



## MORNING BRIEFING

January 18, 2017

### Method to His Madness?

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

(1) A matter of style. (2) The Great Disruptor. (3) Polonius, Hamlet, and Trump. (4) Queen Victoria needed a Twitter account. (5) Who is madder? (6) CEOs kissing Trump's ring. (7) Trump says border tax too complicated. (8) Trump's Rules for Wheeler Dealers: Negotiate from your strength, and find their weakness. (9) IMF also drinking the Kool-Aid. (10) S&P 500 revenues and earnings indicators are mostly upbeat. (11) Fed's talking heads are talking about more rate hikes.

**US Politics: Inauguration & Coronation.** Friday is Inauguration Day: President-elect Donald Trump will become President Donald Trump. He already has stirred things up quite a bit since Election Day. He has made it clear that there won't be any difference in his styles as candidate, president-elect, and president. He is on track to be one of the most disruptive presidents in our country's history. The Great Disruptor's detractors are more convinced than ever that he is nuts. Their agitated attempts to delegitimize his election are starting to border on an attempted coup. He responds to them by doing more to drive them mad.

I wonder what Polonius would have thought of Trump? After listening to a rant by Hamlet, the old courtier muttered in an aside: "Though this be madness, yet there is method in't." Imagine Hamlet with a Twitter account. By the way, speaking of royal courts, if you loved "Downton Abbey," you'll love "Victoria." Needless to say, it is about Queen Victoria, who landed on the British throne when she was just 18 years old. According to the first episode, there was lots of intrigue in the Court and Parliament aimed at declaring the headstrong new monarch insane, both before and after her coronation, and to have her mother appointed as Crown Regent. There were even leaks to the MSM of the time. Odds are that the current charges of Trump's madness will continue after his inauguration right through the end of his first term.

I am certainly seeing method in the madness of Trump's sworn enemies. They want to overthrow him, or at least obstruct his every move. I'm seeing method in what appears to Trump's opponents to be his madness. For starters, he has picked very able people for his Cabinet. They may be controversial, but Cabinet picks always get nitpicked by the opposition party. However, Trump's choices are very experienced in business, particularly in negotiating deals.

While I am philosophically opposed to the President-elect's bullying of corporations, his in-your-face approach is bringing manufacturing facilities and some jobs back to the US. Already, corporations such as United Technologies, Ford, GM, Walmart, Sprint, and Hyundai are kissing Trump's ring. They have pledged to hire more workers and to invest more in the US. He is certainly making good on one of his key campaign promises to his loyal base of voters, who have been mad as heck about all the jobs that have gone abroad.

I am also philosophically opposed to protectionism. However, renegotiating trade deals to make them fairer and calling out abusive practices by our trading partners is okay by me. I'm not a fan of the border adjustment tax, mostly because it seems too protectionist, and frankly too confusing. So I was pleased to read the following in a 1/16 *WSJ* [article](#):

“President-elect Donald Trump criticized a cornerstone of House Republicans’ corporate-tax plan, which they had pitched as an alternative to his proposed import tariffs, creating another point of contention between the incoming president and congressional allies. The measure, known as border adjustment, would tax imports and exempt exports as part of a broader plan to encourage companies to locate jobs and production in the U.S. But Mr. Trump, in his first comments on the subject, called it ‘too complicated.’ ‘Anytime I hear border adjustment, I don’t love it,’ Mr. Trump said in an interview with *The Wall Street Journal* on Friday. ‘Because usually it means we’re going to get adjusted into a bad deal. That’s what happens.’”

I may be reaching for signs of method in his madness, but I hear Trump saying he wants better, fairer trade deals rather than protectionism. While he intends to make America great again, he must know that the US economy is currently great. There can be no doubt that it is much stronger and in much better shape than either China’s or Russia’s, and certainly Iran’s and North Korea’s. As a dealmaker, Trump must know about the weaknesses in the economies of America’s major adversaries. They know all this too. However, for the past eight years, they’ve been allowed to play to their strengths, amplified by their mastery of the dark arts of coercion and propaganda. There’s a new sheriff in town, and I expect he will prey on the weaknesses of America’s adversaries.

The outlines of deals are starting to form. In a 1/16 interview with *The Times of London*, he offered the Russians a deal: The US will end sanctions imposed on Russia over its annexation of Crimea if they agree on a mutual reduction of nuclear arms. There’s no deal outline for China yet, but it will probably be contingent on them backing off from their ambitions to own the South China Sea. In exchange, the US might back off from retaliating against China as a currency manipulator.

Trump already seems to be working on strengthening his position for deal-making on numerous fronts. Love or hate his tweets, they project fearlessness, keep his adversaries off-kilter, and cause other nations’ leaders to hang on his every chirp for clues to their future US relations. He projects fearlessness, for example, by not heeding China’s escalating threats and warnings; blowing off North Korea’s nuclear threat with a simple dismissive “It won’t happen!” tweet; flouting diplomatic convention by criticizing German Chancellor Angela Merkel’s immigrant policy; making paradigm-resetting statements about Russian-US relations, the list goes on. The more fearless and reckless he seems, the more he seems to unnerve his rivals. Note, for example, how his every China-related tweet seems to provoke a stronger reaction from Chinese officials. He is unsettling rival nations, bringing out their worst fears, before negotiations even begin. In other words, there may be method to his madness. The fact that his name is “Trump” couldn’t be more apt!

**Earnings: Yes We Can (Grow).** Debbie and I aren’t the only ones drinking Trump’s Kool-Aid. A week after his election victory, we concluded that he could succeed in stimulating economic growth, so we raised our real GDP forecast for 2017 from 2.5% to 3.0%. Since then, we’ve been keeping track of all the signs showing a revival of “animal spirits” in surveys of consumer and business confidence.

On Monday, the IMF raised its economic growth forecasts for the US, saying output could grow nearly a half-percentage-point faster than previously thought over this year and next, thanks to Trump’s plans to cut taxes and boost infrastructure spending. That would put US real GDP growth at 2.3% this year and 2.5% next year. The IMF’s move follows similar revisions by the World Bank last week.

If so, then the outlooks for the growth rates of S&P 500 revenues and earnings are improving. Both have recovered from the energy-led recession that started during the summer of 2014 and ended early last year, when the price of oil rebounded. Consider the following:

(1) *Forward revenues and forward earnings* of the S&P 500 have been rising rapidly since last spring into record-high territory ([Fig. 1](#)). They are both good harbingers of actual revenues and earnings ([Fig. 2](#) and [Fig. 3](#)).

(2) *Business sales* are recovering from the energy recession. Manufacturing and trade sales rose 2.3% y/y during November, the best growth rate since October 2014 ([Fig. 4](#)). This series is highly correlated with the growth in S&P 500 aggregate revenues, which was 0.6% y/y during Q3-2016. It probably rose to about 2.0% during Q4-2016. Joe and I think the growth rate for revenues this year could be around 4%-5%.

Interestingly, the US M-PMI tends to be a leading indicator for the growth rate in S&P 500 aggregate revenues ([Fig. 5](#)). During December of last year, the M-PMI rose to 54.7, the highest reading since December 2014.

(3) *Retail sales* rose 0.6% m/m during December. Chronic pessimists noted that it was essentially unchanged excluding gasoline and autos. Apparently, they weren't impressed with December's auto sales of 18.4 million units (saar), a cyclical high. Excluding gasoline but including autos, retail sales rose 0.2% to a new record high, and remain highly correlated with our Earned Income Proxy for private industry wages and salaries in personal income, which also rose to a fresh record high last month ([Fig. 6](#)).

(4) *Short-term leading economic indicators* are upbeat. The Citigroup Economic Surprise Index rose to 40.7 on January 17 ([Fig. 7](#)). That's near last year's highest reading. The CRB raw industrials spot price index continues to recover from its cyclical low early last year ([Fig. 8](#)). It was up 23.8% y/y on January 13.

Our Boom-Bust Barometer continues to rise vertically in record high territory ([Fig. 9](#)). The same can be said for the two Weekly Leading Indexes compiled by YRI (us) and ECRI (them) ([Fig. 10](#)).

**The Fed: Yes We Can (Raise Rates).** The Fed will probably normalize monetary policy at a faster pace now that we are all living in Trump World. Fed officials seem to be signaling this by using the word "gradual" less often to describe their outlook for monetary policy. Trump's proposed fiscal stimulus program will pave the way for the Fed to increase interest rates at a faster clip.

Not only is there a changing of the guard at the White House, but also at the Fed. This year's crop of new FOMC voters will probably be inclined to hike rates more rapidly than occurred over the past two years. Lots of Fed officials seem to be leaning toward two or three rate hikes this year, according to a 1/17 Bloomberg [article](#). Let's see who are the new voters, and then review some of the recent comments by key Fed officials:

(1) *New faces.* The new year starts with the annual rotation of FOMC voters, including FRB-Chicago President Charles Evans, FRB-Philadelphia President Patrick Harker, FRB-Dallas President Robert Kaplan, and FRB-Minneapolis President Neel Kashkari. They will bring some new perspective, as the latter three are rookie FOMC voters who are not economists by trade according to a 12/29 *WSJ* [article](#).

President-elect Trump will have the opportunity to fill the long vacant two seats on the Fed's seven-member board of governors, all of whom are members of the FOMC. Indeed, the Fed has not had its full complement of governors since 2013. According to a 4/26 [issue](#) of *The Economist*, the problem has been political gridlock in the Senate over Obama's nominations. He will leave office with the record for the most failed Fed nominations of any president. Trump's picks, if approved by the Senate, could mix things up for Fed Chair Janet Yellen.

(2) *New path.* Evans, the lone veteran in the rotation, has been dovish for a very long time. But he seems to be turning more hawkish these days. “[T]he path is looking a little bit different than it did the last few years,” he told reporters according to a 1/6 MarketWatch [article](#). The 1/16 *WSJ* [reported](#) that last month Evans said that with a strong labor market “you don’t need explicit stimulus.”

In his first public [speech](#) since rates were raised in December as well as his first as a voting member, Harker said that “[a]ll in all, things are looking good” in terms of the labor market, inflation, and growth. In a 11/30 [speech](#), he said: “Monetary policy is a key element of economic policy--but it shouldn’t be the only element of policy. To improve future economic outcomes for our citizens, we need to consider structural and fiscal policies alongside sound monetary policy.” Kashkari hasn’t been very vocal on his monetary policy stance to date. He has had a different agenda. On 11/16, he introduced the Minneapolis [plan](#) to “end too big to fail.” To do so would require support in Congress and from the new administration. Good luck with that.

(3) *Not needed.* Fed Chair Yellen hasn’t said much about fiscal policy following her 12/14 [press conference](#), in which she opined, “I would say at this point that fiscal policy is not obviously needed to provide stimulus to help us get back to full employment.” This implies that Trump’s program could overheat the economy, causing the Fed to raise interest rates more aggressively. That would certainly attract the attention of Trump’s tweets.

(4) *Fair warning.* In a very dense [speech](#) yesterday, Fed Governor Lael Brainard, a Hillary Clinton supporter during the 2016 presidential campaign, focused on the uncertainty surrounding “a significant fiscal policy shift on the horizon.” She said: “However, if fiscal policy changes lead to a more rapid elimination of slack, [monetary] policy adjustment would, all else being equal, likely be more rapid than otherwise.”

She also warned that global imbalances could worsen: “Against the backdrop of deficient demand abroad, if more expansionary fiscal policy here at home raises expectations of a growing divergence between the United States and other economies, upward pressure on the exchange rate will likely result, as we have seen recently with the renewed increase in the dollar. The result could be cross-border spillovers from the increase in U.S. domestic demand, reducing the effect on U.S. real activity and inflation and potentially contributing to external imbalances.”

Finally, FRB-Boston President Eric Rosengren, who is not a FOMC voter this year, said in a [speech](#) on 1/9, “My own forecast is that we will achieve both elements of the dual mandate by the end of 2017, and as a result, I believe that a still gradual but somewhat more regular increase in the federal funds rate will be warranted.”

## CALENDARS

**US. Wed:** Total & Manufacturing Industrial Production 0.6%/0.3%, Capacity Utilization Rate 75.4%, Headline & Core CPI 0.3%/0.2%, Housing Market Index 69, MBA Mortgage Applications, Treasury International Capital, Beige Book, Yellen, Kashkari. **Thurs:** Housing Starts & Building Permits 1.200mu/1.230mu, Jobless Claims 255k, Philadelphia Fed Manufacturing Index 16.0, Weekly Consumer Comfort Index, EIA Petroleum Status Report, Yellen. (Bloomberg estimates)

**Global. Wed:** Eurozone Headline & Core CPI 1.1%/0.9% y/y, Germany CPI 0.7%/m/1.7%/y/y, UK Unemployment Rate 4.8%, UK Jobless Claims Change & Claimant Count Rate 5k/2.3%, Australia Employment Change & Unemployment Rate 10k/5.7%, BOC Rate Decision 0.50%. **Thurs:** China GDP 1.7%q/q/6.7%/y/y, China Industrial Production 6.1% y/y, China Retail Sales 10.7% y/y, ECB Rate

Decision 0.00%, ECB Margin Lending Facility & Deposit Facility Rates 0.25%/-0.40%, ECB Asset Purchase Target (euros) 80b. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P 500/400/600 Forward Earnings** ([link](#)): Forward earnings rose to record highs last week for LargeCap and MidCap, but fell from a record for SmallCap. All three indexes had risen together for eight weeks, their best string of gains for these indexes since they rose for 11 straight weeks through August 2014. The yearly change in forward earnings for all three indexes has been edging higher from six-year lows in early 2016 as y/y comparisons have eased. In the latest week, LargeCap's forward earnings improved to a 25-month high of 5.6% y/y from 4.7%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to a 23-month high of 6.3% y/y from 5.2%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's edged down to 9.4% from a 25-month high of 9.6%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap 0.5% and 12.4%, MidCap 1.9% and 12.6%, and SmallCap 6.2% and 15.6%.

**S&P 500/400/600 Forward Valuation** ([link](#)): Valuations for these three indexes were mixed last week at levels that remain slightly below recent multi-year highs. LargeCap's forward P/E was steady at 17.1, matching its 22-month high of 17.1 in early December. That's up from a 15-month low of 14.9 in mid-January, but remains slightly below the 11-year high P/E of 17.2 in February 2015 (when Energy sector earnings were depressed), and well below the record high of 25.7 in July 1999. MidCap's forward P/E slipped to 18.8 from 18.9; that's below early December's 15-year high of 19.2 and compares to a three-year low of 15.0 in January 2016 and its record high of 20.6 in January 2002. SmallCap's edged up to 19.9 from 19.8; that's up from a three-year low of 15.5 in mid-February, and compares to a 15-year high of 20.5 in early December and record high of 20.9 in April 2002.

**S&P 500 Sectors Quarterly Earnings Outlook** ([link](#)): Q4 earnings estimate revision activity was quiet last week for the S&P 500 sectors just ahead of earnings season. The Q4 consensus dropped w/w for two of the 11 S&P 500 sectors, rose for two, and was steady for seven. Materials and Industrials were the sole gainers, as their Q4 forecasts rose 1.8% and 0.1% w/w, respectively. Sectors with the w/w declines in their Q4 forecasts: Consumer Staples (-0.2%) and Tech (-0.1). The S&P 500's Q4-2016 EPS forecast edged down 10 cents w/w to \$30.76 and is down 2.4% from \$31.53 at the end of Q3. That represents a forecasted pro forma earnings gain of 6.2% y/y, up from 6.1% a week earlier and down from 8.3% at the end of Q3. Since the end of Q3, Q4 estimates are higher for 3/11 sectors and lower for 8/11. Tech's Q4 forecast has risen 1.1%, while Energy's has gained 0.9% and Financials' 0.5%. Materials is down the most (-12.9), followed by Utilities (-7.0), Real Estate (-6.8), Industrials (-5.7), and Consumer Discretionary (-4.3). The S&P 500's Q4-2016 forecasted earnings gain of 6.2% y/y would be its second straight gain after four declines and compares to Q3-2016's blended 4.3%, Q2-2016's -2.1%, Q1-2016's -5.0%, Q4-2015's -2.9%, Q3-2015's -0.8%, Q2-2015's 1.3%, and Q1-2015's 2.2%. Five of the 11 sectors are expected to beat or match the S&P 500's y/y earnings gain of 6.2% in Q4-2016, but analysts expect a y/y earnings gain in Q4-2016 for 7/11 sectors. That forecast is below the 9/11 sectors rising in Q3-2016, which was the best since Q1-2015, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. Energy had been expected to turn in positive y/y growth in Q4-2016 for the first time since Q3-2014, but turned negative in the latest week. The latest forecasted Q4-2016 earnings growth rates vs. their blended Q3-2016 growth rates: Financials (16.5% vs. 8.5%), Utilities (10.0, 10.9), Tech (7.8, 11.5), Consumer Staples (6.2, 7.0), S&P 500 (6.2, 4.3), Materials (6.0, 10.9), Health Care (5.7, 7.6), Consumer Discretionary (1.7, 8.6), Telecom (-0.7, -1.8), Real Estate (-0.8, 2.4), Energy (-2.1, -67.5), and Industrials (-2.8, 4.0).

**S&P 500 Earnings Season Monitor** ([link](#)): With 6% of S&P 500 companies finished reporting Q3-2016 results, their revenue and earnings surprise metrics and y/y growth comparisons are stronger than at

the comparable point of the Q2 season. Of the 29 companies in the S&P 500 that have reported, 69% exceeded industry analysts' earnings estimates by an average of 5.8%; they have averaged a y/y earnings gain of 13.4%. At the same time period in Q3-2016, a higher percentage of companies (83%) in the S&P 500 beat consensus earnings estimates by a larger 8.4% and earnings were down 0.3% y/y. On the revenue side, 35% beat sales estimates so far, coming in 0.8% below forecast and 3.1% higher than a year earlier. During Q3, a higher 68% were above forecast, which exceeded estimates by 1.2% and rose 3.0% y/y. Q4 earnings results are higher for 83% of companies versus 66% at the same point in Q3, and revenues are higher for 83% versus 71%. These figures will change markedly as Q4 results begin pouring in this week, but early data suggest Q2 was indeed the bottom for y/y comparisons.

## US ECONOMIC INDICATORS

**Regional M-PMIs** ([link](#)): The New York Fed district, the first to report on manufacturing activity for this month, shows business activity was modest. The composite index was little changed at 6.5 after climbing from -5.5 in October to 7.6 in December, which was the second-best reading of 2016. The shipments index (to 7.3 from 8.6) held fairly steady, while the orders index (3.1 from 10.4) slowed from December's 27-month high. Inventories (2.5 from -13.9) edged higher for the first time in more than a year. Labor markets remained weak, though less so than in recent months, with both the employment (-1.7 from -12.2) and the average workweek (-4.2 from -7.0) gauges contracting at slower paces--the former on the verge of turning positive. Prices increased significantly this month, with the prices-paid index jumping 13.5 points to 36.1--the highest level since January 2014. Meanwhile, indexes for the six-month outlook remained very optimistic about future conditions; the index for future business conditions was unchanged at December's multi-year high of 49.7.

## GLOBAL ECONOMIC INDICATORS

**European Car Sales** ([link](#)): EU passenger car registrations--a proxy for sales--rose in December by 3.0% y/y to 1,143,653 units. In volume terms, it was the highest December total on record. Among the five major EU markets, Italy (13.1% y/y) and Spain (9.3) recorded the highest gains last month, followed by France (5.8) and Germany (3.7); UK (-1.1) car sales were slightly lower. For all of 2016, sales advanced for the third straight year, up 6.8%--totaling 14,641,356 units. According to the report, "This positive trend is a sign that despite political instability and economic uncertainty following key events in 2016, such as Brexit or the Italian referendum, consumer confidence has remained robust." Last year's gain was across the region and in all major passenger car markets. Italy (15.8%) and Spain (10.9) posted the strongest growth rates for 2016, followed by France (5.1), Germany (4.5), and the UK (2.3).

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