



MORNING BRIEFING

March 14, 2017

Go With the Flows

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

(1) The Fed's world of credit. (2) Supply of equities continues to shrink, while debt continues to expand. (3) Lots of cash flow for nonfinancial corporations. (4) Move from active to passive clear in record purchases by equity ETFs. (5) Big buyers of equities not as valuation-oriented as traditional investors. (6) Treasury borrowing exceeds official deficit numbers. (7) Foreigners are biggest buyers of US corporate bonds. (8) China's social financing blows away credit expansion in US. (9) Draghi's policies have yet to boost Eurozone credit expansion.

US Flow of Funds: Equities & Debt. The Fed released its [Financial Accounts of the United States](#) with data for Q4-2016 last week. It provides amazingly comprehensive insights into the flow of funds, balance sheets, and integrated macroeconomic accounts of the US financial system. It's really almost too much information to wrap one's head around.

To help process it all, Debbie and I have created a bunch of chart publications over the years that visualize quite a bit of it on our website. The saying that a picture is "worth a thousand words" is attributed to newspaper editor Tess Flanders discussing journalism and publicity in 1911. Debbie and I have always believed that a chart is worth a thousand data points in a time series. Given our chosen profession, we tend to focus on the data for the equity and debt markets in the Fed's quarterly statistical extravaganza. Let's start with the latest supply side of these markets, and move on from there to the demand side:

(1) *Supply-side totals.* Net issuance of equities last year totaled minus \$229.7 billion, with nonfinancial corporate (NFC) issues at -\$565.7 billion and financial issues at \$269.7 billion ([Fig. 1](#)). The increase in financials was led by a \$283.9 billion increase in equity ETFs, the biggest annual increase on record. The decline in NFC issues reflected the impact of stock buybacks and M&A activity more than offsetting IPOs and secondary issues.

The net issuance of debt securities totaled \$1,555.3 billion last year, with the major components all increasing, as follows: Treasuries up \$842.8 billion, agency- and GSE-backed securities up \$351.6 billion, and corporate and foreign bonds up \$375.1 billion ([Fig. 2](#)).

The increase in corporate bonds was led by a \$271.7 billion increase in bonds issued by nonfinancial corporations ([Fig. 3](#)). Domestic financial corporations raised just \$12.9 billion as ABS issuers paid down \$99.9 billion. US residents purchased \$90.4 billion in foreign bonds, which is counted as the net issuance of these securities in the US.

The nonfinancial corporations (NFCs) may have used some of the \$271.7 billion in the funds they raised in the bond market to buy back \$565.7 billion in their shares ([Fig. 4](#)). Then again, NFCs had near-record internal cash flow of \$1.8 trillion, with tax-deductible depreciation expense at a record \$1.3 trillion ([Fig. 5](#)). The internal cash flow exceeded NFC capital spending, which also remained in record-high territory, at \$1.7 trillion, despite the recession in the energy sector.

(2) *Demand side for equities.* To get a closer view of the demand for equities, let's focus now on the quarterly data at an annual rate rather than at the four-quarter sum ([Fig. 6](#)). This shows that equity mutual funds have been net sellers for the past five quarters, reducing their holdings by \$151.3 billion over this period. Over the same period, equity ETFs purchased \$266.4 billion, with their Q4-2016 purchases a record \$485.4 billion, at a seasonally adjusted annual rate. Other institutional investors have been selling equities for the past 24 consecutive quarters, i.e., during most of the bull market! Foreign investors have also been net sellers over this same period.

The bottom line is that the current bull market has been driven largely by corporations buying back their shares, as Joe and I have been observing for many years. More recently, we have been seeing individual investors increasingly moving out of equity mutual funds and into equity ETFs. Both kinds of buyers tend to be much less concerned about historically high valuation multiples than more traditional buyers are.

As they have become increasingly popular, equity ETFs have been net issuers of equities at an increasing pace in recent years, while other financial issuers have been mostly dormant ([Fig. 7](#)). At the end of last year, equity mutual funds totaled \$9.19 trillion, while equity ETFs totaled \$2.03 trillion, according to the Fed's data ([Fig. 8](#)). Both have benefitted from the bull market in stocks, of course. However, Investment Company Institute data show that cumulative net inflows into equity mutual funds have been just \$198 billion since the start of the bull market during March 2009 through January 2017 ([Fig. 9](#)). Over the same period, \$1.1 trillion poured into equity ETFs ([Fig. 10](#)). On a year-over-year basis, the pace of net inflows increased by \$240.4 billion, the fastest for the series going back to 2001 ([Fig. 11](#)).

(3) *Demand side for Treasuries.* Interestingly, the Fed's data show total Treasury borrowing of \$842.8 billion, while the [Monthly Treasury Statement of Receipts and Outlays](#) shows that the deficit was \$580.0 billion during calendar 2016 ([Fig. 12](#)). On a 12-month basis, outlays continue to rise into record-high territory to \$3.9 trillion through February, while receipts have flattened out around \$3.3 trillion ([Fig. 13](#)).

So who were the big buyers of Treasuries last year? In first place were money market mutual funds with net purchases of \$313.2 billion. In second place was the household sector, which purchased \$205.5 billion. The biggest seller was the "rest of the world," which sold \$115.0 billion according to the Fed's data. Treasury data show that foreign holders sold \$142.3 billion last year in US Treasuries, led by a \$279.5 billion decline in the holdings of central banks ([Fig. 14](#)).

(4) *Demand side for agencies.* Apparently, the bulk of the \$351.6 billion raised by budget agencies, GSEs, and agency-/GSE-backed mortgage pools was provided by money market mutual funds (specifically, \$210.4 billion last year). The second-biggest buyers were US-chartered depository institutions (\$147.4 billion). In third place were foreign buyers (\$78.6 billion).

(5) *Demand side for corporates.* Much to our great surprise, the Fed's data show that the biggest buyers of the \$375.1 billion of net corporate bond issues last year were foreigners (\$309.8 billion) ([Fig. 15](#)). We thought that US investors were the ones reaching for yield. The household sector actually sold \$156.4 billion last year. However, individual investors might have fueled the \$78.8 billion and \$63.4 billion in purchases by mutual funds and ETFs. Life insurance companies (\$101.1 billion) led the purchasing of corporate bonds by the other institutional investors.

China Flow of Funds: Social Financing. The Chinese government doesn't compile anywhere near as much economic data as the US government does on our economy. The same goes for the flow of funds. However, every month the People's Bank of China does release data on various components of so-called "social financing." In dollars, this total amount of credit rose \$2.7 trillion over the past 12

months and \$19.9 trillion from January 2009 through February 2017 ([Fig. 16](#)). Bank loans rose \$1.1 trillion over the past 12 months and \$11.5 trillion since January 2009. These numbers simply blow away the amount of credit expansion in the US over the same periods.

Eurozone Flow of Funds: Loans. Meanwhile, while ECB President Mario Draghi has been doing whatever it takes to stimulate more credit expansion in the Eurozone, it remains lackluster at best ([Fig. 17](#)). Total lending by monetary financial institutions in the region has increased by just €155 billion over the past 12 months through January.

CALENDARS

US. Tues: NFIB Small Business Index 105.0, PPI-FD Total, Core, and Core Excluding Trade Services 0.1%/0.2%/0.3%, FOMC Meeting Begins. **Wed:** Retail Sales Total, Ex Autos, Ex Autos & Gas 0.2%/0.2%/0.3%, Business Inventories 0.3%, Empire State Manufacturing Index 15.7, Headline & Core CPI 2.7%/2.2% y/y, Housing Market Index 66, MBA Mortgage Applications, Treasury International Capital, EIA Petroleum Status Report, FOMC Meeting Announcement. (Bloomberg estimates)

Global. Tues: Eurozone Industrial Production 1.4%*m/m*/0.9%*y/y*, Germany CPI 0.6%*m/m*/2.2%*y/y*, Germany ZEW Economic Sentiment 13, China Retail Sales (ytd) 10.6% y/y, China Industrial Production (ytd) 6.2% y/y. **Wed:** UK Employment Change & Unemployment Rate 80k/4.8%, Japan Industrial Production. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose last week to record highs for LargeCap and MidCap. SmallCap's was down for a fourth straight week to 1.4% below its early February record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings rose to a 28-month high of 8.2% y/y from 8.1%, which compares to a six-year low of -1.8% in October 2015; MidCap's improved to a 27-month high of 10.4% from 9.5%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to 12.3% from 12.1%, which compares to a 31-month high of 12.5% in late February and a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax rate changes: LargeCap 10.7% and 12.2%, MidCap 10.0% and 13.2%, and SmallCap 11.0% and 18.9%.

S&P 500/400/600 Forward Valuation ([link](#)): Valuations fell across the board last week, but remain close to multi-year highs. P/E's have been melting up recently and beginning to reflect the impact of lower tax rates on corporate earnings, but the 'E' still remains low as analysts await legislative changes to the tax rate. LargeCap's forward P/E edged down to 17.7 from a 13-year high of 17.8. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E dropped to 18.7 from 19.1; that compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's fell to 19.6 from 20.0; that's up from a three-year low of 15.5 in February 2016, and compares to a 15-year high of 20.5 in early December when Energy's earnings were depressed and a record high of 20.9 in April 2002. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.94 and MidCap's 1.36 are at or close to record highs, while SmallCap's 1.07 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Q1 earnings estimate revision was mixed last week for the S&P 500 sectors as analysts began to make early adjustments ahead of the upcoming

quarterly earnings season. The Q1 consensus was steady w/w for one of the 11 S&P 500 sectors, rose for one, and fell for nine. Tech rose 0.5% w/w, and Real Estate was unchanged. Sectors with the biggest w/w percentage declines in their Q1 forecasts: Energy (-3.0%), Health Care (-1.8), Consumer Discretionary (-1.8), Materials (-0.9), Industrials (-0.7), and Consumer Staples (-0.7). The S&P 500's Q1-2017 EPS forecast fell 7 cents w/w to \$29.52, and is down 3.5% from \$30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 10.2% y/y, the strongest growth since Q3-2011, with the forecast down from 10.3% a week earlier and 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are higher for 1/11 sectors and lower for 10/11. The Q1 forecast for Real Estate is up 3.6% and Tech has edged down only 0.4%. Industrials is down the most (-7.2), followed by Materials (-6.8), Consumer Staples (-4.0), Health Care (-3.9), and Consumer Discretionary (-3.0). The S&P 500's Q1-2017 forecasted earnings gain of 10.2% y/y would be its third straight gain after four declines and the highest since Q3-2011. All 11 sectors are expected to record positive y/y earnings growth in Q1-2017, and four are expected to beat the S&P 500's y/y earnings gain of 10.2%. That's an improvement from the 9/11 sectors rising y/y during Q4-2016 and Q3-2016, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. Analysts expect Energy to report a profit relative to a year-ago loss and no longer think Industrials and Telecom will record y/y earnings declines as they had expected six weeks ago. The latest forecasted Q1-2017 earnings growth rates vs. their blended Q4-2016 growth rates: Energy (returning to a profit in Q1 from a year-ago loss vs. 5.4% in Q4), Financials (16.0% vs. 11.3%), Tech (13.7, 12.3), Materials (11.2, 7.1), S&P 500 (10.2, 7.8), Industrials (4.4, -0.9), Consumer Staples (2.5, 7.3), Health Care (2.6, 7.2), Telecom (2.6, -1.5), Real Estate (1.4, 8.7), Utilities (1.5, 10.1), and Consumer Discretionary (1.1, 5.4).

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