Mixed Signals

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(1) Bond yields at historic lows, as credit spreads start widening. (2) LargeCaps up, while SmallCaps down. (3) Q2 GDP estimates weaken, as earnings improve. (4) PMIs in Eurozone and China overstating economic growth. (5) Easy monetary policy is coming and going. (6) US labor market improving, yet there’s still slack. (7) ECB is easy on monetary policy, but tough on banks. (8) Strongest economy in Eurozone is weakening. (9) China’s excess capacity is producing more. (10) Japan losing its growth and inflation mojo. (11) “Lucy” (+).

Strategy: Bullish & Bearish. Financial and economic indicators around the world are giving off mixed signals. Bond yields continue to fall to historic lows, suggesting that economic growth is weakening significantly and that deflation risks are mounting. Credit quality spreads may be starting to widen, another worrisome sign. Yet global stock prices remain at record highs, though small caps are looking toppy.

In the US, overall labor market conditions are improving, yet there remain a few important indicators showing lots of slack. New home sales have stalled at a depressed level, and nondefense capital goods orders are rising at a lackluster pace. Economists have been lowering their estimates for the second quarter’s real GDP. Yet the quarter’s earnings season is mostly upbeat, and so is guidance.

Overseas, GDP growth is strong in the UK, though some recent monthly indicators have weakened. In the Eurozone, the latest flash PMIs continue to signal growth. They’ve been doing so for a while, yet the region’s economic recovery over the past year has been very slow, and shows signs of stalling already. China’s latest flash M-PMI is strengthening, yet growth remains unbalanced with excess capacity in manufacturing. In Japan, the three arrows of Abenomics seem to be missing their marks.

Despite the commitment of the major central banks to be more transparent and to communicate more with market participants, there is quite a bit of confusion in the markets about their next moves. Will the BOE be the first of them to begin raising interest rates? Will the Fed start hiking interest rates sooner rather than later next year? Will the ECB implement quantitative easing? Will the PBOC continue to step on the monetary brakes and accelerator at the same time? Will the BOJ be forced into another round of QQE?

Let’s have a closer look at the mixed signals coming from the world’s financial variables first before turning to the mixed bag of global economic indicators:

(1) Bonds. The Fed continues to taper QE and is expected to terminate the program by October. In recent weeks, most market economists have concluded that the Fed might start raising interest rates earlier rather than later next year. Yet the 10-year Treasury bond yield is down from 3.02% at the beginning of the year to 2.48% (Fig. 1). The 10-year TIPS yield has declined 57bps over this period to 0.20%, the lowest since June 18, 2013, while expected inflation at 2.28% is about where it was at the start of the year.

Helping to hold US yields down are falling yields in the Eurozone, where economic growth is faltering and deflation is a clear and present danger. The 10-year German government yield is down to 1.15%,
near the record low of 1.13% reached at the height of the Eurozone debt crisis in mid-2012 (Fig. 2). The comparable French yield is down to 1.55%. The Spanish and Italian yields are at 2.53% and 2.71%, respectively. In Japan, while Abenomics has promised to boost economic growth and inflation, the bond yield is back down to just 0.53%!

In the US, credit quality spreads remain near recent record lows. However, recent warnings coming out of the Fed about excessive risk-taking in the junk bond market have widened spreads in this market (Fig. 3). The 7/24 FT observed: “Junk bonds are on track for their worst monthly return in nearly a year, with investors fretting the era of easy US central bank money is at an end and calling time on a bull run for one of the market’s riskier asset classes.”

(2) **Equities.** The All Country World MSCI has stalled recently around the record high achieved on July 3 (Fig. 4). The US has been leading the way to new highs. Excluding the US, this index is at a cyclical high but 17.7% below its record peak during 2007. SmallCap stocks in the US have been underperforming both LargeCaps and MidCaps since the start of the year, even before Fed officials warned that valuation multiples were stretched in this asset class (Fig. 5).

(3) **Commodities.** Meanwhile, commodity prices are mostly marking time, continuing to move sideways as they have been for the past two years. The CRB raw industrials spot price index is at the same level as where it was around the end of 2012 (Fig. 6). The price of a barrel of Brent crude oil has declined over the past couple of weeks to $107.40, which is where it was in early December 2012.

**US Economy: Upbeat & Downbeat.** Now let’s turn to the mixed bag of business indicators in the US:

(1) **Employment.** During the week of July 19, initial unemployment claims dropped to 284,000. That’s the lowest reading during the current economic expansion, and the lowest since February 2006 (Fig. 7). It was just the second time since the Great Recession that new weekly claims fell below 300,000 and bested the recovery’s previous low of 298,000 in early May. The 7/24 WSJ observed: “Auto makers traditionally halt production in some factories in July to prepare for new models, but companies this year have minimized those shutdowns because of strong demand for new cars.”

(2) **New home sales.** Nevertheless, Fed Chair Janet Yellen is bound to put more weight on other labor market indicators showing that there remains too much slack in the labor market, as she did during her recent congressional testimony. She also expressed concern that the housing sector “has shown little recent progress.” That was confirmed by the 8.1% drop in new home sales during May and June. They’ve been stuck around 400,000 at an annual rate since the spring of last year (Fig. 8).

(3) **Capital goods spending.** On the other hand, nondefense capital goods orders excluding aircraft increased 1.4% during June, and continues to trend upwards into record-high territory (Fig. 9). The same can be said for shipments, but it was down 1.0% during June.

(4) **Regional business surveys.** The big surprise is the strength in the regional business surveys conducted by the Fed district banks (Fig. 10). The average composite index for the ones available through July (NY, Philly, KC, and Richmond) rose to 16.4, the highest since March 2011. The average orders index rose to 17.5, also the highest since March 2011. (Click ★ to add US Business Surveys to MyPage.)

(5) **Earnings.** Meanwhile, as Joe and I will discuss in detail tomorrow during “Earnings Tuesday,” S&P 500 forward earnings continues to rise to new highs as expectations for 2014 and 2015 are improving. The Q2 earnings season is mostly upbeat, and estimates are rising for the second half of the year on mostly positive guidance from company managements.
Global Economy: On & Off. There are also plenty of mixed signals overseas. Let's review them:

(1) **Europe.** As Debbie discusses below, the UK remains one of the few advanced economies that is advancing at a solid pace. During Q2, real GDP rose 3.1% y/y, the best since Q4-2007. The same can't be said for the Eurozone. The region's July flash PMIs look solid. The composite output index, which was 54.0 this month, has been hovering around that level since February (Fig. 11). It has been looking good since last summer, yet the “hard” data, such as industrial production and retail sales, have been quite soft. (Click 🌟 to add Markit PMIs to MyPage.)

Weighing on the Eurozone is that bank loans continue to fall in the region. They declined by €243 billion at an annual rate over the three-month period through June (Fig. 12). While the ECB has been providing easy monetary policy, bank regulators (including the ones at the ECB) continue to subject the banks to stress tests that discourage risky lending.

Even Germany, the Eurozone’s strongest economy, is showing the negative effects of tough lending standards, particularly on its large trading partners in the region. The strong euro is another headwind. The uncertainty caused by the Ukrainian crisis, with the potential for shortages and higher prices of natural gas this coming winter, is also weighing on the Eurozone. No wonder that Germany’s Ifo business confidence index fell from a recent peak of 111.3 during February to 108.0 in July (Fig. 13). Both its present and expectations components fell sharply this month (Fig. 14).

(2) **China.** July was an upbeat month for China’s flash M-PMI, which rose to 52.0, the highest since January 2013 (Fig. 15). However, as I've argued before, China has lots of excess capacity in manufacturing and construction, which has been exacerbated by the government’s fiscal stimulus programs and the availability of too much easy credit. Just last week, according to a 7/23 article in the WSJ, a Chinese construction company that was on the verge of defaulting on a $64.5 million bond mysteriously found a way to pay at the last minute, “raising concern that investors buying risky assets will expect the government to bail them out.”

(3) **Japan.** Over in Japan, Abenomics seems to be losing its mojo, as we have been predicting. Last week, the government cut its fiscal 2014 growth forecast to 1.2% in real terms from 1.4%. The inflation rate slowed for the second straight month, with the June CPI showing a 1.3% gain y/y, when adjusted for a sales tax increase in April. That’s down from 1.4% in May and 1.5% in April. So far, the weak yen isn’t lifting exports. In yen terms, they rose 1.9% m/m during June, but were down 0.2% y/y (Fig. 16).

Central Banks: Coming & Going. The latest batch of global economic indicators suggests that the BOE will be the first major central bank to raise interest rates since the Great Recession. The UK’s Q2 real GDP rose sharply, exceeding its previous high during Q1-2008 for the first time. That should continue to be bullish for the pound. The Fed is likely to follow with its first rate hike since the start of the current expansion sometime early next year.

The ECB and BOJ could be heading in the other direction, providing more easy money. A recent IMF staff report on Euro Area Policies recommends that “if inflation remains too low, the ECB should consider a substantial balance sheet expansion, including through asset purchases.” Two IMF economists pushed the idea again in a 7/14 blog post.

A 7/25 WSJ blog post notes that the latest disappointing stats out of Japan increase the odds of more easing by the BOJ: “If the Bank of Japan sticks to its word, data like these mean there won’t be an end to its aggressive 'quantitative easing' program anytime soon, and it may well be ramped up in the months ahead. The BOJ has set itself a target of 2% inflation as a benchmark by which it believes it
can safely declare that the multidecade era of deflation is finally over. The bottom line is that the
Japanese economy simply isn’t strong enough to generate strong inflation. If the BOJ does increase its
bond-buying program—currently at 7 trillion yen a month—it could send the yen on another downward
leg.”

Movie. “Lucy” (+) (link) is a good idea for a movie that is badly executed. It should have been more
entertaining. Scarlett Johansson plays modern-day Lucy, who evolved from Lucy, the original ape
woman. In one scene, the two meet and touch their index fingers in a Michelangelo moment. The
modern woman turns into the smartest human who ever lived with the help of a mind-altering drug.
There are some bad guys and lots of clueless guys. There are a few lame jokes, some lame science
fiction, and a lame ending. As in the latest “Planet of the Apes,” I found myself rooting for the ape.

CALENDARS

US. Mon: Markit NM-PMI Flash Estimate 60.0, Pending Home Sales 0.3%, Dallas Fed Manufacturing
Index 12.0. Tues: Consumer Confidence 85.5, S&P Case-Shiller HPI 0.4%m/m/9.9%y/y, FOMC
Meeting Begins. (Bloomberg estimates)

Global. Mon: Japan Retail Trade, Japan Unemployment Rate. Tues: Japan Industrial Production,
Japan Small Business Confidence. (DailyFX estimates)

PERFORMANCE & ASSET ALLOCATION

Global Stock Markets Performance (link): The flat performance for the MSCI United States index last
week ranked 37th of the 49 markets as 35 markets rose in US dollar terms and the AC World ex-US
index increased 0.7%. BRIC led all regions last week with a gain of 2.3%, followed by EM Asia (1.8%)
and EM Latin America (1.3) as the 5.3% gain for Portugal led all countries. The US ranks 25th of the 49
markets so far in July, rising 0.9% versus a 0.2% gain for the AC World ex-US. EM Latin America’s
5.4% rise leads all regions so far in July paced by Brazil (7.2), while EM Eastern Europe (-6.5) is the
biggest underperformer due to Russia’s 8.2% decline. The 2014 ytd leaders: Argentina (30.1), Turkey
(29.7), and Indonesia (29.4). The 2014 laggards: Hungary (-14.0), Russia (-13.7), and Austria (-13.0).
EM Latin America and EM Asia are the ytd leaders with gains of 10.9% and 8.4%, respectively. The
worst-performing indexes ytd: EM Eastern Europe (-10.4) and EMEA (-5.4).

S&P 1500/500/400/600 Performance (link): Two of the three market-cap indexes and 21/30 market-
cap sectors were lower last week, compared to the prior week when one index and 16/30 market-cap
sectors fell. LargeCap was the best performer with a net change of 0.0% for the week, ahead of
MidCap (-0.5%) and SmallCap (-0.7). LargeCap is the best performer in July, with a gain of 0.9%,
ahead of MidCap (-1.9) and SmallCap (-3.4). Only eight of the 30 sectors are higher in July, but 23 are
up so far in 2014. That’s up from nine sectors up ytd in early April, but down from all 30 sectors rising
over the course of 2013. LargeCap and MidCap lead ytd with respective gains of 7.0% and 4.7%,
ahead of SmallCap’s 0.9% decline. The SuperComposite 1500 index is up 6.6% ytd, paced by the
following sectors: Energy (11.4), Health Care (10.9), Utilities (10.8), Tech (10.6), and Materials (8.0).
The worst-performing SuperComposite sectors: Consumer Discretionary (-0.4), Industrials (2.1),
Consumer Staples (4.5), Financials (4.5), and Telecom (4.8).

S&P 500 Sectors and Industries Performance (link): The S&P 500’s ytd performance remained
steady at a 7.0% gain last week. Four of the 10 sectors moved higher w/w and beat the S&P 500’s
performance. Last week’s top performers: Energy (0.8%), Tech (0.7), and Health Care (0.7). The worst
performers were Consumer Discretionary (-1.0) and Industrials (-1.0). Seven of the 10 sectors are
higher so far in July, with the S&P 500 rising 0.9%. The best-performing sectors in July: Tech (3.5) and
Telecom (2.8). The worst performers so far in July: Utilities (-4.1) and Industrials (-0.6). The ytd performance is positive now for nine of the 10 sectors, up from just two in early April. The 2014 leaders: Tech (11.8), Energy (11.7), Utilities (11.6), Health Care (11.4), and Materials (8.5). Sectors that are trailing the S&P 500’s ytd gain of 7.0%: Consumer Discretionary (-0.1), Industrials (2.3), Consumer Staples (4.1), Telecom (4.6), and Financials (4.7).

Commodities Performance (link): Eight of the 16 commodities that we follow rose last week, up from four rising during the prior week. Commodities with the biggest increases last week: Zinc (5.4%) and Lead (3.4). Last week’s laggards: Cotton (-5.1) and Natural Gas (-4.3). Only four of the 16 commodities are higher so far in July, and six are higher ytd. July’s leaders: Zinc (9.1), Lead (4.9), and Tin (2.5). July’s laggards: Cotton (-17.7), Natural Gas (-15.2), Com (-14.4), and Soybean (-13.4). The ytd leaders: Zinc (13.8), Gold (8.4), and Platinum (7.8). The biggest ytd losers: Cotton (-23.0), Corn (-14.0), Wheat (-11.1), and Natural Gas (-10.6).

Assets Sorted by Spread w/ 200-dmas (link): Spreads between prices and 200-day moving averages rose last week for 10/19 commodities, 6/9 global stock index, and 9/44 US stock indexes versus 4/19, 8/9, and 16/44 the week earlier. Ten of the 19 commodity indexes trade above their 200-dmas, up from nine a week earlier. Commodities’ average spread rose to -2.7% last week from -3.1% a week earlier. All nine global indexes trade above their 200-dmas, up from eight a week earlier as their average spread improved to 4.9% from 4.0%. Forty-one of the 44 US stock indexes trade above their 200-dmas, down from 42 a week earlier. Their average spread edged down to 4.6% from 5.3%.

Commitments of Traders (link): What were Large Speculators doing in the futures pits on July 22? They were slightly bullish on the S&P 500 and on the 10-year Treasury note. They were bullish on the US dollar and bearish on the euro. They were bullish on the pound, Canadian dollar, and on the Aussie dollar. They remained very bearish on the yen. They were bullish on gold. They had large bullish positions in crude oil and gasoline.

US ECONOMIC INDICATORS

Durable Goods Orders & Shipments (link): Nondefense capital goods orders ex aircraft (a proxy for future business investment), rebounded in June; the comparable shipments measure (used in calculating GDP) fell for the third month. Both measures saw May gains revised to declines. These orders jumped 1.4% last month after May’s 0.7% gain was revised to a 1.2% loss; shipments slumped 1.0% after May’s 0.4% increase was revised to a 0.1% decrease. Over the three months ending June, growth in these core orders slowed to 6.5% (saar), based on the three-month average, nearly half May’s 11.7%. Core shipments grew 4.1% (saar), slowing from the 7.5% pace in the three months ending May. Total durable goods orders advanced for the fourth time in five months, up 0.7% in June and 7.1% over the period. Orders excluding transportation advanced 0.8% m/m and 5.0% over the same five-month period.

New Home Sales (link): New home sales fell in June, and there was a large downward revision to May’s sales rate. Sales sank an unexpected 8.1% to 406,000 units (saar) from May’s 442,000 units (which was 12.3% less than first reported). They are 11.5% below a year ago. (New home sales are tabulated when contracts are signed and considered a timelier barometer of home demand than existing home sales.) Sales fell in all regions, led by the Northeast (-20.0%) and the South (-9.5). New homes on the market totaled 197,000 units, the most since October 2010. Higher inventory and weaker sales pushed the months’ supply up from 5.2 to 5.8, the highest since October 2011. The y/y percent change in the median new single-family home price, which tends to be volatile, was 5.3% in June after a 7.2% gain in May and a 2.4% loss in April. Based on its 12-month average, the yearly percent change has slowed from a peak of 13.0% in July 2013 to 5.9% last month.
Kansas City Fed Manufacturing Survey (link): Manufacturing activity in the Tenth District showed slightly faster growth this month; producers’ optimism for future activity also improved. The composite index climbed to 9 this month after falling from a cyclical high of 10 in May to 6 in June. The five components making up the index were mostly higher: The orders (from 8 to 12), production (2 to 11), employment (1 to 8), and inventory (8 to 9) indexes all moved up; the supplier delivery index (10 to 5) was the only component to move down. Gauges for the average workweek (7 to -3) and order backlogs (9 to -6), both sub-indexes, dropped into negative territory. The future composite index climbed from 12 to 15; the future production (17 to 23), shipments (20 to 28), and employment (14 to 23) measure also moved higher.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index (link): German business confidence sank to a nine-month low this month. The Ifo business climate index fell for the fourth time in five months to 108.0 after reaching a cyclical high of 111.3 in February. July’s setback was driven by both the expectations and current situation components. Expectations slumped for the third month from 107.2 in April to an 11-month low of 103.4 this month. It reached a cyclical high of 108.8 in January. (The index still remains considerably above its recent low of 93.4 in September 2012.) The current situation component dropped to 112.9 from 114.8 the prior two months. It was at a cyclical high of 115.3 in April. The expectations component correlates closely with German factory orders and production and suggests slower growth in both. The overall index tracks exports more closely and indicates weakening foreign demand.

Eurozone PMI Flash Estimates (link): Overall Eurozone growth accelerated this month, with the Flash Composite Output Index climbing from a six-month low of 52.8 to 54.0 (matching April’s near-three-year high). The Flash NM-PMI accounted for the improvement, reaching a 38-month high of 54.4, up from 52.8 in June; the Flash M-PMI ticked up from 51.8 to 51.9. Germany’s Flash Composite Output Index accelerated to a three-month high of 55.9 from 54.0 in June, with the services sector driving the gain. Its Flash NM-PMI reached a 37-month high of 56.6 (from 54.6); the M-PMI also increased (from 52.0 to 52.9), though remained below early 2014 readings. France’s business sector continued to contract, though more slowly. Its Composite Output index rose from 48.1 to a three-month high of 49.4, with the NM-PMI advancing from 48.2 to 50.4 (first reading above 50.0 in three months). However, France’s M-PMI sank to a seven-month low of 47.6 from 48.2 in June. Markit reports that outside of France and Germany, the rest of the region recorded the largest monthly increase in business activity since August 2007.

Eurozone Money Supply (link): M3 growth, which the central bank regards as a barometer of future inflation, accelerated for the second month to a seven-month high of 1.5% y/y in June after slowing to 0.7% in April, which was the weakest since July 2010. The growth rate was as high as 3.9% in October 2012. Growth rates for M1 (5.3%, y/y) and M2 (2.3) remained around recent lows. By country, M3 growth is contracting in Ireland (-5.9), the Netherlands (-4.0), Spain (-3.1), Portugal (-1.6), and France (-1.2). M3 growth rates are increasing in Germany (4.2), Italy (1.1), and Greece (0.7). (Note: M3 data is through June for Germany, Italy, and the Netherlands, through May for the others.)

Eurozone Credit (link): Credit demand is weak in the Eurozone. We track private-sector lending by Monetary Financial Institutions (MFIs), which shows that the three-month annualized change in total lending was a negative €243 billion in June, following a €185 billion contraction in May. (It had turned slightly positive in April [€20 billion] for the first time since July 2012.) Household demand sank €157 billion (saar) over the three months ending June (the most since December 2008) after increasing earlier this year. Borrowing by nonfinancial corporations (-€118 billion) continues to contract, though at less than half the pace at the start of 2013.
UK GDP (link): The UK’s recovery continues to barrel along, with Q2 real GDP moving past its pre-financial crisis peak in Q1-2008. Real GDP expanded 0.8% last quarter, in line with gains the prior four quarters. On a y/y basis, Q2 growth was up 3.1%, the best since Q4-2007. Services (roughly three-quarters of the economy) grew for a sixth quarter, up 0.9% during Q2 and 3.3% y/y (a six-year high), climbing further above its pre-recession peak. Manufacturing posted its fifth consecutive quarterly gain, though slowing to 0.2% last quarter from 1.3% during Q1 (best since Q2-2010). The yearly growth rate was 3.2%, holding near Q1’s three-year high. Construction output slipped 0.5%, the first decline in five quarters. The yearly growth rate slowed to 4.2% from Q1’s cyclical peak of 6.8%. (The second release of GDP data, due August 15, will show the expenditure breakdown.)

Japan CPI (link): Japan’s core CPI advanced 3.3% y/y ex fresh food in June, slowing from May’s 3.4%, while the core-core CPI--which excludes food and energy--increased from 2.2% to 2.3% y/y, back up at April’s 16½-year high. The April 1 tax hike continues to distort inflation; the BOJ says that underlying inflation is running around 1.25%. Headline inflation was 3.6% y/y, slowing from 3.7% in May. Among the individual components, fuel jumped 8.1% y/y, followed by furniture (5.1%), food & beverages (5.1), reading & recreation (4.7), transportation & communication (3.6), education (2.3), clothing (2.0), and medical care (1.4), with housing costs (0.1) basically flat with a year ago.

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