MORNING BRIEFING
September 6, 2017

H-Bomb Ultimatum

See the collection of the individual charts linked below.

(1) Push comes to shove. (2) How to deal with a pesky saber-rattling brat with nukes. (3) Cruising for a bruising. (4) Two options for getting China to solve the problem. (5) Trade war beats WWIII. (6) Geopolitical crises matter to stocks when they threaten economy. (7) Be ready for trouble. (8) ETFs can grease melt-ups and meltdowns. (9) Equity ETFs still attracting lots of money. (10) Brainard wonders why inflation is disconnected from unemployment. (11) We wonder if she has ever ordered from Amazon. (12) Fed likely to hold off on rate hike.

Geopolitics: A-H. What's the difference between an A-bomb and an H-bomb? Today, the major difference may be that the announcement over the weekend by North Korea's Stalinist regime that the country can produce H-bombs brings the country closer to a push-comes-to-shove military confrontation with US military forces.

The rogue regime's obsession with all things nuclear from A-H including intercontinental ballistic missiles, along with the saber-rattling rhetoric about aiming it all at the US, is certainly upping the ante for the Trump administration. On September 4, 2017, US Ambassador to the United Nations Nikki Haley told an emergency session of the 15-member U.N. Security Council in New York that North Korean leader Kim Jong Un is "begging for war."

Shooting down the next test launch by the North Koreans may be too risky a response by the US to the flagrant provocations from North Korea's deranged leader. He might respond by pounding Seoul, South Korea into oblivion. The city's metropolitan region has over 25 million people living within four minutes' reach of North Korean artillery shells. The Trump administration seems rightly intent on exhausting all non-lethal alternatives to a military confrontation.

Increasingly, the only viable one seems to be to put intense pressure on the Chinese to swat their neighbor's pesky nuke-obsessed brat. One option is to slap tariffs on Chinese imports. So far, threatening to do so hasn't worked. This greatly increases the chances that Trump will impose prohibitive tariffs on China to get their attention. Another option is to place tactical nuclear missiles in South Korea. That would drive the Chinese nuts. It would also put the US in a better negotiating position to work out a no-nukes deal for the Korean peninsula with the Chinese.

When I did a Google search on "Does President Trump have the power to impose tariffs," a 1/23 CNN article by Patrick Gillespie was at the top of the list. It was titled "President Trump can levy tariffs without Congress." Here are the main points:

(1) *Carte Blanche*. The article quotes Gary Hufbauer, a trade expert at the Peterson Institute of International Economics, saying, "A president who wants to restrict trade enjoys almost carte blanche authority."

(2) *War powers*. Gillespie reported, "Trump could invoke the 'Trading with the Enemy Act of 1917' to hit

a nation with tariffs as high as he wants. Under the law, the president can restrict all types of trade 'during time of war.' That definition is very loose though. America doesn't have to be at war with a particular nation—it just has to be 'at war' somewhere in the world in order to apply tariffs against other countries."

(3) *National emergency*. The International Emergency Economic Powers Act of 1977 gives the president authority to use tariffs on another country during a "national emergency."

The article at the beginning of the year was clearly inspired by Trump's threats to impose tariffs on Mexico and China in retaliation over what he deemed to be their unfair trade practices. Trump has hinted a few times that if China solves the North Korea problem for the US, his administration will back off on trade protectionism. The pendulum is swinging the other way now as the Chinese have ignored Trump's deal. Now, the US may have to hit the Chinese with a 2-by-4 to get them to make the deal.

The financial markets may have started yesterday to pay attention to this geopolitical crisis, giving greater odds to the possibility that Trump might launch an economic war against China in a last-ditch effort to avoid an actual war with North Korea. Increasingly, it seems to me that just as deranged as North Korea's regime is the one running the show in China. What are they thinking? Why would they possibly want a nuked-up neighbor, let alone a deranged nuked-up neighbor? They must know that the US would happily let them put any puppet regime in North Korea in exchange for a nuclear-free Korean peninsula.

I'm not advising you to push the panic button. But it might be a good idea to prepare for a market selloff if the crisis continues to worsen rapidly. I'm not predicting Armageddon. However, the risks of a severe geopolitical panic attack are increasing. If that happens, it should once again be followed by a big relief rally assuming that the Chinese take executive action in North Korea. In other words, I still see potential for a stock market melt-up, but it might be preceded by a wicked sell-off.

The safest investment for the near term might be US Treasury bonds. If the North Korean problem is resolved peacefully, bond yields most likely will remain flat. If push-comes-to-shove, bond prices could jump higher as stock prices fall lower. I'm just thinking out loud. I'm also thinking: Didn't our previous president win the Nobel Peace Prize for his much-anticipated efforts to end nuclear proliferation?

ETFs: Greasing Melt-Ups & Meltdowns. Yesterday, in my "What I Am Reading" email, I linked a 9/3 *FT* article titled "Vanguard chief dismisses ETF bubble fears." It reported:

"Bill McNabb, head of the $4.5tn asset management giant Vanguard, has shot down accusations that record breaking inflows into exchange traded funds were helping inflate a stock market bubble. Mr McNabb said index tracking funds, which includes the $4tn invested in ETFs, represent much less than 15 per cent of the equity market capitalisation around the world. He added that index tracking funds accounted for less than 5 per cent of daily trading volumes of global financial markets. 'I don't see the bubble,' he said in an FT interview. 'The data belie the fears.'"

The article also quoted Howard Marks, co-founder of Oaktree Capital, the $100bn US alternative investment manager, who last month warned it was unclear whether ETFs and index mutual funds would find buyers for their holdings in the event of a market crunch: "When the management of assets is on autopilot, as it is with ETFs, then investment trends can go to great excess."

Melissa and I are inclined to agree with Marks. More specifically, in the context of the North Korea issue, if the problem is resolved quickly without military action, ETFs should fuel a melt-up in stocks. If the problem seems more likely to blow up into a blow-up, then panic selling of ETFs could significantly worsen the selloff. ETFs could then fuel a melt-up if the panic is followed by a non-lethal solution. I'm just thinking out loud about a very messy situation that could go either way for the markets, with the end result likely to be new record highs in 2018.

Here is how the ETFs could worsen a selloff, as Melissa first explained in the 7/19 *Morning Briefing*. A broker is required for retail investors to make ETF trades. These transactions occur in the secondary market where ETF shares are traded rather than the underlying securities associated with them. Retail investors do not have the power to create new ETF shares, or destroy them. That happens in the primary ETF markets where SEC approved "authorized participants" come into play. Their role is to keep ETFs trading near the funds' net-asset values (NAVs), based on the prices of the underlying securities. But what could happen during a massive selloff? Well, APs aren't under any obligation to engage in these transactions. They only do so when they have the cash or credit available to capitalize on a perceived ETF arbitrage opportunity at a risk they're willing to take.

Melissa and I worry that these buyers and sellers could take a cigarette break or shut down their high-frequency trading algos and cause the gap between the price and NAV to widen, resulting in some retail investors getting lower prices than they should be based on the value of the stocks held by the ETF. That could cause other retail investors to hurriedly sell their ETF shares, causing more market dysfunction, especially if the APs bow out. It's possible that the market could turn extremely illiquid for ETFs. However, the odds of that are slim because there are currently lots of APs out there with the incentive to maintain ETFs at equilibrium. It would take a big negative shock to shake things up, but then we'd have bigger problems than just the ETF markets.

In *Barron's* 9/1 cover story, Ben Levisohn explored the ways the bull market could end, including one related to ETFs. The article quoted Michael Shaoul, CEO of Marketfield Asset Management, saying: "A bear market dominated by passive investing will be more volatile." Because, the author paraphrased, "if they all own the same ETFs, everyone selling will be dumping the same stocks at the same time, exerting enormous downward pressure on their prices." Levisohn reminds us of the rise of portfolio insurance during the 1980s. It was "a fairly simple system designed to protect against losses that involved quickly selling into market downdrafts—that turned what could have been a run-of-the-mill selloff on Oct. 19, 1987 into Black Monday."

For now, ETFs continue to enjoy solid net inflows. Let's review July's data:

(1) *Monthly.* Equity ETFs attracted $17.7 billion during July, the weakest since last October (*Fig. 1*). Some of that money might have come out of equity mutual funds, which had net outflows of $11.8 billion.

(2) *12 months.* Over the past 12 months through July, equity ETFs had net inflows of $337.9 billion, down slightly from June's record of $357.8 billion (*Fig. 2*). Equity mutual funds had net outflows of $95.3 billion over the same period.

(3) *Domestic vs world.* Over the past 12 months, investors have poured $212.0 billion into domestic equity ETFs while pulling $150 billion out of domestic equity mutual funds (*Fig. 3* and *Fig. 4*).

Investors have been uniformly keener on both sorts of funds that invest globally. Inflows into global equity ETFs rose to a record $125.9 billion over the past 12 months, while global equity mutual funds attracted $54.7 billion over the same period.

The Fed: In Another World. Might the developing geopolitical crisis between the US and North Korea cause the Fed to hold its fire on raising the federal funds rate again at the September 19-20 meeting of the FOMC? Melissa and I think so. The monetary policy committee started raising rates at the end of 2015, then it did so once again at the end of 2016, and twice so far this year (*Fig. 5*). Along the way, the FOMC signaled that monetary policy would be normalized at a very gradual pace.

Apparently, bond investors think it will be very gradual indeed, as the US Treasury 10-year yield fell from last year's high of 2.60% on December 16 to this year's low of 2.07% yesterday. The yield curve has flattened dramatically over this period from 213bps to 91bps (*Fig. 6*). The 12-months-ahead federal funds futures contract is priced for a rate of 1.33% in 12 months, down from a high of 1.45% on July 7 (*Fig. 7*). The current federal funds target rate is 1.13%, implying just one rate hike over the next 12 months.

Yesterday, Fed Governor Lael Brainard gave a speech at The Economic Club of New York. She often reflects the views of Fed Chair Janet Yellen and provides useful insight into what may be the consensus view on the FOMC. The title of her talk was "Understanding the Disconnect between Employment and Inflation with a Low Neutral Rate."

We didn't expect her to mention the geopolitical crisis, and she didn't. The speech basically confirmed our view that the Fed is disconnected from the world most of us live in. We really wonder if any members of the FOMC have ever ordered anything on Amazon. They seem to be clueless about the forces keeping a lid on inflation to the benefit of all consumers. Brainard would like to see higher inflation. In her conclusion she said, "I am concerned that the recent low readings for inflation may be driven by depressed underlying inflation."

She said that she is frustrated by the Fed's inability to hit its inflation target: "[W]hat is troubling is five straight years in which inflation fell short of our target despite a sharp improvement in resource utilization." In another sign of disconnecting from reality, or at least a major non sequitur, she said, "I believe it is important to be clear that we would be comfortable with inflation moving modestly above our target for a time."

Her nostalgia for 2.0% inflation, which is the Fed's target, is obviously shared by other members of the FOMC (*Fig. 8*). She suggested that the committee might move forward with reducing its balance sheet while holding off on instituting another rate hike anytime soon. The brewing geopolitical crisis may also be on their radar screen. They can't be that disconnected from reality.

CALENDARS

US. Wed: Merchandise Trade Balance -$44.6b, ISM & Markit NM-PMIs 55.4/56.9, MBA Mortgage Applications, Beige Book. **Thurs:** Productivity & Unit Labor Costs 1.3%/0.3%, Jobless Claims 239k, Weekly Comfort Index, EIA Natural Gas Report, EIA Petroleum Status Report, Dudley. (Bloomberg estimates)

Global. Wed: Germany Factory Orders 0.2%m/m/5.8%y/y, Australia GDP 1.8% y/y, BOC Rate Decision 0.75%. **Thurs:** Germany Industrial Production 0.6%m/m/4.6%y/y, Japan GDP 2.9%q/q/-0.4%y/y, Japan Leading & Coincident Indexes 105.1/115.8, ECB Rate Decision 0.0%, ECB Marginal Facility & Deposit Facility Rates 0.25%/-0.40%, ECB Asset Purchase Target (euros) 60b. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—rebounded by 5.0% during the seven weeks ending August 26 to another new record high, after falling six of the prior seven weeks by 3.6%. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB jumped 5.5% over the seven-week period to a new record high. Jobless claims sank for the seventh week to 236,750 (4-wa), back near the 235,500 reading in late May—which was the lowest since April 1973; claims were at 246,000 seven weeks ago. The CRB raw industrial spot price index—another BBB component—continued to move higher. Meanwhile, the WCCI climbed for the seventh week, by a total of 13.4%, to a new cyclical high.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to a record high last week for LargeCap and MidCap; SmallCap's remained 0.9% below its mid-July record despite rising for the second time in six weeks. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, but the easy y/y comparisons may be waning. In the latest week, LargeCap's forward earnings edged down w/w to 9.6% y/y from 9.7%, which compares to a 64-month high of 10.2% in mid-May and a six-year low of -1.8% in October 2015; MidCap's was steady at 13.5% y/y, which compares to a 66-month high of 14.0% in early August and a six-year low of -1.3% in December 2015; and SmallCap's improved to 10.4% from 10.2% and a seven-month low of 9.9% several weeks ago, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. LargeCap's consensus growth rates expected for 2017 have been edging higher lately, leading to a slight decline in the 2018 growth rates. However, 2018 should improve if the corporate tax rate changes. Here are the latest consensus earnings growth rates: LargeCap 11.6% and 10.9%, MidCap 11.6% and 12.9%, and SmallCap 5.7% and 20.6%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios rose for the three indexes last week. Valuations have improved from their more-than-five-month lows in mid-April, but remain below their multi-year highs in early March. P/Es are easing now after melting up since the election, but the "E" still remains low as analysts await legislative changes to the tax rate and its impact on corporate earnings. LargeCap's forward P/E rose to 17.5 from 17.3 and is up from an 18-week low of 17.2 in the prior week, and compares to the 13-year high of 17.8 in early March. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the Tech bubble's record high of 25.7 in July 1999. MidCap's forward P/E rose to 17.6 from 17.3 and is up from a post-election low of 17.2 a week earlier, which compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002. MidCap's was up from a three-year low of 15.0 in January 2016. SmallCap's rose to 18.9 from 18.6 and is also up from a post-election low of 18.4 in the prior week, which compares to a recent high of 19.7 in early June and a 15-year high of 20.5 in early December, when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016, but down 2.5 points from SmallCap's record-high P/E of 20.9 in April 2002. Looking at their daily forward price/sales (P/S) ratios since data became available in 2004, valuations last week were similarly lower for the three indexes: LargeCap's P/S of 1.96 on Friday is down from a record high of 1.97 in late July; MidCap's 1.25 is down from a record high of 1.39 in early March, and SmallCap's 0.97 is down from 1.08 in early March and its record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Q3 earnings revisions activity was quiet for the 11 S&P 500 sectors last week. The Q3 consensus rose w/w for one of the 11 S&P 500 sectors and was steady for 10. Consumer Staples rose 0.4% w/w for the sole gain among the 11 sectors. The S&P 500's Q3-2017 EPS forecast edged down 1 cents w/w to $33.15, and is down 2.0% from $33.82 at the end of Q2. That represents a forecasted pro forma earnings gain for Q3-2017 of 6.5% y/y, down from Q2's blended 12.1% and Q1's 15.3%, which was the strongest growth since Q3-2011 owing mostly to easier comps for Energy. The Q3-2017 forecast is unchanged from a week earlier, and down from 8.7% at the end of Q2. Since the end of Q2, Q3 estimates are lower for eight sectors and higher for three. Real Estate's Q3 forecast has risen 2.5%, Tech's is up 1.2%, and Telecom has gained 0.6%. Energy's has tumbled 19.7% for the worst decline, followed by the Q3 forecasts for Consumer

Discretionary (-4.4), Materials (-4.4), and Utilities (-2.8). The S&P 500's Q3-2017 forecasted earnings gain of 6.5% y/y would be its fifth straight gain after four declines. Nine of the 11 sectors are expected to record positive y/y earnings growth in Q3-2017, but only three are expected to beat the S&P 500's forecasted y/y earnings gain of 6.5%. That's because analysts expect Energy to report another large profit jump in Q3 relative to very low earnings a year ago. That's down from Q2-2017 when all 11 sectors rose y/y on a blended basis, the first time that has occurred since Q3-2011 when 10/10 sectors rose y/y. The latest forecasted Q3-2017 earnings growth rates vs their blended Q2-2017 growth rates: Energy (127.5% in Q3 vs 533.7% in Q2), Tech (9.7% vs. 16.7%), Industrials (7.8, 7.3), S&P 500 (6.5, 12.1), Financials (4.9, 12.1), Health Care (3.7, 8.7), Consumer Staples (2.7, 4.5), Materials (2.1, 7.7), Real Estate (3.5, 4.6), Consumer Discretionary (0.3, 4.1), Telecom (-1.1, 4.8), and Utilities (-2.0, 6.1).

US ECONOMIC INDICATORS

Manufacturing Orders (*link*): A plunge in volatile civilian aircraft orders in July triggered the biggest decline in factory orders in nearly three years, but the big story is the strength in core capital goods orders and shipments at the start of the third quarter. Yesterday's report showed both core capital goods orders (to 1.0% from 0.4%) and shipments (1.2 from 1.0) had larger gains than the advance estimate. Nondefense capital goods orders ex aircraft (a proxy for future business investment) rose for the fifth time this year—climbing to a 21-month high in July—while the comparable shipments measure (used in calculating GDP) climbed for the seventh time in eight months to its highest reading since October 2015. Both core capital goods orders and shipments expanded at solid rates of 5.0% and 5.3% (saar), respectively, during the three months ending July, based on the three-month average. Headline manufacturing orders tumbled 3.3% as a 70.8% plunge in civilian aircraft orders pushed transportation orders down by nearly 20%. Excluding transportation, orders climbed 0.5% in July to a new cyclical high.

GLOBAL ECONOMIC INDICATORS

Eurozone Retail Sales (*link*): Eurozone retail sales fell in July, for the first time this year, after a string of increases to new record highs. Sales slipped 0.3% following a 1.8% surge the first six months of the year. July's decline was led by a 0.9% decline in automotive fuels, which had jumped 2.1% the previous two months. Spending on food, drinks & tobacco (-0.5%) was also in the red, while non-food products ex auto fuel (0.1) eked out a small gain. Data were available for three of the Big Four economies: Sales in Germany sank 1.2% from June's record high, after expanding in four of the prior five months by a total of 2.7%; Spain's slipped 0.4% after increasing the prior five months by 3.1% to a new cyclical high; and French sales advanced 0.6% following a 0.4% loss and a 0.6% gain the prior two months. Germany's decline was the largest among the Eurozone economies, recording sales losses in July, followed closely by Austria and Estonia, which both fell 1.0%. Slovenia (1.4) posted the largest increase among the Eurozone countries.

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