MORNING BRIEFING
August 12, 2015

Shock Without Awe

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China: Stir-Fried. I’ve been expecting the Chinese government to provide a shock-and-awe stimulus program to stir up China’s flagging economy. Yesterday, Reuters reported, “The yuan suffered its biggest fall in more than two decades on Tuesday, hitting a three-year low after the Chinese central bank surprised markets by devaluing it by almost 2 percent, firing a broadside in what some analysts saw as a looming currency war.”

It was a big surprise. So like everyone else, I am shocked. However, I’m not awed. Neither were financial markets, where the immediate reaction was a drop in stock prices around the world. The dollar strengthened, which depressed commodity prices. The shock-and-awe program I’m waiting for would boost global stock prices, depress the dollar, and lift commodity prices.

The PBOC described the move as a “one-off depreciation,” billing it as free-market reform. More likely is that this is the latest desperate measure by Chinese officials to revive economic growth. As Debbie and I noted on Monday, exports fell 8.3% y/y during July (Fig. 1). The yuan is up 61% relative to the yen since September 13, 2012 and 24% relative to the euro since April 30, 2014 (Fig. 2 and Fig. 3). It was pegged to the US dollar during 2008 and 2009, and then allowed to appreciate starting during June 2010 (Fig. 4). It is up 8% since then.

There was plenty of shock, but no awe in the commodity markets. Professor Copper, the economist in the commodity markets, gave the Chinese move a big thumbs down with a decline of 7 cents in the nearby futures price of the red metal to $2.33 per pound, the lowest reading since July 2009 (Fig. 5). The CRB raw industrials spot price index is at the lowest levels since November 2009. The ongoing rout in commodity prices is sending commodity currencies into freefalls among emerging economies (such as Brazil, Indonesia, and South Africa) as well as Canada and Australia (Fig. 6 and Fig. 7). The trade-weighted dollar is up 17% from last year’s low on July 1 and at the highest level since September 16, 2003 (Fig. 8).

Mohamed El-Erian did a good job of making sense of China’s shocker in an 8/11 BloombergView article titled “Making Sense of China’s Currency Move.” He wrote, “With this move, China explicitly joins other nations trying to capture economic activity outside their borders, and it is doing so as the global economy is struggling to generate sufficient growth. …. The longer countries fail to deliver domestically driven growth, the more they will be tempted to ‘steal’ it from others. A time-tested way of trying to do so is to devalue a national currency in an attempt to make exports more competitive and imports more expensive—thus diverting both internal and external demand to domestic production, at the expense of foreign suppliers.”
We’ve been commenting on the weakness of the global economy and the end of the commodity super-cycle for the past couple of years. In brief, our view is that borrowers have borrowed too much over the past few decades, so easy money has lost its effectiveness in boosting demand. On the other hand, easy money has led to too much supply. The result has been subpar global economic growth with near-zero inflation.

Japan resorted to massive currency depreciation starting at the end of 2012, when Abenomics was introduced. The Eurozone joined in when ECB President Mario Draghi started to talk the euro down during the summer of 2014 and implemented a QE program in March of this year. The markets were clearly spooked to see China start playing the currency depreciation game yesterday.

Although the yuan was devalued by only 2%, there is mounting evidence and concern that Chinese officials are clueless and frantically trying to manage their economy. Maybe now is the time for them to stop managing it so much. They aren’t as good at doing so as they seemed to be in the past. Borrowing lots of money to fuel growth looked like a smart game plan until it stopped working. Let’s review the latest monthly data on social financing:

1. **Total social financing** increased by only $117.5 billion during July, the weakest monthly pace since October 2014 (Fig. 9). Of course, that’s only weak compared to the monthly average pace of $206 over the past 12 months. Since the start of 2009, social financing totaled a whopping $15.6 trillion. Yet real GDP growth peaked at a recent high of 12.1% y/y during Q1-2010, and was down to 7.0% during Q2-2015. The Chinese are getting much less bang per yuan.

2. **Total bank loans**. Bank loans increased at a relatively slow $96.3 billion during July. Nevertheless, they are up $1.8 trillion over the past 12 months and $9.2 trillion since the start of 2009 (Fig. 10). Bank loans have increased from a recent low of 44.9% of total social financing during May 2013 to 71.6% in July (Fig. 11).

The banks have been financing state-owned enterprises and local governments. The former have created too much excess capacity, while the latter have built too many trophy buildings. Now the central government wants the commercial banks to lend to so-called policy banks to fund more infrastructure projects at home and along the Silk Road.

3. **Massive misallocation of capital**. The bank loans have been funded mostly by deposits. The Chinese have a huge savings rate, reported to be around 50% of their incomes. They save too much and don’t spend enough. The money they deposit in the banks has financed too much excess capacity. This would be much less of a problem if they saved less, spent more, and built less capacity.

China’s M2 money supply has doubled since January 2011 to a record $22.1 trillion during July. It is up $11.0 trillion over this period, and $2.7 trillion just over the past 12 months (Fig. 12). (Click ✭ to add China Social Financing to MyPage.)

4. **Capital outflows**. Yesterday, I wrote about the record capital outflows implied by China’s merchandise trade balance and the change in the country’s international reserves. The former rose to a near-record $541 billion over the 12 months through July, while the latter fell by a record $318 billion over the same period, implying record capital outflows of $859 billion. Depreciating the currency might worsen the situation if it doesn’t boost the trade surplus much while accelerating capital outflows to a stronger currency like the dollar. That might actually put more downward pressure on the yuan.
Global Economy: Leaders Are Lagging. Yesterday, Debbie reviewed June’s batch of OECD leading economic indicators (LEI). In recent months, we’ve observed that most of the global economic indicators suggest a scenario of secular stagnation, with neither a boom nor a bust. The OECD LEI is leaning more in the direction of a bust, but we aren’t convinced.

During June, the index for the 34 advanced economies that are members of the OECD fell to 100.0, the lowest reading since June 2013 (Fig. 13). Among the weakest components of the overall index is the US LEI, which fell to 99.4, the weakest since November 2011 (Fig. 14). Sorry, that doesn’t make any sense to us. Making more sense is the LEIs for the BRICs, which all remained below 100 during June (Fig. 15). (Click ✽ to add OECD LEI to MyPage.)

Then, again the weakness in the CRB raw industrials spot price index is of concern to us. We also note that Japan’s exports and imports remained lackluster during June (Fig. 16).

Fed Speak: Talking Heads. Debbie and I are still expecting a one-and-done Fed rate hike in September. However, given international developments, we are starting to think that none-and-done is still a possibility this year, and also possible next year. The members of the FOMC continue to talk about raising rates even as commodity prices plummet and global economic activity slows.

Fed Chair Janet Yellen has repeatedly commented on the Committee’s willingness to make a move this year depending on the domestic data on unemployment and inflation. The Fed’s objectives include reasonable signs of a decrease in the headline unemployment rate near 5% and an increase in inflation near a target of 2%. The latest unemployment rate of 5.3% is nearly there, while inflation, as measured by the core personal consumption expenditures deflator, has remained subdued at 1.3% y/y through June. The latest drop in commodity prices suggests that inflation may remain subdued well into next year.

Let’s review the most recent comments from a couple of Fed heads:

(1) Fischer’s inflation concern. Federal Reserve Vice Chairman Stanley Fischer’s comments in an 8/10 interview with Tom Keene on Bloomberg Television took on a dovish tone. He indicated that he is pleased with the improvement in employment, but remains concerned about low levels of inflation. He said that he does not foresee an interest-rate move “before we see inflation, as well as employment, returning to more normal levels.”

On the other hand, Fischer also said that “the current inflation is temporary” and should “stabilize at some point, so we’re not going to be as low as we are forever.” However, he added a cautionary note, remarking that while the Fed isn’t focused abroad, a global slowdown is “not good for the U.S. economy.”

(2) Lockhart’s happy ending. On the same day, FRB-Atlanta President Dennis Lockhart stated in a speech: “the point of liftoff is close” as in “sometime later this year” with “gradual” increases to follow. Lockhart characterized the current official unemployment rate at “just a shade above” full employment. He also cited improvements in the broader measures of unemployment.

Yet, like Fischer, Lockhart seemed to remain perplexed by the chronically low levels of inflation. He explained that the likely causes of this are “temporary influences” such as “falling oil prices and the appreciating dollar’s effect on import prices.” Lockhart said such factors are complicating the headline figures, which has caused an “analytical challenge” that may “persist for a while.”
Nevertheless, Lockhart’s outlook is upbeat: “I expect somewhat stronger growth in the second half of the year. I expect the employment markets to continue to tighten. I expect continuing labor market progress to begin to put upward pressure on wages across the economy. And I expect convincing evidence to emerge that inflation is rising to a safer level and approaching our 2 percent target.” He concluded: “It has been a long story, sometimes frustratingly so, but one I am increasingly confident will have a happy ending.”

**CALENDARS**

**US. Wed:** JOLTS data, Treasury Budget, MBA Mortgage Applications, Dudley. **Thurs:** Jobless Claims 270k, Retail Sales Total, Ex Autos, and Ex Autos & Gas 0.5%/0.4%/0.4%, Business Inventories 0.3%, Import & Export Price Indexes -1.0%/-0.3%, Weekly Consumer Comfort Index. (Bloomberg estimates)

**Global. Wed:** China Industrial Production 6.6% y/y, China Retail Sales 10.6% y/y, Eurozone Industrial Production -0.1%m/m/1.7%y/y, UK Employment Change & Unemployment Rate -55k/5.6%, Japan Machine Orders 17.6% y/y. **Thurs:** Germany CPI 0.2% y/y, ECB Minutes. (DailyFX estimates)

**STRATEGY INDICATORS**

**Fundamental Stock Market Indicator** (link): Our FSMI--a good coincident indicator that can confirm or raise doubts about stock market swings--continued its up-and-down pattern, climbing 0.8% during the week of August 1 after a 0.3% downturn and a 0.2% uptick the previous two weeks. It’s now 3.2% below its mid-May peak. Our FSMI is the average of our Boom-Bust Barometer (BBB) and Bloomberg’s Weekly Consumer Comfort Index (WCCI). The BBB rose by a total of 3.0% the past three weeks, following a three-month slide of 4.3%. Jobless claims dropped for the third week to 268,250 (4-wa) after climbing the previous three weeks from 273,750 to 282,500. The CRB raw industrials spot price index--another BBB component--continues to set new cyclical lows. The WCCI has slumped a total of 8.4% over the past five weeks after recovering 9.7% the prior three weeks from a nine-week plunge of 16.3%.

**LargeCaps & SMidCaps** (link): All the indexes are positive ytd now after starting the year off in the red, but are between 1.3% and 5.6% below their record highs. Here’s the ytd score and percent from their record high: S&P MidCap 400 (4.0% ytd, -2.5% from record high), Russell MidCap (2.6, -2.5), Russell 1000 (2.6, -1.3), Russell 3000 (2.5, -1.5), S&P 500 (2.2, -1.3), S&P SmallCap 600 (2.1, -4.4), and Russell 2000 (1.5, -5.6). The yearly change in forward earnings is around multi-year lows for the three S&P indexes due to earnings hits from the strong dollar and lower energy prices. The yearly change in forward earnings is likely to remain around multi-year lows until the end of the year, when comparisons become easier. LargeCap’s forward earnings dropped to a five-year low of -0.7% y/y from -0.4%; MidCap’s dropped to a five-year low of 1.3% from 1.7%; and SmallCap’s rose to 3.5% from 2.7% (and is well up from late June’s 2.3% five-year low). Valuations, near multi-year highs, edged down across the board last week: LargeCap’s P/E dropped to 16.3 from 16.5, and is down from its 11-year high of 17.2 (February); MidCap’s slipped to 17.6 from 17.8, down from its 18.6 13-year high (May); and SmallCap’s fell to 18.0 from 18.4, below its 19.6 13-year high (March).

**S&P 500 Growth vs. Value** (link): The Growth index is up 5.3% so far in 2015 after rising 13.0% in 2014. That’s above Value’s 1.2% decline ytd and its 2014 gain of 7.2%. Growth is expected to deliver markedly higher revenue and earnings growth than Value over the next 12 months (6.1% revenue and 10.0% earnings growth, respectively, versus 2.1% and 5.5% for Value). Value’s STEG of 5.5% is up from February’s record low of -0.6%, using data back to 1995. Value’s forward revenues is up 1.1% from its two-year low in April, but remains down 6.2% since its record high in October. Growth’s forward revenues is back at a cyclical high, but remains 11.4% below its record high in September 2008.
Value’s forward earnings has stalled at 5.1% below its record high in early October, while Growth’s has improved to 0.9% below its record high in December. Growth’s P/E (18.6) is down from a 10-year high of 19.1 in February, while Value’s (15.0) is down from an 11-year high of 15.8 then. Value’s NERI was negative for an 11th straight month in July, but improved to a nine-month high of -4.0% from -8.3% in June and from a five-year low of -20.3% in April. Growth’s NERI was negative for a tenth straight month, but also improved to a nine-month high of -4.0% from -6.6% in June, and is up from a five-year low of -16.2% in April. The projected forward profit margin for Value is at a seven-year high of 8.9%, while Growth’s is down to 14.0% from a record high of 14.2% in December.

S&P 500 Q2 Earnings Season Monitor (link): With over 90% of S&P 500 companies finished reporting Q2-2014 results, the earnings metrics are worse than at the comparable point of the Q1 season for the same companies, but the revenue metrics are mostly better. Of the 452 companies in the S&P 500 that have reported, 70% exceeded industry analysts’ earnings estimates by an average of 5.4%, averaging y/y earnings growth of 1.5%. During the same time period in Q1-2014, a higher percentage of companies (72%) in the S&P 500 beat consensus earnings estimates by a larger surprise of 6.9% and higher growth (2.5). On the revenue side, 48% beat sales estimates so far, coming in 0.6% above forecast and 4.0% lower than a year earlier. That’s mostly better than Q1’s comparable results of 44% above forecast, which reported earnings on target (0.0) but had slightly better y/y revenue decline of 3.5%. Just four of the 10 sectors have a positive revenue surprise (Energy, Financials, Health Care, and Tech), but all 10 have a positive earnings surprise. Six sectors have positive revenue growth y/y (all but Energy, Industrials, Materials, and Utilities), and eight have positive earnings growth (all but Energy and Industrials). Ex-Energy, the S&P 500’s revenue surprise falls to 0.0% from 0.6%, but y/y revenue growth improves to 1.7% from -4.0%. The earnings surprise ex-Energy improves to 5.5% from 5.4%, and earnings growth improves to 10.2% from 1.5%.

US ECONOMIC INDICATORS

NFIB Small Business Survey (link): “July has produced the most grudging of gains in the Index’s history and is still not above the 42 year average of 98.0, 99.5 through 2007. This leaves current readings just over two points below the average and five points below the December 2014 reading,” reported NFIB’s chief economist. The Small Business Optimism Index (SBOI) advanced 1.3 points to 95.4 last month after sinking 4.2 points to 94.1 in June (lowest since March 2014), and advancing 3.1 points the prior two months to a high for this year of 98.3. Seven of the 10 index components rose last month, while three fell. The biggest net contributions came from business conditions (from -9% to -4%), plans to increase inventories (-4 to 0), good time to expand business (9 to 12), job creation (9 to 12), and sales expectations (4 to 6); job openings (24 to 25) and capital spending plans (23 to 24) were minor contributors. Earnings trends (-17 to -19), current inventories (-4 to -6), and expected credit conditions (-4 to -5) were a drag on the SBOI.

Productivity & Costs (link): Nonfarm productivity rebounded last quarter after posting its first back-to-back declines since 2006. Second-quarter nonfarm productivity advanced 1.3% (saar) after declines of -1.1% (narrower than the initial -3.1% decline) during Q1 and -2.2% during Q4. Output accelerated 2.8% (saar) from Q1’s revised 0.5% gain (first reported as a -1.6% decline), while the 1.5% increase in hours worked was in line with Q1’s unrevised 1.6% increase. Unit labor costs climbed only 0.5% (saar) last quarter after gains of 2.3% (revised down from 6.7%) and 5.7% the prior two months. Hourly compensation accelerated 1.8% (saar) after a downwardly revised 1.1% advance during Q1, one-third the 3.3% previous estimate. Compared to a year ago, productivity increased 0.3%, reflecting increases in output and hours worked of 2.8% and 2.6% y/y, respectively. Unit labor costs (from 1.1 to 2.1 y/y) accelerated along with hourly compensation (1.7 to 2.4) compared to Q1. Historical revisions for 2012 through 2014 showed that 2014 productivity growth was unchanged at 1.7%, while rates for 2013 (from
0.9% to 0.0%) and 2012 (1.0 to 0.9) were revised lower. Unit labor costs climbed at a faster pace in 2014 (1.8 to 2.0) and 2013 (0.2 to 1.1), and were unchanged at 1.7% for 2012.

**GLOBAL ECONOMIC INDICATORS**

**Mexico Industrial Production** (link): Headline production in Latin America’s second-largest economy climbed for the first time in four months in June. Total production rose 0.2% after falling an unexpected 0.4% in May, which was the steepest monthly decline since September 2013, following no change the previous two months. Manufacturing production edged up only 0.1% after tumbling 1.0% in May, which followed a 2.1% rebound in April. Mining (1.1%), utilities (0.6), and construction (0.4) were also in the black. Headline production rose 1.4% y/y after contracting 1.0% in May, the first yearly decline since April 2014. Manufacturing (4.4% y/y), construction (2.1), and utilities (2.1) output were above a year ago, with the pace accelerating for all. Mining was 6.2% below a year ago, reflecting a 6.8% drop in oil & gas output.

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