



MORNING BRIEFING

June 26, 2018

Protectionist Fever

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

(1) Beach tug of war: Yardeni vs Clinton and Patterson. (2) Trump stoking protectionist fever. (3) Bullish for the dollar. (4) Bearish for commodity currencies. (5) Even the Stay Home stocks could be hurt by a trade war, but less so than Go Global ones. (6) Bond market sends conflicting signals on recession outlook. (7) Yield curve turning more bearish on economy, but credit quality spread isn't. (8) Fed officials may have to taper monetary normalization if trade policy turns more abnormal. (9) FANGs grow by disrupting other business models, but could be ripe for profit-taking. (10) Lots of hot spots in US stock market, though protectionist fever could cause occasional chills.

My Book: On the Beach. In the event you haven't read my new book yet, may I suggest you take [Predicting the Markets](#) along to the beach this summer? In many ways, it is a users' guide to my research service. In other words, much of it will be familiar, but with a much broader historical perspective than I can provide in our daily commentaries. If you enjoy reading histories that focus on financial markets and the economy, you should enjoy my book. If you prefer thrillers, then *The President Is Missing* by Bill Clinton and James Patterson might be a better choice, though I haven't read it and have no plans to do so. If you have read my book, then please review it on Amazon's [website](#) if you have the time and inclination.

Strategy I: Global Cooling. It's summertime. However, the global equity markets are experiencing cold chills. Chills can occur with a fever and cause shivering or shaking. The problem for stock markets around the world is that trade protectionism is starting to turn feverish as America's major trading partners are threatening to retaliate against the import tariffs that the Trump administration has imposed so far, with more in the works. Let's review the impact on global financial markets:

(1) *Currencies.* As a result of proliferating trade skirmishes, the trade-weighted dollar has jumped 6% from this year's low on February 1 through last Friday ([Fig. 1](#)). It is now flat on a y/y basis, and about to turn positive for the first time in roughly a year; if the strength continues, it may start to weigh on US corporate earnings.

The currency rout has hit the foreign exchange rates of commodity producers especially hard so far in June: South Africa (-6.0%), Canada (-2.7), Australia (-2.2), and Brazil (-1.1). The Emerging Markets MSCI currency ratio has fallen 1.2% so far in June ([Fig. 2](#)).

(2) *Stocks.* US stock markets have been less rattled by the protectionist saber-rattling than most other ones around the world—until yesterday. That's because while the US has the world's largest trade deficit, US exports and imports are relatively small compared to their importance to the economies of our major trading partners. That might be partly because they got used to exporting more and more products to the US without any significant trade barriers.

In addition, the Tax Cuts and Jobs Act (TCJA) passed at the end of last year provided a big boost to

consumer incomes and corporate earnings this year. That's offset any negative economic developments from trade protectionism—so far.

This is all consistent with our recommendation to come back home. Joe and I had been promoting a Stay Home investment strategy during most of the bull market, until late 2016. That's when we detected more signs of a global synchronized expansion, and when we changed to a Go Global weighting for stocks. On June 4, we flipped back to Stay Home.

The ratio of the US MSCI stock price index to the All Country World ex-US index denominated in dollars jumped to a record high last week ([Fig. 3](#)). Using local currencies for the latter, the ratio may be on the verge of breaking out to a record high. Here is the performance derby of the major MSCI stock price indexes in local currencies on a ytd basis through last Friday: US (3.4%), China (1.4), EMU (-0.9), EM Asia (-1.5), EAFE (-1.9), EM (-2.7), Japan (-3.9), and EM Latam (-6.1). Last week was especially bad for China's stock market, as investors reacted to Trump's new tariffs on Chinese goods. The China MSCI stock price index fell 3.7% in local currency, while the S&P 500 edged down by 0.9% ([Fig. 4](#)).

(3) *Bonds*. The US bond markets are flashing mixed signals. There's no hint of an imminent recession triggered by a trade war in the yield spread between high-yield corporate bonds and the 10-year US Treasury note ([Fig. 5](#)). On the contrary, the spread has been remarkably stable in a very narrow range around 350bps since early 2017.

On the other hand, the yield curve spread between the 10-year and 2-year US Treasury notes fell to 35bps at the end of last week, the lowest since August 27, 2007 ([Fig. 6](#)). In other words, it is close to inverting, a development widely feared to be a sure signal of an imminent recession.

Trump's threatened tariffs could boost the inflation rate if he implements most of them. Yet the inflationary expectation embedded in the yield spread between the nominal and TIPS 10-year Treasuries has remained steady around 2.1% since the start of this year ([Fig. 7](#)). Then again, the flattening of the yield curve suggests inflationary expectations are closer to zilch than to 2.1%.

Meanwhile, the 10-year Treasury yield has remained just below 3.00% since the start of this year despite two 25bps hikes in the federal funds rate, with the Fed's dot plot promising two more this year and more to come next year ([Fig. 8](#)). The potential for inverting the yield curve could unnerve Fed officials, reducing their determination to proceed as planned with monetary normalization. Obviously, if push comes to shove and a trade war erupts, the Fed might be forced to lower interest rates and even to reverse course on trimming its balance sheet.

Strategy II: FANG-dango. Meanwhile, back at the ranch, while the S&P 500 has stalled since the start of this year, the US bull market continues in stocks that are relatively immune to a trade war. That statement was true through last Friday. Yesterday's broad-based rout suggests that the downside risks for stocks across the board will increase if the trade war continues to heat up.

Leading the S&P 500 higher have been the FANG stocks, i.e., Facebook, Amazon, Netflix, and Google's parent, Alphabet. They are the Great Disruptors. In the process of using technology to disrupt all sorts of business models, they are actually generating strong earnings. That's been reflected in their remarkable appreciation and lofty valuation multiples—and makes them ripe for profit-taking if investors become increasingly unnerved by a trade war. I asked Joe to slice and dice the key metrics driving their extraordinary outperformance. Here are his findings:

(1) *Performance & market-cap share*. Since late 2012, when all FANG stocks were trading, their market capitalization soared 583%, dramatically outpacing the rest of the S&P 500, which was up 169% over

the same period ([Fig. 9](#)). As a share of the S&P 500, FANGs now account for 10.3% of the index's market cap, up from 3.2% in early 2013 ([Fig. 10](#)). The FANGs' earnings share is less impressive at 3.0%, up from 0.8% in early 2013.

(2) *Valuation*. The FANGs are in nosebleed territory when it comes to their valuations based on forward P/Es: Facebook (29.0), Amazon (126.8), Netflix (113.7), and Google's parent, Alphabet (59.0). The S&P 500 is currently trading at a forward P/E of 16.7 with them and 15.5 without them ([Fig. 11](#)). On price-to-sales ratios, Amazon (3.2) and Google (5.4) are bargains compared to Netflix (10.0) and Facebook (9.1) ([Fig. 12](#)).

(3) *Forward revenues and earnings*. Investors are willing to pay such high multiples for the FANGs because their collective revenues are up 350% since early 2013 vs 121% for the overall S&P 500 index ([Fig. 13](#)). Forward earnings is up 567% for the former and 149% for the latter ([Fig. 14](#)). While they may be relatively immune to a trade war, they are not immune to catching a profit-taking fever.

Strategy III: Other US Hot Spots. Let's face it: If you own the FANGs, you love them. If you don't, you hate them but secretly wish you owned them. During the current bull market, the bears who hate stocks have frequently had opportunities to claim that the bull market wasn't all that impressive since it was narrowly led by the FANGs. They warned that such narrow breadth was bearish. The bull invariably refused to give in as the breadth widened.

Today, thanks to Trump, investors are finding lots of companies that should benefit from his tax cuts. However, many of these companies will also suffer if he proceeds with his "America First" protectionism. As a result, investors have been scrambling to buy companies that benefit from the tax cuts and have relatively little exposure overseas. This has resulted in some spectacular gains:

(1) *Nasdaq and technology stocks*. The Nasdaq finally rose above its previous record high of March 10, 2000 on April 23, 2015 ([Fig. 15](#)). It was 52.4% above that previous record high at the end of last week. The Nasdaq is heavily weighted in technology stocks. It includes all of the FANG stocks.

The S&P 500 Information Technology stock price index exceeded its March 27, 2000 record high on July 19, 2017 ([Fig. 16](#)). It's trading at a forward P/E of 18.7, which is less than half the valuation multiple at the 2000 peak, while the sector's forward earnings is nearly 250% above that year's peak.

(2) *Consumer discretionary retailing*. Most consumers received a significant boost to their take-home pay from the TCJA. That's been reflected in the S&P 500 Consumer Discretionary Retailing Industry Group, which is up 29.0% ytd through Friday ([Fig. 17](#)). Keep in mind that this sector includes Amazon and Netflix. However, also boosting the group is the S&P 500 Department Stores stock price index, which is up even more impressively by 33.6% ytd.

(3) *SmallCaps*. The Russell 2000 SmallCaps index is up 9.8% ytd through Friday ([Fig. 18](#)). Here is the ytd performance derby for the S&P 600 SmallCaps, which is up 11.4% ytd: Health Care (32.6%), Consumer Discretionary (11.9), Telecom (10.6), Energy (10.5), Tech (10.3), Financials (9.9), Industrials (7.5), Consumer Staples (6.9), Materials (3.4), Utilities (0.6), and Real Estate (-1.4) ([Fig. 19](#)).

Strategy IV: Bottom Line. Yesterday, most of the high-flyers in the US stock market lost a little bit of altitude. Joe and I aren't turning bearish given the extraordinary tailwind provided by earnings. However, the flying weather even for the high-flyers could be more turbulent, with more headwinds, if Trump continues to raise the protectionist ante. For now, we are sticking with our year-end target of 3100 for the S&P 500. We will move it to the middle of next year if there is much more turbulence. If Fed officials start to give more weight to the looming protectionist threat to growth, they might hold off

on hiking the federal funds rate for a while. In this scenario, the 10-year Treasury bond yield is likely to remain in a range of 2.50%-3.00% until the fog of a trade war lifts.

CALENDARS

US. Tues: Consumer Confidence 128.1, Richmond Fed Manufacturing Index 16, S&P Corelogic Case-Shiller HPI 0.5%/m/m/6.8%/y/y, Bostic. **Wed:** Durable Goods Orders, Total, Ex Transportation, and Core Capital Goods -0.4%/0.4%/0.2%, Advanced Merchandise Trade Balance -\$69.0b, Pending Home Sales 0.7%, MBA Mortgage Applications, EIA Petroleum Status Report, Rosengren. (*Wall Street Journal* estimates)

Global. Tues: None. **Wed:** China Industrial Profits, Carney, Poloz. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings zigged to record highs last week for LargeCap and SmallCap, but MidCap zagged down from its record high a week earlier. Forward earnings activity has been relatively strong in the past 10 months, as LargeCap's forward earnings has risen in 46 of the past 47 weeks, MidCap's is up in 41 of the past 43 weeks, and SmallCap's is up in 40 of the past 43. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016 and should remain strong in 2018. In the latest week, the rate of change in LargeCap's forward earnings was steady at 21.3% y/y, which compares to a seven-year high of 21.7% in mid-May and a six-year low of -1.8% in October 2015; MidCap's dropped to 22.7% from 23.7% and is down from a seven-year high of 24.0% in early June, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose w/w to 32.3% from 30.2%, that's the highest since October 2010 and compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018 and 2019: LargeCap 22.0% and 9.8%, MidCap 20.4% and 12.7%, and SmallCap 29.4% and 15.3%.

S&P 500/400/600 Valuation ([link](#)): Last week saw forward P/E ratios move lower for a second straight week for LargeCap and SmallCap, and remain steady for MidCap. They're all down from 12-week highs in early June to levels that are not much above their recent post-election lows. LargeCap's weekly forward P/E dropped to 16.3 from 16.5, which is up from a post-election low of 16.0 in late March and down from 18.6 on January 26—the highest since May 2002. That compares to the post-Lehman-meltdown P/E of 9.3 in October 2008, but is well below the tech-bubble record high of 25.7 in July 1999. MidCap's forward P/E of 16.7 is up from its 25-month low of 16.1 in early April. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and compares to the record high of 20.6 in January 2002; however, it is up from a three-year low of 15.0 in January 2016. MidCap's P/E had mostly been at or below LargeCap's P/E from August to March for the first time since 2009. SmallCap's P/E dropped down to 17.8 from 18.0, which compares to a post-election low of 17.0 in mid-March. That's well below its 51-week high of 20.2 in December (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed), but is comfortably above its three-year low of 15.5 in February 2016. Looking at daily forward price/sales (P/S) ratios, they also improved w/w for all three indexes, but remain at levels well below January highs: LargeCap's P/S of 2.02 is down from a record high of 2.19 on January 26; MidCap's 1.33 compares to its record high of 1.40, also on January 26; and SmallCap's 1.02 is down from 1.05 then, which compares to its record high of 1.17 in November 2013, when Energy revenues were depressed.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the books set to close on Q2 results in a week, analysts are doing their channel checks and incorporating guidance from the companies they cover into their earnings models. The S&P 500's Q2-2018 EPS forecast rose 13 cents w/w to \$39.16.

That's up 0.5% since the end of Q1, 7.8% ytd, and 8.5% since the passage of the TCJA. The \$39.16 estimate represents a forecasted pro forma earnings gain for Q2-2018 of 20.6%, up from 20.2% a week earlier. That compares to Q1-2018's blended 26.5% (which is the strongest since Q4-2010), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. Since the end of Q1, Q2-2018 estimates are higher for four sectors, down for six, and steady for Real Estate. Energy's Q2 forecast has surged 14.3%, followed by the forecasts for Materials (1.9%), Tech (1.4), and Health Care (0.9). Consumer Staples is the biggest decliner, with its Q2-2018 forecast down 4.7% since the end of Q1, followed by Consumer Discretionary (-3.3), Telecom (-2.7), Industrials (-2.0), Financials (-1.9), and Utilities (-0.9). The S&P 500's Q2-2018 forecasted earnings gain of 20.6% y/y would be its eighth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q2-2018—with eight rising at a double- or triple-digit percentage rate—and four are expected to beat the S&P 500's forecasted y/y earnings gain of 20.6%. That compares to all 11 sectors rising y/y during Q1-2018, when ten rose at a double-digit pace and four outpaced the S&P 500. Analysts expect Energy to report another large profit jump in Q2 relative to very low earnings a year ago, with the pace improving from Q1. The latest forecasted Q2-2018 earnings growth rates vs their blended Q1-2018 growth rates: Energy (139.3% in Q2-2018 vs 87.9% in Q1-2018), Materials (33.7, 39.4), Tech (25.2, 36.5), Financials (22.2, 30.7), S&P 500 (20.6, 26.5), Consumer Discretionary (15.3, 18.7), Industrials (14.8, 24.7), Telecom (13.0, 14.7), Health Care (11.1, 16.2), Consumer Staples (9.5, 13.1), Real Estate (2.2, 3.1), and Utilities (1.1, 16.4). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 17.0% y/y in Q2, down from 24.5% in Q1; that compares to 12.7% in Q4-2017 and 6.1% in Q3-2017 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016).

S&P 500 Q2 Earnings Trend vs Past Quarters ([link](#)): With a week left before the June-quarter books close, the current Q2-2018 EPS forecast of \$39.16 is up 0.5% over the 12 weeks since the quarter's start. That's only the second time the forecast has risen since Q2-2011, and the 14th increase in the 97 quarters dating back to 1994. The 0.5% gain in the forecast since the end of the prior quarter compares to an average decline of 4.1% over the same time period since 1994 and a TCJA-boosted 5.1% rise during Q1-2018. Analysts expect EPS for Q2-2018 to be up 20.2% y/y on a frozen actual basis, which would mark the eighth straight quarter of higher EPS on a y/y basis and the third straight quarter of double-digit percentage growth. While the current forecast is a tad below the 23.1% growth rate recorded for Q1-2018, it has a good chance of beating that mark and achieving the strongest growth since a 34.2% gain during Q4-2010. Since 1994, the Q2 earnings surprise has been positive in 21/24 years (all but 1998, 2002, and 2008). Q2 should mark the S&P 500's record 38th straight quarter of positive surprises—a streak dating back to Q1-2009.

US ECONOMIC INDICATORS

New Home Sales ([link](#)): New home sales—tabulated when contracts are signed—rebounded to a six-month high in May—boosted by a surge in sales in the South. Sales jumped 6.7% to 689,000 units (saar), following April's -3.7% slide; these sales are up 8.3% ytd. Sales accelerated 14.1% y/y, and are now within 3.2% of November's cyclical high of 712,000 units. The South (17.9%) was the only region to post a gain last month; however, the Northeast was the only region to post sales below a year ago. In May, there were 299,000 new homes on the market, up 10.3% y/y, suggesting construction is beginning to catch up with demand. At the current sales pace, there was a 5.2 months' supply of new homes on the market at the end of May. 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."

Regional M-PMIs ([link](#)): Three Fed districts have now reported on manufacturing activity for June—New York, Philadelphia, and Dallas—and they show growth remains around its best readings since the mid-2000s, accelerating in New York and Dallas while slowing from a heady pace in Philly. We average the composite, orders, and employment measures as data become available. The composite index remained at 27.1, not far from its recent high of 28.4 recorded in October—which was the best reading since March 2006. The New York (to 25.0 from 20.1) region expanded at its fastest pace since October, while growth in the Dallas (36.5 from 26.8) region was back up near February’s cyclical high. Meanwhile, growth in the Philadelphia (19.9 from 34.4) region slowed from May’s vigorous pace, which was the fastest pace in a year. The new orders gauge (22.9 from 28.1) slowed from May’s cyclical high, as orders growth in the Philly (17.9 from 40.6) region slowed more than the New York’s (21.3 from 16.0) and Dallas’ (29.6 from 27.7) accelerated; the former’s had soared to a 45-year high in May. The employment measure (24.4 from 20.8) recorded its best showing in the history of the series going back to 2001, as manufacturers in the Philly (30.4 from 30.2), Dallas (23.9 from 23.4), and New York (19.0 from 8.7) regions added to factories at a powerful pace.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): “The boom is over ... The discussion about a trade war ... is weighing on the mood. Uncertainty has increased slightly,” Ifo Economist Klaus Wohlrabe told Reuters. German business confidence resumed its decline this month, falling for the sixth time in seven months, with activity declining in all four sectors—manufacturing, services, trade, and construction. The new index, which now incorporates responses from the services sector, sank to 101.8 this month—the lowest reading since May 2017; it had peaked at a record high of 105.2 in November. The present situation component climbed to a record high of 108.4 at the start of this year, sinking to a 12-month low of 105.1 this month. The expectations component was unchanged this month at 98.6; it hasn’t posted an increase since peaking at 103.6 in November. Ifo’s expectations component correlates closely with German factory orders and production, while the overall index tracks exports more closely. Recent Ifo data continue to suggest continued easing in growth across the board.

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