MORNING BRIEFING
June 20, 2018

Tit for Tat

See the collection of the individual charts linked below.

(1) A chronology of the US-China trade dispute. (2) Some threats, a few concessions, and some tariffs. (3) Upping the ante. (4) Risk of public tiff over tariffs is global slowdown, or a recession if tiff leads to war. (5) Will the smoke clear, or is it the fog of war? (6) Seeking peace and quiet. (7) S&P 500/400/600 continue to send strong bullish signals, which are hard to hear over all the noise about protectionism. (8) Trump risks losing mid-term congressional elections to the "resistance" if he doesn't resolve major trade disputes soon.

Trade War I: Heating Up. Wars can start as a result of tit for tat. This expression describes the inability of either side to back away from conflict, for fear of being perceived as weak. That certainly describes the behavior of the US and China in their recent confrontation on trade:

(1) *January.* It started on January 17, when the US imposed tariffs on Chinese steel. On January 22, the US imposed tariffs on washing machines, which are mostly imported from Mexico but with some parts made in China.

(2) *February.* On February 14, the US imposed anti-dumping duties on cast-iron pipes from China. On February 27, the US imposed anti-dumping and countervailing duties on aluminum foil from China. The Chinese commerce ministry complained about the foil tariff the next day.

(3) *March.* On March 8, the US imposed tariffs on forged steel fittings made in China. On the same day, Trump approved stiff tariffs on imported steel and aluminum. On March 20, tariffs were imposed on stainless steel flanges from China (and India too).

On March 22, the US Trade Representative (USTR) recommended 25% duties on Chinese products. On March 23, the US filed a complaint against China with the World Trade Organization (WTO) about protection of intellectual property. Also on March 23, China announced tariffs on $3 billion of US goods (including fresh fruits, nuts, wine, and pork) in response to US duties on aluminum and steel.

(4) *April.* On April 3, the US released a list of $50 billion of Chinese goods that faced tariffs. China responded with a 25% levy on 106 US products (including soybeans, automobiles, chemicals, and aircraft). On April 4, China filed a complaint about US tariffs with the WTO.

On April 5, Trump instructed the USTR to "consider whether $100 billion of additional tariffs would be appropriate" and to identify which products to apply this to in response to China's "unfair retaliation." The next day (on April 6), China's commerce ministry warned that the nation would retaliate if the latest US threat were implemented. (For more, see Bloomberg's timeline through April 6.)

On April 10, Chinese President Xi promised to encourage "normal technological exchange" and to "protect the lawful ownership rights of foreign enterprises." On the same day, the WTO released a statement from China claiming that the US duties on steel and aluminum imports violate WTO agreements.

During mid-April, the Chinese government promised to end foreign ownership caps on electric vehicle, shipping, and aircraft manufacturing in China. However, the concession was accompanied by a 178% duty placed on US sorghum crops.

(5) *May.* As a part of talks held during early May, the US presented China with a list of trade demands, including a reduction in the bilateral trade deficit by $200 billion with a deadline of 2020, up from previous demands of $100 billion in the next year, reported the 5/4 *FT*.

On May 20, Treasury's Steven Mnuchin said: "We are putting the trade war on hold. Right now, we have agreed to put the tariffs on hold while we try to execute the framework."

On May 22, China reduced its import tariff on autos from 25% to 15% starting July 1 in what the *WSJ* called "a concession to U.S. trade complaints," adding "but the move is likely to pay the biggest benefits to German auto makers and Chinese consumers." Import tariffs on auto parts will also be cut.

On May 29, the White House said that it would announce by June 15 a final list of $50 billion in imports from China that would be subject to 25% tariffs to be implemented "shortly thereafter." The $50 billion may be the first part of a total of $150 billion in Chinese imports to face tariffs, confirmed the White House. Restrictions intended to prevent Chinese acquisition of US technology are to be announced by June 30.

(6) *June.* During weekend talks in early June, China offered to purchase nearly $70 billion of US farm, manufacturing, and energy products. That was short of the previous US request for a plan to reduce the US merchandise trade deficit with China by $200 billion. Chinese officials made it clear that the offer would be void if the US moved ahead with the tariffs expected shortly after June 15. The June talks ended without settlement.

On June 14, President Trump approved a list of tariffs on $50 billion in Chinese goods, Bloomberg reported. It was released on June 15 and covered 1,102 categories of goods aimed at Chinese strategic plans to dominate new high-technology industries. Trump said that the US would respond with more tariffs if China retaliates.

That very same day, China's State Council announced it would levy penalties of the same rate on the US goods of the same value. In retaliation, China expanded the list of US products that would be subject to tariffs from 106 to 659 types of goods. The tariffs on US goods are scheduled to begin on July 6, the same day as the first round of US tariffs are set to be implemented.

On June 18, Trump ordered the identification of $200 billion in Chinese imports—such as toys tools, and t-shirts—for incremental tariffs of 10% and on more goods if China retaliates. In effect that could drive Beijing to penalize US imports beyond tariffs, as the US exports about $150 billion in goods to China, observed the *WSJ*.

Trade War II: Noise Drowning Out Signal. I stand corrected: Yesterday, I wrote that it is hard to imagine that a bear market top was made on January 26 since there's no sign of an imminent recession. However, Trump's protectionist saber-rattling has led to multi-front trade skirmishes with America's major trading partners. Now Trump threatens to up the tit-for-tat ante with an incremental 10% tariff on $200 billion of Chinese imports. He did so Monday evening. The Chinese immediately said that they would retaliate in kind.

This may all be Trump's art of the deal-making. However, bullying the Chinese in public rather than negotiating with them in private is risky. The longer that the noisy dispute continues, the more it could harm global economic growth as businesses postpone spending until the smoke clears. The biggest risk, of course, is that the smoke is actually the fog of war. Trump's approach risks escalating the trade skirmishes into an all-out trade war, which would depress global economic activity. Now let's try to tune out the noise of war and find some peace and quiet:

(1) *Forward earnings.* Notwithstanding all of the above, Joe and I continue to focus on the strong signal coming from S&P 500/400/600 forward earnings (*Fig. 1*). All three rose to record highs in mid-June.

The forward earnings of the S&P 500 is up to $168.40 per share, quickly approaching our target of $170 for the end of this year (*Fig. 2*). Barring an all-out trade war, that level seems easily achievable, since forward earnings will equal the consensus expectation for 2019 by the end of this year. That expectation has been rising ever since the cut in the corporate tax rate at the end of last year. It was $176.94 in mid-June.

(2) *Forward revenues.* We guess that industry analysts haven't gotten the trade-war memo yet. Their forward revenues estimates for the S&P 500/400/600 continued to climb to fresh record highs in mid-June (*Fig. 3*). The upward slope is particularly steep for both the forward revenues and forward earnings of the S&P 600 SmallCaps.

(3) *Profit margins.* The S&P 500 forward profit margin continues to rise in record-high territory (*Fig. 4*). It was 12.2% in mid-June, up from 11.1% during the December 14 week, just before Trump's tax cut.

(4) *Bottom line.* Our bottom line is that while the noise continues to drown out the signal, the signal remains strong enough so that stocks have held up quite well despite the noise of war. We expect that the noise will diminish as the mid-term congressional elections approach. Trump can't afford to lose the House, especially to Democrats aiming to impeach him. He also needs the economy to remain strong and the bull market in stocks to remain intact.

Trump never learns from his defeats because he never admits that he has been defeated or stalemated. Instead, he pretends he has won and moves on ("Won-and-On Don"). He may very well do the same with the Chinese, accepting their initial concessions—as noted above—and moving on. He did that with North Korea, which remains a nuclear power despite Trump's summit with NoKo dictator Kim Jong-un. But Little Rocket Man hasn't launched a missile since late last year.

CALENDARS

US. Wed: Existing Home Sales 5.520mu, MBA Mortgage Applications, EIA Petroleum Status Report. **Thurs:** Leading Indicators 0.3%, Jobless Claims 220k, Philadelphia Fed Manufacturing Index 28.0, FHFA House Price Index 0.5%, Weekly Consumer Comfort Index, EIA Natural Gas Report, Fed Releases Result of 2018 Bank Stress Test. (*Wall Street Journal* estimates)

Global. Wed: Draghi. **Thurs:** Eurozone Consumer Confidence 0.0, Japan CPI Headline, Core, and Core-Core 0.6%/0.7%/0.3% y/y, BOE Bank Rate 0.50%, BOE Asset Purchase Target & Corporate Bond Target £435b/£10b, Carney. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 TCJA Earnings Leaders & Laggards (*link*): The 2018 earnings forecast for the S&P 500 has surged 10.0% in the 26 weeks since the TCJA was signed into law on December 22. This outstanding performance has no comparison over the years since consensus earnings forecasts were first derived in 1978. The change in the 2018 forecast was unchanged from a week earlier as analysts took a breather from post-Q1 earnings season revisions. The top sector gainers since the TCJA was passed: Energy (40.8%), Telecom (15.8), Financials (11.8), Materials (11.5), and Industrials (10.6). Real Estate is the sole decliner, with a drop of 0.1%; also underperforming the S&P 500 are Consumer Staples (1.3), Utilities (1.6), Health Care (6.7), Tech (8.5), and Consumer Discretionary (9.6). Higher oil prices have contributed heavily to the improvement in Energy's 2018 earnings forecast.

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI was positive for a 14th straight month in June, its longest positive streak since the 26-month string ending August 2011. Still reflecting the impact of big revisions due to the passage of the TCJA, NERI remained very strong despite falling to a six-month low of 8.7% from 9.9% and from a record high of 22.1% in March. NERI improved m/m for 4/11 sectors, but was positive for eight sectors (compared to two improving and eight positive in May). Tech has the longest positive NERI streak, of 23 months, the best since August 2011 when its 28-month streak ended. Financials has the next best positive streak at 21 months, followed by Materials (9), Energy (8), and Industrials (7). Real Estate has the worst recent track record, with 10 straight months of negative NERI, but improved to a nine-month high. Here are the sectors' June NERIs compared with their May readings, ranked in descending order: Tech (16.1% in June, down from 16.6% in May), Energy (14.2, 12.1), Materials (13.2, 15.2), Health Care (9.8, 10.6), Industrials (9.7, 12.1), Consumer Discretionary (7.6, 8.8), Financials (7.5, 10.0), Utilities (4.0 [47-month high], 2.8), Real Estate (-1.2 [nine-month high], -7.2), Telecom (-7.0, -8.7), and Consumer Staples (-9.0 [15-month low], -2.0).

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus per-share forecasts for forward revenues and earnings rose to another record high last week. Their forward revenue growth forecast was unchanged w/w at 6.0%, but forward earnings growth improved 0.1ppt to 14.7%. The forward profit margin remained steady at a record high of 12.2%, which is up from 11.1% prior to the passage of the TCJA in December and a 24-month low of 10.4% in March 2016. Forward revenue growth of 6.0% is little changed from an 80-month high of 6.3% at the end of February, and compares to a cyclical low of 2.7% in February 2016. The annual 2018 and 2019 revenue growth forecasts were steady w/w at 7.7% and 4.9%, respectively. Forward earnings growth of 14.7% is up from a 21-week low of 14.6% a week earlier, but that's down from 16.9% in February, which was the highest since October 2010. Still, that's up 3.6ppts from 11.1% prior to the passage of the TCJA, and up 9.8ppts from the cyclical low of 4.8% in February 2016. Turning to the annual earnings growth expectations, the earnings growth forecasts for 2018 and 2019 each improved 0.1ppt w/w to 22.1% and 9.9%, respectively. Energy's contribution to forward growth peaked at the start of 2017. The S&P 500 ex-Financials forward revenue growth forecast rose 0.1ppt w/w to 6.4%, and the forward earnings growth forecast was steady at 13.7%. The S&P 500 ex-Financials forward profit margin rose 0.1ppt to a record high of 11.4%, which is up from 10.4% before the TCJA. Valuations barely edged higher w/w, but maintained the distance between current levels and recent lows. The S&P 500's forward P/E of 16.7 compares to a 16-year high of 18.6 at the market's peak in late January and its recent low of 16.0 in early May. The S&P 500 price-to-sales ratio of 2.04 compares to late January's record high of 2.16 and early May's low of 1.95.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose w/w for six of the 11 sectors, and forward earnings forecasts rose for 4/11 sectors. These four had both measures improve w/w: Energy, Health Care, Materials, and Real Estate. The per-share measures for forward revenues and earnings are at or around record highs for 4/11 sectors: Consumer Discretionary, Health Care, Industrials, and Tech. Forward margins are at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate. Energy's forward revenues and earnings are back on uptrends after stalling during 2016-2017, and its earnings have about tripled from their 18-year low in April 2016. Looking at last week's readings for forward growth among the 11 sectors, just three (Financials, Tech, and Utilities) had a w/w improvement in their forward revenue growth forecast as eight were unchanged. Five sectors had a w/w improvement in forward earnings growth, four fell, and two were steady. Tech and Utilities had both forward growth measures improve w/w. Forward P/S and P/E ratios are down from their recent highs in early 2018 for all sectors, and only half of them improved w/w. Energy's valuations remain elevated relative to historical levels, but are slowly returning to normal now after soaring in 2016 when revenues and earnings collapsed. Energy's P/S ratio of 1.29 compares to a record high of 1.56 in May 2016, and its P/E of 17.8 is down from a record high of 57.5 then. Due to the TCJA, higher margins are expected y/y in 2018 for all sectors but Real Estate, but that sector's forward earnings includes gains from property sales and typically improves as the year progresses. Energy had its forward profit margin rise 0.1ppt w/w to a 42-month high. Two sectors had their forward profit margin drop w/w from record highs: Materials and Consumer Staples. Here's how the sectors rank based on their current forward profit margin forecasts: Information Technology (22.8%), Financials (18.7), Real Estate (16.2), Telecom (13.4), Utilities (12.4), S&P 500 (12.2), Materials (11.2), Health Care (10.6), Industrials (10.2), Consumer Discretionary (8.3), Consumer Staples (7.6), and Energy (7.2).

US ECONOMIC INDICATORS

Housing Starts & Building Permits (*link*): Housing starts in May rebounded to a near 11-year high, while permits fell for the second month since reaching a cyclical high in March. Total starts jumped 5.0% last month to 1.350mu (saar), more than reversing April's revised -3.1% drop—which was less negative than the initial estimate of -3.7%; both single- and multi-family starts contributed to May's gain. Builders broke ground on 936,000 units (saar) in May, climbing 3.9% m/m and 10.5% ytd to within striking distance of a new cyclical high. Meanwhile, volatile multi-family starts rebounded 7.5% to 414,000 units (saar) after a -13.5% loss and a 14.1% gain the previous two months. Building permits fell -5.5% during the two months ending May to 1.301mu (saar), with single-family permits sliding for the second time in three months, by a total of -4.7%, to 844,000 units (saar). Multi-family permits dropped -13.1% the past two months to 457,000 units (saar), after a 20.4% surge in March. Meanwhile, builder confidence slipped 2 points in June to 68, with current sales (to 75 from 76), sales expectations (76 from 77), and traffic (50 to 51) all taking a step back. "Builders are optimistic about housing market conditions as consumer demand continues to grow," said NAHB Chairman Randy Noel. "However, builders are increasingly concerned that tariffs placed on Canadian lumber and other imported products are hurting housing affordability. Record-high lumber prices have added nearly $9,000 to the price of a new single-family home since January 2017."

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