Yardeni Research

MORNING BRIEFING
July 10, 2018

Trade Wall of Worry

See the collection of the individual charts linked below.

(1) Channeling the chart of the S&P 500. (2) Market top or the pause that refreshes? (3) Climbing a trade wall of worry. (4) MEGA = Making Earnings Great Again. (5) Leading the Q2 earnings pack are Energy, Materials, IT, and Financials. (6) Analysts remarkably bullish on 2018 and 2019 S&P 500 revenues. (7) Fed officials see downside risks (flattening yield curve, escalating protectionism, European discord, and EM turmoil) and upside ones (fiscal stimulus and overheating economy). (8) Fed study questions usefulness of yield curve as recession warning signal. (9) No recession signal in "near-term forward spread."

Strategy: Season's Greetings. Look at a chart of the S&P 500 (*Fig. 1*). What do you see? The index obviously has been zigzagging so far this year. If you are bearish, then you are seeing a major market top. If you are bullish, it looks more like a consolidation that is forming a base for the S&P 500 to rocket to new record highs. Joe and I remain in the latter camp.

The S&P 500 has been climbing a trade wall of worry since it bottomed on February 8 at 2581. It retested that low on April 2. Since then, it is up 7.9% through yesterday's close. We are particularly impressed that the index is up 1.7% over the past two days, despite the imposition on Friday morning of a 25% tariff by the Trump administration on $34 billion of Chinese imports, perhaps with more to come (*Fig. 2*).

Helping the market to climb the wall of worry are expectations that the Q2-2018 earnings season, which will unfold this month, will be another mega-hit. Trump may or may not Make America Great Again (MAGA). However, there is no disputing that his tax cuts at the end of last year are Making Earnings Great Again (MEGA) this year. Consider the following:

(1) *Q2 consensus estimates.* As of the 7/5 week, industry analysts were expecting that Q2 earnings for the S&P 500/400/600 jumped 20.3%, 17.0%, and 32.0% y/y (*Fig. 3* and *Fig. 4*). Growth rates are expected to remain high during the last two quarters of the year as a result of the tax cuts at the end of last year.

Joe reports that industry analysts are currently expecting the following Q2 earnings growth rates for the 11 sectors of the S&P 500 from highest to lowest: Energy (141.2%), Materials (33.6), Tech (25.5), Financials (22.0), S&P 500 (20.7), Consumer Discretionary (16.4), Industrials (15.1), Health Care (11.1), Consumer Staples (9.6), Telecom (8.1), Real Estate (2.2), and Utilities (1.2).

(2) *Forward revenues and earnings.* The strength in earnings growth is mostly attributable to the tax cut at the end of last year. However, notwithstanding all the chatter about a global economic slowdown and the dangers of trade protectionism, the forward revenues of the S&P 500/400/600 continued to rise in record-high territory during the 6/28 week (*Fig. 5*). The same can be said of S&P 500/400/600 forward earnings (*Fig. 6*).

(3) *2018 and 2019 consensus estimates*. Again, it seems that industry analysts didn't get the memo about a global economic slowdown. Their S&P 500 revenues estimates for both 2018 and 2019 have been making new highs nearly every week since this year began (*Fig. 7*). They are currently expecting revenues to increase 7.9% this year and 5.1% next year.

Analysts' S&P 500 earnings estimates for this year and next jumped dramatically in the weeks immediately after the tax cut, and have continued to inch higher. Industry analysts are expecting earnings to grow 22.3% in 2018 and 9.9% in 2019 (*Fig. 8*).

The Fed I: Balancing Act. Melissa and I continue to subscribe to the Fed's official narrative for the course of monetary policy through the end of next year. The members of the FOMC remain committed to gradually normalizing monetary policy. That means they will continue to taper the Fed's balance sheet, and to raise the federal funds rate by 25bps four more times before the end of next year. That would put the federal funds rate in a range of 2.75%-3.00%. And that is about where Fed officials expect the range to settle for the long term.

We can comfortably say once again that the Fed is likely to stay the course, after carefully reading the minutes of the June 12-13, 2018 FOMC meeting, released on July 5. The minutes stated that "members expected that further gradual increases" in the federal funds rate "would be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation" near 2.0% over the medium term. Participants in the FOMC meeting "generally" shared this view.

FOMC officials should be giving each other high-fives for finally achieving the Fed's dual mandate. Inflation, as measured by the core PCED, rose to the Fed's 2.0% y/y target during May after falling below it since the target was first announced January 25, 2012. And the unemployment rate is at historical lows. Meanwhile, US economic growth is chugging along at a good clip, with the latest GDPNow forecast at 3.8% for Q2.

But the officials aren't celebrating just yet because there are too many significant uncertainties ahead, according to the minutes. Importantly, the minutes characterizes the risks to the economic outlook as "roughly balanced." So it makes sense that the Fed is continuing an approach to policy that is not too fast or too slow, because "balanced" means that the upside and downside risks to the outlook are equally concerning. Let's have a look at the minutes' characterization of risks on both sides of the outlook:

(1) *Downside risk from inversion of the yield curve*. "A number of participants thought it would be important to continue to monitor the slope of the yield curve, given the historical regularity that an inverted yield curve has indicated an increased risk of recession in the United States," noted the minutes. The slope of the yield curve reflects the spread between long-term and short-term Treasury yields. When the short end of the yield curve is higher than the long end, that means that investors expect interest rates to decline, which usually happens as a result of recessions.

If officials raise the federal funds rate too fast, the yield curve could invert, signaling a recession as it has in the past. Nonetheless, FOMC participants pointed to many "factors, other than the gradual rise of the federal funds rate, that could contribute to a reduction in the spread between long-term and short-term Treasury yields." Those include "a reduction in investors' estimates of the longer-run neutral real interest rate; lower longer-term inflation expectations; or a lower level of term premiums in recent years."

During the meeting, Fed staff presented an alternative "indicator of the likelihood of recession." It's based on the spread between the current level of the federal funds rate and the expected federal funds rate several quarters ahead, derived from futures market prices. The staff noted that this measure would be less sensitive to the factors noted above than the traditional yield curve. (For more, see the 6/28 Fed note titled "(Don't Fear) The Yield Curve" and our discussion of it in the next section.)

Missing in the list of explanations for the flattening of the yield curve is that the bond market has been globalized in recent years. So the US Treasury bond yield may reflect the fact that comparable yields in Germany and Japan are near zero.

(2) *Downside risk of trade uncertainty slowing investment*. The section in the minutes titled "Participants' Views on Current Conditions and the Economic Outlook" stated that although district contacts were generally upbeat, they "expressed concern about the possible adverse effects of tariffs and other proposed trade restrictions, both domestically and abroad, on future investment activity."

More specifically: "Districts indicated that plans for capital spending had been scaled back or postponed as a result of uncertainty over trade policy. Contacts in the steel and aluminum industries expected higher prices as a result of the tariffs on these products but had not planned any new investments to increase capacity. Conditions in the agricultural sector reportedly improved somewhat, but contacts were concerned about the effect of potentially higher tariffs on their exports."

Participants don't seem to be too concerned about the direct economic effects of Trump's tariffs. But they are worried about the "negative effects" that trade policy uncertainty could have on "business sentiment and investment spending."

(3) *Downside risk of spillover from Europe and EMEs*. Fed officials are concerned that economic weakness abroad could spill over back home. Many participants saw "potential downside risks to economic growth and inflation associated with political and economic developments in Europe and some EMEs." In Europe, the Italian economic and political situation was noted as an area of particular vulnerability.

(4) *Upside risk from tax cuts.* Last year's tax cuts received a brief mention in the "Staff Review of the Economic Situation" section of the June minutes. The minutes stated that "the lower tax withholding resulting from the tax cuts enacted late last year still appeared likely to provide some additional impetus to spending in coming months." While some participants aren't sure that fiscal policy is on a sustainable path, "a few" see fiscal policy changes as an "upside risk."

On a separate but related note, the Fed's 6/13 Summary of Economic Projections shows the median forecast for the federal funds rate moving up to 3.40% by the end of 2020, then back down to 2.90% over the longer run. Fed forecasters seem to be anticipating the need to cool off shorter-term growth, probably related to fiscal stimulus, which is expected to subside over the longer run.

(5) *Upside risk of overheating economy*. Some participants are worried about letting the economy run "beyond potential" for too long. As a result, inflation could overheat or bubbles could emerge in asset prices and the credit markets. Some worry that either of these scenarios could lead to a downturn. The question is whether the economy is currently running "beyond potential." A "number of participants" noted that it was "premature" to conclude that the FOMC had achieved the 2.0% inflation objective.

Participants also suggested "that there may be less tightness in the labor market than implied by the unemployment rate alone, because there was further scope for a strong labor market to continue to draw individuals into the workforce." As a result, a number of participants anticipate "wage inflation to pick up further." The minutes don't name names, but we know that Fed Chairman Jerome Powell believes that there is room for labor market participation and compensation to improve, as we discussed last week.

The basic message of the minutes is that there are a lot of moving parts to monetary policy right now. So slow and steady is the pace.

The Fed II: Don't Fear the Yield Curve. The FOMC minutes mentions staff research on the yield curve as an indicator of recessions. That research is explained in a 6/28 FEDS Notes titled "(Don't Fear) The Yield Curve" by two Fed economists. In brief, they question why a "long-term spread" between the 10-year and 2-year Treasury notes should have much power in predicting imminent recessions. As an alternative, they've devised a 0- to 6-quarter "near-term forward spread."

Here is their main point: "This [near-term] spread can be interpreted as a measure of the market's expectations for the direction of conventional near-term monetary policy. When negative, it indicates the market expects monetary policy to ease, reflecting market expectations that policy will respond to the likelihood or onset of a recession. By that token, the current level of the near-term spread does not indicate an elevated likelihood of recession in the year ahead, and neither its recent trend nor survey-based forecasts of short-term rates point to a major change over the next several quarters."

The authors of the note stress that the long-term spread reflects the near-term spread, which they argue makes more sense as an indicator of a recession that is expected to occur within the next few quarters. In any case, they also note that an inversion of either yield spread does not mean that the spread causes recessions. In their words:

"This does not mean that inversions of the near-term spread cause recessions. Rather, the near-term spread merely reflects something that market analysts already track closely—investors' expectations for monetary policy over the next several quarters and, by extension, the economic conditions driving those expectations."

And here is their complete conclusion:

"The narrow lesson to take away from this exercise is that the current near-term forward spread, which arguably serves as a proxy for market expectations of Federal Reserve policy, indicates the market is putting fairly low odds on a rate cut over the next four quarters. Unlike far-term yield spreads, the near-term forward spread has not been trending down in recent years, and survey-based measures of longer-term expectations for short term interest rates show no sign of an expected inversion. More generally, our findings do not support the practice of appealing to the long-term spread for a different signal about the prospects for year-ahead economic performance. A more subtle suggestion from our analysis is that the predictability of recessions by the near-term spread would appear to be a case of 'reverse causality.' That is, the near-term spread may only predict recessions because it impounds expectations that market participants have already formed."

So let's all give a big sigh of relief!

CALENDARS

US. Tues: NFIB Small Business Optimism Index 106.0, Job Openings 6.700m. **Wed:** PPI-FD Total, Core, and Core Less Trade Services 0.2%/0.2%/0.2%, Atlanta Fed Business Inflation Expectations, Wholesale Trade Inventories 0.5%, MBA Mortgage Applications, EIA Petroleum Status Report, Williams. (*Wall Street Journal* estimates)

Global. Tues: Germany ZEW Survey Current Situation & Expectations 78.2/-18.5, UK Headline &

Manufacturing Industrial Production 1.9%/1.9% y/y, UK Trade Balance £3.38b, UK Statistics Office Publishes First Monthly Estimate of GDP, Japan Machine Orders -5.0%m/m/10.2%y/y, China New Yuan Loans 1520b, China Aggregate Financing 1400b, China CPI & PPI 1.9%/4.5% y/y. **Wed:** BOC Rate Decision 1.50%, Draghi, Carney. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to record highs for all three of these indexes last week. Forward earnings activity has been relatively strong in the past 11 months, as LargeCap's forward earnings has risen in 48 of the past 49 weeks, MidCap's is up in 43 of the past 45 weeks, and SmallCap's is up in 42 of the past 45. 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 21.4% 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 rose to 23.2% from 22.7%, which compares to a seven-year high of 24.0% in early June and a six-year low of -1.3% in December 2015; and SmallCap's dropped w/w to 31.5% from 32.0%, which was 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 22.2% and 9.8%, MidCap 20.6% and 12.7%, and SmallCap 29.7% and 15.2%.

S&P 500/400/600 Valuation (*link*): Last week saw forward P/E ratios rise for the first time in four weeks. However, they remain 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 rose to 16.3 from 16.1, 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 increased to 16.6 from 16.4, which 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 rose sharply to 17.8 from 17.2, 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 1.34 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 closed on Q2 results, analysts and investors are awaiting Q2 results and guidance about the future. The S&P 500's Q3-2018 EPS forecast dropped 4 cents w/w to $41.02. That's down 0.1% since the end of Q2, but up 8.7% ytd, and 9.4% since the passage of the TCJA. The $41.02 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 23.3%, down from a 23.4% forecast a week earlier at the end of Q2 and up from 22.1% at the end of Q1. That compares to Q2-2018's blended 20.7%, Q1-2018's 26.6% (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 Q2, Q4-2018 estimates are higher for four sectors, down for four, and steady for three. Energy's Q3 forecast has risen 0.9%, followed by the forecasts for Materials (0.2%), Tech (0.1), and Consumer Discretionary (0.1). Telecom is the biggest decliner, with its Q3-2018 forecast down 0.5% since the end of Q2, followed by Industrials (-0.3), Financials (-0.2), and Utilities (-0.2). The S&P 500's Q3-2018 forecasted earnings gain of 23.3% y/y would be its ninth straight gain after four declines. All 11 sectors are expected to record positive y/y earnings growth in Q3-2018, but nine are expected to rise at a double- or triple-digit percentage rate compared to eight during Q2. However, just three are expected to beat the S&P 500's forecasted y/y earnings gain of 23.3% compared to four during Q2. 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 Q3 relative to very low earnings a year ago, with the pace slowing from Q2. The latest forecasted Q3-2018 earnings growth rates vs their blended Q2-2018 growth rates: Energy (103.5% in Q3-2018 vs 141.2% in Q2-2018), Financials (44.6, 22.0), Materials (33.4, 33.6), S&P 500 (23.3, 20.7), Telecom (21.2, 8.1), Consumer Discretionary (19.6, 16.4), Industrials (19.3, 15.1), Tech (16.9, 25.5), Consumer Staples (11.3, 9.6), Health Care (11.0, 11.1), Utilities (7.1, 1.2), and Real Estate (4.9, 2.2). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 20.2% y/y in Q3, up from a blended 17.0% in Q2; that compares to 24.5% in Q1-2018, 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).

US ECONOMIC INDICATORS

Consumer Credit (*link*): Consumer credit accelerated in May at the fastest pace this year, and more than double April's rate. Credit jumped an unexpected $24.6 billion in May, to a new record high, up from gains of $10.3 billion and $8.8 billion the previous two months. Revolving credit advanced at a six-month high of $9.8 billion in May, suggesting consumers used their credit cards to fuel an acceleration in spending last quarter; revolving credit was flat during Q1. Meanwhile, nonrevolving credit, which includes student and auto loans, climbed $14.8 billion during May—above the $10.3 billion average monthly advance the first four months of the year.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (*link*): Global economic activity in June accelerated for the third month, posting its strongest reading since February's 3.5-year high. The JP Morgan Global Composite Output Index (C-PMI) rose steadily to 54.2 last month, after falling in March (to 53.3) for the first time in six months; it had climbed the prior five months from 53.8 in September to 54.8 in February—which was its best reading since September 2014. The NM-PMI recovered for the third month from 53.2 in March to 54.6 in June, while the M-PMI fell for the fifth time in six months, from 54.5 in December to an 11-month low of 53.0 last month. Developed markets (to 55.0 from 54.8) continued to outperform emerging markets (52.4 from 52.2), with the former's C-PMI measure rising to a four-month high last month while the latter's was little changed from May's six-month low. Rates of expansion were solid in both the US (56.2) and Eurozone (54.9), remaining close to May's 3.5-year high in the former and accelerating in the latter. Ireland (58.1, 5-month high) posted the best growth of the Eurozone economies in June, followed by France (55.0, 2-month high), Spain (54.8, 17-month low), Germany (54.8, 3-month high), and Italy (53.9, 4-month high), with only Spain's decelerating during the month. Meanwhile, the UK (55.2) accelerated at its fastest pace in eight months, while growth in Japan (52.1) also improved after slowing in May. Among the largest emerging economies, India (53.3) and China (53.0) were the best performers, posting their strongest readings in 20 and 4 months, respectively, while growth in Russia (52.0) was the weakest in over two years, and the contraction in Brazil (47.0) accelerated.

Global Non-Manufacturing PMIs (*link*): The global service sector in June continued to rebound back toward February's three-year high. The JP Morgan's NM-PMI climbed from 53.2 in March to 54.6 in June, the second-highest rate of the past three years—February's 54.8 being the highest. The report notes that the US (to 56.5 from 56.8) once again was the leader in the global service economies covered by the survey, barely budging from May's three-year high. NM-PMIs for the UK (55.1 from 54.0) and the Eurozone (55.2 from 53.8) showed the fastest growth in eight and four months, respectively. Within the Eurozone, rates of expansion accelerated among the "Big Three" economies—

with Germany (54.5) and Italy (54.3) logging their fastest pace in four months and France (55.9) in two. Ireland (59.5) recorded the best growth of all the nations covered, while Spain (55.4) placed third—though was the only one to see a deceleration in growth (to a seven-month low). NM-PMIs for both China (53.9 from 52.9) and Japan (51.4 from 51.0) showed an acceleration within their services' industries, though were below global-average rates. Meanwhile, India's (52.6 from 49.6) returned to growth, while Russia's (52.3 from 54.1) rate was the slowest in over two years, and Australia's (52.7 from 55.9) was the weakest in that nation's 26-month survey history.

US Non-Manufacturing PMI (*link*): The ISM measure of US service sector growth showed acceleration in June, while IHS Markit's measure barely budged from its three-year high of May. Specifically, ISM's NM-PMI (to 59.1 from 58.6) accelerated again in June, rebounding back near January's 59.9—which was the fastest rate since August 2005. Last month's acceleration was led by big gains in both the business activity (63.9 from 61.3) and new orders (63.2 from 60.5) components—which moved further above 60.0. The remaining two components, supplier deliveries (55.5 from 58.5) and employment (53.6 from 54.1), eased. Markit's NM-PMI slipped to 56.5 in June after shooting up to 56.8 in May—its best reading since April 2015. According to the report, "The latest rise in output was the second-fastest since April 2015, behind May's recent high. The rate of new order growth remained sufficiently strong to encourage the second-highest degree of job creation since September 2015. The rate of input price inflation meanwhile matched that seen in May and was the joint-fastest since September 2013. Output charges also increased strongly in response to robust demand."

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823