



## MORNING BRIEFING

January 10, 2017

### Let's Get Fiscal

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

(1) BeeGees, Olivia Newton-John, and Janet Yellen. (2) Counting words: "Fiscal" and "dollar" pop up often in FOMC minutes. (3) Trump may fill the wishes of Fed officials for more fiscal stimulus. (4) Fed officials hoping that fiscal policy can lift  $R^*$ . (5) Mixed with confusion. (6) Dollar strength reflecting divergence between Fed and other major central banks. (7) Foreigners scrambling to repay dollar-denominated debts that financed carry trades. (8) Constructing an implied capital flows proxy for the world ex-US. (9) Our proxy explains strength of the dollar. (10) So does the drop in non-gold international reserves.

**The Fed: 'Fiscal' Is the Word.** "I saw my problems and I'll see the light" go the opening [lyrics](#) of the 1978 BeeGees song "Grease." It was the theme song of the popular movie about the 1950s and the word that defined a generation. Another line in the song goes: "We start believin' now that we can be who we are, grease is the word."

The word among Fed officials these days is "fiscal." Actually, they seem to be humming another tune, namely "Physical" by Olivia Newton-John, who starred in "Grease." This song was a big hit, too, in 1981. The suggestive [lyrics](#) include: "Let's get physical, physical / I want to get physical / Let's get into physical." The word "physical" occurs 20 times.

The Fed released its version of the song, "Let's Get Fiscal," last Wednesday, January 4. The lyrics appear in the [minutes](#) of the December 13-14 FOMC meeting. The word "fiscal" appears 15 times, compared to just once during the previous [meeting](#) on November 1-2, which was before Election Day on November 8. Fed Chair Janet Yellen sang the song during her [press conference](#) following the December 14 meeting. The word was mentioned 20 times by her or reporters. During her previous [press conference](#) on September 21 last year, it was mentioned just three times.

Prior to Election Day, a few Fed officials had called on Congress to step in to revive US economic growth with fiscal stimulus. They want to proceed with "normalizing" monetary policy so that they will have room to ease in the event of a future shock. They were looking for a way to continue to gradually raise rates without hampering economic growth, which has been slow. President-elect Donald Trump might just solve their problem and show them the light they are seeking.

Last year, Fed officials reckoned that the economy's "natural" real rate of interest ( $R^*$ ) might have dropped close to zero and that only fiscal stimulus might raise it back to normal. FRB-SF President John Williams has written quite a bit on  $R^*$ . A December 2016 [paper](#) that he coauthored concluded: "For example, estimates using the Laubach-Williams (2003) model indicate the natural rate in the United States fell to close to zero during the crisis and has remained there into 2016. Explanations for this decline include shifts in demographics, a slowdown in trend productivity growth, and global factors affecting real interest rates."

There's not much that monetary policy can do to offset these factors, but fiscal policy might have a role to play in reviving  $R^*$  and boosting real growth so that the Fed can proceed with raising interest rates to

more normal levels. Here are some of the relevant points that Melissa and I gleaned from the latest Fed minutes:

(1) *It's got a groove.* The promise of fiscal stimulus is greasing the markets broadly. The minutes stated: "Most participants attributed the substantial changes in financial market conditions over the intermeeting period--including the increase in longer-term interest rates, the strengthening of the dollar, the rise in equity prices, and the narrowing of credit spreads--to expectations for more expansionary fiscal policies in coming years or to possible reductions in corporate tax rates."

(2) *It's got a meaning.* Fiscal stimulus should translate into higher GDP growth. According to the minutes: "The staff's forecast for real GDP growth over the next several years was slightly higher, on balance, largely reflecting the effects of the staff's provisional assumption that fiscal policy would be more expansionary in the coming years." It added: "About half of the participants incorporated an assumption of more expansionary fiscal policy in their forecasts." Importantly, "almost all also indicated that the upside risks to their forecasts for economic growth had increased as a result of prospects for more expansionary fiscal policies in coming years."

(3) *Mixed with confusion.* Even so, "[s]everal participants pointed out that, depending on the mix of tax, spending, regulatory, and other possible policy changes, economic growth might turn out to be faster or slower than they currently anticipated. However, almost all also indicated that the upside risks to their forecasts for economic growth had increased as a result of prospects for more expansionary fiscal policies in coming years." Members who have a vote "agreed that there was heightened uncertainty about possible changes in fiscal and other economic policies as well as their effects." Many participants pointed out the downside possibility "of a sharp rise in financial market volatility in the event that fiscal and other policy changes diverged from market expectations."

One thing is certain: The Fed will use the opportunity to tighten should fiscal stimulus be delivered as promised. The minutes stated: "[M]any participants noted that the effects on the economy of such policy changes, if implemented, would likely be partially offset by tighter financial conditions, including higher longer-term interest rates and a strengthening of the dollar."

The next important questions are: How much higher will the federal funds rate go and how fast? According to the minutes: "Many participants noted that there was currently substantial uncertainty about the size, composition, and timing of prospective fiscal policy changes, but they also commented that a more expansionary fiscal policy might raise aggregate demand above sustainable levels, potentially necessitating somewhat tighter monetary policy than currently anticipated."

**US Dollar: Bullish Capital Flows.** Interestingly, the word "dollar" was given importance equal to the word "fiscal" in the latest minutes, also with 15 mentions, up from seven in the minutes of the November 1-2 meeting. Fed officials are expressing some concern that the ongoing strength of the dollar could weigh on the economy, and even on inflation. That might allow them to continue to raise the federal funds rate at a very gradual pace even if the incoming Trump administration provides fiscal stimulus through tax cuts and some infrastructure spending. But it would rule out a more aggressive pace of monetary normalization.

The trade-weighted US dollar is up 26% since July 1, 2014 through yesterday ([Fig. 1](#)). It dipped at the start of last year, but has increased 9% since last year's low on May 2. While the Fed raised the federal funds rate at the ends of 2015 and 2016 by 25bps each time, the ECB and BOJ continue to keep their official rates near zero. In addition, two or three more Fed rate hikes are expected this year. The 12-months-ahead federal funds future contract is at 1.14% ([Fig. 2](#)).

The ECB still has slightly negative rates on bank reserve deposits ([Fig. 3](#)). The ECB holdings of securities of euro area residents has soared over the past two years by €1.38 trillion to a record high of €1.97 trillion at the end of last year ([Fig. 4](#)). Reserve balances at the BOJ have soared 626% since December 2012 through December 2016 ([Fig. 5](#)). Meanwhile, the Fed terminated its QE purchases of securities at the end of October 2014 ([Fig. 6](#)). The federal funds rate is up 50bps since late 2015.

This divergence between the monetary policies of the Fed and the other major central banks is the reason the dollar is soaring. Much of the upward pressure may be attributable to foreign borrowers who are scrambling to pay off their dollar-denominated debts. The Chinese seem to be leading this pack, as we discussed yesterday and showed with our international capital flows proxy for China. Now let's show what a similar proxy looks like for the world excluding the US:

(1) *World ex-US capital flows proxy.* We can construct such a proxy by subtracting the world's 12-month trade surplus with the US (which is the negative of the US trade deficit) from the 12-month change in non-gold international reserves, which are held by all the central banks in the rest of the world (ROW) ([Fig. 7](#) and [Fig. 8](#)).

This proxy shows significant capital outflows from the ROW to the US since the second half of 2014, just when the Fed started to signal that it was moving toward normalizing its monetary policy. Over the past 12 months through October, the outflows from the ROW to the US totaled \$1.0 trillion.

(2) *Implied capital flows & the dollar.* Our proxy for world ex-US capital flows is highly correlated with the inverse of the yearly percent change in the trade-weighted dollar, particularly since 2005 ([Fig. 9](#)). Since the second half of 2014, the substantial outflows from the ROW into the US have driven up the dollar. Much of the inflow into the US probably reflects foreign borrowers repaying their borrowings in the US. The carry trade is no longer a profitable one for them, i.e., to borrow in the US at very low rates and invest the proceeds in higher-yielding assets overseas, particularly in emerging economies.

(3) *International reserves & the dollar.* Not surprisingly, there is also a very good fit between the yearly percent change in total non-gold international reserves and the inverse of the yearly percent change in the trade-weighted dollar ([Fig. 10](#)). The former was down 2.5% y/y during October. It's been negative on this basis since December 2014.

## CALENDARS

**US. Tues:** NFIB Small Business Optimism Index 99.6, JOLTS, Wholesale Inventories 0.9%. **Wed:** MBA Mortgage Applications, Atlanta Fed Business Inflation Expectations, EIA Petroleum Status Report. (Bloomberg estimates)

**Global. Tues:** China New Yuan Loans 676.0b, China Aggregate Financing 1300b, China M2 11.4% y/y, Japan Consumer Confidence. **Wed:** UK Headline & Manufacturing Industrial Production 0.6%/0.4% y/y, UK Trade Balance (pounds) -3500, Japan Trade Balance (yen) 587.6b, Japan Coincident & Leading Indexes. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** ([link](#)): Forward earnings rose last week for all three indexes for a seventh week, and were at record highs too. That's the best string of gains for these indexes since they rose for 11 straight weeks through August 2014. All three indexes have been on solid uptrends since March, and two--MidCap and SmallCap--at record highs since June. The yearly change in forward earnings for all three indexes has been edging higher from six-year lows in early 2016 as y/y

comparisons have eased. In the latest week, LargeCap's forward earnings improved to a 24-month high of 4.7% y/y from 4.6%, which compares to a six-year low of -1.8% in October 2015; MidCap's slowed to 5.2% y/y from a 21-month high of 5.6%; which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a 25-month high of 9.6% from 9.2%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap 0.5% and 12.3%, MidCap 1.5% and 12.5%, and SmallCap 6.7% and 15.9%.

**S&P 500/400/600 Forward Valuation** ([link](#)): Valuations for these three indexes were mostly higher last week, but at levels that remain slightly below recent multi-year highs. LargeCap's forward P/E increased to 17.1 from 16.9, matching its 22-month high of 17.1 in early December. That's up from a 15-month low of 14.9 in mid-January, but remains slightly below the 11-year high P/E of 17.2 in February 2015 (when Energy sector earnings were depressed), and well below the record high of 25.7 in July 1999. MidCap's forward P/E improved to 18.9 from 18.7; that's below early December's 15-year high of 19.2 and compares to a three-year low of 15.0 in January 2016 and its record high of 20.6 in January 2002. SmallCap's was steady at 19.8; that's up from a three-year low of 15.5 in mid-February, and compares to a 15-year high of 20.5 in early December and record high of 20.9 in April 2002.

**S&P 500 Sectors Quarterly Earnings Outlook** ([link](#)): Q4 earnings estimate revision activity was quiet last week for the S&P 500 sectors. The Q4 consensus dropped w/w for two of the 11 S&P 500 sectors, rose for two, and was steady for seven. Consumer Discretionary and Consumer Staples were the sole gainers, as their Q4 forecasts rose 0.7% and 0.2% w/w, respectively. Sectors with the w/w declines in their Q4 forecasts: Tech (-0.5%) and Industrials (-0.3). The S&P 500's Q4-2016 EPS forecast edged down three cents w/w to \$30.86 and is down 2.1% from \$31.53 at the end of Q3. That represents a forecasted pro forma earnings gain of 6.1% y/y, unchanged from a week earlier and down from 8.3% at the end of Q3. Since the end of Q3, Q4 estimates are higher for 3/11 sectors and lower for 8/11. Tech's Q4 forecast has risen 1.1%, while Energy's has gained 0.9% and Financials' 0.5%. Materials is down the most (-14.5), followed by Real Estate (-8.7), Utilities (-7.0), Industrials (-5.9), and Consumer Discretionary (-4.3). The S&P 500's Q4-2016 forecasted earnings gain of 6.1% y/y would be its second straight gain after four declines and compares to Q3-2016's blended 4.3%, Q2-2016's -2.1%, Q1-2016's -5.0%, Q4-2015's -2.9%, Q3-2015's -0.8%, Q2-2015's 1.3%, and Q1-2015's 2.2%. Five of the 11 sectors are expected to beat the S&P 500's y/y earnings gain of 6.1% in Q4-2016, but analysts expect a y/y earnings gain in Q4-2016 for 8/11 sectors. That forecast is below the 9/11 sectors rising in Q3-2016, which was the best since Q1-2015, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. Energy is expected to turn positive y/y in Q4-2016 for the first time since Q3-2014. The latest forecasted Q4-2016 earnings growth rates vs. their blended Q3-2016 growth rates: Financials (15.7% vs. 8.5%), Utilities (10.3, 10.9), Tech (7.8, 11.5), Materials (6.4, 10.9), Consumer Staples (6.2, 7.0), S&P 500 (6.1, 4.3), Health Care (5.4, 7.6), Energy (2.1, -67.5), Consumer Discretionary (2.0, 8.6), Real Estate (-0.8, 2.4), Telecom (-0.8, -1.8), and Industrials (-3.5, 4.0).

**S&P 500 Q4 Earnings Trend vs. Past Quarters** ([link](#)): With the December-quarter books closed, the current Q4-2016 EPS forecast of \$30.86 has dropped 2.1% over the 14 weeks since the quarter's start. That's the smallest decline in the quarterly forecast over comparable weeks since Q2-2014, but is smaller than the average 4.3% decline since 1994. Analysts expect EPS for Q4-2016 to be up 4.6% y/y, better than the 4.1% gain for Q3-2016 and the second straight quarter of higher EPS on a y/y basis. Since 1995, the Q4 earnings surprise has been positive in 14/22 years, and final EPS has exceeded Q3's 14 out of 22 times. We think that Q4's EPS will be \$31.25 and that earnings will rise 5.9% y/y in Q4. That would mark the S&P 500's second straight quarter of rising earnings y/y, and its 32nd straight quarter of positive surprises--longer than its prior, 10-quarter positive surprise streak (Q1-2003 to Q2-2005).

## US ECONOMIC INDICATORS

**US Trade** ([link](#)): Trade was likely a drag on real GDP growth last quarter for the first time since Q4-2015. The real merchandise trade deficit in November widened for the second month to -\$63.6 billion after narrowing steadily from -\$64.4 billion in June to -\$54.2 billion in September. The average monthly deficit for the first two months of Q4 was -\$61.9, widening from Q3's -\$56.6 billion average. Real exports fell for the second month, down 0.9% m/m and 3.9% over the period, while real imports rose 1.2% and 2.6%, respectively, over the comparable periods. The two-month decline in real exports was widespread, with food (-13.1%), capital goods ex autos (-3.9), autos (-2.9), consumer goods ex autos (-1.8), and industrial supplies (-0.9) all in the red over the period. Meanwhile, the two-month increase in real imports was broad-based, with consumer goods ex autos (5.0), industrial supplies (3.0), capital goods ex autos (2.5), and food (1.8) all posting solid gains; autos (-2.1) was the sole loser.

## GLOBAL ECONOMIC INDICATORS

**Global Composite PMI** ([link](#)): Global economic activity in December accelerated at its best pace in 13 months, supported by stronger inflows of new business and better job gains. The J.P. Morgan Global Composite Output Index edged up from 53.3 to 53.4, considerably above its cyclical low of 50.8 posted in February. Developed nations (54.0) continued to fare better than emerging ones (52.1) last month, though the latter was the highest since September 2014. Composite output measures expanded in the UK (56.7 from 55.3), Russia (56.6 from 55.8), the Eurozone (54.4 from 53.9), US (to 54.1 from 54.9), China (53.5 from 52.9), and Japan (52.8 from 52.0), with all accelerating but the US--which held near 2016 highs. In contrast, India's downturn accelerated, with its composite output index (47.6 from 49.1) contracting at its fastest pace since October 2013 as its M-PMI (49.6 from 52.3) dropped below 50.0 for the first time in a year; Brazil's composite measure (45.2 from 45.3) contracted for the 22nd straight month.

**Global Nonmanufacturing PMI** ([link](#)): The global service sector in December continued to expand at a solid pace. The J.P. Morgan NM-PMI was unchanged at 53.3 last month, the highest reading since last fall. Of the 13 surveys for which data are available, 10 reported an increase, with the fastest rates of expansion recorded in Ireland (to 59.1 from 56.0), Russia (56.5 from 54.7), and the UK (56.2 from 55.2), which saw growth accelerate. Upturns in Spain (55.0 from 55.1), Germany (54.3 from 55.1), and the US (53.9 from 54.6) saw growth ease from November's pace, though remain robust. Elsewhere in Europe, growth picked up in France (52.9 from 51.6) and slowed in Italy (52.3 from 53.3). Service activity accelerated in both China (53.4 from 53.1) and Japan (52.3 from 51.8) at the fastest rates in 17 and 11 months, respectively. Meanwhile, services activity in India (46.8 from 46.7) and Brazil (45.1 from 44.4) continued to contract.

**US Nonmanufacturing PMI** ([link](#)): The US service sector in December matched November's pace according to the ISM survey (which was the best in 13 months); it slowed for the second month according to Markit, though job creation grew at its fastest pace since September 2015. ISM's NM-PMI remained at 57.2 in December; it was as low as 51.4 in August. The business activity index (to 61.4 from 61.7) held above 60.0, while the new orders gauge (61.6 from 57.0) moved back above 60.0; the employment measure (53.8 from 58.2) gave back most of November's gain. Supplier deliveries was unchanged at 52.0. Markit's NM-PMI fell to 53.9 from 54.6 in November and 54.8 in October, which was the highest since November 2015. According to the report, while business activity and incoming new work lost some momentum in December, they remained near highs for the year. Business optimism continued to rebound from its post-crisis low, helping to boost job growth.

**Germany Manufacturing Orders** ([link](#)): German factory orders in November took a step back after surging to a new cyclical high in October. Billings contracted 2.5% after October's 5.0% jump, which was the biggest monthly gain since July 2014. In November, both domestic (-2.8%, 5.7%) and foreign (-

2.3, 4.6) orders contracted after big gains in October. November's loss in domestic orders was driven by declines in capital (-4.7%) and intermediate (-1.6) goods orders; the two combined had advanced two of the prior three months by a total of 7.4%. Domestic consumer goods orders increased for the third time in four months by 2.3% in November and 6.5% over the period. Foreign orders from both inside (-2.7) and outside (-2.0) the Eurozone fell in November. The decline in the former was led by capital (-8.7) and consumer (-4.6) goods orders, which more than offset a rebound in intermediate (7.5) goods billings; the latter reflected losses in capital (-2.9) and intermediate (-1.3) goods orders, partially offset by a 5.7% jump in consumer goods orders.

**Germany Industrial Production** ([link](#)): Germany's headline production, which includes construction, expanded in November for the third time in four months, up 0.4% m/m and 2.4% over the four-month span. The Economy Ministry says that production has picked up noticeably after a weak summer half and notes "orders in manufacturing and construction, as well as sentiment indicators in these sectors, promise solid output growth in the winter half." November's output increase was boosted by a 1.5% surge in construction, while manufacturing production advanced 0.4% for the second straight month; energy output fell 0.4%. Excluding construction, November output was up 0.3% after a 0.4% climb in October. Within industry, gains in intermediate (0.9%) and consumer (0.3) goods output more than offset a 0.1% downtick in capital goods production. Germany's M-PMI in December reached a 35-month high of 55.6, a good omen for future production.

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