



MORNING BRIEFING

February 8, 2017

Holey Walls

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

(1) Practical issues with a wall on US border with Mexico. (2) Maybe it needs to be south of Mexico rather than south of the US. (3) Believe it or not: Chinese believe in free markets! (4) Not when it comes to capital flows, as they slap controls to stem outflows. (5) China's international reserves fall to \$3 trillion. (6) Railway freight traffic improving. (7) A billionaire disappears. (8) The Silk Route project is rolling down the tracks.

US: Border Wall. Nope, I'm not going to say anything new about Trump's proposal to build a wall on the Mexican border. I've previously raised some practical issues, such as: What's to keep all those Mexican workers whose jobs have moved back to automated factories in the US from digging tunnels under the wall to enter the US? Presumably, by doing so they will demonstrate that they are shovel-ready. So they might be good candidates for legal work permits so that they can build the wall and other infrastructure in the US if it turns out that there aren't enough able-bodied US citizens to do the job, given that the economy seems to be at full employment.

Don't get me wrong: I am against illegal immigration. The problem we seem to have currently isn't with Mexicans crossing the border illegally, but rather desperate people fleeing horrendous conditions in Central America. Obviously, Mexico's government hasn't done enough to stem the tide coming from its southern border. The problem is exacerbated by lots of "bad *hombres*" trafficking in drugs and humans.

In other words, walls rarely solve the underlying issues, antagonisms, and conflicts that fester between neighbors who just can't seem to figure out how to get along in peace, which is why they build walls. The old saying "Good fences make good neighbors" doesn't seem like a universal truth, as evidenced by the wall between Israelis and Palestinians. Standing in front of the Berlin Wall, President Ronald Reagan gave a memorable speech on June 12, 1987, calling on the Soviets to "tear down this wall."

Robert Frost wrote a [poem](#) called "Mending Wall" that has some relevance to today's headlines. Here is an excerpt: "Before I built a wall I'd ask to know / What I was walling in or walling out / And to whom I was like to give offence / Something there is that doesn't love a wall / That wants it down." Again, I am against illegal immigration. I'm just not sure a wall will do much to stop it. Stopping traffickers in drugs and humans would probably be much more effective.

China: Not-So-Great Wall. The oldest and most famous wall is the Great Wall of China, which is actually a series of fortifications built over several years along the historical northern borders of China to protect the Chinese from raids and invasions of the various nomadic groups roaming the Eurasian Steppe. The idea was to keep the barbarians out.

Today, China's government leaders have responded to Trump's protectionist threats by endorsing globalization and free trade. They don't want to see the US putting up a tariff wall blocking their exports to the US. In a 1/17 [speech](#) at Davos, Chinese President Xi Jinping said:

"The point I want to make is that many of the problems troubling the world are not caused by economic globalization. ... Economic globalization has powered global growth and facilitated movement of goods

and capital, advances in science, technology and civilization, and interactions among peoples. ...”

“Whether you like it or not, the global economy is the big ocean that you cannot escape from. Any attempt to cut off the flow of capital, technologies, products, industries and people between economies, and channel the waters in the ocean back into isolated lakes and creeks is simply not possible. Indeed, it runs counter to the historical trend.”

Isn't that rich! Xi endorsed the free flow of capital as his government is scrambling to build a wall to contain the massive outflows from China that started around mid-2014. The native-born barbarians want to leave China with the riches they've amassed. They seem to have been instigated to do so by Xi's anti-corruption drive, which may actually be a purge of successful entrepreneurs, as well as plutocrats, who aren't following his lead. Perhaps doing more to protect property rights might stem the capital outflow.

That's not likely to happen anytime soon. So for now, the government is resorting to capital controls. Let's review:

(1) *A quick review of the yuan.* The yuan has dropped from a high of 6.04 yuan/dollar on January 14, 2014 to 6.88 currently ([Fig. 1](#)). To avoid a freefall in its currency, the government has been forced to intervene in the currency markets, resulting in a \$1.0 trillion drop in its international reserves from a record high of \$4.0 trillion during June 2014 to \$3.0 trillion during January. In terms of market psychology, the 7.0 level for the yuan and the \$3.0 trillion level for reserves are widely viewed as critical levels that the government must defend even if that requires capital controls.

By the way, over the past year through November, China's holdings of US Treasury bonds in both official and private accounts has dropped \$215 billion to \$1,049 billion ([Fig. 2](#)). Over the same period, China's international reserves fell \$382 billion.

(2) *A brief analysis of recent capital outflows.* Debbie and I track a proxy for China's net international capital flows using the 12-month sum of the country's trade surplus less the y/y change in the country's international reserves ([Fig. 3](#) and [Fig. 4](#)). This proxy shows mostly net capital inflows from the end of 2001, when China joined the World Trade Organization, through 2011. There were some outflows during 2012 coincident with the announcement of the government's anti-corruption drive. The following year, there were offsetting inflows, perhaps because the drive seemed to be in low gear. As the drive picked up speed, that seemed to instigate a mass dash of capital out of China.

We reckon that outflows over the past two years have been about \$2.0 trillion. Last year, net capital outflows totaled \$828 billion, following \$1.1 trillion during 2015, according to our measure.

(3) *A brief history of recent capital controls.* In November, China was reported to be planning to block most foreign investments of more than \$10 billion, reported a 1/24 Bloomberg [article](#). Also, banks were requested to report to authorities capital account transactions involving foreign currency higher than \$5 million. A 1/23 *FT* [article](#) noted that “regulators have tried everything from blocking dividend repatriation at multinational corporations to restricting Chinese citizens from importing gold or buying insurance policies in Hong Kong.”

It is too soon to tell whether these measures are stopping the bleeding. However, the threat of having cash trapped in China is complicating overseas transactions. “Trade finance has at times been at the heart of China's efforts to curb illicit capital outflows. Importers in China and exporters in Hong Kong often collude by inflating the value of imported goods to move cash offshore in the form of bloated payments,” observed the *FT* article. Fearing default may result from the regulations designed to stop

illegitimate transactions, legitimate sellers into China are requiring extra credit guarantees from domestic importers.

(4) *Better growth might slow outflows.* The anti-corruption drive isn't the sole explanation for China's capital outflows. Another explanatory factor might be the slowdown in the country's economic growth. We don't give this thesis much weight, but it might have had some influence. In any event, there is mounting evidence that China's economy may be improving.

Railways freight traffic rebounded smartly during the second half of last year, rising 9.6% y/y though December ([Fig. 5](#) and [Fig. 6](#)). This series is highly correlated with the sum of China's exports plus imports (in yuan), as well as with the yearly percent change in the PPI, which was up 5.5% during December, the fastest increase since September 2011 ([Fig. 7](#) and [Fig. 8](#)).

The two alternative measures of China's M-PMI remained solidly above 50.0 during January with readings of 51.3 (official) and 51.0 (Caixian). China's NM-PMI was even better at 54.6 ([Fig. 9](#) and [Fig. 10](#)).

(5) *A billionaire vanishes.* Again, a significant amount of China's capital outflows may have been triggered by the government's anti-corruption campaign. It certainly challenges notions of due process, property rights, and even the right to life. Consider the following excerpt from a 2/6 *Fortune* [article](#) titled "Billionaire's Disappearance in Hong Kong May Be Part of China's Anti-Corruption Campaign":

"Ten days ago, Chinese authorities took a Chinese investor estimated to be worth \$6 billion from his apartment in Hong Kong's Four Seasons Hotel and moved him across the border to mainland China, according to multiple reports. For almost a week, during China's weeklong holiday celebrating the Lunar New Year, no news followed. It now appears, as watchers have speculated, that the investor--Xiao Jianhua--was caught up in China President Xi Jinping's anti-corruption campaign, possibly related to China's stock market plunge in 2015."

Asia: Bullet Trains Demolish Walls. While the US and China are meddling with the free flow of goods and capital, other countries are taking fast trains to more globalization. A 2/6 *Nikkei Asian Review* [article](#) reports that Thailand and Malaysia are set to start talks on the construction of a 1,500km high-speed railway that would connect the two countries' capitals and enhance regional connectivity. If this happens, it could be the beginning of a rail network that runs all the way from Singapore to the southern Chinese city of Kunming, through Malaysia, Thailand, Myanmar, Cambodia, Vietnam, and Laos. This development would fit in with Xi Jinping's "Belt and Road" initiative (a.k.a. the "New Silk Route"), which aims to create an economic corridor from Asia to Europe by developing overland and maritime routes.

Meanwhile, the New Silk Route already exists and is expanding. The 1/3 [article](#) on the BBC website reported:

"China has launched a direct rail freight service to London, as part of its drive to develop trade and investment ties with Europe. China Railway already runs services between China and other European cities, including Madrid and Hamburg. The train will take about two weeks to cover the 12,000 mile journey and is carrying a cargo of clothes, bags and other household items. It has the advantage of being cheaper than air freight and faster than sea.

"London will become the 15th European city to join what the Chinese government calls the New Silk Route. The service will pass through Kazakhstan, Russia, Belarus, Poland, Germany, Belgium and France before arriving at Barking Rail Freight Terminal in East London, which is directly connected to the High Speed 1 rail line to the European mainland."

All aboard!

CALENDARS

US. Wed: MBA Mortgage Applications, EIA Petroleum Status Report. **Thurs:** Jobless Claims 250k, Wholesale Trade Inventories 1.0%, Weekly Consumer Comfort Index. (Bloomberg estimates)

Global. Wed: China Direct Investment 2.8% y/y, Japan Machine Orders 3.1% m/m/4.5% y/y. **Thurs:** Germany Trade Balance (euros) 20.5b, Japan Machine Tool Orders, Carney. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Earnings Season Monitor ([link](#)): With nearly 57% of S&P 500 companies finished reporting Q4-2016 results, their revenue and earnings surprise metrics are mostly weaker than at the comparable point of the Q3 season. On a positive note, their y/y revenue and earnings growth comparisons are the highest since Q3-2014. Of the 284 companies in the S&P 500 that have reported, 69% exceeded industry analysts' earnings estimates by an average of 4.0%; they have averaged a y/y earnings gain of 8.9%. At the same point in Q3-2016, a higher percentage of companies (74%) in the S&P 500 had beaten consensus earnings estimates by a larger 6.6% and earnings were up a smaller 2.1% y/y. On the revenue side, 47% beat sales estimates so far, coming in 0.2% above forecast and 4.1% higher than a year earlier. During Q3, a higher 56% were above forecasts, results exceeded estimates by a smaller 0.1%, and results rose a smaller 1.5% y/y. Q4 earnings results are higher y/y for 72% of companies versus 69% at the same point in Q3, and revenues are higher for 72% versus 72%. These figures will continue to change markedly as more companies report Q4 results, but early data suggest that Q1-2016 was the bottom for y/y revenue growth and that Q2-2016 was the earnings growth bottom.

US ECONOMIC INDICATORS

US Trade ([link](#)): The real merchandise trade gap in December narrowed for the first time in three months, to \$62.3 billion, after widening the prior two months from \$54.4 billion in September to \$63.9 billion in November. The trade gap averaged \$62.3 billion for the quarter, considerably above Q3's \$56.8 billion. Net exports subtracted 1.7ppt from Q4 real GDP, the most since Q2-2010. In December, real exports rebounded 3.6%, after a two-month loss of 3.8%, outpacing the 1.5% increase in imports, which was in line with prior months. Leading the jump in real exports was an 8.0% surge in capital goods exports less autos, followed by auto (1.6) and consumer goods ex autos (1.1) exports; food exports (-0.5) edged lower, while exports of industrial supplies were flat. The advance in real imports was led by auto (5.6), food (3.8), and capital goods ex autos (2.1) imports; imports of consumer goods ex autos (0.7) were slightly higher, industrial supplies (-0.9) slightly lower.

JOLTS ([link](#)): Job openings in December remained stalled around record highs, falling 4,000 to 5.501 million after a 54,000 gain and a 180,000 loss the previous two months. It's within 344,000 of April's record high of 5.845 million. Hirings rose for the third month, up 40,000 m/m and 131,000 over the period to 5.252 million; separations slipped 50,000 to 4.968 million after a two-month gain of 82,000. The latest hirings and separations data yielded an employment advance of 284,000 for December, 127,000 above December's payroll gain of 157,000--coming in above the payroll gain for the third consecutive month. The job-opening rate (3.9%) held just below its record high of 4.2% recorded in April, while the total hires rate (4.0) also remained just below its cyclical high of 4.2%. The quit rate (2.3) edged down from its cyclical high of 2.4%. The ratio of unemployed workers per job opening ticked up to 1.37 after falling from 1.42 to 1.35 in November, holding just above its cyclical low of 1.33

posted in July.

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production ([link](#)): German output in December posted its sharpest drop in eight years, dragged lower by seasonal factors. December's headline production, which includes construction, unexpectedly plunged 3.0%--largely due to reduced workdays during the holiday season--after climbing three of the prior four months by a total of 2.6%. December's decline was broad-based, with manufacturing (-3.4%), construction (-1.7), and energy (-0.9) output all moving lower. Following the report, the Economic Ministry noted that the data won't alter the government's positive economic outlook. Recent data are very encouraging: This week, Germany reported factory orders in December jumped 5.2% to a new cyclical high--the best growth in two and a half years. Earlier this month, Germany's M-PMI in January reached a three-year high of 56.4, supported by the steepest expansion in output and new work since early 2014.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).