



## MORNING BRIEFING

July 25, 2017

### Go With the Capital Flows

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

(1) Dollar moved down as global economy was moving on up. (2) Dollar peaked after Trump won and before latest two Fed rate hikes. (3) Draghi and Kuroda are more dovish than Brainard and Yellen. (4) Our international capital flows proxy turned less bullish for the dollar last year. (5) International reserves holdings by central banks also a good barometer for the dollar. (6) Draghi has done whatever it takes, yet the euro is strengthening again. (7) Are emerging markets less prone to Fed tightening tantrums? (8) Oil and the dollar divergence is unusual.

**Currencies I: Our Doves vs Theirs.** The neighborhood is improving. Since late last year, the global economy has been showing signs of better growth that seems to be outpacing US growth. That's most likely why the US trade-weighted dollar is down 7% to 116.90 since peaking at 126.21 on January 11 ([Fig. 1](#)). That's after it rose 26% from 99.89 on July 1, 2014 to this year's peak, with the rally reflecting the fact that the Fed started to normalize monetary policy during the second half of 2014, while the ECB and BOJ remained committed to maintaining their ultra-easy monetary policies.

The Fed had greater confidence in the US economy than the ECB had in the Eurozone's economy and the BOJ had in Japan's economy. So the Fed terminated QE on October 31, 2014, hiking the federal funds rate by 25bps at the end of 2015, and again at the end of 2016. The dollar jumped after Donald Trump's Election Day victory boosted animal spirits and expectations of stimulative fiscal policies. While those high hopes haven't been dashed, they certainly have been postponed given the ongoing turmoil in DC that's weighed on the dollar.

The dollar peaked on January 11 despite another two Fed rate hikes of 25bps so far this year on March 15 and June 14, while the official rates of both the ECB and BOJ remain slightly south of zero ([Fig. 2](#)). Furthermore, despite speculation that the ECB and BOJ might soon join the Fed in normalizing their monetary policies, the assets on both their balance sheets continued to grow. They recently exceeded the Fed's assets, which have been flat around \$4.4 trillion since QE was terminated during October 2014 ([Fig. 3](#)). As Melissa and I wrote yesterday, both ECB President Mario Draghi and BOJ Governor Haruhiko Kuroda signaled last week that they are in no rush to normalize given that their CPI inflation rates remain below their 2.0% targets.

This suggests that perhaps the dollar might stop falling. We don't expect it will resume rallying. More likely is that it will move sideways for a while. Consider the following:

(1) *Easy does it on Fed tightening.* Melissa and I have noted that during her congressional testimony on monetary policy during July 12 and 13, Fed Chair Janet Yellen reiterated that the FOMC is still committed to rate hikes. However, she added that her goal is to reach a neutral level of interest rates that is lower than it has been historically and not so far off from where the federal funds rate is set now.

She thus supported a similar view expressed by her colleague (and BFF) Fed Governor Lael Brainard, who said in a 7/11 [speech](#) that "the neutral level of the federal funds rate is likely to remain close to

zero in real terms over the medium term.” Considering that, there would not be “much more additional work to do on moving to a neutral stance” from the moderately accommodative stance now. She added that the FOMC “decided to delay balance sheet normalization until the federal funds rate had reached a high enough level to enable it to be cut materially if economic conditions deteriorate.”

(2) *Brainard’s dollar dialectic*. Brainard’s speech was all about the impact of the Fed’s monetary normalization on the dollar. It was titled “Cross-Border Spillovers of Balance Sheet Normalization,” and mentioned “exchange rate” 47 times in her comments and footnotes, obviously acknowledging that the foreign exchange value of the dollar is now an important consideration in the setting of monetary policy. Brainard seemed to conclude that it is best to lean toward reducing the balance sheet, as it should put less upward pressure on the dollar than raising interest rates, in her opinion. In other words, rate-hiking might end soon once balance-sheet reductions start.

These dovish sentiments have been reflected in the recent weakness of the dollar, in our opinion, while the dollar’s rally from mid-2014 through early 2016 discounted the divergent monetary policy in the US and elsewhere—i.e., the gradual normalization of US policy and the continuation of ultra-easy policy in the Eurozone and Japan. On a relative basis, it seems to us that Draghi and Kuroda are even more dovish than Brainard and Yellen, which is why the dollar should stop falling.

**Currencies II: Capital Flows Weaken Dollar.** The value of the trade-weighted dollar is driven by the US trade balance with the rest of the world and by US capital inflows and outflows. The US has been running a trade deficit with the rest of the world for many years. The flip side of the US trade deficit is the trade surplus of the world with the US ([Fig. 4](#)). This trade surplus provides foreigners with dollars, which they can use to purchase US assets. If they would rather convert them to their own currencies, then the dollar will depreciate, unless foreign central banks intervene by purchasing the dollars and holding them as international reserves. Many foreign central banks have been inclined to do so over the years, supporting the dollar, because otherwise strength in their currencies relative to the dollar might depress the competitive position of their exports in America, the world’s largest market for foreign goods.

Debbie and I calculate implied net capital flows of the rest of the world (ROW) simply by subtracting the ROW’s trade surplus, on a 12-month basis, from the 12-month change in the non-gold international reserves held by the central banks of the ROW ([Fig. 5](#)). Our proxy is highly inversely correlated with the trade-weighted dollar on a y/y basis. Let’s have a closer look:

(1) *Implied net capital flows & the dollar*. Since the financial crisis of 2007/08, there have been a few significant swings in our proxy ([Fig. 6](#)). It showed large net outflows from the ROW during 2008, 2012, and 2014/15—coinciding with periods of strength in the dollar. There were net capital inflows for the ROW during 2010/11 and a significant easing in net capital outflows since early 2016—coinciding with weakness in the dollar.

(2) *International reserves & the dollar*. Most of the volatility in our proxy is attributable to the yearly change in international reserves held by the ROW, which is also highly inversely correlated with the trade-weighted dollar ([Fig. 7](#)). When the ROW’s reserves are increasing, that shows that foreign central banks are accumulating reserves mostly in dollars to keep their currencies from appreciating relative to the dollar. Most recently, reserves fell by \$877 billion during the 12 months through January 2016, which coincided with the dollar’s strength. Over the past, 12 months through April, the proxy showed net capital outflows of only \$49 billion.

Finally, there is even a better fit between the yearly percent change (rather than the y/y change) in international reserves and inverse of the yearly percent change in the trade-weighted dollar ([Fig. 8](#)).

The former was flat y/y through April, but that's better than the recent trough of -7.2%.

**Currencies III: For Draghi, Strong Euro a Drag.** Draghi's dovish tone last week must have been related to the recent strength in the euro ([Fig. 9](#)). It is up from last year's low of \$1.04 to \$1.16 currently. To an important extent, Draghi's rounds of ultra-easy monetary policies were aimed at depreciating the Eurozone's currency. His "whatever it takes" speech on July 26, 2012 didn't do that at first, as the euro actually rose from \$1.23 on that day to peak at \$1.39 during May 6, 2014.

Draghi resorted to a shock-and-awe approach with negative interest rates starting on June 5, 2014 followed by a QE program on January 22, 2015, and an expansion of that program on March 10, 2016. That all worked to bring the euro down to last year's low of \$1.04.

What can Draghi do if the euro continues to strengthen? Not much other than to coo dovishly as often as possible.

**Currencies IV: EM Currencies Emerging Again.** Perversely, the weakness in the dollar since early this year may have something to do with the Fed's two rate hikes during March and June. As noted above, Fed officials have been softening the blows by saying that the rate hikes should be gradual, and might be over relatively soon. Furthermore, the dollar may have weakened because the rate hikes haven't had any adverse impact on the bonds, currencies, and stock markets of emerging market economies. There have been no tightening tantrums in any of those financial markets.

This suggests that emerging markets may be able to handle Fed rate hikes, at least gradual ones, without any adverse consequences. Indeed, the Emerging Markets MSCI stock price index is up 18.9% y/y in local currency through last Friday and 21.7% in US dollars ([Fig. 10](#)). The Emerging Markets MSCI Index Currency Ratio is up 2.3% y/y ([Fig. 11](#)).

**Currencies V: Slippery Slope.** The price of a barrel of Brent crude oil has had one of the best inverse correlations with the trade-weighted dollar since 2005 ([Fig. 12](#)). However, they've diverged so far this year, with the former down 14% ytd, while the latter is down 7% over the same period. In the past, a weak dollar would have been bullish for oil. Since we think causality runs both ways, weak oil prices should be bullish for oil. We think there is a better fundamental case to be made for weak oil prices than for a weaker dollar from this level.

## CALENDARS

**US. Tues:** Consumer Confidence 117.0, Richmond Fed Manufacturing Index 8, S&P Case-Shiller HPI 5.8% y/y, FHFA House Price Index 0.6%, FOMC Meeting Begins. **Wed:** New Home Sales 612k, MBA Mortgage Applications, EIA Petroleum Status, FOMC Meeting Announcement 1.125%. (Bloomberg estimates)

**Global. Tues:** Germany Ifo Business Climate, Current Assessment, and Expectation Indexes 114.9/123.8/106.5. **Wed:** UK GDP 0.3%q/q/1.7%y/y, Australia CPI 2.2% y/y. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings ([link](#)):** LargeCap's forward earnings edged down from a record high last week for the first time in 23 weeks, but MidCap's and SmallCap's rose to new records. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016. In the latest week, LargeCap's forward earnings was up 9.6% y/y, down from 9.9% a week earlier, and compares to a 64-month high of 10.2% 11 weeks ago and a six-year low of -1.8% in

October 2015; MidCap's ticked down to 13.0% from 13.1%, 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 improved to a 39-month high of 13.0% from 12.9%, which compares to a six-year low of 0.3% in December 2015. Consensus growth rates expected for 2017 and 2018 are edging lower now, but should improve if the corporate tax rate changes: LargeCap 11.2% and 11.5%, MidCap 10.8% and 13.6%, and SmallCap 9.8% and 18.9%.

**S&P 500/400/600 Forward Valuation** ([link](#)): Forward P/E ratios were slightly 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 an 18-week high of 17.7 from 17.6, which compares to 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 six-week high of 18.2 from 18.1, 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 a five-week high of 19.2 from 19.1, 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 1.97 is at a new record high, while MidCap's 1.32 is close to its record high of 1.37 in late February. SmallCap's 1.01 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 Q2 earnings results began trickling in. The Q2 consensus fell w/w for six of the 11 S&P 500 sectors, rose for three, and was steady for two. Financials rose 5.6% w/w, ahead of Industrials (0.8%), and Tech (0.7). Sectors with the biggest w/w decline in their Q2 forecast: Energy (-6.8), Health Care (-1.7), and Consumer Staples (-0.8). The S&P 500's Q2-2017 EPS forecast rose 22 cents w/w to \$31.64, and is down just 1.4% from \$32.04 at the end of Q1. That represents a forecasted pro forma earnings gain for Q2-2017 of 9.6% 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 8.1% a week earlier, but down from 11.9% at the end of Q4. Since the end of Q1, Q2 estimates are lower for eight sectors and higher for three. Industrials' Q2 forecast has risen 2.5%, Financials' is up 1.9%, and Utilities' has gained 0.7%. Energy's has tumbled 23.2% for the worst decline, followed by the Q2 forecasts for Materials (-5.2), Telecom (-4.7), and Consumer Discretionary (-3.8). The S&P 500's Q2-2017 forecasted earnings gain of 9.6% 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 9.6%. 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 (540.0% in Q2 vs a return to a profit in Q1), Tech (16.3% vs. 19.8%), Financials (11.8, 19.9), S&P 500 (9.6, 15.3), Industrials (4.8, 4.1), Consumer Staples (3.3, 3.7), Materials (3.3, 19.3), Health Care (3.0, 7.3), Real Estate (2.8, 2.8), Consumer Discretionary (1.0, 6.0), Telecom (0.9, -4.9), and Utilities (-3.8, 2.7).

**S&P 500 Q2 Earnings Season Monitor** ([link](#)): With nearly 21% of S&P 500 companies finished reporting Q2-2017 results, their revenue and earnings surprise data are better than at the comparable point of the Q1 season, but y/y growth comparisons are mixed. Of the 103 companies in the S&P 500 that have reported, 75% exceeded industry analysts' earnings estimates by an average of 7.0%; they

have averaged a y/y earnings gain of 17.2%. At the same point during the Q1-2017 reporting period, a similar percentage of companies (75%) in the S&P 500 had beaten consensus earnings estimates by a lower 6.0%, and earnings were up a lower 11.7% y/y. On the revenue side, 73% beat sales estimates so far, with results coming in 1.3% above forecast and 4.2% higher than a year earlier. At this point in the Q1 season, a lower 63% had exceeded forecasts, companies reported revenues a lower 0.9% above forecast, and sales rose a slightly higher 4.4% y/y. Q2 earnings results are higher for 64% of companies vs 75% at the same point in Q1, but revenues are higher for 84% vs 79% a quarter ago. Although these figures will change markedly as more Q2-2017 results are reported in the coming weeks, the early results are encouraging. Q2-2017 should mark the fourth straight quarter of positive y/y earnings growth, but growth is likely to fall back into the single digits following Q1's double-digit percentage growth, which was the first double-digit growth seen since Q3-2011.

## US ECONOMIC INDICATORS

**Existing Home Sales** ([link](#)): “The demand for buying a home is as strong as it has been since before the Great Recession. Listings in the affordable price range continue to be scooped up rapidly, but the severe housing shortages [afflicting] many markets are keeping a large segment of would-be buyers on the sidelines,” according to NAR’s chief economist. Existing home sales—tabulated when a purchase contract closes—remained volatile around recent highs in June, falling 1.8% to 5.52mu (saar) after changes of 1.1%, -2.5%, and 4.2% the prior three months. Sales remain slightly above year-ago levels. Single-family home sales sank 2.0% to 4.88mu (saar), falling three of the first six months of 2017 for a ytd decline of 0.6%; multi-family sales were flat at 640,000 units in June and are up 6.7% ytd. Regionally, sales in June rose in the Midwest, but fell in the other regions; compared to a year ago, sales were up in the West (2.5% y/y) and Northeast (1.3) and unchanged in the Midwest and South. The number of existing single-family homes on the market remained at 1.74mu last month after rising steadily from 1.45mu in December—they were still 7.5% lower than a year ago, and have recorded y/y declines for 25 consecutive months. Unsold inventory was at 4.3 months’ supply, up from 3.5 in December, still an exceptionally low reading.

## GLOBAL ECONOMIC INDICATORS

**US PMI Flash Estimates** ([link](#)): Private-sector growth continued to gain momentum this month, posting its fastest growth in six months on accelerated manufacturing activity. The C-PMI flash estimate climbed for the fourth month from 53.0 in March to 54.2 this month, the best reading since January’s 14-month high of 55.8. The M-PMI rebounded to a four-month high of 53.2 after sinking to a nine-month low of 52.0 in June; the NM-PMI was unchanged at June’s five-month high of 54.2. According to the report, levels of business activity in the manufacturing sector were supported by the strongest increase in new orders in six months, with job gains the fastest so far this year. Respondents in the service sector noted a greater willingness to spend among their clients this month, showing the strongest upturn in new work in two years, leading to stronger job creation. As for price inflation, an acceleration in input price pressures across the manufacturing sector contrasted with a slowing in cost inflation in the service sector.

**Eurozone PMI Flash Estimates** ([link](#)): Growth in the Eurozone in July slowed for the second straight month, though “remained at an elevated level by historical standards and signaled one of the strongest expansions seen over the past six years,” according to Markit. Meanwhile, inflationary pressures continued to cool from the five-and-a-half-year high recorded at the start of the year. July’s flash estimate shows the C-PMI slipped to a six-month low of 55.8, not far from April/May’s 56.8, which was the best pace since spring 2011. Both the M-PMI (to 56.8 from 57.4) and NM-PMI (unchanged at 55.4) remained around their cyclical highs of 57.4 and 56.4 in June and April, respectively. According to the report, growth of new orders and backlogs rose at rates only modestly below recent six-year peaks,

while job creation continued to run at one of the highest seen over the past decade—with manufacturing reporting its second-highest employment gain on record. By country, C-PMIs in Germany (55.1 from 56.4) and France (55.7 from 56.6) both showed growth slowed this month though remained robust. While NM-PMIs in both Germany (53.5 from 54.0) and France (55.9 from 56.9) eased, France saw its M-PMI (55.4 from 54.8) reach a 75-month high; growth in Germany's (58.3 from 59.6) manufacturing sector slowed, but continued to outpace France's. Growth across the rest of the Eurozone perked up, recording the second largest monthly rise in output in the past decade, while employment gains remained one of the highest seen in the past ten years.

**Japan M-PMI Flash Estimate** ([link](#)): Japan's manufacturing activity this month rose at the slowest pace in eight months, according to its flash estimate. The M-PMI slipped for the second month to 52.2 in July after climbing from 52.4 to 53.1 the prior two months, continuing to bounce around February's cyclical high of 53.3. July's report notes a further easing of growth in both new orders and output from May's recent highs, driven by weaker demand in orders from the Southeast Asia markets. Still, employment growth in the sector remains among the best since the financial crisis. Meanwhile, optimism reached its highest level in five years of data collection.

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