



MORNING BRIEFING

February 19, 2020

In a Good Place?

Check out the accompanying [audio excerpts](#) and [chart collection](#).

(1) Some light reading. (2) From good to very good. (3) Beware of Fed mantras. (4) US beats China currently in the health department. (5) Soft patch in US manufacturing not worrying Fed. (6) Powell is pleased to see labor force participation rate rising. (7) Housing and consumer spending looking good, while capital spending is not so good. (8) Advanced economies should advance as trade tensions ease. (9) Fed worrying more about subdued inflation than feverish virus. (10) Submerging emerging economies are a concern. (11) China's virus mentioned several times in Fed's report. (12) Lots of risky businesses in the corporate debt markets. (13) Running out of room to lower interest rates.

Fed I: Balanced *MPR*. Melissa and I read the Federal Reserve's 71-page semi-annual [Monetary Policy Report](#) (*MPR*) to Congress dated 2/7. We concluded that Fed officials believe the US economy is well balanced and that they will keep the federal funds rate in the current range of 1.50%-1.75%. Nevertheless, they are concerned about several global issues, which they are monitoring closely.

Federal Reserve Chair Jerome Powell emphasized during his *MPR* congressional [testimony](#) on [2/11](#) and [2/12](#) that the "US economy is in a very good place." The threat from the coronavirus is something to watch, he said, but too early to understand. Nevertheless, he affirmed that "there is no reason why the expansion can't continue."

Below, we review reasons that Fed officials are sanguine about the US economic outlook, followed by the concerns they are monitoring. Most of the issues discussed in the *MPR* have been around since the current expansion began. The two new exceptions are trade tensions, which started in 2018 but have recently diminished, and the coronavirus, which has been a global risk to health, economic growth, and stock markets only since the start of this year.

Fed II: In a Good Place. Powell first used "in a good place" in reference to inflation during his 9/26/18 [press conference](#). In his 1/30/19 [presser](#), he said, "The US economy is in a good place." He used "in a good place" to describe the economy and Fed policy four times during his 3/20/19 [presser](#). The four-word phrase appeared again at the following pressers: 5/1/19

(once), 6/19/19 (thrice), 7/31/19 (once), 9/18/19 (nope), 10/30/19 (thrice), and 12/11/19 (once). At his 1/29 presser this year, he said that “household debt is in a good place, a very good place.” In his latest congressional testimony, he upgraded his assessment of the US economy as being in a “very good place.”

We wish he would stop using that expression. Our contrary instincts come out every time he says it. Nevertheless, he is right: The US is currently in a very good place compared to China. Let’s review what’s so good in the good old USA according to the Fed:

(1) *US manufacturing slump not severe.* After increases in 2017 and 2018, manufacturing output declined in 2019. But do not be alarmed; the report dismissed the decline as too small to “initiate a major downturn for the economy.” The *MPR* observed that mild slowdowns are not atypical during business-cycle expansions; to signal a broad recession, manufacturing would need to be experiencing a severe downturn. Every recession since 1960 included some months when the 12-month change in industrial production was at least 7 ppts below trend. The recent US data are well above that threshold: 2019 growth averaged 2 ppts below trend ([Fig. 1](#)).

(2) *Solid labor market gains.* Overall, the Fed has been pleased with the pace of gains in the job market. The *MPR* noted the following supportive data: The average monthly pace of payroll gains in 2019 of 176,000 was slightly below the pace of 2018 but faster than required to allow for net new labor force entrants as the population grows. During December 2019, unemployment fell to the lowest level since 1969, 3.5%, down from 3.9% a year ago. It ticked up just slightly m/m during January to 3.6% ([Fig. 2](#)).

Labor force participation increased, including for prime-aged individuals. Wage gains remained moderate. Powell indicated he was pleased to see labor force participation picking up as a result of stronger labor market conditions forcing employers to hire and train less skilled employees ([Fig. 3](#)).

(3) *Residential investment moving up.* “Financing conditions for consumers remain supportive of growth in household spending,” the Fed reported, observing that housing starts and permits for new construction rose to the highest levels in more than 10 years ([Fig. 4](#)). Sales of new and existing homes also increased during 2019 despite home price appreciation, reflecting reduced mortgage interest rates.

(4) *Consumer spending strong.* Strong consumer spending last year was supported by the “relatively high level of aggregate household net worth” as both house prices and US equity prices increased.

(5) *Growth for advanced economies stabilizing.* Growth in several advanced foreign nations has shown tentative signs of “steadyding.” Brexit risk has lessened, but the final resolution of the UK’s divorce from the EU remains to be settled. Economic growth in Japan has deteriorated, but that’s expected to be a transitory effect of the October consumption tax increase. Following the report, Japan’s Q4 GDP was released at an annualized rate of -6.3%, largely attributable to weak private consumption given the sales tax increase to 10% from 8% (Fig. 5). For the US, fewer Fed officials “judged the risks to the economic outlook to be tilted to the downside” in their projections made in December versus last June, observed the report.

(6) *Trade policy progress made.* Uncertainty around trade policy recently “diminished somewhat,” the report highlighted, reflecting progress in the US–China trade negotiations.

(7) *Global monetary policy accommodative.* The current stance of monetary policy and low level of interest rates remain supportive of global growth. “Amid weak economic activity and dormant inflation pressures, foreign central banks generally adopted a more accommodative policy stance,” according to the report. Long-term interest rates in many advanced economies remained low. Indeed, central bank balance sheets continue to grow, as we discussed yesterday. For example, China’s central bank has moved aggressively to combat the coronavirus on the economic front by injecting more liquidity into the credit markets.

(8) *Financial stability solid.* The Fed believes that the US financial system is “substantially more resilient than it was before the financial crisis,” primarily because leverage in the financial sector and total household debt have moderated.

(9) *Fiscal policy boosting growth.* Current fiscal policy is expected to continue to boost growth. The Tax Cuts and Jobs Act of 2017, which lowered personal and business income taxes, and the recent boost in federal purchases have added to growth, the report said—a point Powell reiterated in his testimony. Following the report, news broke that the Trump administration is planning another possible US fiscal stimulus package—including middle-class income and capital-gains-tax cuts—should Trump be reelected.

Fed III: When China Sneezes. The coronavirus has led to unprecedented quarantines throughout China's Hubei province and several of the country's major cities. In effect, China has been quarantined from the rest of the world, as international flights have been suspended until the virus stops spreading and goes into remission. As a result, supply chains that go through China are being disrupted. China's overall GDP, along with consumer demand, could either stop growing or actually turn down as a result of the epidemic. All this was confirmed by Apple's warning on Monday that it does not expect to meet its quarterly revenue forecast because of lower iPhone supply globally and lower Chinese demand as a result of the coronavirus outbreak.

Not surprisingly, therefore, the *MPR* includes the coronavirus on the Fed's worry list. The report was released to the public on 2/7, two weeks after the outbreak hit the headlines. Let's review the Fed's worry list:

(1) *Weak pace of inflation.* According to the Fed, low readings in the US inflation rate were attributed to possible transitory influences, specifically "idiosyncratic" declines in "specific categories such as apparel, used cars, banking services, and portfolio management services." After briefly rising toward the Fed's 2.0% inflation goal during 2018, the pace of inflation during 2019 dropped well below that target again. The 12-month change in the PCED (personal consumption expenditures deflator) for both the headline and the core rates were just 1.6% as of December 2019, below year-ago readings for both ([Fig. 6](#)). Global inflation also remains subdued. Powell expects US inflation to move closer to 2.0% over the next few months, according to his testimony.

(2) *Declines in business investment.* The report voiced concerns about the stalling of business investment in structures, equipment, and intangibles last year. Private nonresidential fixed investment in real GDP was flat y/y during Q4, the weakest growth rate since Q1-2016 ([Fig. 7](#)). That reflected trade policy uncertainty and weak global growth, according to the Fed's report, among other factors (including the "suspension of deliveries of the Boeing 737 Max aircraft" and "the continued decline in drilling and mining structures investment"). Going forward, the Fed expects business investment to remain subdued.

(3) *Weak productivity trend growth.* Wage gains remained moderate despite solid job market improvement. The Fed attributed this to weak productivity growth, partly as a result of "the sharp pullback in capital investment ... during the most recent recession" and the slow recovery that followed. "While it is uncertain whether productivity growth will continue to

improve,” the Fed said, “a sustained pickup in productivity growth, as well as additional labor market strengthening, would support stronger gains in labor compensation.” Powell said in his testimony that boosting productivity “should remain a national priority.”

Following the report, data covering last year’s productivity growth was released showing a 1.7% gain ([Fig. 8](#)). As we see it now, GDP has been growing at a little over 2.0%, so we are getting more of our economic output from productivity, which bodes well for real wages and profit margins ([Fig. 9](#)). In other words, we may be able to cross this one off the Fed’s worry list soon.

(4) *Weak emerging markets growth*. Growth in many Latin American and Asian economies (e.g., China, Hong Kong, and India) has slowed markedly. Social and political unrest in Hong Kong and Latin America have resulted in severe economic disruptions. In India, the “ongoing credit crunch continues to weigh on activity.”

(5) *China spillover potential*. In China, GDP growth slowed further in 2019 against the backdrop of “increased tariffs on Chinese exports, global weakness in trade and manufacturing, and authorities’ deleveraging campaign that continued to exert a drag on the economy” ([Fig. 10](#)). “[S]ignificant distress in China could spill over to U.S. and global markets through a retrenchment of risk appetite, U.S. dollar appreciation, and declines in trade and commodity prices,” the report stated.

(6) *Coronavirus possible contagion*. Coronavirus was mentioned eight times in the report, including “[M]ore recently, possible spillovers from the effects of the coronavirus in China have presented a new risk to the outlook” and “The recent emergence of the coronavirus ... could lead to disruptions in China that spill over to the rest of the global economy.”

(7) *Corporate debt & asset valuations elevated*. “[A]sset valuations are elevated and have risen since July 2019, as investor risk appetite appears to have increased,” the report observed. Business debt remains elevated as well, whether viewed as a ratio of business assets or growth measures. In addition, that debt has gotten riskier: The lowest investment-grade category (triple-B) represents about half of investment-grade-rated debt outstanding; that’s near an all-time high. Economic deterioration could lead to a liquidity crunch in the credit markets.

(8) *Uncertainty in setting monetary policy.* The report dedicated a box to discussing the Fed's concern about the future effectiveness of its current approach to conducting monetary policy. The US economy has "changed in ways that matter for monetary policy. For example, the neutral level of the policy interest rate appears to have fallen in the United States and abroad, increasing the risk that the effective lower bound on interest rates will constrain central banks from reducing their policy interest rates enough to effectively support economic activity during downturns."

CALENDARS

US: **Wed:** PPI Ex Food & Energy 0.2%/m/m/1.3%/y/y, PPI Final Demand 0.1%/m/m/1.6%/y/y, Housing Starts & Building Permits 1.415mu/1.450mu, MBA Mortgage Applications, FOMC Meeting Minutes (1/29), Barkin, Kaplan, Kashkari, Bostic. **Thurs:** Leading Indicators 0.4%, Jobless Claims 210k, Philadelphia Fed Manufacturing Index 11, DOE Crude Oil Inventories, EIA Natural Gas Storage. (DailyFX estimates)

Global: **Wed:** UK Headline & Core CPI 1.6%/1.5% y/y, Canada CPI 0.2%/m/m/2.3%/y/y, Australia Employment Change & Unemployment Rate 10k/5.2%, China 1-Year & 5-Year Loan Price Rates 4.05%/4.75%. **Thurs:** Eurozone Consumer Confidence -8.2, Germany GfK Consumer Confidence 9.8, UK Retail Sales Including & Excluding Fuel 0.6%/0.5% y/y, Japan Headline, Core, and Core-Core CPI 0.7%/0.8%/0.8% y/y, Account of ECB's Monetary Policy Meeting (January), Guindos. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell for two of these three indexes last week. LargeCap's was up for the tenth time in 13 weeks after falling a week earlier. MidCap's and SmallCap's were down for the second time in 13 weeks as SmallCap registered a second straight decline. These indexes began a forward-earnings uptrend during March but stumbled from July to November. LargeCap's forward earnings has risen during 38 of the past 52 weeks, MidCap's 30 of the past 48 weeks, and SmallCap's 28 of the past 46 weeks. While LargeCap's is just 0.3% below its record high, MidCap's and SmallCap's are 2.7% and 5.1% below their October 2018 highs. Index changes for the SMidCaps at the end of 2019 helped MidCap's forward earnings improve from November's 18-month low, while SmallCap's is up from September's 17-month low. 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 2018 as y/y comparisons became more difficult. In the latest week,

the rate of change in LargeCap's forward earnings was steady at 4.1% y/y, which compares to an eight-month high of 4.4% at the end of January and a 38-month low of 1.0% in early December. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's improved w/w to a five-month high of -0.2% y/y from -0.3%, and compares to -5.5% in mid-November, which was the lowest since December 2009. That also compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's slipped w/w to 0.7% y/y from an eight-month high of 1.0%; that's up markedly from -9.6% in mid-September, which was the lowest since December 2009 and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 during late 2018, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2019, 2020, and 2021: LargeCap (0.5%, 8.0%, 11.3%), MidCap (-6.1, 11.5, 10.7), and SmallCap (0.0, 10.6, 14.1).

S&P 500/400/600 Valuation ([link](#)): Valuations moved higher last week for these three indexes. LargeCap's forward P/E rose w/w to 18.9 from 18.6. That's the highest level since June 2002 and compares to a five-year low of 13.9 during December 2018. Of course, that's still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E rose w/w to 17.3 from 16.9. That's up from 13.0 during December 2018, which was the lowest reading since November 2011. MidCap's P/E is down from a 22-month high of 17.4 in mid-December 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 increased w/w to 17.5 from 17.1, but is down from mid-December's 16-month high of 18.1. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is back below LargeCap's again. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the bulk of December quarter-end companies having already reported Q4 earnings, earnings revisions activity should begin to slow. The blended Q4 EPS forecast rose 23 cents w/w to \$41.93. That represents a gain of 1.8% on a frozen actual basis and an increase of 2.6% y/y on a pro forma basis. That compares to a 0.3% decline in Q3 and y/y gains of 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). If the y/y earnings gain comes to pass in Q4-2019, it would mark a return to growth following Q3's drop, which was its first since earnings fell y/y for four straight quarters through Q2-2016. Seven of

the 11 sectors are expected to record positive y/y earnings growth in Q4, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. The same seven sectors are expected to beat the S&P 500's 2.6% gain in Q4 as in Q3; that's up sharply from just three beating the S&P 500 during Q2. Five sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Financials, Health Care, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 5.5% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1 but is well below ex-Energy's 25.0% and 14.2% y/y gains in Q3-2018 and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their final Q3-2019 growth rates: Utilities (15.9% in Q4-2019 versus 6.7% in Q3-2019), Financials (12.4, 2.6), Health Care (9.6, 8.8), Communication Services (8.8, -1.4), Information Technology (8.7, -1.7), Real Estate (5.5, 5.9), Consumer Staples (2.8, 3.7), Consumer Discretionary (-6.8, 1.8), Industrials (-9.4, 3.4), Materials (-11.3, -10.9), and Energy (-40.9, -37.8).

US ECONOMIC INDICATORS

Regional M-PMI ([link](#)): The New York Fed—the first district to report on manufacturing activity for February—showed activity picked up this month from a very subdued pace in prior months. The composite index rose for the third month from 2.5 in November to a nine-month high of 12.9 this month; the index averaged 2.3 the prior eight months. Both new orders (to 22.1 from 6.6) and shipments (18.9 from 8.6) posted notable gains, climbing to their best readings since September 2017 and November 2018, respectively. Delivery times were longer (8.3 from -2.7) this month and inventories (12.9 from -0.7) accumulated at their fastest pace since January 2018. Meanwhile, employment indicators softened a bit, with employment (6.6 from 9.0) expanding at a slightly slower pace, while the average workweek (-1.0 from 1.3) was little changed—holding around zero for the third month. As for inflationary pressures, the prices paid (25.0 from 31.5) index eased a bit this month, after accelerating to a 10-month high in January, while the prices received (16.7 from 14.4) index accelerated at its fastest pace since last March. Optimism about the six-month outlook was restrained this month, with the index for future business conditions (22.9 from 23.6) easing a bit and both the new orders (27.5 from 31.5) and shipments (26.5 from 32.7) measures moving lower.

GLOBAL ECONOMIC INDICATORS

European Car Sales ([link](#)): EU passenger car registrations (a proxy for sales) fell 7.5% y/y in

January to 956,779 units. According to the report, “Major taxation changes announced by some EU member states for 2020 pulled registrations forward into December 2019, explaining this January drop.” Aside from tax changes, sales were also impacted by the continued weakness in the global economy, along with some uncertainty following the UK’s exit from the European Union. All four of the major EU economies saw a contraction in sales in January, led by a double-digit decline in France (-13.4% y/y), followed by Spain (-7.6), Germany (-7.3), and Italy (-5.9).

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