



MORNING BRIEFING

October 23, 2019

A World of Lowflation

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

(1) Unconventional monetary policies are now conventional. (2) Mixed results, so far. (3) Worldwide reach for yield continues. (4) Powell's warning in 2013 more relevant than ever. (5) Greek bonds are good credits again. (6) Deflation has been persistent problem in Japan, while low inflation prevails in the Eurozone and the US. (7) Deflation in durable goods is widespread. (8) CPI services inflation rate higher in US than in Eurozone and Japan. (9) Rent inflation is higher and has a greater weight in US CPI than in Eurozone and Japan. (10) A brief global guide for CPI wonks.

Global Inflation I: Central Banks Agonistes. Like the Fed, the other major central banks responded to the Great Financial Crisis by adopting unconventional monetary policies that have become all too conventional. They've all flooded the global economy with lots of liquidity in efforts to avoid another financial crisis and to avert deflation. They've succeeded so far. They also deserve some credit for the significant improvements in their labor markets since the Great Recession.

However, inflation remains below their 2.0% targets notwithstanding all the liquidity that they provided. Moreover, their unconventional policies seem to be losing their effectiveness, which raises the question of whether they will have enough ammo left to fight the next recession.

Another concern is that their untested policies may have unintended adverse consequences, including undermining financial stability in unexpected ways. Their near-zero interest-rate policies (NZIRP), zero interest-rate policies (ZIRP), and negative interest-rate policies (NIRP) have resulted in a worldwide "reach for yield."

Then-Fed-Governor Jerome Powell warned about this problem in a 6/27/13 [speech](#) titled "Thoughts on Unconventional Monetary Policy": "Demand for higher-yielding fixed-income securities has outstripped new supply. The result has been very low rates, declining spreads, increasing leverage, and pressure on non-price terms such as covenants. These concerns have diminished somewhat as rates have risen since mid-May. Nonetheless, since it is likely that asset purchases will continue for some time, markets will need careful monitoring."

When Powell became chair of the Fed's Board of Governors early last year, he seemed determined to normalize monetary policy. But he changed his mind at the beginning of this year. So the Fed raised the federal funds rate four times during 2018, but lowered it two times so far during 2019 back down to 1.75%-2.00% ([Fig. 1](#)). More rate cuts are widely expected, as can be seen from Monday's federal funds futures contracts: nearby (1.63), 3-month (1.58), 6-month (1.45), and 12-month (1.34) ([Fig. 2](#)).

So the reach for yield continues. In the US, this is evident in the record forward P/E of the S&P 500 Utilities sector at 19.7 ([Fig. 3](#)). It can also be seen in the narrow yield spread between junk bonds and Treasury bonds ([Fig. 4](#)).

In Europe, the European Central Bank (ECB) first adopted NIRP on 6/5/14. Since then, it lowered the interest rate on its deposit facility for bank reserves five times, from zero to -0.50% most recently. As a result, government bond yields are close to zero in France (0.19%), Germany (-0.52), Italy (0.68), and Spain (0.31) ([Fig. 5](#)).

In early October, Greece sold 13-week bills at a yield of -0.02%. It also recently sold 10-year bonds at a yield of just 1.50%. In 2012, yields on similar bonds were closer to 24%.

Global Inflation II: Comparing CPIs. In addition to lowering their interest rates toward zero, the major central banks have purchased lots of bonds through quantitative easing programs. The central banks of the US, the Eurozone, Japan, and China collectively have expanded their combined balance sheet from \$5 trillion at the start of 2007 to over \$19 trillion currently ([Fig. 6](#)).

In my opinion, the central bankers are trying to fix problems that can't be fixed with ultra-easy monetary policies. They are trying to fight the four powerful forces of deflation: Détente, Disruption, Debt, and Demographics. I call them the deflationary "4Ds," and have examined them on several occasions in the past.

For now, let's review the latest CPI inflation rates in the Eurozone, Japan, and the US, and examine how they differ:

(1) *CPI headline and core inflation rates.* The latest stats show headline CPI inflation of 0.8% in the Eurozone, 0.2% in Japan, and 1.7% in the US ([Fig. 7](#)). The comparable core rates are 1.0%, 0.3%, and 2.4% ([Fig. 8](#)). Since 1996, Japan has experienced prolonged periods of core deflation (i.e., falling prices), while core CPI inflation has hovered around 1.5% in the Eurozone and 2.0% in the US.

(2) *CPI durable and nondurable goods inflation rates.* Since 1996, the durable goods CPI often has deflated, particularly in Japan, but also in the Eurozone ([Fig. 9](#)). On a y/y basis, it has fluctuated around zero in the US, with moderate bouts of deflation followed by equally moderate bouts of inflation.

The nondurable goods CPI inflation rates are currently closer together than usual in the Eurozone (0.2%), Japan (0.1), and US (-0.4) ([Fig. 10](#)). They all fluctuate quite a bit, though mostly around zero.

(3) *CPI services inflation rates.* The big difference among the three CPIs, since 1996, is that the services price inflation rate runs hotter in the US than in the Eurozone ([Fig. 11](#)). The comparable series for Japan fluctuates around zero. This is mostly because rent inflation runs hotter in the US (3.5% currently) than in the Eurozone (1.5) and Japan (0.0) ([Fig. 12](#)). It also has a much higher CPI weight in the US (33.1%) than in the Eurozone (6.5) and in Japan (17.8).

I asked Melissa to dig deeper into the statistical similarities and differences among the three CPIs. Her report follows.

Global Inflation III: Different Strokes for Different Folks. Inflation around the globe has been persistently low, bordering on too low, for over a decade now. In some countries (e.g., Europe and Japan), prices are rising at a slower pace than in others (e.g., the US). But are their respective central banks' preferred inflation measures comparable? Not entirely.

Let's have a closer look at these measures for the ECB, Bank of Japan (BOJ), and the Fed and how they differ (major differences are underlined):

(1) *ECB's HICP.* Price stability is the ECB's primary objective, as set by the Treaty on the Functioning

of the European Union. The Treaty does not define price stability, but the ECB adopted a formal definition in 1998. The ECB's price stability target is close to, but below, a 2.0% y/y increase in the Harmonised Index of Consumer Prices (HICP) for the euro area over the medium term.

Why a 2% goal rather than 0% or 1%? Three [reasons](#): "To account for the fact that inflation figures can be slightly overstated, to have a safety margin against the potential risks of deflation, and to leave room for differences in inflation across euro area countries."

The HICP [measures](#) the change over time in the prices of consumer goods and services acquired, used, or paid for by euro area households. To ensure that the data are comparable across the euro area, the term "harmonised" denotes that all EU member countries follow the same methodology. Eurostat [compiles](#) the HICP.

(2) *ECB's scope*. Within the scope of the HICP are most consumer goods and services purchased via monetary transactions. That includes purchases by all types of households (e.g., those headed by foreigners) in all EU geographic areas. One major exclusion is expenditure on housing by homeowners. That's not because the ECB thinks housing shouldn't be included but rather because the statistics needed for doing so consistently across all EU countries aren't available. Also excluded: price changes for state-funded purchases (e.g., state-funded education).

(3) *ECB's methodology*. The HICP is a Laspeyres-type price index as opposed to a cost-of-living index. The former defines a basket of goods and services in the base period that is priced in each subsequent period; the goods and services are weighted according to their share in overall consumption in the base period. The latter "measures the change in expenditure necessary to maintain the utility of the base period."

The HICP is not based on a fixed basket, as it measures the "development of prices over time for fixed 'consumption segments'—sets of consumer expenditures that serve a common purpose." However, specific items may enter and exit a basket over time as they become relevant or irrelevant.

The HICP aims to measure "pure" price changes over time. To that end, prices are adjusted for changes in specifications or quality.

(4) *ECB's weights*. The HICP weighs product groups by survey-based measures of "the share of each group in the total expenditure of all households for the goods and services covered by the index." Most countries update these weights annually, though law requires they do so only every seven years.

For the entire euro area, the HICP is calculated as an average of the national HICPs for each country "weighted by the countries' relative household consumption expenditure shares in the euro area total."

(5) *BOJ's CPI ex food*. The BOJ [set](#) its price stability target at 2% y/y for the CPI in January 2013. The CPI is affected by short-term factors, while the bank is primarily interested in the underlying trend of inflation. Therefore, the BOJ's preferred measure of inflation is the CPI for all items less fresh food. A CPI for all items less fresh food and energy is also released but isn't the favored measure because Japan's energy prices don't fluctuate significantly, as the bank pointed out in a [2013 Background Note](#). Both measures are released by the Statistics Bureau of the Ministry of Internal Affairs and Communications. The bank excludes the direct effects of changes in the consumption tax rate on prices when it makes sense to do so.

(6) *BOJ's methodology & weights*. Japan's CPI is compiled based on the fixed-weight Laspeyres formula described above, but with the consumption basket of goods and services in the base year fixed

for five years. To calculate the CPI, goods and services that are important components of household spending are chosen and weighted based on their rates of consumption. The shares are survey based. At every five-year revision interval, the weights are recalculated.

The BOJ acknowledges that Japan's CPI has both upward and downward biases. It's biased upward because the weights of cheaper goods and services in the whole consumption basket are not reflected on a real-time basis. It's biased downward for two reasons: survey respondents are mainly large-scale stores and housing rents aren't quality adjusted over time (e.g., to account for units deteriorating with age). "The weight of housing rents in the CPI (all items excluding fresh food) is small (i.e., 2.8 percent), but this applies to imputed rents as well, whose weight is 16.2 percent," according to the 2013 note.

(7) *BOJ's micro notes.* In its note, the BOJ explains a couple of important micro fluctuations in prices that impact the overall measure.

For one, the decline in durable goods prices is particularly pronounced in Japan. Since the same durable goods products are sold in Japan and the US, "the difference in the declining pace of durable goods between the two countries is likely due to different statistical compilation methods (i.e., sampling method of survey items and quality adjustment method) and the difference in the competitive environment in the retail sectors."

For two, there is a significant gap in the rates of increase in services prices between Japan and the US because Japanese firms tend to adjust wages rather than lay off employees when faced with a decline in demand.

(8) *BOJ's imputed rent.* Unlike the ECB but similar to the US CPI, Japan's CPI accounts for a proxy of owner-occupied household living expenses. While "buying a house or a piece of land is a form of property acquisition and not consumption expenditure," the Statistics Bureau [reasons](#), "a household living in a house it owns receives some service from the house." Imputed rent of an owner-occupied house "refers to the rent paid to owner-occupied houses assuming that owned houses were rented," as a proxy for the benefit the household receives from living in an owner-occupied house. These "rents" are included in the CPI calculation.

(9) *Fed's PCE vs CPI.* In the US, there are two primary measures of inflation: the Personal Consumption Expenditures Deflator (PCED) produced by the Bureau of Economic Analysis and the CPI released by the Bureau of Labor Statistics. In 2012, the Fed set an inflation target of 2.0% as measured by the annual change in the PCED. The CPI and the PCED are similar but not exactly the same. The CPI tends to run higher than the PCE. The Fed's 2.0% goal is primarily based on the headline PCED as opposed to the alternative core measure (excluding food and energy).

"Both indexes calculate the price level by pricing a basket of goods. If the price of the basket goes up, the price index goes up. But the baskets aren't the same, and it turns out that the biggest differences between the CPI and PCE arise from the differences in their baskets," according to a 2014 [note](#) from the Cleveland Fed. The CPI is based on surveys of what households are buying; the PCE is based on surveys of what businesses are selling.

Another major difference is that the CPI covers only out-of-pocket expenditures on goods and services purchased and excludes other expenditures that are not paid for directly (not unlike the ECB's exclusion for state-funded purchases)—for example, medical care paid for by employer-provided insurance, Medicare, and Medicaid. These are, however, included in the PCED.

Last, the PCED aims to account for substitution of goods when one becomes more expensive, while the CPI uses the same basket as before.

CALENDARS

US. Wed: Home Price Index 0.4%, MBA Mortgage Applications, DOE Crude Oil Inventories. **Thurs:** Durable Goods Orders Total & Ex Transportation -0.7%/-0.2%, Core Capital Goods Orders & Shipments 0.0%/-0.2%, Jobless Claims 215k, New Home Sales 703k, IHS Markit M-PMI & NM-PMI 50.7/51.0, Kansas City Fed Manufacturing Index -4, EIA Natural Gas Storage. (DailyFX estimates)

Global. Wed: Eurozone Consumer Confidence -6.7, Japan PMI Flash Estimates, Australia PMI Flash Estimates. **Thurs:** Eurozone, Germany, and France C-PMI Flash Estimates 50.4/48.9/50.9, Eurozone, Germany, and France M-PMI Flash Estimates 46.0/42.0/50.0, Eurozone, Germany, and France NM-PMI Flash Estimates 51.9/52.0/51.5, ECB Rate Decision 0.00%, ECB Deposit & Marginal Lending Facility Rates -0.50%/0.25%, Draghi. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues and earnings dropped for a second week from their record highs. Analysts expect forward revenues growth of 5.2% and forward earnings growth of 8.8%, down from 5.2% and 9.1% a week earlier. Forward revenues growth is down 1.1ppt from a seven-year high of 6.3% in February 2018 and is closing in on its 31-month low of 5.0% in mid-February. Forward earnings growth is down 8.1ppts from a six-year high of 16.9% in February 2018 but has improved from a 34-month low of 5.9% in February 2019. 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 3.9% in 2019 and 5.3% in 2020. They're calling for earnings growth to slow sharply from 23.9% in 2018 to 1.4% in 2019 before improving to 9.8% in 2020. The forward profit margin was steady w/w at a five-month low of 12.0% and is down 0.4ppt from a record high of 12.4% in September 2018. 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 11.9% in 2018 to 11.6% in 2019 before improving to 12.1% in 2020. The S&P 500's forward P/E rose 0.5pt w/w to 17.1, which 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. The S&P 500 price-to-sales ratio gained 0.05pt w/w to 2.05, which 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 and earnings rose w/w for two of the 11 S&P 500 sectors. Health Care had both measures rise w/w. 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 remain near record or cyclical highs for Communication Services, Consumer Discretionary, Information Technology, Real Estate, and Utilities. Health Care is near a cyclical low while the remaining sectors are 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. Industrials and Utilities are the only sectors still at record highs. Here's how the sectors rank based on

their current forward profit margin forecasts versus their highs during 2018: Information Technology (21.5%, down from 23.0%), Financials (18.2, down from 19.2), Real Estate (15.8, down from 17.0), Communication Services (15.0, down from 15.4), Utilities (13.1, record high), S&P 500 (12.0, down from 12.4), Health Care (10.6, down from 11.2), Industrials (10.4, record high), Materials (10.2, down from 11.6), Consumer Discretionary (7.6, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (6.4, down from 8.0).

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI weakened for a fifth straight month in October and was negative for the tenth time in 12 months as several sectors fell to cyclical lows. NERI edged down to an eight-month low of -6.4% in October from -6.0% in September, which compares to February's 34-month low of -7.9% and a record high of 22.1% in March 2018. NERI improved m/m for five of the 11 sectors; that compares to six improving in September and just three improving in August and July. All 11 sectors had improved m/m in May, which was the first time that had happened since January 2018. NERI was positive in October for 3/11 sectors, unchanged since July and down from five in June. That compares to negative readings for all 11 sectors from February to April. Materials has the worst track record, with 13 months of negative NERI, followed by Industrials (12), Financials (11), and Utilities (11). Here are the sectors' October NERIs compared with their September readings: Health Care (10.4% in October, down from 12.5% in September [18-month high]), Real Estate (7.4, 9.4 [62-month high]), Communication Services (1.9 [12-month high], 1.0), Utilities (-2.5, -4.6), Consumer Staples (-3.3, -0.9), Tech (-4.1, -3.5), Consumer Discretionary (-6.3, -6.8), Materials (-10.0, -10.8), Industrials (-13.4 [35-month low], -10.3), Financials (-13.7, -16.6 [41-month low]), and Energy (-27.0 [42-month low], -26.5).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With nearly 20% of the S&P 500 companies finished reporting revenues and earnings for Q3-2019, revenues and earnings are beating the consensus forecasts by 1.1% and 4.3%, respectively. At the same point during the previous earnings season for Q2, revenues had beaten forecasts by a smaller 0.9%, but earnings exceeded estimates by a wider 5.6%. A slightly higher percentage of companies are recording a positive earnings surprise—82% in Q3 versus 79% in Q2. However, a lower percentage of companies are showing a positive revenue surprise—63% versus 65%. Of the 98 companies in the S&P 500 that have reported through mid-day Tuesday, they have recorded a y/y earnings gain of 1.7%, dragged down by Micron Technology's earnings deceleration. On the revenue side, results are 5.6% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps 3.5ppts to 5.2% and revenue growth improves 0.6ppt to 6.2%. Overall, Q3 earnings growth results are positive y/y for 71% of companies versus a similar 71% at the same point in Q2, and revenues have risen y/y for 81% compared to a much lower 71% in Q2. These figures will continue to change markedly as more Q3-2019 results are reported in the coming weeks, but the early results indicate that y/y earnings growth could be positive after all. However, what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors' main focus.

US ECONOMIC INDICATORS

Existing Home Sales ([link](#)): "We must continue to beat the drum for more inventory," said Lawrence Yun, NAR's chief economist, "Home prices are rising too rapidly because of the housing shortage, and this lack of inventory is preventing home sales growth potential." Yun has been calling for additional home construction for over a year now. Existing home sales—tabulated when a purchase closes—fell 2.2% in September, to 5.38mu (saar) after advancing 4.0% during the two months through August to a 17-month high of 5.50mu. All four regions posted declines last month, though three of the four were above year-ago levels. Here's a tally: West (-0.9% m/m & 5.6% y/y), South (-2.1 & 6.0), Northeast -2.8 & 1.5), and the Midwest (-3.1 & 0.0). Single-family sales dipped 2.6% last month to 4.78mu (saar) after a two-month surge of 4.2%; these sales were up 3.9% y/y—the best yearly rate since March 2017.

Multi-family sales rose 3.4% during the two months ending September, to 600,000 units (saar); they're up 3.4% y/y—the first positive reading since April 2018, and the best since January 2017. The number of single-family homes available for sale at the end of September was 1.61mu—the same as in August—but 3.0% below the 1.66mu available a year ago. The months' supply of these homes was at 4.0, down from 4.3 months a year ago.

Regional M-PMIs ([link](#)): The three Fed districts that have reported on manufacturing activity for October so far—Philadelphia, New York, and Richmond—show overall activity remained subdued, though orders and employment picked up. The composite (to 5.9 from 1.7) index accelerated slightly, though was considerably below the 18.9 reading a year ago. Richmond's composite (8.0 from -9.0) index showed activity in its area moved from contraction to expansion, growing at its best pace in six months. Meanwhile, Philadelphia's composite (5.6 from 12.0) showed growth expanded at half September's pace, while New York's (4.0 from 2.0) grew at double September's pace—though was still at a near a standstill. New orders (12.2 from 4.8) growth accelerated at the best rate since last November, as the Philadelphia (26.2 from 24.8) region recorded its strongest gain in billings since May 2018, while Richmond's (7.0 from -14.0) orders are expanding again; New York's index was unchanged at 3.5. Employment (17.8 from 9.5) expanded at its best pace since July 2018, with Philadelphia (32.9 from 15.8) factories hiring at a record pace, while New York (7.6 from 9.7) and Richmond (13.0 from 3.0) manufacturers are hiring again after cutting payrolls in prior months.

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