



MORNING BRIEFING

November 13, 2019

Zombies in the Fed's Soup

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

(1) How to watch the Fed. (2) Suffering from group-think. (3) Doubling down on faulty models. (4) An embarrassing case in point: Undershooting the inflation target for 8 years. (5) A glut of demand-side macroeconomists. (6) Debt-financed demand for goods and services can be weighed down by too much debt. (7) Borrowing by zombie companies creates deflationary excess capacity. (8) Borrowing binges, now and then. (9) The Fed is feeding the zombies, postponing the IMF's zombie apocalypse. (10) More on comparative global valuation by sectors.

Central Banks: Demand-Side Obsession. I've been finishing up the writing of my next book, *Fed Watching for Fun and Profit: A Primer for Investors*. I've had a lot of fun writing it, and it has allowed me to see more clearly the Fed in particular and central bankers in general.

In my opinion, they all suffer from group-think.

They all use the same or similar models of the economy. Some are empirical models, but most are theoretical. The empirical ones create the illusion of a precise scientific analysis of how the economy works. The theoretical ones tend to be, well, too theoretical. Both can be quite misleading, especially if they are based on faulty assumptions and logic. Put simply, most of the models reflect thinking that bears little resemblance to reality and lacks plain old common sense.

When reality conflicts with what their models suggest to be the case, the central bankers—rather than questioning their models and learning from their mistakes—resolve the cognitive dissonance by doubling down on their commitment to their models. In other words, they do more of the same, expecting that the result will eventually coincide with their models' predictions.

A case in point is their determination to provide ultra-easy monetary policies to boost inflation to their target of 2.0%. The major central bankers have been trying to do so for over 10 years without success. They seem totally befuddled. Fed officials have recently been talking about their "symmetrical target" of 2.0%, implying that they are willing to let the economy run hot, with inflation exceeding 2.0% for a while, since it has been running below that pace for so long. That's an interesting idea, but they can't even get inflation up to 2.0%—why embarrass themselves further by shooting for an even higher target?

Outgoing European Central Bank (ECB) President Mario Draghi loaded up his bank's bazookas yet again as he was walking out the door. On 9/12, the ECB's Governing Council voted to lower the bank's deposit facility rate from -0.40% to -0.50% and to restart the asset purchase program at the pace of €20 billion per month with no set end date. The Bank of Japan never let up on its ultra-easy policies, but it did stop projecting when inflation might get up to 2.0%. The inflation rates in the US, Eurozone, and Japan are currently 1.7% (core US PCED), 0.7% (Eurozone CPI), and 0.3% (core Japan CPI) ([Fig. 1](#), [Fig. 2](#), and [Fig. 3](#)).

The major central banks all are run by PhD macroeconomists as well as people like Jerome Powell at the Fed and Christine Lagarde at the ECB who have been surrounded by macroeconomists their entire careers. Most of the macroeconomists working at the central banks were trained as demand-side Keynesians. They believe that easy money should stimulate demand, which should revive inflation. That's their core belief, in fact.

More specifically, easy money should boost consumer spending on durables and housing. It should stimulate capital spending by businesses. When the economy runs out of slack, that's when it will run hot enough to heat up inflation. The central bankers admit that there has been more slack than they expected, but once the economy runs out of workers, wage inflation will rise, pushing price inflation higher, especially once capacity utilization gets to be tight enough. The Phillips Curve and output-gap models are variations of this demand-side view of the world.

There are two major flaws in this model: It fails to recognize that there are limits to how much debt demand-side borrowers can carry to keep buying stuff. And it completely ignores the impact of easy money on supply-side borrowers. Consider the following:

(1) *Too much debt on the demand side.* In the past, when demand-side borrowers had plenty of capacity to take on more debt, easy money effectively stimulated demand. It seems to have lost its effectiveness because monetary policy has been easy for so long, resulting in high debt-to-income ratios. Even historically low interest rates, which reduce the cost of servicing debt, don't seem to be stimulating demand, which might explain why interest rates are historically low, of course.

(2) *Too many zombies on the supply side.* Meanwhile, supply-side borrowers, who produce the goods and services purchased by demand-side borrowers, can take advantage of easy money to refinance their debts at lower rates. Producers may also borrow more to keep their businesses going. The ones who are most likely to do so are the ones who would be out of business if they couldn't borrow money. In other words, they are zombie businesses, i.e., the living-dead companies that won't die because they are resuscitated by the cash infusions provided by their lenders. As long as they stay alive, they create deflationary pressures by producing more goods and services than the market needs.

And why are lenders willing to lend to the zombies? Instead of stimulating demand, historically low interest rates incite a reach-for-yield frenzy among lenders. They are willing to accept more credit risk for the higher returns offered by the zombies. Besides, if enough zombies fail, then surely the central banks will come up with some sort of rescue plan.

(3) *Debt binges, now and then.* It's interesting to compare the borrowing binge in home mortgages that led to the Great Financial Crisis and the current borrowing binge in nonfinancial corporate (NFC) debt, including bonds and loans. At the start of 1990, the amount outstanding of both equaled around \$2.4 trillion each ([Fig. 4](#)). Home mortgages then soared by 378%, or \$9.0 trillion, to a record \$11.3 trillion during H1-2008. Over the same period, NFC debt rose 162%, or \$4.0 trillion to \$6.4 trillion.

After peaking, home mortgages outstanding fell \$1.4 trillion through Q1-2015, and then increased by \$1.1 trillion to \$11.0 trillion by Q2-2019. That was still slightly below the record high. Over the same period, NFC debt rose 55%, or \$3.5 trillion, to a record \$10.0 trillion.

During Q2-2019, NFC corporate bonds outstanding rose to a record \$5.7 trillion ([Fig. 5](#)). NFC loans held by banks rose to a record \$1.1 trillion, while "other loans" (which are mostly leveraged loans) rose to a record \$1.8 trillion ([Fig. 6](#)).

(4) *Central banks fueling deflation by feeding zombies.* Our interpretation of the data is that excessively

easing credit conditions fueled the mortgage borrowing binge and housing boom that ended with the Great Financial Crisis. The strong debt-financed demand for homes stimulated economic activity and caused home prices to soar.

Since the Great Financial Crisis, the borrowing binge in NFC debt hasn't contributed much to economic growth, and consumer price inflation has remained subdued. Apparently, a significant percentage of NFC debt is attributable to zombie companies using most of the proceeds from their borrowing to stay in business. The Fed's May 2019 [Financial Stability Report](#) nailed it, as follows:

"[T]he distribution of ratings among nonfinancial investment-grade corporate bonds has deteriorated. The share of bonds rated at the lowest investment-grade level (for example, an S&P rating of triple-B) has reached near-record levels. As of the first quarter of 2019, a little more than 50 percent of investment-grade bonds outstanding were rated triple-B, amounting to about \$1.9 trillion."

The report also warned about leveraged loans as follows:

"The risks associated with leveraged loans have also intensified, as a greater proportion are to borrowers with lower credit ratings and already high levels of debt. In addition, loan agreements contain fewer financial maintenance covenants, which effectively reduce the incentive to monitor obligors and the ability to influence their behavior. The Moody's Loan Covenant Quality Indicator suggests that the overall strictness of loan covenants is near its weakest level since the index began in 2012, and the fraction of so-called cov-lite leveraged loans (leveraged loans with no financial maintenance covenants) has risen substantially since the crisis."

During his 10/30 [press conference](#), Fed Chair Jerome Powell was asked about financial stability. He responded: "Obviously, plenty of households are not in great shape financially, but in the aggregate, the household sector's in a very good place. That leaves businesses which is where the issue has been. Leverage among corporations and other forms of business, private businesses, is historically high. We've been monitoring it carefully and taking appropriate steps."

He didn't specify those steps. However, the Fed's three interest-rate cuts are likely to feed the zombies' appetite for more debt. In other words, the easy money provided by the Fed and the other central banks may be contributing to deflationary pressures attributable to supply-side borrowers. This would certainly explain why easy money has failed to boost inflation as expected by the proponents of demand-side models.

(5) *Is a zombie apocalypse inevitable?* If you want to read a very frightening script of how this horror movie plays out, see the October 2019 [Global Financial Stability Report](#) prepared by the International Monetary Fund. Melissa and I reviewed it in the 10/30 [Morning Briefing](#). Here is the punchline: "In a material economic slowdown scenario, half as severe as the global financial crisis, corporate debt-at-risk (debt owed by firms that cannot cover their interest expenses with their earnings) could rise to \$19 trillion—or nearly 40 percent of total corporate debt in major economies, and above post-crisis levels."

We concluded: "There's certainly lots to digest and think about in this unsettling report as the S&P 500 climbs to another record high. Apparently, investors expect that before doomsday arrives, even the Fed will lower interest rates close to zero again, allowing all the zombie borrowers to refinance their debts, thus postponing the zombie apocalypse."

The NFC data discussed above is less alarming when scaled by nominal GDP ([Fig. 7](#) and [Fig. 8](#)). Home mortgages outstanding peaked at a record 77% of GDP during Q1-2009. NFC debt rose to a record high of 47% of GDP during Q2-2019.

Strategy: More on Global Valuation by Sectors. Joe and I continue to do our homework on global forward P/E comparisons between the US and the rest of the world. Yesterday, we compared the 10 major MSCI sectors (excluding the Real Estate sector, which can be funky) in the US MSCI vs those in the All Country World ex-US MSCI. Joe expanded this work to compare the sectors in the US vs those in the MSCI indexes for the EMU, Japan, Emerging Markets, and China. (See our [Forward P/Es: US MSCI Sectors vs Rest of World](#).) Here are some of our findings, with numbers in parentheses showing first the latest US forward P/Es then the same for comparable forward P/Es abroad:

(1) *US vs EMU* ([Fig. 9](#)). Consumer Staples (19.8, 19.2) have been remarkably close since 2006. The same can be said about Health Care (15.5, 13.9), Industrials (17.4, 15.9), and Materials (17.3, 15.8). They all currently are cheaper in the EMU, with the exception of IT.

Surprisingly, IT (20.3, 21.0) tends to have a higher P/E in the EMU. Financials (12.3, 9.6) and Utilities (19.6, 14.7) tend to be cheaper in the EMU. The same goes for Consumer Discretionary (22.3, 13.4), but the spread is the widest ever thanks to Amazon's forward P/E of 67.0.

(2) *US vs Japan* ([Fig. 10](#)). Consumer Discretionary (22.3, 12.5) also tends to be much cheaper in Japan than in the US. IT (20.3, 18.0) valuations tend to be similar. Since the start of the current bull market, the following sectors have tended to be cheaper than in the US: Financials (12.3, 8.7), Industrials (17.4, 13.5), Materials (17.3, 12.6), and Utilities (19.6, 9.0). They are all relatively cheaper now in Japan than they have been since the start of the bull market.

The valuation outliers since 2006 are Consumer Staples (19.8, 21.1) and Health Care (15.5, 30.2).

(3) *US vs EMs* ([Fig. 11](#)). Consumer Staples (19.8, 21.9) and Health Care (15.5, 24.5) have been more expensive in EMs than in the US during the current bull market. The same can be said about Communication Services (18.5, 19.1) over the past three years. The other sectors have tended to be cheaper in the EMs, and increasingly so recently: Consumer Discretionary (22.3, 18.8), Energy (16.2, 8.4), Financials (12.3, 8.8), Industrials (17.4, 11.6), IT (20.3, 15.6), Materials (17.3, 9.1), and Utilities (19.6, 11.7).

CALENDARS

US. Wed: Headline & Core CPI 1.7%/2.4% y/y, MBA Mortgage Applications, Monthly Budget Statement -\$128.2b, Powell, Kashkari. **Thurs:** Jobless Claims, PPI Final Demand 0.3%/m/m/0.9%/y/y, DOE Crude Oil Inventories, EIA Natural Gas Report, Powell, Williams, Bullard, Clarida, Evans, Quarles, Kaplan. (DailyFX estimates)

Global. Wed: Eurozone Industrial Production -0.2%/m/m/-2.3%/y/y, Germany CPI 0.1%/m/m/1.1%/y/y, UK Headline & Core CPI 1.6%/1.7% y/y, China Industrial Production 5.4% y/y, China Retail Sales 7.8% y/y, Japan GDP 0.9%(saar), Australia Employment Change & Unemployment Rate 16k/5.2%. **Thurs:** Eurozone GDP 0.2%/q/q/1.2%/y/y, Eurozone Employment, Germany GDP -0.1%/q/q/0.4%/y/y, UK Retail Sales Including & Excluding Fuel 3.7%/34.% y/y, Japan Industrial Production, Mexico Overnight Rate 7.50%, Guindos, Knot, Poloz. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q3 Earnings Season Monitor ([link](#)): With the Q3-2019 earnings reporting season now nearly 91% complete, S&P 500 revenues and earnings are beating the consensus forecasts by 0.9% and 4.8%, respectively. At the same point during the previous earnings season for Q2, revenues and

earnings had beaten forecasts by a higher 1.3% and 6.1%, respectively. However, a higher percentage of companies has recorded a positive earnings surprise in Q3 than in Q2—75% versus 74%. A slightly higher percentage of companies showed a positive revenue surprise—58% versus 57%. The 453 companies in the S&P 500 that have reported through mid-day Tuesday collectively have recorded an earnings decline of 0.3% y/y, dragged down by Micron Technology's earnings deceleration. On the revenue side, results are 3.8% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps 1.0ppt to 0.7% and revenue growth improves 0.2ppt to 4.0%. Adjusting for the dismal y/y growth declines for the Energy sector, Q3's S&P 500 ex-Energy revenue growth improves 1.2ppts to 5.0% and earnings growth rises 2.7ppts to 2.4%. Overall, Q3 earnings growth results are positive y/y for 62% of companies versus a higher 66% at the same point in Q2, and revenues have risen y/y for 69% compared to a lower 67% in Q2. These figures will continue to change slightly as more Q3-2019 results are reported in the coming weeks. However, y/y earnings growth is likely to trail revenue growth for a third straight quarter, something that hasn't happened since the last Energy "recession" in H1-2016. Regardless, what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors' main focus.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): "A continued focus on a recession by policymakers, talking heads, and the media clearly caused some consternation among small businesses in previous months, but after shifting their focus to other topics, it's become clear that owners are not experiencing the predicted turmoil," said NFIB President and CEO Juanita D. Duggan. "Small business owners are continuing to create jobs, raise wages, and grow their businesses, thanks to tax cuts and deregulation, and nothing is stopping them except for finding qualified workers." The Small Business Optimism Index (SBOI) climbed to 102.4 in October (only 6.4 points below August 2018's record high of 108.8), after dipping from 104.7 in July to 101.8 in September. Last month, eight of the 10 SBOI components rose, led by plans to increase inventories (to 5% from 2%), capital spending (29 from 27), and employment (18 from 17). As for current job openings, 34% of business owners reported job openings they couldn't fill last month, while 25% said finding qualified workers remained their single biggest business problem. In the meantime, the NFIB Uncertainty Index fell 4 points last month to 78, and is down 9 points from its recent high of 87 in June of this year.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators ([link](#)): In September, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—anticipated below-trend growth momentum in the OECD area as a whole. September's OECD CLI held at a decade low of 99.1. Among the major OECD economies, stable growth momentum is still the assessment for both France (99.4) and Canada (98.9), and is now anticipated for Japan (99.3) and Italy (99.1)—with similar signs now emerging in the Eurozone (99.0) as a whole. Easing growth momentum remains the assessment for the US (98.8) and Germany (98.7), and now is the assessment for the UK (98.9). For the UK, it's a downgrade from August's stable growth momentum assessment—though the report notes that large margins of error persist due to continuing Brexit uncertainty. Among the major emerging economies, stable growth momentum is still the assessment for Brazil (102.1) and China's (99.1) industrial sector, and now also for Russia (99.4)—which was flagged as showing signs of easing growth momentum in August. Easing growth momentum remains the call for India (99.4).

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