Abnormal Times

See the collection of the individual charts linked below.

(1) Former Fed head Dudley joins the resistance. (2) Exploding heads. (3) Depressing global economic headlines. (4) Fiscal and monetary stimulus losing their effectiveness as trade policies increase uncertainty. (5) In US, tax-cut boost to growth is wearing off already. (6) What’s the matter with Germany? (7) Yet: S&P 500 forward revenues and earnings at record highs. (8) CBO predicting trillion-dollar budget deficits for the next 10 years, with Treasury debt rising to $21 trillion by 2029. (9) Lots of assumptions. (10) A hard Brexit may be too hard to swallow.


He wants the Fed to fight fire with fire: “I understand and support Fed officials’ desire to remain apolitical. But Trump’s ongoing attacks on Powell and on the institution have made that untenable. Central bank officials face a choice: enable the Trump administration to continue down a disastrous path of trade war escalation, or send a clear signal that if the administration does so, the president, not the Fed, will bear the risks—including the risk of losing the next election.”

In other words, the Fed shouldn’t offset the uncertainties caused by Trump’s trade policies with lower interest rates, even if that leads to a recession. The Fed should refuse to meet its legal mandate to maintain full employment and price stability rather than enable Trump.

Dudley is essentially calling for the Fed to overthrow the President in the coming election: “There’s even an argument that the election itself falls within the Fed’s purview. After all, Trump’s reelection arguably presents a threat to the U.S. and global economy, to the Fed’s independence and its ability to achieve its employment and inflation objectives. If the goal of monetary policy is to achieve the best long-term economic outcome, then Fed officials should consider how their decisions will affect the political outcome in 2020.”

I am almost speechless. Dudley may be calling on the Fed to join the resistance and to fight fire with fire, but that would be playing with fire for the Fed. Welcome to the New Abnormal, where everyone loses their minds! Trump has the amazing ability to make sane people go insane. (For more on this, Google search “Trump Derangement Syndrome.”)

Strategy: Industry Analysts Remain Bullish. The headlines about the global economy remain depressing, yet industry analysts who cover the S&P 500 corporations remain upbeat. That’s impressive considering that 30%-40% of S&P 500 revenues and earnings comes from overseas. Not only are overseas economies weak, but the dollar remains strong, which reduces the dollar value of
earnings from abroad.

In our opinion, the economic weakness overseas isn’t attributable solely to Trump’s trade skirmishes. Debbie and I believe that aging demographic profiles and piles of burdensome debt are weighing on economic growth around the world. Not even ultra-easy monetary conditions in Europe and Japan or plentiful bank loans in China are rousing the global economy out of its funk.

In the US, real GDP has resumed growing at around a 2% annual rate after receiving a short-lived boost from Trump’s tax cuts last year. The President is clearly disappointed and upset that his supply-side tax cuts have yet to sustainably boost economic growth. That’s evident in his railings about the Fed as he calls for more interest-rate cuts. Let’s have a closer look at some recent developments:

(1) **US real GDP growth back to 2%**. On a y/y basis, US real GDP rose 2.0% during Q4-2016, just before Trump moved into the White House (Fig. 1). His tax cuts boosted that growth rate to 3.2% during Q2-2018. But it was back down to 2.3% during Q2-2019. Economic uncertainty attributable to Trump’s helter-skelter trade policies undoubtedly are weighing on the economy. And so might be the prospects of huge federal deficits over the next 10 years, as Melissa and I discuss below.

The good news is that the Index of Leading Economic Indicators (LEI) jumped 0.5% during July after two straight months of decline (Fig. 2). Keep in mind that one of the 10 components of the LEI is the yield-curve spread, which was negative for the second month in July, after turning negative in June for the first time since January 2008 (Fig. 3).

The Index of Coincident Economic Indicators rose 0.2% during July to yet another record high. It is up 1.8% y/y, consistent with real GDP growth of around 2% (Fig. 4).

(2) **Something is wrong with Germany**. German real GDP fell 0.3% (saar) during Q2 after rising 1.5% during Q1 (Fig. 5). It is up just 0.4% y/y (Fig. 6).

Germany relies heavily on exporters that sell a large amount of goods to China and the US, which are locked in a trade war. The country’s carmakers are facing weak global auto demand, and fears of a disorderly Brexit remain a drag. The outlook remains grim for Q3, as Germany’s IFO business confidence index plummeted from 99.8 during January to 94.3 during August, the lowest since November 2012 (Fig. 7).

(3) **Industrial commodity prices remain weak**. Confirming the weakness in the global economy, especially in global manufacturing, is the CRB raw industrials spot price index (Fig. 8). It is down 7.5% ytd. Weak commodity prices tend to be associated with a strong trade-weighted dollar, which is up 4.0% y/y.

(4) **S&P 500 forward revenues and earnings are at record highs**. Notwithstanding all of the above, Joe reports that S&P 500 forward revenues rose once again to a new record high during the 8/15 week (Fig. 9). As we have often observed in the past, this weekly series is a very good coincident indicator of actual quarterly S&P 500 revenues, which rose to a record high during Q2. Also near recent record highs are S&P 500 forward earnings and the forward profit margin.

**US Budget Deficits: A Trillion Here, a Trillion There**. Here is some grim reading: Last week, the Congressional Budget Office (CBO) released its August 2019 *The Budget and Economic Outlook: 2019 to 2029*. It projects that the federal budget deficit will be $960 billion in FY2019 and average $1.2 trillion between 2020 and 2029 (Fig. 10).
Treasury debt held by the public is projected to nearly double from $16.6 trillion this year to $29.3 trillion in 2029. Over this same period, the ratio of this debt to GDP should rise from 78.9% to 95.1%, according to the CBO (Fig. 11). Many investors are concerned that the government is quickly running out of room for more fiscal stimulus, should it be needed, at a time when the Fed is running out of ammo to fight off the next recession.

Here are some of the key underlying assumptions behind the CBO’s projections and our spin:

1. **GDP.** The CBO expects real GDP to grow by 2.3% in 2019. From 2020-2023, annual output growth is projected to slow to an average of 1.8%. From 2024-2029, growth is expected to stay at that rate, which is lower than the long-term historical average.

2. **Productivity.** Approximately 40% of that slowdown is a result of slower growth of the potential labor force, with the remaining 60% from lower potential labor productivity growth, according to CBO. Labor productivity growth is expected to slow from an annual average of 1.6% from 2019-2023 to 1.4% from 2024-2029 (see CBO’s Figure 2-1).

We think productivity could grow faster and may be starting to do so already, as we discussed in our 8/19 Morning Briefing. CBO acknowledges that there is a high degree of uncertainty in these projections.

3. **Inflation.** When GDP is higher than its potential (as it is now, according to the CBO), it means that the demand for goods and services is higher than the economy’s maximum sustainable level of production. That leads to increased demand for labor and puts upward pressure on inflation and interest rates, observed the CBO.

After 2019, the CBO expects inflation, as measured by the core PCED, to rise above 2.0%, which is the Fed’s target for inflation. Specifically, the CBO sees core PCED inflation increasing to 2.2% in 2020 from 1.9% in 2019. From 2024-2029, when actual and potential GDP are expected to be about the same, the CBO projects inflation to average 2.0%.

We expect lower inflation than that, as the powerful deflationary forces we call the “4Ds” (déétente, disruption, demographics, and debt) continue to contain it below 2.0% for the foreseeable future.

4. **Interest rates.** The estimates for inflation impact the assumptions for interest costs to the government. From 2020-2029, primary deficits, excluding net interest outlays, are projected to be $1.9 trillion higher than they were in the CBO’s previous baseline projections. That increase is partially offset by a reduction of $1.1 trillion in interest costs.

The CBO stated: “The largest factor contributing to that change is that CBO revised its forecast of interest rates downward, which lowered its projections of net interest outlays by $1.4 trillion (including interest savings from the resulting reductions in deficits and debt).” No wonder President Trump keeps beating up the Fed to lower rates!

If we’re right that productivity growth could be faster than the CBO projects, that could promote higher output while keeping a lid on inflation. That in turn could cause interest rates—and thereby the interest cost associated with the federal debt—to fall short of CBO estimates.

5. **Trade.** Among the many uncertainties included in the CBO’s projections, US and foreign trade policies are paramount. That’s especially so in the near term because businesses are expected to adjust supply chains to mitigate these effects over the longer term. For its baseline projection, the CBO
expects that changes in these policies, particularly tariffs put in place since January 2018, will reduce the level of real US GDP by 0.3% by 2020.

These changes reflect the policies in force as of 7/25, when the CBO’s economic projections were compiled, and assume that they remain in force through 2029. Accordingly, “if trade disputes were resolved such that trade barriers were lowered or removed, economic growth would be faster than CBO projects” and vice-versa.

For now, we remain optimistic on the trade front for the longer term; but, as we have discussed in recent days and months, there are a lot of moving parts on trade.

**Brexit: Deal, No Deal, or Delay?** The latest Brexit deadline, 10/31, is fast approaching. That’s the hard date by which the UK must leave the European Union (EU), deal or no deal, says UK Prime Minister Boris Johnson. Leaving without a deal could have dire consequences for the UK economy, with “sizeable negative spillovers on growth in other countries,” says the OECD. That’s why Melissa and I expect either a deal by the deadline or a delay in Brexit. Consider the following:

(1) *Deal.* On 6/23/16, 52% of voters in a UK referendum voted to leave the EU. The separation was slated to occur during March 2019. That was two years after former Prime Minister Teresa May triggered Article 50 of the EU treaty, which specified the formal process for a state to leave the union. UK leadership and the EU agreed on a deal during November 2018. Its three main clauses cover the rights of EU citizens in the UK and British citizens in the EU, the UK’s exit fee to be paid to the EU, and the “backstop.” (For more, see the BBC’s primer titled “Brexit: All you need to know about the UK leaving the EU.”)

(2) *No deal.* The UK Parliament has rejected the deal on three occasions. Many Members of Parliament (MPs) disapprove of the backstop. It dictates that if the UK and the EU do not reach a satisfactory trade deal soon after Brexit is finalized, Northern Ireland would stay within the EU’s customs union and be subject to the rules of the EU single market. That means it would have to allow the free and untaxed movement of goods, capital, services, and labor from EU member states across its borders and not strike trade deals with countries outside the EU. Critics of the backstop worry that it could become permanent, which effectively would sign away the UK’s economic independence.

If the UK leaves the EU on 10/31 without a deal, then the EU would call for a hard border between Northern Ireland, which is part of the UK, and the Republic of Ireland, a separate member state of the EU. Physical check points would inspect British goods, causing potential supply delays and damaging the UK economy. UK PM Boris Johnson has promised funding reserves to avoid these outcomes.

(3) *Alternative deal or delay.* Nevertheless, most MPs don’t want a no-deal Brexit. UK PM Johnson prefers an alternative agreement whereby technology would replace the need for a hard border. Customs checks would be done at warehouses rather than points of entry, via mobile phone or microchip technology. But EU officials say proper controls would be impossible without physical checks.

Regarding the backstop, Tusk and Johnson have a major rift. Both have referred to the other as “Mr. No Deal.” Both hardliners have argued that a no-deal result would be the fault of the other. Johnson is all for leaving the EU on the 10/31 deadline with or without a deal. Tusk says he is open to hearing “realistic” alternatives to the backstop, but presumably he has doubts about Johnson’s technology solution.

One way to prevent a no-deal scenario is for the MPs to vote down Johnson with a vote of no confidence, replacing the government with an alternative one that’s willing to further delay a Brexit until
an amicable deal is reached, a 7/29 Business Insider article observed.

“If a majority in the Commons threatens to topple the government rather than contemplate ‘no deal,’ it would force Johnson into a compromise, either proposing his own deal or by extending the Article 50 period, perhaps for a general election that might … give him the majority he needs,” according to the article based on an analysis by Pantheon Macroeconomics’ Samuel Tombs.

Yet before pursuing a no-confidence vote, considered to be a last-resort option, MPs who oppose a no-deal Brexit could feasibly change UK law to delay the deadline, as they have done once before. Taking the first steps toward this, MPs plan to apply for an emergency debate as early as next week, according to BBC sources.

**CALENDARS**

**US. Wed:** MBA Mortgage Applications, DOE Crude Oil Inventories. **Thurs:** GDP & PCE 2.0%/4.3%, GDP Price Index & PCE Core Index 2.4%/1.8%, Jobless Claims 215k, Advance Goods Trade Balance - $74.6b, Pending Home Sales 0.0%m/m/1.8%y/y, EIA Natural Gas Storage. (DailyFX estimates)

**Global. Wed:** None. **Thurs:** Eurozone Economic Sentiment 102.3, Germany CPI -0.1%m/m/1.5%y/y, Germany Unemployment Change & Unemployment Claims Rate 3.5k/5.0%, France GDP 0.2%q/q/1.3%y/y, UK GfK Consumer Confidence -11, Japan Industrial Production -0.5%m/m/0.3%y/y, Japan Retail Trade 0.9%m/m/-0.6%y/y. (DailyFX estimates)

**US ECONOMIC INDICATORS**

**Consumer Confidence** ([link]): Consumer confidence (to 135.1 from 135.8) in August was relatively unchanged from July’s reading—and was only 2.8 points below October’s cyclical high of 137.9. The present situation (177.2 from 170.9) component jumped to a 19-year high as consumers’ appraisals of both labor and business conditions continued to improve. The percentage of respondents saying that jobs are plentiful (to 51.2% from 45.6%) jumped to a new cyclical high, while those saying jobs are hard to get (11.8 from 12.5) fell to within a fraction of February’s cyclical low of 11.7%. Consumers claiming business conditions are good (42.0 from 39.9) continued to way outpace those saying business conditions are bad (9.8 from 11.2). Meanwhile, the expectations (107.0 from 112.4) component took a step back this month, but remains at a relatively high level, considerably above its recent low of 89.4 at the start of this year. Expected business conditions remained very favorable, with those expecting better conditions (21.9% from 24.0%) continuing to exceed those who expect conditions to worsen (10.0 from 8.4). The job outlook also remained favorable, with the percentage of respondents expecting more jobs (19.7 from 19.9) continuing to outpace those expecting fewer jobs (13.6 from 11.1)—with the spread at 6.1ppt, near this year’s high. Lynn Franco, senior director of economic indicators at the Conference Board, noted: “While other parts of the economy may show some weakening, consumers have remained confident and willing to spend. However, if the recent escalation in trade and tariff tensions persists, it could potentially dampen consumers’ optimism regarding the short-term economic outlook.”

**Regional M-PMIs** ([link]): Five Fed districts have now reported on manufacturing activity for August—Philadelphia, New York, Kansas City, Dallas, and Richmond—and show anemic growth, with performances in the regions mixed. The composite (to 3.9 from 1.4) index revealed that manufacturing activity was only slightly above July’s sluggish pace, which was an improvement from June’s (-3.7) dip into contractionary territory. Philadelphia’s composite (16.8 from 21.8) index showed activity remained at a healthy, though slower rate, while New York’s (4.8 from 4.3) matched July’s pace after contracting at its fastest pace since October 2016 in June. In the meantime, Dallas’ (2.7 from -6.3) manufacturing
sector swung from contraction to expansion, while Richmond’s (1.0 from -12.0) stopped contracting; Kansas City’s (-6.0 from -1.0) posted its first back-to-back decline in three years—recording its biggest decline since March 2016. New orders (5.6 from 0.6) growth this month was lackluster but improved over no growth the prior two months. Philadelphia (25.8 from 18.9) billings were the strongest since May 2018, while Dallas’ (9.3 to 5.5) improved for the third straight month. Meanwhile, New York (6.7 from -1.5) and Richmond (2.0 from -18.0) billings are rising again, while Kansas City’s (-16.0 from -2.0) fell further into negative territory. Employment (-1.1 from 5.5) is declining for the first time since September 2016. Manufacturers in both the Philadelphia (3.6 from 30.0) and Dallas (5.5 from 16.0) regions hired at a considerably slower pace than last month, while New York (-1.6 from -9.6) Kansas City (-7 from -6), and Richmond (-6.0 from -3.0) factories continued to cut payrolls.

**Regional Manufacturing Price Indexes** *(link)*: Available August data for the New York, Philadelphia, Richmond, Kansas City, and Dallas regions show pricing remains on a disinflationary trend, based on both the prices-paid and prices-received indexes. Prices-paid indexes in all regions moved lower in August, with Kansas City’s and Philadelphia’s the lowest since 2016 and New York’s since 2017. As for the prices-received indexes, only Philadelphia’s moved up, with Kansas City’s and New York’s the lowest since 2016 and 2017, respectively. Here’s a look at the prices-paid indexes for August versus their respective peaks during 2018: Philadelphia (to 12.8 from 60.0), New York (23.2 from 54.0), Kansas City (-2.0 from 52.0), Dallas (9.8 from 54.3), and Richmond (2.7 from 5.2). Here are the same comparisons for the prices-received indexes: Philadelphia (13.0 from 35.0), New York (4.5 from 23.3), Kansas City (-3.0 from 27.0), Dallas (-2.6 from 26.2), and Richmond (1.7 from 2.4). (Note: Richmond prices are not diffusion indexes but rather average annualized inflation rates.)

**GLOBAL ECONOMIC INDICATORS**

**Germany GDP** *(link)*: Germany is on the brink of recession, as real GDP contracted last quarter for the second time in four quarters, driven by the biggest drop in exports since Q4-2012. Real GDP declined 0.3% (saar) during Q2, as exports (-5.3%) fell at a faster pace than imports (-1.1)—with trade exerting a big negative drag on GDP growth. Meanwhile, domestic demand rebounded 2.0% (saar) during Q2, after slipping 0.4% during Q1, but wasn’t strong enough to offset the decline in net trade in Germany’s export-led economy. Within domestic demand, equipment (2.5%, saar) and government (2.0) investment posted the biggest gains, with household consumption (0.4) subdued. Total capital investment (-0.5) was held back by a drop in construction (-4.0) spending—following Q1’s weather-related surge of 10.2%.