MORNING BRIEFING
September 11, 2019

Yields Backing Up

See the collection of the individual charts linked below.

(1) Despite another round of easy money, bond yields move higher. (2) It's more about German recession than no-deal Brexit. (3) German fiscal policy may provide more oomph. (4) Draghi's parting plea. (5) Recession fears abate as CESI rebounds, depressing bond prices. (6) Quits at record high. (7) Small business owners can't find help. (8) Fed's favorite inflation measure remains under 2.0%, while alternative measures show somewhat higher inflation.

Credit I: US Bond Yields Made in Germany. Yesterday, Melissa and I wrote that another round of central bank easing is underway. So why are bond yields rising?

The 10-year US Treasury bond yield rose from a recent low of 1.47% on 9/4 to 1.72% yesterday (*Fig. 1*). The record low was 1.37%, hit on 7/8/16 just after the Brits voted to leave the European Union (EU). The risks of a no-deal Brexit have eased in recent days, though it still could happen next month. A hard Brexit could cause the bond yield to retest its recent low.

In any event, the main reason that the US bond yield has moved higher in recent days has more to do with Germany than the UK. The 10-year German government bond yield has risen from a recent record low of -0.71% on 8/30 to -0.54% yesterday. Reuter's reported: "Germany's 30-year government bond yield briefly rose into positive territory on Tuesday for the first time in over a month, lifted by expectations for fiscal stimulus and caution over the scale of stimulus the European Central Bank might deliver this week."

During a parliamentary budget debate on Tuesday, Germany's Finance Minister Olaf Scholz said that Germany can counter a possible recession with a big stimulus package. On Monday, Reuters reported that Germany was considering creating a "shadow budget" to boost public investment above and beyond limits set by its national debt rules, sparking a bond sell-off.

European Central Bank (ECB) President Mario Draghi has been lobbying for fiscal policy to turn more stimulative to support the ECB's ultra-easy monetary policies. Germany has resisted doing so and even questioned whether the ECB's asset purchase program could legally buy sovereign bonds, as we discussed yesterday. We also observed yesterday that Germany's fiscal and monetary conservatives might be starting to waver as a result of Germany's intensifying manufacturing recession, with factory orders and production down 5.6% and 4.8% y/y through July (*Fig. 2*).

Last year, when there was widespread bearishness in the bond market, with some predicting that the US yield would rise from 3% to 4%-5%, we observed that the US bond yield might be "tethered" to the comparable German and Japanese yields, which were barely above zero. This year, both have dropped solidly below zero.

During the Q&A portion of his 7/25 press conference, Draghi pleaded for more fiscal stimulus, especially from Germany:

"What's hitting the manufacturing sector in Germany and [elsewhere in Europe is] an idiosyncratic shock. Here what becomes really very important is fiscal policy. [T]he mildly expansionary fiscal policy is supporting activity in the euro area. But if there were to be a significant worsening in the Eurozone economy, it's unquestionable that fiscal policy … becomes of the essence. … I started making this point way back in 2014 in a Jackson Hole speech: monetary policy has done a lot to support the euro area … but if we continue with this deteriorating outlook, fiscal policy will become of the essence."

Credit II: Recession Scare Blowing Away. Meanwhile, back in the USA, fears of a recession have been receding, although the yield-curve spread between the 10-year Treasury and the federal funds rate remains negative (*Fig. 3*). On the other hand, the comparable spread based on the 2-year Treasury yield rather than the federal funds rate remains around zero.

More importantly, there is still no sign of a credit crunch in the US. In our study titled "The Yield Curve: What Is It Really Predicting," Melissa and I observed that in the past an inverted yield curve didn't cause recessions. Rather, it often correctly anticipated that monetary policy was too tight and might trigger a financial crisis, which would turn into an economy-wide credit crunch and cause a recession.

The credit-quality yield spread between high-yield corporate bonds and the 10-year US Treasury bond remains low around 400bps (*Fig. 4*). Commercial and industrial loans have stalled in recent weeks but are at a record high and are up 6.4% y/y (*Fig. 5* and *Fig. 6*).

Meanwhile, lots of US economic indicators continue to show an expanding economy:

(1) *Citigroup Economic Surprise Index.* The Citigroup Economic Surprise Index (CESI) has rebounded smartly from a recent low of -68.3% on 6/28 to 7.0% yesterday (*Fig. 7*). While it is based on seasonally adjusted indicators, it continues to show a seasonal pattern of weakness during the first half of the year followed by strength during the second half. Indeed, looking at the past 11 years, we can pick six years where the index bottomed almost exactly midway through the year.

There is a very good correlation between the CESI and the 13-week change in the 10-year US Treasury bond yield (*Fig. 8*). The CESI is clearly seasonally bearish for bonds.

(Then again, let's not get too bearish on bonds. The yield is also highly correlated with the nearby futures price of copper (*Fig. 9*). The latter remains relatively weak, though not so much as suggested it might be by the 131bps drop in the bond yield over the past year. In other words, the bond yield might have gone down too far relative to the weakness in the global economy, as signaled by Professor Copper, the metal with a PhD in economics.)

(2) *JOLTS*. Friday's weak payroll employment gain of 130,000 for August remains an outlier. Most other labor market indicators remain very strong. For example, yesterday's JOLTS report for July showed that quits rose to a record high of 3.6 million (*Fig. 10*). That's confirmed by the jump during August in the "jobs plentiful" response of the survey used to construct the Consumer Confidence Index. When workers perceive that there are lots of job openings, they are more likely to quit to change jobs. While these openings are actually down 3.0% y/y through July, at 7.2 million they remain above the number of unemployed workers for 17 months in a row (*Fig. 11*).

By the way, the JOLTS data also show more employment than does the official payrolls series. We regularly compare the 12-month change in payrolls to the 12-month sum of total hires minus total separations in the JOLTS report (*Fig. 12*). The former is up 2.2 million through July, or 185,500 per month on average, while the latter is up 2.6 million (also through July), or 213,000 per month on average!

In any case, on Monday, Debbie and I blamed the weakness in payroll employment on a shortage of workers rather than weakening demand for them. Yesterday, the National Federation of Independent Business's survey of small business owners reported that a record 57% of them said that there are few or no qualified applicants for their job openings during August (*Fig. 13*).

Credit III: Inflation Scare Ahead? Low inflation is "the problem of this era," said New York Federal Reserve Bank (FRB) President John Williams in a 9/4 speech. Melissa and I agree that low inflation is a real challenge for the major central banks of the world. They have been trying to revive inflation to 2% with their ultra-easy monetary policies for the past 10 years without any success.

But what if inflation makes a surprising rebound? That would certainly shock markets into fearing that the low-interest-rate era might be over. In fact, several funky measures of inflation suggest that inflationary pressures may be mounting in the US already. Might that be what the bond market is starting to discern?

We tend to be traditionalists when it comes to inflation measures, preferring the headline and core readings of the personal consumption expenditures deflator (PCED) rather than alternative indicators—not only because that's what the Fed most often relies on but also because the alternatives tend to exclude too many price categories that are important to consumers, in our opinion. Let's dig into the numbers:

(1) *Mind the headline & the core PCED*. During July, the headline and core PCED inflation rates were only 1.4% and 1.6% y/y, respectively (*Fig. 14*). The Federal Open Market Committee announced its 2.0% inflation target for the first time in January 2012. The core PCED has achieved that during just six months, from mid-2012 through July of this year. The three-month annualized percent change in the core PCED was 2.2% through July (*Fig. 15*). It tends to be much more volatile than the y/y measure. The headline PCED was up 1.7% on the same basis.

(2) *Don't mind the alternatives*. The Atlanta FRB's sticky-price CPI is an alternative inflation measure based on a weighted basket of items that change price relatively slowly. It rose 2.5% y/y in July, while the actual CPI rose 1.8%. However, the core sticky (excluding food and energy) increased just 1.6%, while the core CPI rose 2.2%. The headline sticky has not been above 2.5% since June 2018, while the core sticky has remained below 2.0% since September 2016 (*Fig. 16*).

The Cleveland FRB tracks two of its own alternative inflation measures: median CPI and trimmed mean CPI. These measures exclude the items that change the most in price on a monthly basis. The median CPI excludes all price changes except for the ones in the center of the distribution of price changes. The trimmed mean CPI excludes price changes on the highest and lowest sides of the distribution.

The Cleveland FRB's median CPI has been on an upward trend since early last year, rising well above 2.0% during that time to 2.9% during July. Its trimmed mean CPI has remained above 2.0% since May 2018, registering a reading of 2.2% during July (*Fig. 17*).

During his 5/1 press conference, Fed Chair Jerome Powell focused on the Dallas FRB's trimmed mean PCE inflation rate, which is calculated similar to the Cleveland FRB's trimmed CPI version, noting that it has been consistently at or above 2.0% since May 2018 (*Fig. 18*). But Powell's enthusiasm for the measure seems to have been short-lived. The Fed has since dropped its focus on that figure, obviously crafting its recent monetary policy decisions based on the more traditional measures.

Williams closed his speech by saying that "stubbornly low inflation is a reflection of the broader economic picture—the July rate adjustment [was] an appropriate response to ease financial conditions and support the economy."

CALENDARS

US. Wed: PPI Final Demand 1.7% y/y, Wholesale Inventories 0.2%, MBA Mortgage Applications, DOE Crude Oil Inventories. **Thurs:** Headline & Core CPI 1.7%/2.3% y/y, Jobless Claims, EIA Natural Gas Storage. (DailyFX estimates)

Global. Wed: Japan Machine Orders -8.1%m/m/-43.5y/y, Mexico Industrial Production. **Thurs:** Eurozone Industrial Production 0.1%m/m/-1.3%y/y, Germany CPI -0.2%m/m/1.4% y/y, ECB Rate Decision 0.00%, ECB Marginal Lending Facility & Deposit Facility Rates 0.25%/-0.50%. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps (*link*): All of these price indexes have healthy gains so far in 2019; only one, SmallCaps, is still in correction territory measured from the indexes' record highs. Here's how they rank ytd through Monday's close, along with their percentage changes since their record highs: Russell LargeCap 1000 (18.9% ytd, -1.9% from record high), S&P LargeCap 500 (18.8, -1.6), S&P MidCap 400 (15.8, -6.0), Russell SmallCap 2000 (13.0, -12.4), and S&P SmallCap 600 (11.7, -14.1). Forward earnings remain in the uptrends that began during March, but the SmidCaps have yet to return to their record highs from 2018. LargeCap's has risen during 25 of the past 30 weeks, MidCap's 16 of the past 26 weeks, and SmallCap's 14 of the past 24 weeks. LargeCap's has been at record highs since early June, while MidCap's and SmallCap's remain 1.6% and 6.4% below their mid-October highs. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: S&P 500 LargeCap (22.7%, 1.6%, 11.2%), MidCap (22.7, -1.9, 13.6), and SmallCap (22.4, -0.9, 17.6).

S&P 500 Growth vs Value (*link*): The S&P 500 Growth and Value price indexes are down modestly from their record highs, and remain strong ytd. However, Value's 2.9% gain so far in September is outperforming Growth's 0.9% rise. The Growth index leads with a gain of 25.4% ytd through Monday's close, but is down 2.0% from its record high on 7/26. Value is up 12.6% ytd, but is down just 1.1% from its 2019 high on 7/26 and 2.2% below its below its record high more than 20 months ago on 1/26/18. Since the election in late 2016, Growth's 51.7% gain is double the 25.6% increase logged by Value. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Specifically, 8.3% STRG and 10.4% STEG are projected for Growth, respectively, versus 4.0% and 6.1% for Value. Growth's valuation peaked at 21.8 on 7/26, matching January 2018's highest level since the Tech bubble deflated in 2002. Through Monday, Growth's P/E was down to 21.2, up from its 50-month low of 15.9 on 12/24. Value's forward P/E has rallied in the past month from 13.1 to 14.0 and is a tad below its 2019 high of 14.1 on 7/26. That's up from a six-year low of 11.5 on 1/3 of this year, but down from a 16-year high of 16.6 on 1/3/2018. Regarding NERI, Growth's was negative in August for the first time in four months, dropping to -2.0% from 0.2% in July. That compares to a 25-month low of -4.4% in February and a record high of 22.3% in March 2018. Value's NERI was negative in August for a 10th month, falling to a five-month low of -7.9% from -4.4%; that compares to a 34-month low of -9.8% in February and a record high of 21.2% in March 2018. The Tax Cuts and Jobs Act (TCJA) sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value. They're rising again now after dropping in late 2018 but remain below their record highs. Growth's forward profit margin of 15.9% is up from 14.4% prior to the TCJA's passage, but down from its record high of 16.7% during mid-September. Value's forward profit margin of 10.2% is down from a record high of 10.5% in December, but up from 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

JOLTS (*link*): Job openings in July fell for the third time in four months, though were still within 409,000 of November's record-high reading of 7.626 million. Openings fell 31,000 in July and 257,000 over the four-month period to 7.217 million. July's ratio of unemployed workers per job opening was below 1.00 for the 17th straight month, at 0.84, with job openings exceeding unemployed workers by 1.2 million. Hirings rebounded 237,000 in July to 5.953 million after falling 275,000 during the two months through June. Separations climbed 246,000, after a two-month slide of 174,000, to 5.759 million in July. The latest hiring and separations data yielded an employment advance of 194,000 in July, 35,000 above July's payroll gain of 159,000—overstating the increase for the sixth time this year. Those quitting their jobs jumped 130,000 to a record-high 3.592 million in July—with the quit rate jumping to a cyclical high of 2.4% after hovering at 2.3% for a year. July's job openings rate (4.5%) continued to hold just below its record rate of 4.8% at the start of the year, while the hires rate was at 3.9%—fluctuating in a range from 3.8% to 4.0% for over a year.

NFIB Small Business Optimism Index (*link*): "In spite of the success we continue to see on Main Street, the manic predictions of recession are having a psychological effect and creating uncertainty for small business owners throughout the country," said NFIB President and CEO Juanita D. Duggan. "Small business owners continue to invest, grow, and hire at historically high levels, and we see no indication of a coming recession." The Small Business Optimism Index (SBOI) slipped 1.6 points to 103.1—remaining within the top 15% of readings and within 5.7 points of August's record high of 108.8. The biggest negative contributors to the SBOI last month reflected weakened expectations for the future regarding business conditions (to 12% from 20%) and sales (17 from 22)—which accounted for 80% of the decline in August's SBOI. Meanwhile, the report noted an acceleration in job creation, positive earnings trends, and strong quarter-on-quarter sales growth. The uncertainty index climbed to 80 from July's 11-month low of 76. The report warned that "[p]essimism is contagious, even when the real economy is doing well, expectations can be infected and turn sour."

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