



MORNING BRIEFING

November 20, 2019

Global Capital Flows & the Dollar

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

(1) The jury is out on Go Global vs Stay Home. (2) US came out of Great Financial Crisis better than most. (3) US financial system is strong. (4) US consumers are in very good shape. (5) High-tech capital spending booming. (6) Inverse correlation between the trade-weighted dollar (TWD) and commodity prices, which remain weak. (7) Our capital flows proxy is also inversely correlated with TWD. (8) Emerging markets tend to do best when Fed is easing. (9) Dollar remains key reserve currency. (10) Deflating Asian PPIs.

Global Economy I: Downshift for Dollar Drivers. In my discussions with our accounts in London last week, I was often asked about the outlook for the US dollar. Since the beginning of the current bull market, Joe and I promoted a Stay Home investment strategy rather than a Go Global one. We figured that the US stock market would outperform most of the other ones around the world and that the dollar would be strong.

So far so good, but in early October, we expected that the Fed would cut the federal funds rate for a third time this year, providing a lift to emerging market economies and weighing on the dollar. So far, the jury is out on whether Go Global is set to outperform Stay Home over the next 6-12 months as we expect.

After the Great Financial Crisis, we believed that the US economy and financial system would be restructured much faster and much better than overseas ones. The US banking system is certainly in much better shape now than most other ones around the world. The American capital markets are more fully developed than most others overseas. The private equity market continues to provide lots of financing for new ventures.

American consumers remain among the most dependable ones around the world. The inflation-adjusted wage of production and nonsupervisory workers has been increasing 1.0% per year on average since the mid-1990s ([Fig. 1](#)). Full-time employment is at a record high of 131.5 million ([Fig. 2](#)).

The US industrial base is much more diversified than most others. As we observed yesterday, the sum of the market caps of the S&P 500 Information Technology plus Communications Services sectors currently accounts for 33.1% of the total market cap of the S&P 500 ([Fig. 3](#)). The sum of the Consumer Discretionary, Consumer Staples, plus Health Care sectors' market caps accounts for 31.0% of the total market cap ([Fig. 4](#)). The aggregate market cap of Materials, Energy, and Industrials represents 16.5% of the S&P 500's total market cap ([Fig. 5](#)). Financials, Real Estate, and Utilities combined account for 19.4% of the S&P 500 total ([Fig. 6](#)).

The high-tech revolution continues to flourish in the US. Capital spending on information processing equipment, software, and R&D rose to yet another record high of \$1.34 trillion (saar) during Q3 in current dollars ([Fig. 7](#)). Together, these three categories account for 46.6% of capital spending, up from less than 20% in the early 1960s ([Fig. 8](#)).

In recent weeks, we've been discussing the attractiveness of Go Global on a valuation basis relative to Stay Home. Yesterday, we drilled down and compared the valuations and market-cap shares of the 11 sectors of various MSCI stock price indexes for selected countries and regions. Today, let's discuss the outlook for the dollar:

(1) *Commodity prices and the dollar.* Our basic model of the foreign-exchange value of the US trade-weighted dollar (TWD) is very simple. Debbie and I have observed that the dollar tends to be strong (weak) when the global economy is relatively weak (strong), as evidenced by weak (strong) commodity prices. Indeed, there is a very discernible inverse correlation between the TWD and the Goldman Sachs Commodity Index (GSCI) ([Fig. 9](#)).

There's no clear buy or sell signal for the dollar coming from the commodity pits currently since the GSCI has been moving mostly sideways this year. We are expecting the index to firm up in 2020 on better global economic growth. If that happens, then it would suggest dollar weakness ahead.

(2) *Capital flows and the dollar.* A less ambiguous sell signal for the dollar may be our World Capital Flows Proxy (WCFP), which is a monthly capital-flows series for the world excluding the US. On a 12-month basis, the US has been running widening trade deficits for many years ([Fig. 10](#)). The US trade deficit must equal the trade surplus of the rest of the world. So the 12-month change of non-gold international reserves held by all central banks (with the notable exception of the Fed, thanks to the dollar standard) minus the trade surplus of the rest of the world should be a proxy for capital inflows (outflows) to the rest of the world from (to) the US ([Fig. 11](#)). The WCFP starts in 1995.

The credibility of our proxy for international capital flows between the US and the rest of the world is confirmed by its high inverse correlation with the yearly percent change in the trade-weighted dollar ([Fig. 12](#)). This makes a great deal of sense. It suggests that the dollar is much more sensitive to capital flows than to trade. When the rest of the world is experiencing capital inflows, the dollar tends to be weak. When capital is pouring out of the rest of the world and into the US, the dollar tends to be strong.

The non-gold international reserves component of our proxy tends to be much more volatile than the trade component, reflecting the greater volatility of capital flows than of merchandise trade. Therefore, it isn't surprising to see that the inverse of the yearly percent change in the TWD is also highly correlated with both the 12-month absolute change and the 12-month percent change in non-gold international reserves ([Fig. 13](#) and [Fig. 14](#)).

The latest WCFP data showed capital outflows from the rest of the world to the US of \$608 billion during the 12 months through September. That's bearish, but the TWD was fractionally higher y/y through early November. Nongold international reserves were up slightly during September, by \$246 billion y/y, or 2.3%.

(3) *Emerging markets and the dollar.* Our bet is that the Fed's pivot from signaling three rate hikes this year to actually cutting rates three times will reverse capital flows away from the US back to the rest of the world, especially emerging economies. That reversal should put some downward pressure on the dollar. It's interesting to note that the Emerging Markets MSCI stock price index has held up remarkably well this year ([Fig. 15](#)).

(4) *The world's reserve currency.* Of course, the dollar's ace-in-the-hole is that it remains the world's #1 reserve currency. Data compiled by the International Monetary Fund show that nongold international reserves totaled \$12 trillion during September. Allocated reserves totaled \$11 trillion during Q2, with 62% in dollars ([Fig. 16](#)).

Global Economy II: Deflating PPIs. Debbie and I continue to search for signs of life in the global economy, but aren't finding much to get excited about. In the US, it's still early, but the Atlanta Fed's [GDPNow](#) is tracking at only 0.4% for Q4's real GDP. The Citigroup Economic Surprise Index (CESI) has been surprisingly weak recently, dropping from the year's high of 45.7 on 9/25 to -5.7 on Monday ([Fig. 17](#)). Then again, as Debbie reports below, October's housing starts and building permits were both very strong.

Over in Asia, we are paying more attention to PPI inflation rates because they are mostly deflating as follows: Singapore (-6.9% y/y, September), Taiwan (-6.2, October), Thailand (-2.5, October), Malaysia (-2.4, September), China (-1.6, October), South Korea (-0.8, September), and Indonesia (-0.8, September) ([Fig. 18](#)).

Deflating PPIs tend to signal weakness in profits. The forward earnings of the Emerging Markets Asia MSCI was falling from the spring of 2018 through the summer of 2019. In recent weeks, it has been firming, suggesting that the worst might be over. (See our [Global Index Briefing: Emerging Markets Asia MSCI](#).)

CALENDARS

US. Wed: MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Meeting Minutes (October 30). **Thurs:** Existing Home Sales 5.49mu, Philadelphia Fed Manufacturing Index 6.1, EIA Natural Gas Report, Kashkari, Mester. (DailyFX estimates)

Global. Wed: Canada CPI 0.3%/m/m/1.9%/y/y, ECB Publishes Financial Stability Review, Lane. **Thurs:** Eurozone Consumer Confidence -7.2, Japan CPI Headline, Core, and Core-Core 0.3%/0.4%/0.6% y/y, OECD Economic Outlook, ECB Account of October Policy Meeting, Guindos, Mersch, Poloz. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Sectors Net Earnings Revisions ([link](#)): The S&P 500's NERI weakened for a sixth straight month in November and was negative for the 11th time in 13 months as several sectors fell to cyclical lows. NERI tumbled to a 43-month low of -8.9% in November from -6.4% in October, which compares to the prior 34-month low of -7.9% in February and a record high of 22.1% in March 2018. NERI improved m/m for four of the 11 sectors; that compares to five improving in October, six 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 November for two sectors, down from three from July to October and five in June. That compares to negative readings for all 11 sectors from February to April. Materials has the worst track record, with 14 months of negative NERI, followed by Industrials (13), Financials (12), and Utilities (12). Here are the sectors' November NERIs compared with their October readings: Health Care (2.2% in November, down from 10.4% in October), Real Estate (1.7, 7.4), Utilities (-0.6 [10-month high], -2.5), Tech (-1.0, -4.1), Consumer Staples (-5.7, -3.3), Communication Services (-7.3 [18-month low], 1.9 [12-month high]), Consumer Discretionary (-10.4 [32-month low], -6.3), Financials (-11.5, -13.7), Materials (-15.6, -10.0), Industrials (-18.5 [46-month low], -13.4), and Energy (-26.9, -27.0 [42-month low]).

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues and earnings dropped last week for the fifth time in six weeks from their record highs. Analysts expect forward revenues growth of 5.1% and forward earnings growth of 8.8%, with the revenues measure up 0.1pt w/w and earnings measure down from 9.0% a week earlier. Forward revenues growth is down

1.2ppt 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 is still comfortably above its 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 5.2% in 2020. They're calling for earnings growth to slow sharply from 23.9% in 2018 to 1.2% in 2019 before improving to 9.1% 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 edge down 0.3ppt y/y from 11.9% in 2018 to 11.6% in 2019 before improving to 12.0% in 2020. The S&P 500's forward P/E rose 0.2pt w/w to a 22-month high of 17.7. That's up from 14.3 during December 2018, 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 a miniscule 0.01pt w/w to a 22-month high of 2.11. That's up from 1.75 during December 2018, 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 rose w/w for four of the 11 S&P 500 sectors last week, and forward earnings was higher for 2/11 sectors. Utilities saw 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 the sectors. Industrials and Utilities are the only sectors with margins 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 (21.7%, down from 23.0%), Financials (18.2, down from 19.2), Real Estate (15.8, down from 17.0), Communication Services (14.9, down from 15.4), Utilities (13.2, new record high this week), S&P 500 (12.0, down from 12.4), Health Care (10.6, down from 11.2), Industrials (10.4, record high), Materials (10.3, down from 11.6), Consumer Discretionary (7.4, down from 8.3), Consumer Staples (7.4, down from 7.7), and Energy (6.3, down from 8.0).

US ECONOMIC INDICATORS

Housing Starts & Building Permits ([link](#)): Housing starts rebounded in October, while building permits (an indicator of future housing demand) soared to its best reading since May 2007. Housing starts advanced 3.8% last month to 1.314mu (saar), as single-family starts rose for the fifth consecutive month—and the eighth time this year—while volatile multi-family starts rebounded after a sharp drop in September. Single-family starts rose an impressive 2.0% last month, and 15.0% during the five months through October, to 936,000 units (saar)—back near January's cyclical high of 966,000 units. Multi-family starts recovered 8.6% to 378,000 units (saar) last month, after a 25.3% drop in September and a 39.9% jump in August, climbing 9.2% y/y. Housing permits surged 5.0% last month, and 18.6% during the four months through October, to 1.46mu (saar)—with both single- and multi-family permits moving higher. Single-family permits advanced for the sixth straight month, by 3.2% in October and 15.6% over the period, to a new cyclical high of 909,000 units (saar). Multi-family permits increased for the third time in four months, by a whopping 35.0% over the period, to a 19-month high of 552,000 units (saar). Looking ahead, builder confidence held strong in November. The National Association of Home Builders Housing Market Index (HMI) for November shows homebuilders' confidence (to 70 from 71)

was little changed at October's 20-month high—up from 56 at the end of last year. “Single-family builders are currently reporting ongoing positive conditions, spurred in part by low mortgage rates and continued job growth,” said NAHB Chairman Greg Ugalde. “In a further sign of solid demand, this is the fourth consecutive month where at least half of all builders surveyed have reported positive buyer traffic conditions.”

GLOBAL ECONOMIC INDICATORS

European Car Sales ([link](#)): EU passenger car registrations (a proxy for sales) rose 8.7% y/y in October, posting its highest October total (1.18mu) since 2009. The report notes, “During the same month last year, registrations fell by 7.3% after the WLTP test came into effect, setting a low base of comparison for 2019.” Four of the five major EU markets rose in October, led by a double-digit gain of 12.7% y/y in Germany, followed by France (8.7% y/y), Italy (6.7), and Spain (6.3); sales in the UK (-6.7) contracted. The only other EU country recording a decline was Cyprus (-3.8% y/y). Looking at sales through the first 10 months of this year, they were down 0.7% compared with the comparable 2018 period. While demand increased across the EU in September and October, Germany (3.4% y/y) was the only major European market to be in the plus column through the first 10 months of this year. Sales in Spain (-6.3% y/y) and the UK (-2.9) contracted ytd, while Italy (-0.8) and France (-0.3) were nearly back to 2018 levels.

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