Housing Starts & Building Permits 1.250mu/1.336mu, MBA Mortgage Applications, FOMC Rate Decision 1.75%-2.00%, FOMC Economic Projections, Powell. (DailyFX estimates)

Global. Tues: Germany ZEW Economic Sentiment, Japan Trade Balance – ¥147.9b, RBA Minutes of September Meeting, Coeure. **Wed:** Eurozone Headline & Core CPI Final 1.0%/0.9% y/y, Eurozone Trade Balance, UK Headline & Core CPI 1.9%/1.7% y/y, Canada CPI 0.2% m/m/1.7% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): LargeCap's forward earnings rose for a sixth straight week, but the SMidCaps' were down for a third week. LargeCap and MidCap remain in the forward-earnings uptrends that began during March. SmallCap's forward earnings was at a 15-month low primarily because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. LargeCap's forward earnings has risen during 26 of the past 31 weeks, MidCap's 16 of the past 27 weeks, and SmallCap's 14 of the past 25 weeks. LargeCap's has been at record highs since early June, while MidCap's and SmallCap's are 2.1% and 10.7% 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 was steady w/w at a 34-month low of 2.0% y/y. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change fell to a 45-month low of -1.0% from -0.3%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -8.9% y/y change is down from -8.5% 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%, 1.5%, 11.2%), MidCap (22.7, -3.1, 14.4), and SmallCap (22.4, -16.5, 38.1).

S&P 500/400/600 Valuation ([link](#)): Valuations recovered for a third straight week from three-month lows for these three S&P market-cap indexes. LargeCap's forward P/E rose 0.1pt w/w to 16.9 and is down 0.3pt 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 0.5pt to a five-month high of 16.1. That's 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 0.8pt w/w to a 12-month high of 17.8, primarily due to substantially lower forward earnings for Frontier Communications. That's 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 above back above LargeCap's P/E for a second week after being below for 16 weeks—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With a few weeks 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 5 cents w/w to \$41.43. That represents an earnings decline of 2.9% y/y compared to the prior week's forecasted earnings drop of 2.8%. The consensus' \$41.48 estimate is down 3.7% in the 11 weeks since the start of the quarter, which compares to a 2.1% drop for Q2 over the similar 11 weeks. While the consensus Q3 EPS estimate is below our forecast of \$43.00 and is now 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 2.2% 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 beating the S&P 500 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. On an ex-Energy basis, the consensus expects earnings to fall 0.4% y/y in Q3. 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 (4.2% in Q3-2019 versus 10.0% in Q2-2019), Real Estate (3.4, 3.1), Health Care (2.4, 10.4), Utilities (1.8, 1.1), Industrials (1.6, -9.1), Consumer Discretionary (0.6, 2.6), Consumer Staples (-0.7, 1.7), Communication Services (-0.6, 17.8), Information Technology (-7.6, -2.2), Materials (-9.0, -12.7), and Energy (-28.7, -9.0).

US ECONOMIC INDICATORS

Regional M-PMI ([link](#)): The New York Fed—the first district to report on manufacturing activity for September—showed limited growth, while the six-month outlook deteriorated noticeably. The composite index eased from 4.8 to 2.0 this month, averaging 3.7 during Q2; it had plunged a record 26.4 points in June to -8.6—which was the lowest reading since October 2016. New orders (to 3.5 from 6.7) expanded at roughly half the pace of August, though any level of expansion beats the order contractions seen in June and July. Shipments (5.8 from 9.3) are still growing—though at the slowest pace since October 2016. The measure for unfilled orders (-2.6 from -9.7) was in negative territory for the fourth consecutive month. There's encouraging news on the employment front, with gauges for both employment (9.7 from -1.6) and hours worked (1.7 from -1.3) swinging from negative to positive this month. Meanwhile, delivery times (0.7 from 0.0) held fairly steady this month, while inventories (8.5 from 5.8) accumulated at the fastest pace this year. On the inflation front, both prices paid (29.4 from 23.2) and prices received (9.2 from 4.5) increased at a faster pace than August. The index for future business conditions (13.7 from 25.7) fell 12.0 points, back near April's 12.4 reading—which was the weakest since January 2016. The indexes for future new orders (21.9 from 31.7) and shipments (20.4 from 31.3) both eased, along with employment (12.1 from 21.1). The capital expenditures index plunged 18.6 points to 4.6 this month—a three-year low—while the technology spending index fell to 6.5, also a multi-year low.

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