MORNING BRIEFING
July 16, 2018

The Kindness of Strangers

See the collection of the individual charts linked below.

(1) Blanche DuBois vs Donald Trump. (2) Stagflation debate: Will tariffs depress growth and boost inflation? (3) Bond yields remain eerily subdued. (4) So do inflationary expectations implied by TIPS. (5) Dr. Copper bearish on China. (6) Fed data show foreigners buying lots of US bonds. (7) Weakening yuan could offset inflationary consequences of Trump's tariff on Chinese goods. (8) Fed, not trade, is driving the US stock market, as S&P 500 cyclicals beating interest-rate sensitive ytd.

Trade War I: Flight to the US Dollar, Bonds, & Equities. Much like Blanche DuBois in Tennessee Williams' play "A Street Car Named Desire," the US has "always depended on the kindness of strangers," or at least it has for a very long time. That's because foreigners have been big buyers of bonds issued by Americans. They've helped to finance the US federal budget deficit. They've also bought lots of mortgage-backed and corporate bonds.

Trump's escalation of the trade war between the US and all our major trading partners has raised concerns that foreigners will respond to Trump's "America First" protectionism by cutting back on their purchases of US debt. Furthermore, Trump's tariffs may boost inflation in the US by increasing the cost of imports. Both possibilities should be bearish for bonds. Yet bond yields remain eerily subdued. As a follow-up to my discussion of the yield curve in last Wednesday's *Morning Briefing*, let's examine the foreign-inflow-of-funds story before turning to the inflationary consequences of Trump's trade war:

(1) *Bond yields and expected inflation.* The 10-year US Treasury bond yield peaked this year at 3.11% on May 17, and has been trading below 3.00% most of the time since then (*Fig. 1*). The comparable 10-year TIPS yield has mirrored the nominal yield so far this year.

Expected inflation, as implied by the spread of the two yields, has been relatively stable around 2.00% after mostly rising during the second half of 2017 from a low of 1.66% on June 21, and jumping after passage of the Tax Cuts and Jobs Act (TCJA) on December 22 (*Fig. 2*).

The escalating trade war hasn't boosted the expected inflation spread, so far, despite Trump's threat to impose tariffs on lots of Chinese imports. So far, there is no sign that foreigners are bailing out of US debt securities. On the contrary, the outbreak of protectionist saber-rattling, and now jousting, has boosted the trade-weighted dollar (*Fig. 3*). This suggests that some global investors are taking sides in the trade war, betting that the US will win, if there is a winner, or at least will emerge the least bloodied.

Meanwhile, despite the potential of an escalating trade war to cause a global recession, the credit-quality yield spread between high-yield corporate bonds and the 10-year Treasury bond also remains eerily serene. It's been in a tight range around 350bps since early 2017 (*Fig. 4*).

(2) *Dr. Copper.* As we noted a week ago, the price of copper has been falling since it peaked this year at 329.3 cents per pound on June 8 (*Fig. 5*). It continued to move lower last week, closing at 277.0

cents, down 15.9% from the recent peak. Since this says more about the economy of China than that of the US, it's not surprising to see that Chinese stocks are getting hammered (*Fig. 6*).

Meanwhile, the S&P 500/400/600 are up 8.5%, 10.8%, and 17.1% since their lows on February 8. Our switch back to a Stay Home from a Go Global investment strategy on June 4 was well timed, so far, as evidenced by the ratios of the US MSCI to the All Country World ex-US MSCI in both dollars and local currency terms. Both soared to record highs last week (*Fig. 7*).

(3) *Flow of funds.* To monitor the flow of funds in the US capital markets, we use the Fed's quarterly report *Financial Accounts of the United States*. The data are currently available through Q1-2018. They show that the "rest of the world" acquired $674 billion in US fixed-income securities over the past four quarters (*Fig. 8*). That's among the highest readings since the 2008 financial debacle. The figure includes $332 billion in US Treasuries and $267 billion in corporate bonds (*Fig. 9* and *Fig. 10*).

Trade War II: Markets Betting Against China. The consensus view among economists is that Trump is wrong about trade wars. They aren't "good, and easy to win," as he tweeted on March 2. It is also widely believed that if he continues to escalate the trade war, everyone will lose because the result is most likely to be stagflation or worse. Weakening global trade will depress global growth, while higher tariffs will boost inflation.

Debbie and I aren't dismissing this widely believed narrative. However, while Trump has opened up lots of fronts in his battle for fair trade with America's major trading partners, the major fight is with China. Will China put up the white flag and make major concessions to get a cease fire out of Trump?

Currently, that seems to be an unlikely scenario. However, that's exactly the story being told by the financial markets. Consider the following:

(1) *Stocks and copper.* As noted above, while Chinese stocks are falling, US stocks are rising. The weakness in the price of copper is a better economic indicator for the economy of China than for that of the US.

(2) *Currencies*. While the Fed continues to gradually normalize monetary policy, the People's Bank of China cut reserve requirements sharply in recent weeks (*Fig. 11*). That undoubtedly contributed to the 6.2% plunge in the yuan from its mid-April peak (*Fig. 12*).

If Trump does raise the ante by slapping a 10% tariff on $200 billion of imports from China, a stronger dollar relative to the yuan might very well offset most of the inflationary consequences for the US. To add insult to injury, Trump could revive his attacks on China as a "currency manipulator." However, in my opinion, it is US trade policies, not Chinese intervention, that is weakening the yuan.

Trump knows that a weak yuan could cause the Chinese some real pain, by increasing the yuan cost of buying dollar-priced commodities like copper, oil, and soybeans. China's PPI inflation rate, which was 4.7% on a y/y basis in June, could go higher and put upward pressure on the CPI inflation rate, which was 1.9% last month (*Fig. 13*).

(3) *S&P 500 sectors.* In the US, the ytd performances of the S&P 500 sectors suggest that investors are more concerned about rising interest rates resulting from a strong economy than about a trade war depressing the economy (*Fig. 14*): Information Technology (15.3%), Consumer Discretionary (14.1), Health Care (5.8), Energy (5.7), S&P 500 Index (4.8), Real Estate (-0.1), Utilities (-0.3), Industrials (-2.8), Materials (-3.1), Financials (-3.5), Consumer Staples (-7.8), and Telecom Services (-10.3). Cyclical stocks are mostly outperforming interest-rate sensitive ones.

CALENDARS

US. Mon: Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.6%/0.4%/0.5%/0.4%, Business Inventories 0.4%, Empire State Manufacturing Index 21.0. **Tues:** Headline & Manufacturing Industrial Production 0.6%/0.7%, Capacity Utilization Rate 78.3%, Housing Market Index 69, Treasury International Capital, Fed Chair Powell's Semiannual Monetary Policy Testimony Before the Senate Banking Committee. (*Wall Street Journal* estimates)

Global. Mon: Eurozone Trade Balance €18.6b, China GDP 6.7% y/y, China Retail Sales 9.0% y/y, China Industrial Production 6.5% y/y, China Fixed Assets Ex Rural (ytd) 6.2% y/y. **Tues:** European Car Registrations, UK Jobless Claims Change & Claimant Count Rate, UK Employment Change & Unemployment Rate (3-month) 115k/4.2%, RBA July Meeting Minutes, BOE's Carney, Cunliffe, and Stheeman Speak on Financial Stability. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): The US MSCI index rose 1.5% last week, ranking 11th out of the 49 markets in a week when 28 countries rose in US dollar terms and the AC World ex-US index increased 0.5% for its fourth gain in 12 weeks. That compares to the US MSCI's 1.5% rise a week earlier, which ranked 21st as 32 markets rose and the AC World ex-US index edged up 0.2%. EM Latin America performed best with a gain of 2.2%, followed by BRIC (1.7%), EM Asia (1.7), and EM Eastern Europe (1.2). The underperforming regions relative to the AC World ex-US were EMEA (-0.4), EMU (-0.2), and EAFE (0.2). Indonesia was the best-performing country as it rose 5.4%, followed by Brazil (4.1), India (3.0), Malaysia (2.7), and the Philippines (2.6). Of the 28 countries that underperformed the AC World ex-US MSCI last week, Turkey fared the worst as it tumbled 14.1%, followed by Norway (-2.9), Spain (-2.3), and Morocco (-2.2). On a ytd basis, the US MSCI improved w/w to a 5.1% gain, and gained four places in the ytd performance ranking to 4/49. The US MSCI is ahead of the AC World ex-US (-4.6) in the ytd period; 37/49 countries and all other regions are in negative territory ytd. EM Eastern Europe leads all regions with a decline of 2.5% so far this year, putting it ahead of EMU (-3.3) and EAFE (-3.8). EM Latin America (-8.9) is biggest laggard relative to the AC World ex-US's performance, followed by EMEA (-7.8), EM Asia (-6.0), and BRIC (-5.1). The best country performers ytd: Colombia (10.8), Finland (7.1), Israel (6.4), the United States (5.1), and Russia (4.7). The worst-performing countries ytd: Argentina (-42.0), Turkey (-40.3), the Philippines (-20.0), Indonesia (-17.9), and Poland (-17.5).

S&P 1500/500/400/600 Performance (*link*): Two of these three market-cap indexes rose last week as LargeCap, with a 1.5% gain, outperformed MidCap (0.3%) and SmallCap (-0.4). SmallCap is down 1.1% from its record high on July 9 while MidCap is 0.6% below its record on that same day. LargeCap is the biggest laggard, down 2.5% from its record high nearly six months ago on January 26. Sixteen of the 33 sectors rose in the latest week, down from 32 rising a week earlier, which was the highest count since early March. The best performers in the latest week: LargeCap Tech (2.3), LargeCap Industrials (2.2), LargeCap Consumer Discretionary (2.1), and LargeCap Health Care (1.6). MidCap Telecom (-10.3) was the biggest decliner this week, followed by these underperformers: SmallCap Utilities (-3.1), SmallCap Real Estate (-2.0), SmallCap Consumer Staples (-1.8), and MidCap Consumer Staples (-1.8). LargeCap is now up 4.8% ytd and catching up to MidCap's 5.0%, but both are significantly trailing SmallCap's 11.7% gain. Twenty-one sectors are now positive to date in 2018, down from 26 a week earlier and compared to just three in early February. The best-performing sectors ytd: SmallCap Health Care (36.6), MidCap Health Care (22.8), MidCap Energy (16.0), and LargeCap Tech (15.3). The worst performers ytd: LargeCap Telecom (-10.3), LargeCap Consumer Staples (-7.8), MidCap Telecom (-7.6), LargeCap Financials (-3.5), and LargeCap Materials (-3.1).

S&P 500 Sectors and Industries Performance (*link*): Eight sectors rose last week, and four outperformed the S&P 500's 1.5% rise. That compares to 10 rising a week earlier, when five outperformed the S&P 500's 1.5% gain. Tech was the best-performing sector, with a gain of 2.3%, ahead of the performances of Industrials (2.2%), Consumer Discretionary (2.1), and Health Care (1.6). Telecom was the biggest underperformer, with a drop of 1.6%, followed by Utilities (-1.2), Real Estate (-0.8), Materials (0.3), Energy (0.8), Consumer Staples (1.0), and Financials (1.1). Four sectors are in the plus column so far in 2018, down from six a week earlier and down from nine in early March. Just four sectors have bested the S&P 500's 4.8% ytd gain: Tech (15.3), Consumer Discretionary (14.1), Health Care (5.8), and Energy (5.7). The seven ytd underperformers: Telecom (-10.3), Consumer Staples (-7.8), Financials (-3.5), Materials (-3.1), Industrials (-2.8), Utilities (-0.3), and Real Estate (-0.1).

Commodities Performance (*link*): Last week, the S&P GSCI index tumbled 3.6% w/w for its sixth drop in eight weeks and its biggest since early February as just four of the 24 commodities that we follow moved higher. That compares to the prior week's 1.4% decline when 7/24 commodities rose. Last week's strongest performers: Cotton (4.0%), Cocoa (1.9), Live Cattle (0.9), and Nickel (0.4). Last week's biggest decliners: Lean Hogs (-26.7), Soybeans (-6.7), Zinc (-5.7), and Lead (-5.7). The S&P GSCI commodities index is up 4.7% ytd and near its highest level since December 2014, but remains about 50% below its record high in July 2008 just before the financial crisis. The top performer so far in 2018 is Cocoa (32.8), followed by Wheat (16.4), Crude Oil (15.8), Unleaded Gasoline (15.6), and Kansas Wheat (15.1). The biggest laggards of 2018 to date: Sugar (-27.7), Lean Hogs (-23.0), Zinc (-22.5), Copper (-13.9), and Soybeans (-13.3).

Assets Sorted by Spread w/ 200-dmas (*link*): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 3/24 commodities, 8/9 global stock indexes, and 14/33 US stock indexes, compared to 7/24 commodities, 3/9 global stock indexes, and 31/33 US stock indexes rising a week earlier. Commodities' average spread fell w/w to -2.5% from 1.0% as 11 commodities trade above their 200-dmas, down from 12 a week earlier. Crude Oil leads all commodities at 11.2% above its 200-dma, while Cotton (10.0%) performed the best among commodities last week, rising 3.6ppts. Lean Hogs now trades at 23.3% below its 200-dma, the lowest of all commodities and all assets; it also had by far the worst performance of all assets last week, tumbling 27.9ppts. The global indexes trade at an average of 2.4% below their 200-dmas, up from 4.2% below in the prior week. Three of the nine global indexes trade above their 200-dmas, up from two a week earlier. Canada (4.2) leads the global indexes, but Indonesia (-3.5) gained 4.1ppts last week for the best w/w improvement among global assets. China (-11.4) is the biggest laggard among global indexes, but Chile (-3.5) dropped 0.1ppt w/w, the biggest decline among global indexes. The US indexes trade at an average of 5.4% above their 200-dmas, with 26 of the 33 sectors above, down from 6.0% a week earlier, when 26 sectors were above. SmallCap Health Care (22.8) continues to lead the US stock indexes and all assets, but LargeCap Industrials (-1.3) rose 2.1ppts w/w for the biggest gain among US stock indexes and all assets last week. MidCap Telecom (-5.8) now trades the lowest among all US stock indexes.

S&P 500 Technical Indicators (*link*): The S&P 500 price index rose 1.5% last week and improved relative to both its short-term 50-day moving average (50-dma) trend line and its long-term 200-dma for the second time in five weeks. The index remained in a Golden Cross (50-dma higher than 200-dma) for a 116th straight week (after 17 weeks in a Death Cross) as the S&P 500's 50-dma relative to its 200-dma rose for the fifth time in six weeks following 17 straight weekly declines. The current Golden Cross reading of 2.0% is up from 1.7% a week earlier, but well below its 55-month high of 7.2% in early February; these compare to its 25-month low of 1.0% at the end of May and four-year low of -4.5% in March 2016. The S&P 500's 50-dma rose for a sixth week, but has fallen in eight of the past 16 weeks—including four straight weeks of decline through mid-April that constituted its worst performance since before the 2016 election. The index appears to have successfully tested its 50-dma in recent weeks, rising to 2.2% above its rising 50-dma from 1.2% a week earlier and an eight-week low of slightly below its rising 50-dma at the end of June. That compares to a 25-month low of 5.6% below its falling 50-dma near the end of March and a two-year high of 6.2% above its rising 50-dma on January 29. The 200-dma continued to rise, as it has done since May 2016, but at near the slowest pace since October 2011. The S&P 500 successfully tested its 200-dma in early April, and improved to a four-week high of 4.2% above its rising 200-dma from 2.1% a week earlier, but remains below its 11-week high of 4.6% in early June. Those readings compare to 0.6% below the index's rising 200-dma on April 3 (the lowest reading since June 2016), a seven-year high of 13.5% above its 200-dma on January 29, and a four-year low of -10.1% in August 2015.

S&P 500 Sectors Technical Indicators (*link*): Among the 11 S&P 500 sectors, last week saw all but four improve relative to their 50-dmas and 200-dmas. Eight sectors now trade above their 50-dmas, unchanged from a week earlier. All 11 sectors had been trading below their 50-dmas at the end of March (a first since February 2016). The longer-term picture—i.e., relative to 200-dmas—shows 6/11 sectors trading above, also unchanged from a week earlier. That's up from just four sectors trading above their 200-dmas in early May (which matched the lowest count since January 2016). Financials was below its 200-dma for a fifth week and for the first time in 10 months after being mostly above since early 2016. Telecom remained below its 200-dma in the latest week, where it's been for most weeks since April 2017. Industrials and Materials were below too, but only for a fourth week. Sectors trading the longest above their 200-dmas: Tech (above 200-dma for 106 straight weeks), Consumer Discretionary (88 straight weeks), and Energy (13 weeks). Those trading below for a long time include Consumer Staples (below for a 21st week) and Telecom (17th week). All 11 sectors had been above both their 50-dmas and 200-dmas briefly in mid-December (for the first time since July 2016). Just five sectors are in a Golden Cross (with 50-dmas higher than 200-dmas), up from three a week earlier as Health Care and Real Estate joined the club in the latest week. All 11 had been in a Golden Cross in mid-January for the first time since a 26-week streak ended in October 2016. Telecom was out for a 15th week, Consumer Staples for a 17th, and Utilities for a 25th. Health Care is in a Golden Cross for the first time in nine weeks, and so is Real Estate, but barely so for the first time in 23 weeks. Ten sectors have rising 50-dmas now, up from eight a week earlier as Industrials' and Telecom's 50-dma resumed rising. Financials is the only sector remaining in the declining 50-dma club. That compares to all 11 sectors with falling 50-dmas during early April (the worst count since before the election in November 2016). Eight sectors have rising 200-dmas, up from seven a week earlier and up from six in early February, which was the lowest since May 2017. In the latest week, Industrials' 200-dma began rising and Utilities' turned down. The 200-dma for Consumer Staples dropped for a 21st week, and Telecom's fell for a tenth week, though it has been mostly declining since December 2016.

US ECONOMIC INDICATORS

CPI (*link*): The core CPI rate in June remained just above the Fed's target rate of 2.0% y/y for the fourth month. June's rate rose to a 17-month high of 2.3%, following a 2.2% gain in May and 2.1% in both April and March; it had fluctuated between 1.7% and 1.8% the prior ten months. Meanwhile, the three-month rate slipped to 1.7% (saar), below February's 3.1%—which was the fastest since January 2008. On a monthly basis, core prices rose 0.2% for the second month after a 0.1% gain in April. June's shelter index rose, along with costs for medical care, used cars & trucks, new vehicles, and recreation. Partially offsetting these gains were declines in prices for apparel, air fares, and household furnishings & operations. Headline CPI accelerated 2.9% y/y last month—the highest since February 2012—as the energy index jumped 12.0% y/y; the headline rate has been mostly trending upward since falling to 1.6% in June 2017.

PPI (*link*): The PPI for final demand climbed 0.3% in June after increases of 0.5% and 0.1% the prior two months. Prices for final demand goods edged up 0.1% after jumping 1.0% in April—which was the biggest gain in three years—while prices for final demand services accelerated 0.4% after gains of 0.3% and 0.1% the previous two months. A major factor in the June increase in prices for final demand goods was the index for motor vehicles, which moved up 0.4%. Prices for diesel fuel, electric power, industrial chemicals, and fresh fruits and melons also advanced. Meanwhile, Over 40% of the advance in the index for final demand services is attributable to a 21.8% jump in the index for fuels and lubricants retailing. The yearly inflation rate for the headline series accelerated 3.3% y/y, the highest since December 2011, as the goods (4.3% y/y) rate posted its largest increase since the end of 2011. The rate for final demand services rose to 2.7%, just shy of March's peak rate of 2.8%. Meanwhile, the core (2.8) rate climbed to its highest reading since September 2011; the core ex trade services rate edged up from 2.6% to 2.7% y/y, remaining below its record high of 3.0% in March.

Import Prices (*link*): Import prices fell in June on widespread weakness. Total import prices dropped -0.4% after a two-month climb of 1.3%, as prices for both petroleum (-0.8%) and nonpetroleum (-0.3) products dropped. Petroleum prices had soared 12.0% during the two months ending May, while nonpetroleum prices showed little change from March through May. The yearly rate for import prices in June was 4.3% y/y, just below May's 4.5%—which was the highest since February 2017—as prices for petroleum products (37.8% y/y) rose at the fastest pace in 15 months and nonpetroleum (1.4) at the slowest pace in six months. The rate for capital goods imports (0.6) eased for the second month after a steady acceleration from -2.5% at the end of 2015 to 1.1% during March and April of this year, while the rate for industrial materials & supplies (18.9) was at a 15-month high. Meanwhile, rates for both consumer goods ex autos (0.3) and autos (0.0) remained in volatile flat trends around zero; the rate for food prices (-2.1) turned negative for the first time since June 2016.

Consumer Sentiment (*link*): Consumer sentiment in mid-July sank to a six-month low on tariff concerns, though was still not far from March's 14-year high. The Consumer Sentiment Index (CSI) fell for the third time since reaching a cyclical high of 101.4 in March, falling to 97.1 this month. The report noted that while consumers under the age of 45 are anticipating the largest income gains since July 2000, the darkening cloud on the horizon is due to the impact of tariffs on the domestic economy—as negative concerns have accelerated from 15% in May, to 21% in June, and 38% in July. The present situation component fell to 113.9 in mid-July after rising from 111.8 to 116.5 in June; it hit a record high of 121.2 in March. The expectations index barely budged, ticking up from 86.3 to 86.4 this month, holding around recent highs.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production (*link*): Output in May rebounded to within 0.6% of November's cyclical high. Industrial production (excluding construction) rebounded 1.3% after sliding four of the previous five months by a total of -1.9%. May's jump was widespread, with spending on consumer durable (2.1%), consumer nondurable (2.1), and intermediate (1.6) goods production all recovering from April declines—to a new record high for consumer nondurable goods. Meanwhile, capital goods production rebounded 2.9% during the two months ending May, and energy output edged up 0.5% after a -5.2% drop in April. Data available for the top four Eurozone economies show output in Germany (2.5%) rebounded to a new record high, while Spain (1.0) and Italy (0.7) were also in the plus column, holding around their cyclical highs. Production in France contracted for the third month by -0.2% m/m and -1.3% over the period. Among the member states posting the largest gains were Lithuania (11.6) and Ireland (3.2), while Portugal (-2.0) recorded the largest decline.

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