



## MORNING BRIEFING

July 18, 2017

### Orient Express

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

(1) Stir-frying China's economic growth with lots of debt. (2) Don't bet against a billion people. (3) China following Japan down the same road. (4) Chinese economy getting Botoxed as it ages and slows. (5) Premier Xi doing more of the same. (6) Social financing and bank lending at record highs. (7) A bit of good news: Shadow banking doing less of the lending, and capital outflows slowing. (8) Aging is a drag on China. (9) Improving margins.

**China: The Xi Dynasty.** China's real GDP rose 6.9% y/y during Q2 ([Fig. 1](#) and [Fig. 2](#)). During the quarter, it rose 6.7% (saar), which it's been hovering around since the end of 2013. That's a slowdown from the 10%-plus pace that was the norm in the years prior to the global financial crisis of 2008 and for a couple of years afterwards. Nevertheless, China's growth rate is impressive compared to those in most other countries in the world. Even more impressive is how much credit it is taking to prop up China's growth. Of course, this isn't impressive in a positive way, since economic growth financed by excessive debt often ends badly.

Nevertheless, Melissa and I aren't among China's doomsayers. We don't want to bet against over a billion Chinese people who are mostly hard-working, entrepreneurial, aspirational, and materialistic—kind of like Americans. Instead of a big-bang implosion, China may follow the path of Japan. China is going down the same demographic road as Japan, with a rapidly aging population. Both countries have piled up lots of debt to boost growth. Both are financing their debt extravaganzas mostly internally. Both of their central banks are pumping massive amounts of liquidity into their economies. So, like Japan, China's economic growth inevitably will slow as the population continues to age. All the injections of debt are akin to injections of Botox, which can make you look younger while you age and slow down. Consider the following:

(1) *Social financing.* Total social financing over the past 12 months through June rose by a record 19.2 trillion yuan, or a near-record US\$2.8 trillion ([Fig. 3](#)). It has been on a tear since the Chinese government pumped up the economy in response to the financial crisis of 2008. The country has become increasingly addicted to debt, and can't seem to break the habit despite government officials' previous assurances that will happen. It hasn't happened so far because the government hasn't figured out any other way (such as free-market capitalism) to boost growth. Since Premier Xi Jinping assumed command during November 2012, social financing has totaled a whopping \$11.2 trillion, with bank loans up \$6.4 trillion!

(2) *Bank loans & M2.* Bank loans are the largest component of social financing. Over the past 12 months through June, they rose by a record 13.2 yuan, or a record US\$1.9 trillion ([Fig. 4](#)). Astonishingly, bank loans have more than tripled since the end of 2008, soaring by 280% to a record \$16.8 trillion during June ([Fig. 5](#)).

The good news—we guess—is that all of this bank debt has been financed entirely by an increase in M2. So the Chinese owe it to themselves, similar to what has been happening in Japan for many years.

(3) *Shadow banking system.* Also mildly encouraging—we guess—is that the authorities seem to be making a bit of progress throttling back the shadow banking system. We estimate shadow banking activity by subtracting bank lending from total social financing ([Fig. 6](#)). Doing so suggests that on a 12-month basis, the shadow banks accounted for a record 55.1% of social financing through May 2013 ([Fig. 7](#)). That percentage fell to a recent low of 25.1% through July 2016. It was back up to 31.3% in June of this year.

(4) *PBOC & capital flows.* The Chinese government's efforts since early last year to stem capital outflows are showing some signs of success. The PBOC's non-gold international reserves, which peaked at a record \$4.0 trillion during June 2014, fell to \$3.0 trillion during December 2016 ([Fig. 8](#)). It has been stable since then through June. The yuan fell along with reserves, but has firmed up since making a recent low on January 3.

Debbie and I calculate an implied international capital flows proxy by subtracting China's 12-month trade surplus from the 12-month change in China's international reserves ([Fig. 9](#) and [Fig. 10](#)). It still shows a significant net outflow of \$602 billion over the past 12 months through June, but that's a big improvement from the record \$1.18 trillion through January 2016.

(5) *Industrial production & trade.* Just for fun, we compare the growth rates of China's bank loans to industrial production and track the ratio of the former to the latter ([Fig. 11](#) and [Fig. 12](#)). The ratio of bank loans to industrial production confirms our concerns about China's increasingly debt-financed growth. All that debt seems to be having a decreasing impact on boosting economic growth. The ratio was relatively stable around 100 from 2000-2008. Since then, it has risen sharply and persistently to a record 170 during June. The Chinese seem to be getting less and less output bang per yuan.

The good news is that China's trade data (in yuan) has improved significantly since early last year, with both exports and imports near record highs in June ([Fig. 13](#)). The y/y growth rates for these categories were strong at 16.9% and 22.6% ([Fig. 14](#)). The exports data suggest that the global economy is growing solidly, though some of that may be due to the stimulus provided indirectly by China's ongoing borrowing binge.

(6) *Demographics.* Weighing on China's growth rate is its geriatric demographic profile. The country's fertility rate dropped below the replacement rate of 2.1 children per woman during 1995, and is expected to remain below that level through the end of the century, according to UN projections ([Fig. 15](#)).

The growth rate of the population is projected to turn negative during 2033 ([Fig. 16](#)). The growth rate of the working-age population (WAP) already turned negative during 2016 and is expected to remain so through the end of the century—with WAP falling to 558 million from a peak of 1,015 million during 2015 ([Fig. 17](#) and [Fig. 18](#)).

(7) *MSCI metrics.* The China MSCI stock price index (in yuan) is up 29.3% ytd through Friday, and 57.6% from last year's low on February 12 ([Fig. 19](#)). It is selling at a relatively low forward P/E of 12.6 currently ([Fig. 20](#)). Weighing on valuation may be the flat trend in forward revenues since early last year ([Fig. 21](#)). On the other hand, forward earnings has turned up since late last year. The big story in the MSCI data may be that China's forward profit margin has been expanding from a low of 3.3% during the week of November 29, 2012 to a nine-year high of 4.1% in early July of this year ([Fig. 22](#)).

## CALENDARS

**US. Tues:** Import & Export Prices -0.3%/0.0%, Housing Market Index 68, Treasure International

Capital. **Wed:** Housing Starts & Building Permits 1.170mu/1.206mu, MBA Mortgage Applications, EIA Petroleum Status Report. (Bloomberg estimates)

**Global. Tues:** Germany ZEW Economic Sentiment 18, UK Headline & Core CPI 2.9%/2.6% y/y, ECB Bank Lending Survey, RBA July Meeting Minutes. **Wed:** Japan Merchandise Trade Balance (yen) 488b. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** ([link](#)): Forward earnings rose last week to record highs for all three market-cap indexes. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early. In the latest week, LargeCap's forward earnings was up 9.9% y/y, unchanged from a week earlier and compares to a 64-month high of 10.2% ten weeks ago and a six-year low of -1.8% in October 2015; MidCap's improved to 13.1% from 12.9%, which compares to a 65-month high of 13.2% in late June and six-year low of -1.3% in December 2015; and SmallCap's slowed to 12.9% from a 38-month high of 13.0%, which compares to a six-year low of 0.3% in December 2015. Consensus growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 11.3% and 11.8%, MidCap 11.0% and 13.6%, and SmallCap 10.0% and 18.9%.

**S&P 500/400/600 Forward Valuation** ([link](#)): Forward P/E ratios were higher for the three indexes last week. Valuations have improved from their more-than-five-month lows in mid-April, but remain below their multi-year highs in early March. P/Es have melted up since the election, but the "E" still remains low as analysts await legislative changes to the tax rate and its impact on corporate earnings. LargeCap's forward P/E rose to a six-week high of 17.6 from 17.4, which compares to early June's 11-week high of 17.7 and the 13-year high of 17.8 in early March. 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 rose to a five-week high of 18.2 from 18.0, which compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002. MidCap's is up from a three-year low of 15.0 in January 2016. SmallCap's improved to 19.2 from 19.0, which compares to a recent high of 19.7 in early June and a 15-year high of 20.5 in early December when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016 and remains close to SmallCap's record-high P/E 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 remains near mid-June's record high of 1.95, while MidCap's 1.30 is close to its record high of 1.37 in late February. SmallCap's 1.00 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](#)): Q2 earnings estimates for the 11 S&P 500 sectors were mixed last week as analysts and investors awaited Q2 earnings results. The Q2 consensus fell w/w for six of the 11 S&P 500 sectors, rose for four, and was steady for one. Utilities rose 2.7% w/w, ahead of Industrials (0.9%), Consumer Staples (0.5), and Health Care (0.2). Sectors with the biggest w/w decline in their Q2 forecast: Energy (-5.3), Financials (-0.9), and Real Estate (-0.8). The S&P 500's Q2-2017 EPS forecast fell 5 cents w/w to \$31.42, and is down just 2.1% from \$32.04 at the end of Q1. That represents a forecasted pro forma earnings gain for Q2-2017 of 8.1% y/y, down from Q1's blended 15.3%, which is the strongest growth since Q3-2011 owing mostly to easier comps for Energy. The Q2-2017 forecast is up from 7.9% a week earlier, but down from 11.9% at the end of Q4. Since the end of Q1, Q2 estimates are lower for nine sectors and higher for two. Industrials' Q2 forecast has risen 1.7%, and Utilities has gained 1.0%. Energy's has tumbled 17.6% for the worst decline, followed by the Q2 forecasts for Materials (-4.8), Telecom (-4.7), Consumer Discretionary (-3.6), and Financials (-3.5). The S&P 500's Q2-2017 forecasted earnings gain of 8.1% y/y would be its

fourth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q2-2017, but only three are expected to beat the S&P 500's forecasted y/y earnings gain of 8.1%. That's because analysts expect Energy to report a large profit jump in Q2 relative to very low earnings a year ago. Still, that matches the 10/11 sectors that rose y/y on a blended basis during Q1-2017. The latest forecasted Q2-2017 earnings growth rates vs their blended Q1-2017 growth rates: Energy (578.2% in Q2 vs a return to a profit in Q1), Tech (11.2% vs. 19.8%), Financials (9.0, 19.9), S&P 500 (8.1, 15.3), Consumer Staples (4.1, 3.7), Materials (3.9, 19.3), Industrials (3.1, 4.1), Health Care (2.4, 7.3), Real Estate (1.8, 2.8), Consumer Discretionary (1.1, 6.0), Telecom (1.0, -4.9), and Utilities (-3.4, 2.7).

## US ECONOMIC INDICATORS

**Regional M-PMI** ([link](#)): The New York Fed district, the first to report on manufacturing for this month, shows business activity continued to expand in July, though at a slower pace. The composite index fell to 9.8 in July after rebounding from -1.0 in May to 19.8 in June, which was the best growth since September 2014. Both orders (to 13.3 from 18.1) and shipments (10.5 from 22.3) continued to grow, though at a more leisurely pace than during June; the employment gauge (3.9 from 7.7) revealed a slowing in hirings for the third month, while hours worked (0.0 from 8.5) were flat this month. Delivery times (4.7 from 5.4) continued to lengthen, and inventory levels (2.4 from 7.7) were fairly steady. While the sixth-month outlook deteriorated a bit, it remained favorable, with the future business conditions index down 6.8 points to 34.9—still a healthy level.

## GLOBAL ECONOMIC INDICATORS

**World CPI** ([link](#)): Global consumer prices continued to slow, from 3.1% in January to 2.6% y/y in May, nearing its cyclical low of 2.4% recorded last August—which was the lowest since October 2009. World inflation has been trending lower since peaking at 5.2% in September 2011. April's inflation rate for emerging economies, at 4.0% y/y, is the lowest since February 1969, easing steadily since its recent peak of 6.0% at the end of 2015. Meanwhile, the rate for advanced economies has slowed the past few months to 1.6% y/y in May after accelerating from 0.1% in September 2015 to 2.0% in February of this year, which was the highest since April 2012.

**Eurozone CPI** ([link](#)): June's CPI rate was 1.3% y/y (matching the flash estimate), holding below the ECB's goal of just under 2.0% for the second month; April's 1.9% rate was in line with the ECB goal. Looking at the main components, energy (to 1.9% from 4.5% y/y) had the highest annual rate, though it slowed significantly, while the rates for services (1.6 from 1.3) and non-energy industrial goods (0.4 from 0.3) accelerated slightly; the rate for food, alcohol, and tobacco (1.4 from 1.5) was little changed. The core rate—which excludes energy, food, alcohol, and tobacco—rose from 0.9% to 1.1%, back near April's 1.2%, which was the highest in almost four years. Of the top four Eurozone economies, inflation rates in Spain (1.6% y/y) and Germany (1.5) were above the Eurozone's 1.3%, while Italy's (1.2) and France's (0.8) were below. Ireland (-0.6) was the only Eurozone economy with a negative rate.

**US CPI** ([link](#)): The core CPI rate in June held at 1.7%, below the Fed's target rate of 2.0% y/y for the third month, after 15 months above—ranging from 2.1% to 2.3%—from December 2015 through February of this year. The three-month rate accelerated 1.0% (saar) after no change in May, which was the lowest reading in seven years. On a monthly basis, core prices edged up 0.1% for the third month, after edging down 0.1% in March—which was the first monthly loss since January 2010. During June, shelter costs continued to climb along with medical care, motor vehicle insurance, education, and personal care; prices for air fares, used cars & trucks, wireless telephone services, and new vehicles moved lower. The headline CPI was flat after falling two of the prior three months. The yearly rate slowed for the fourth month to 1.6% after climbing steadily from 0.8% in July 2016 to 2.7% in February.

**US PPI** ([link](#)): The PPI for final demand ticked up 0.1% in June after showing no change in May. Prices for final demand goods inched up 0.1% after falling 0.5% in May, which was the biggest decline in 15 months; prices for final demand services advanced 0.2%, slowing from 0.3% and 0.4% the prior two months. Most of last month's gain in the final demand goods can be attributed to a 0.5% increase in food costs, specifically meat prices, which jumped 5.5%; energy prices fell 0.5% during the month. June's gain in final demand services was led by a 4.0% jump in costs for securities brokerage, dealing, investment advice & related services. The yearly inflation rate for the headline series was 2.0%, slowing from 2.4% in May and 2.5% in April, which was the largest increase since February 2012. The goods rate slowed to 2.2% y/y since peaking earlier this year at a five-year high of 4.0%, while the services rate eased to 1.9% y/y after accelerating to a 29-month high of 2.1% in May. The rate for the core (1.9% y/y) slowed from May's reading of 2.1%, which was the highest since May 2014, while the core ex trade services ticked down to 2.0% from the April/May high of 2.1%.

---

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](#).