# Yardeni Research

**MORNING BRIEFING**
**September 24, 2019**

## The Dissenters

*See the collection of the individual charts linked below.*

(1) Ugly data out of Germany. (2) What's wrong with Germany's economy? (3) German autos getting sideswiped. (4) Chinese EVs are coming. (5) Germans like budget surpluses. (6) Germany's green new deal likely to weigh on economy. (7) Despite global economic slowdown, S&P 500 revenues continue to grow. (8) Powell sees dissent as healthy counter to groupthink at the Fed. (9) Three dissenters. (10) Rosengren makes a persuasive case against easing. (11) Not so persuasive on financial instability. (12) Is co-working model bad for real estate?

**Global Economy I: Germany Still Sinking.** IHS Markit has released its flash estimates for September's Purchasing Managers' Indexes (PMIs) in the Eurozone along with those for France and Germany. The German data were downright ugly. There's no oomph or oompah in Germany. Instead, manufacturing has fallen into a recession and is dragging down the rest of the economy. Real GDP edged down 0.3% (saar) during Q2 and is up just 0.4% y/y (*Fig. 1*). Another q/q decline is likely during Q3.

In the Eurozone, Markit estimates that the Composite PMI (C-PMI) fell from 51.9 during August to 50.4 this month (*Fig. 2*). The drop was led by the Manufacturing PMI (M-PMI), which is down from a recent peak of 60.6 during December 2017 to 45.6 this month. However, the Nonmanufacturing (NM-PMI) also contributed to the month's decline, falling from 53.5 to 52.0. Germany stands out with an M-PMI that is now down to 41.4 compared to 50.3 in France (*Fig. 3*). Also weakening in Germany is the NM-PMI, which is down from this year's high of 55.8 during June to 52.5 in September (*Fig. 4*).

We've previously observed that there is something wrong with Germany's economy. Trump's trade wars may be part of the problem, but Germany—along with most of the rest of the world—has a serious homegrown problem: not enough babies and too many seniors. Babies tend to stimulate consumption as they grow older. It's hard to stimulate people who are already old to do much of anything.

That may explain the weakness in global auto sales in recent years (*Fig. 5*). Germany's manufacturing economy is particularly dependent on the auto industry. Let's have a closer look at Germany's economy:

(1) *Tougher emission standards.* In the Eurozone, regulators made things worse for the industry with new emission standards imposed a year ago. The new EU-wide test procedure was the authorities' reaction to VW's 2015 admission to widescale cheating on diesel vehicles, with suspicions since spreading to other manufacturers.

(2) *Losing cache.* Germany's high-performance and high-priced Bimmers and Benzes may not be as popular with Millennials around the world as they were with the Baby Boomers. Millennials tend to be minimalists. They are more concerned about fuel economy and are likely to favor electric vehicles once EVs become cheaper and have more range.

(3) *Competing with Chinese EVs.* A 9/20 Bloomberg article titled "China Is Winning the Race to Dominate Electric Cars" hits on several of the issues plaguing Germany's automakers. For starters: "The global auto market is not only not growing, but it is also shrinking. Sales peaked in 2017 at nearly 86 million on a trailing-12-months basis; right now in 2019, sales are closer to 76 million."

The future for the auto industry is electric vehicles, which are mostly made in China: "There is only one company in the top 10 by percent of electric passenger vehicle revenue that isn't Chinese: Japan's Mitsubishi Corp. Two Chinese automakers get more than 40% of revenue from electric vehicle sales; a third gets nearly a quarter of its revenue from EVs."

(4) *Fiscal stimulus coming?* In August, German Chancellor Angela Merkel said she sees no need for a stimulus package "so far" but added that "we will react according to the situation." She pointed to plans to remove the so-called solidarity tax, an added income tax aimed at covering costs associated with rebuilding the former East Germany, for most taxpayers.

(5) *Green new deal.* The problem is that the government plans to spend $60 billion through 2030 on green new deals, which are more likely to weigh on the economy than to stimulate it. According to the 9/20 *WSJ* article on this subject:

"The measures, including subsidies for green power generation, will be financed by revenues from higher taxes on polluting activities, such as air travel and car fuel, as well as a new carbon emission certificate trading scheme to be launched in 2021. The package won't affect Germany's balanced budget. Despite international pressure on Berlin to loosen the purse strings and revive a slowing economy, the country's budget surplus is projected to stand at over €40 billion in 2019."

The government will help to finance more than a million charging stations for EVs by 2030. Owners and buyers of EV cars will get government subsidies, which might further depress gasoline-powered auto sales.

**Global Economy II: S&P 500 Revenues Still Growing.** The weakness in global manufacturing activity is confirmed by the 17% drop in the CRB raw industrials spot price index since mid-2018 (*Fig. 6*). The price of copper, which is especially sensitive to global factory demand, actually peaked in 2011. It has been weakening since mid-2018 following a modest rebound during 2016-17 (*Fig. 7*).

Notwithstanding the litany of global economic woes, S&P 500 revenues per share continued to trend higher, into record territory, through Q2, rising 5.2% y/y (*Fig. 8*). Weekly forward revenues per share, which is a good coincident indicator of the quarterly series, has done the same through mid-September. And the same can be said for S&P 500 forward earnings, which is a good leading indicator of actual earnings. Earnings seem to be growing in line with revenues given that the forward profit margin has been flat at around 12.0% since the start of this year.

**Fed I: Better than Groupthink?** Dissension among FOMC voters isn't unusual from a historical perspective, but the last FOMC meeting—on 9/17-9/18—saw three dissenters, the first time there were that many since 2016, and opposing views among them, a first in recent memory. Boston Fed President Eric Rosengren and Kansas City Fed President Esther George opposed rate-cutting, as they did in July, while the third dissenter, St. Louis Fed President James Bullard, favored an even bigger rate cut.

One measure of success for a Fed chair is the ability to unite colleagues with differing opinions. This level of dissension represents a clear challenge for Powell. Nevertheless, the 9/18 *WSJ* observed that

"Powell has taken the variety of arguments in stride." Earlier this month in Zurich, he said that the current FOMC doesn't submit to "groupthink," and that he "wouldn't have it any other way." We would: The problem with too many opinions, in our view, is that lack of unanimity among officials can unsettle financial markets.

In any event, here's more on the dissenters' views:

(1) *Cut poses risks to financial stability.* In a 9/20 statement, Rosengren said: "The stance of monetary policy is accommodative." Additional stimulus "risks further inflating the prices of risky assets" and encourages too much leverage. "While risks clearly exist related to trade and geopolitical concerns, lowering rates to address uncertainty is not costless." He elaborated on these thoughts in a 12-page speech.

(2) *Cut not warranted based on incoming data*. George last explained her dissenting view with a brief follow-up statement on 8/2: "In my view, incoming economic data and the outlook for economic activity over the medium term warranted no change in the policy rate."

(3) *Cut should have been bigger to stimulate inflation*. Bullard is for "lowering the target range for the federal funds rate by 50 basis points" to ward off further declines in expected inflation and a slowing economy with downside risks. In his view, it is prudent "to cut the policy rate aggressively now and then later increase it should the downside risks not materialize."

**Fed II: Rosengren's Dissent.** Speaking on 9/20 at a conference on credit markets, Rosengren gave a 12-page speech titled "Assessing Economic Conditions and Risks to Financial Stability" addressing his concerns about cutting rates at this time—the main one being a "potential buildup" in the credit markets as a result of too-low interest rates. Here are the key points (see also his supporting figures):

(1) *Already accommodative*. Rosengren thinks that monetary policy is already accommodative enough. Two factors indicate so, in his mind. For one, the rate on unsecured overnight credit is near the rate of inflation, so the return on federal funds just about compensates for inflation. Secondly, the current federal funds rate, set at 1.75%-2.00%, is below the estimated longer-run rate of 2.50%.

(2) *Expansion continues*. Further, "[t]he data we have in hand suggest instead that the recovery would continue apace even with little monetary policy accommodation," he said. Rosengren cited the unemployment rate at 3.7% and the 12-month change in the core CPI, which stood at 2.4% in August, as well as the fact that the trimmed mean PCE and core PCE have been near the Fed's 2.0% target rate (see Rosengren's Figures 4 and 5).

The data do not indicate a forthcoming recession, Rosengren explained, showing charts of building permits (his Figure 6) and initial unemployment claims (his Figure 7). Non-manufacturing indicators of recession are not a concern, nor is any recession signal in the yield curve.

(3) *Unmaterialized risks.* Rosengren admitted that there are "elevated risks" to the outlook, especially the uncertainty surrounding the US-China trade dispute, that could cause a further slowdown in manufacturing growth and business investment. Nevertheless, real GDP grew by 2.0% in Q2, close to GDP's sustainable rate (see Rosengren's Figure 1).

Rationalizing his views on trade, he said: "Most of the U.S. trade dispute is currently with one country. And while the trade dispute has the potential for painful impacts on some industries in the U.S., in total the estimated direct impacts for the U.S. macroeconomy to date are not particularly large—perhaps several 10ths of a percentage point on GDP (in part because exports are only 12 percent of U.S. GDP and tariffs are not on all goods from all countries).”

(4) *Financial stability cost*. The costs outweigh the benefits of lowering rates further, the Boston Fed president believes. Too much stimulus “entails costs, and thus introduces risks of its own,” he said, adding that very low rates may cause households and firms to take on “excessive risks” in the form of increased leverage and asset inflation that becomes unsustainable.

This might not cause, but could “amplify,” a downturn, should one occur, in his view. Rosengren is worried about commercial real estate leverage, especially the fast-growing market for shared office spaces (see his Figures 9 and 10). Highly leveraged loans’ rising debt-to-EBITDA levels don’t sit well with him either (see his Figure 8).

**Fed III: Financial Instability?** We agree with Rosengren that monetary policy is accommodative enough to sustain the expansion and that cutting rates further is not necessary right now. However, we don’t see financial stability risk as a pressing reason.

We had a look at the Fed’s flow-of-funds data through Q2, released last week, and its May 2019 *Financial Stability Report* (*FSR*). Both suggest that household debt isn’t a problem given its size relative to GDP. The buildup of corporate debt relative to GDP is of greater concern. Consider the following:

(1) *Debt to GDP*. The debt of the nonfinancial domestic sectors including households and nonfinancial corporations (NFCs) as a ratio of nominal GDP has been stable at about 1.5 from early 2013 through Q2-2019, well below the nearly 1.8 it reached at the height of the financial crisis.

(2) *Leveraged loans*. Rosengren mentioned specific concern about leveraged loans, but he didn’t put them into a macro perspective. According to the Fed’s most recent *FSR*, NFC credit ($9.8 trillion) is composed of bonds and commercial paper ($6.2 trillion), bank lending ($1.5 trillion), and leveraged loans ($1.1 trillion). Per the report, leveraged loan growth for 2018 was the highest of all categories, but it remains the smallest share of total NFC credit.

Additionally, these days most leveraged loans are structured in a much simpler, more transparent, “plain-vanilla” way than was typical before the crisis, as we have mentioned before. It is also notable that the big banks are significantly better capitalized than before the crisis, the *FSR* pointed out.

(3) *CRE and co-working*. Rosengren detailed the model for co-working spaces in his figure 10. Without getting into the details, we understand his concern that this growing trend could bode ill for the commercial real estate (CRE) market in the event of an economic downturn. However, the effects should be isolated to that market, in our opinion.

For a sense of scale, CRE loans ($2.4 trillion) were about a quarter the size of the mortgage market ($10.3 trillion) as of the latest *FSR*. How much CRE debt is related to co-working is unknown, but co-working is a rapidly growing subset of the CRE market. By 2028, flexible workspaces are expected to account for about 10% of Class A (i.e., newest and highest-quality) buildings, according to a July 2019 Allwork Space post. And co-working spaces made up about 18.0% of new leasing activity in Manhattan during 2018.

## CALENDARS

**US. Tues:** Consumer Confidence 133.0, S&P Case-Shiller Home Price Index 2.2% y/y, Richmond Fed Manufacturing Index 1. **Wed:** New Home Sales 660k, MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

**Global.** **Tues:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 94.5/97.0/92.0, BOJ Minutes of July Meeting, Lowe, Guindos, Kuroda. **Wed:** Eurozone Consumer Confidence 102, Coeure, Lautenschlaeger. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** (*link*): LargeCap's forward earnings rose for a seventh straight week as the SMidCaps' moved higher for the first time in four weeks. LargeCap and MidCap remain in the forward-earnings uptrends that began during March. SmallCap's forward earnings is near a 15-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. LargeCap's forward earnings has risen during 27 of the past 32 weeks, MidCap's 17 of the past 28 weeks, and SmallCap's 15 of the past 26 weeks. LargeCap's has been at record highs since early June, while MidCap's and SmallCap's are 2.0% and 10.6% 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 down to a 34-month low of 1.9% y/y from 2.0%. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's y/y change was steady w/w at a 45-month low of -1.0%, which compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -9.6% y/y change is down from -8.9% 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, -3.2, 14.2), and SmallCap (22.4, -17.0, 38.2).

**S&P 500/400/600 Valuation** (*link*): Valuations fell for the first time in four weeks for these three S&P market-cap indexes, but remain above their three-month lows from late August. LargeCap's forward P/E dropped 0.1pt 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 eased 0.2pt to 15.9 from a five-month high of 16.1 a week earlier. 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 fell 0.3pt w/w to 17.5 from a 12-month high of 17.8. 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 third week primarily due to substantially lower forward earnings for Frontier Communications. It had been below for 16 weeks—the first time that has happened since 2003.

**S&P 500 Sectors Quarterly Earnings Outlook** (*link*): With just a week left before the Q3 books are closed, analysts have taken a paring knife instead of a hatchet to their forecasts for the quarter. The S&P 500's Q3-2019 EPS forecast dropped 4 cents w/w to $41.39. That represents an earnings decline of 3.0% y/y compared to the prior week's forecasted earnings drop of 2.9%. The consensus' $41.39 estimate is down 3.7% in the 12 weeks since the start of the quarter, which compares to a 2.1% drop for Q2 over the similar 12 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 expected 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 (2.3, 1.1), Industrials (1.3, -9.1), Consumer Discretionary (0.6, 2.6), Consumer Staples (-0.7, 1.7), Communication Services (-0.5, 17.8), Information Technology (-7.6, -2.2), Materials (-9.5, -12.7), and Energy (-28.8, -9.0).

## GLOBAL ECONOMIC INDICATORS

**US PMI Flash Estimates** (*link*): Business activity accelerated slightly in September, according to flash estimates, after slowing to a 3.5-year low in August. September's C-PMI (to 51.0 from 50.7) climbed to a two-month high, as both the M-PMI (51.0 from 50.3) and NM-PMI (50.9 from 50.7) showed slight improvements this month, though growth remained subdued. Manufacturers reported that slightly stronger rates of output, new orders, and employment helped to push September's M-PMI somewhat higher—to a five-month high—though export orders continued to weaken as new work from abroad fell during four of the last five months. The NM-PMI for the service sector barely budged, inching up to a two-month high, still posting one of the lowest readings seen over the past 3.5 years. Inflows of new service-sector business almost stalled in September, registering the smallest rise since the survey began in 2009. Meanwhile, price pressures have eased, with both input costs and average selling prices for goods and services dropping again in September, "painting a picture of the weakest corporate inflationary pressures for a decade," according to the report.

**Eurozone PMI Flash Estimates** (*link*): The Eurozone's factory downturn deepened in September, pushing the overall economy closer to contraction, according to flash estimates. The C-PMI (to 50.4 from 51.9) fell closer to the breakeven point of 50.0—posting its poorest performance since June 2013. The M-PMI (45.6 from 47.0) contracted for the eighth straight month, sinking to an 83-month low, while the NM-PMI (52.0 from 53.5) dropped to an eight-month low, after trending higher through the first half of this year. Looking at the top two Eurozone economies, flash estimates show the C-PMI for Germany (49.1 from 51.7) posted its first reading below 50.0 since April 2013, as the M-PMI (41.4 from 43.5) contracted at its fastest pace since the depths of the global financial crisis in mid-2009, while the NM-PMI (52.5 from 54.8) showed the weakest service-sector growth this year. France's C-PMI (51.3 from 52.9) pointed to the softest expansion in private sector activity in four months, after accelerating fairly steadily since contracting during two of the first three months of this year. France's M-PMI (50.3 from 51.1) moved closer to contractionary territory, driven by a renewed deterioration in exports, while the NM-PMI (51.6 from 53.4) slipped to a four-month low. The report notes that the rest of the Eurozone also saw growth soften, posting its slowest pace since November 2013. Manufacturers suffered the steepest drop in output since May 2013, down for a fourth successive month, while service-sector activity growth eased to a four-month low.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823