



MORNING BRIEFING

July 31, 2018

Growth & Inflation in Trump World

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

(1) Is there an internal contradiction in Trump's agenda? (2) Over-the-top growth. (3) Donald Trump vs. Adam Smith. (4) Is Trump a mercantilist or not? (5) Donald Trump vs. Charles Koch. (6) Trump's ceasefire with Europe. (7) Exports boosted by beating the tariffs. (8) Strong capital spending. (9) Five regional business surveys showing lots of strength. (10) Trump's tax cuts and tariffs stress-testing our low-inflation scenario. (11) Record profit margins may be inflationary shock-absorber. (12) Regional, national, and *Beige Book* surveys all seeing more cost pressures.

Trump World I: Trade. President Donald Trump continues to pursue his agenda of boosting US economic growth while upending the old world order of trade. Most economists seem to believe that there is an internal contradiction in Trump World. Free trade, even if it isn't completely fair trade, is better than no trade, according to the conventional view. Trade boosts economic growth on balance. So Trump's latest pronouncements on the subject seem to be designed to drive economists to distraction:

(1) *Over-the-top growth?* On Friday, Trump told talk show host Sean Hannity that the US could achieve unprecedented growth rates if the trade deficit were cut in half. His remarks followed the release of Q2 real GDP showing a 4.1% (saar) growth rate. He claimed that the country could reach GDP growth of 8%-9%. "If I cut [the trade deficit] in half, right there we will pick up three or four points," Trump said.

(2) *Saving money?* The previous day, on Thursday, speaking in Granite City, Illinois, Trump declared, "We lost \$817 billion a year, over the last number of years in trade. In other words, if we didn't trade, we'd save a hell of a lot of money."

These statements fly in the face of everything that economists have believed about trade since Adam Smith demolished comparable mercantilist beliefs in *The Wealth of Nations* (1776). Smith convincingly argued that high tariffs immiserate a nation, while low tariffs and flourishing trade increase the wealth of a nation.

The risk is that Trump's art-of-the-deal antics backfire, causing an escalation of the trade war and triggering a recession. Billionaire Charles Koch told reporters at his political network's conference on Sunday that President Trump's trade policies could prove to be "disastrous." He said, "Any protectionism at any level, certainly at a national level, is very detrimental. There are scientific and historical reasons. I mean, every nation that has prospered is one that didn't engage in trade wars."

On the other hand, economists will uniformly applaud Trump if his bilateral trade negotiations—which have resulted from his threats to shut off trade with our major trading partners—succeed in lowering tariffs. The stock market rallied at the end of last week when Trump essentially agreed to a ceasefire in his trade war with the European Union, so that negotiations can proceed with the aim of lowering tariffs.

Trump World II: Growth. Q2's 4.1% (saar) growth rate was the best since Q3-2014. It was clearly

boosted by Trump's tax cut, implemented at the end of last year. During the quarter, real personal consumption outlays rose 4.0% (saar), accounting for 2.69 percentage points of the growth, as Debbie discussed in yesterday's [Morning Briefing](#) (see page 8). It was up 0.5% during Q1.

The bad news is that real exports rose 9.3% (saar), accounting for 1.12 percentage points of the growth. That's bad because it mostly reflects a scramble by US exporters to do their thing before foreigners raise their tariffs once Trump raises US duties. So soybean exports soared last quarter.

Then again, real capital spending rose 7.3% (saar) during Q2, following an 11.5% gain during Q1. That's despite mounting anxiety about the negative consequences of the trade war, as expressed by Charles Koch. A week ago Monday in the [Morning Briefing](#), Melissa and I wrote:

"Despite the trade uncertainty, capital spending plans are going strong, according to July's [Beige Book](#). In the Philadelphia Fed District, about 40% of manufacturing firms 'expected increases in future capital expenditures, which represented an improved outlook for capital expenditures since the prior period.' So too, Kansas City manufacturers' capital spending plans 'grew moderately.' Most energy firms in Kansas City reported 'continued strong capital spending plans.'

"The anticipated strength in capital spending is partially due to the labor shortages discussed above! In the Cleveland Fed District, one commercial builder 'stated that the firm boosted spending to use drones for surveying to make up for the shortage of workers.' Further, Cleveland contacts in business advisory and software development 'remarked that their services were in demand because businesses were modernizing their IT infrastructures and attempting to understand the implications of worker scarcities.'"

The latest Fed district business surveys suggest that the economy continued to grow at a solid (if not 8%-9%!) pace during July. Currently available are the surveys for Dallas, Kansas City, New York, Philadelphia, and Richmond ([Fig. 1](#)). Debbie and I average the five composite business indexes along with their orders and employment sub-indexes. Let's review the key points, which Debbie examines in more detail below:

(1) *Composite index*. The average composite index edged down from June's record high of 26.1 to 24.7 this month. This regional composite is highly correlated with the national composite M-PMI compiled by the Institute of Supply Management (ISM). So the regional index remains bullish for the national one, which will be updated for July on Wednesday.

(2) *Orders*. The same can be said of the regional orders index. It remains high and very positive for the July national orders index. Meanwhile, nondefense capital goods orders excluding aircraft rose in June to the best pace since September 2014 ([Fig. 2](#)). This measure of capital spending has fully recovered from the 2015 mini-recession attributable to the collapse in capital spending by the energy industry when the price of oil plunged.

(3) *Employment*. Also dipping slightly in July from its record June high is the regional employment composite index. Nevertheless, it suggests strength is likely in July's M-PMI employment index. That's confirmed by the four-week average of initial unemployment claims at 218,000 through the 7/21 week. That's not far from its recent low of 213,500 in early May, which was the lowest reading since December 13, 1969 ([Fig. 3](#)).

Meanwhile, the three-month average of the ATA Truck Tonnage Index rose in June to yet another record high ([Fig. 4](#)). It has been hitting highs at a faster pace since early 2017. The 26-week average of railcar loadings of intermodal containers has also been making new record highs recently, including through the 7/21 week ([Fig. 5](#)).

Trump World III: Inflation. With the labor market so tight and the economy getting a boost from Trump's tax cuts, there are mounting concerns about inflation making a long-awaited rebound. Godot has been a no-show so far; is he about to take center stage in the economy? Adding to inflationary pressures are the tariffs that Trump has already imposed on solar panels, washing machines, steel, aluminum, and numerous Chinese goods.

In other words, our thesis that globalization, technological innovations, and aging demographics will keep a lid on inflation is about to be stress-tested. So is our thesis that while cost pressures may mount, they should be absorbed by the corporate profit margin, which is at a record high and so has room to act as a shock-absorber for cost-push inflation. Now consider the following related observations:

(1) *Soaring freight rates.* It's quite remarkable to see that the ATA Truck Tonnage Index is so strong despite numerous reports around the country that truck drivers are hard to find. Over the past 18 months, the index is up 10.1%, while the number of truck drivers is up 1.8% ([Fig. 6](#)). The ratio of the former to the latter suggests big gains in the trucking industry's productivity ([Fig. 7](#)). Sure enough, the ratio is up 6.0% over the past 12 months through June.

Nevertheless, the PPI for truck transportation of freight jumped 7.7% y/y through June ([Fig. 8](#)). It was around zero at the start of 2017. The macro data suggest that the trucking industry must be very profitable. Trucking companies are raising freight rates, while boosting productivity and keeping a lid on wage inflation below 2.5% ([Fig. 9](#)).

(2) *Rising regional price indexes.* The five regional surveys discussed above also include indexes for "prices paid" and "prices received." Not surprisingly, the two series are highly correlated in all five regions, and the former are almost always higher than the latter ([Fig. 10](#)). This suggests the obvious: It isn't easy to pass costs into prices.

The average of the five prices paid indexes rose to 48.3 during July, the highest since May 2011 ([Fig. 11](#)). This series is highly correlated with the y/y percent change in the PPI for final demand, which is highly correlated with the comparable inflation rate for the CPI for consumer goods ([Fig. 12](#)). All three are heavily influenced by the price of oil.

(3) *Darker shade of beige.* The latest [Beige Book](#) was released by the Fed on July 18, 2018. It is billed as a summary of commentary on current economic conditions. It's essentially an informal survey by regional Fed Bank officials of their local business contacts. Unlike the formal regional surveys, the *Beige Book* doesn't come with quantitative metrics. Its content is more like informed gossip.

Here are the conclusions on a nationwide basis: "Pricing pressures are expected to intensify further moving forward in some Districts, while in others the outlook is for stable price increases at a modest to moderate pace." Furthermore: "[M]any Districts reported higher prices and supply disruptions that they attributed to the new trade policies." In addition: "The prices of key inputs rose further, including fuel, construction materials, freight, and metals; a few Districts described these input price pressures as elevated or strong. Tariffs contributed to the increases for metals and lumber." (See [Table 1](#) for some *Beige Book* excerpts on regional inflationary pressures.)

CALENDARS

US. Tues: Personal Income & Spending 0.4%/0.4%, Headline & Core PCED 2.3%/2.0% y/y, Consumer Confidence 126.9, Employment Cost Index 0.7%, S&P Corelogic Case-Shiller HPI 0.4%/m/m/6.6%/y/y,

Chicago PMI 62.0, FOMC Meeting Begins. **Wed:** ADP Employment 172k, Motor Vehicle Sales Total & Domestic 17.1mu/12.9mu, Construction Spending 0.3%. ISM & IHS Markit M-PMIs 59.4/55.5, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Announcement 1.875% (1.75% to 2.00%). (*Wall Street Journal* estimates)

Global. Tues: Eurozone GDP 0.4%q/q/2.2%y/y, Eurozone Headline & Core CPI 2.0%/1.0% y/y, Eurozone Unemployment Rate 8.3%, Germany Retail Sales 1.0%m/m/1.5%y/y, Germany Unemployment Change & Unemployment Claims Rate -10k/5.2%, Italy GDP 0.2%q/q/1.3%y/y, China M-PMI & NM-PMI 51.3/55.0, Japan Consumer Confidence 43.8, Japan Housing Starts 0.960mu, BOJ Rate Decision -0.10%, BOJ 10-Year Yield Target 0.00%, BOJ Outlook Report, Canada GDP 0.3%m/m/2.3%y/y, Mexico GDP 0.3%q/q/2.9%y/y. **Wed:** Eurozone, Germany, France & Italy M-PMIs 55.1/57.3/53.1/53.0, UK M-PMI 54.2. (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—is just shy of a new record high. Our WLI, which is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI), climbed 1.0% during the three weeks ending July 21, just 1.3% below early May's record high. Our BBB rebounded 1.3% over the three-week period, and was within 3.8% of its record high. Jobless claims—one of the components of our BBB—moved down for the third week to 218,000 (4-wa), not far from its recent low of 213,500 10 weeks ago, which was the lowest reading since December 13, 1969. Meanwhile, the CRB raw industrial spot price index, another BBB component, has moved up from recent lows. The WCCI climbed 7.7% over the past seven weeks to a new cyclical high.

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 12 months, as LargeCap's forward earnings has risen in 50 of the past 52 weeks, MidCap's is up in 49 of those weeks, and SmallCap's has risen in 45 times. 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 rose to a seven-year high of 22.3% y/y from 21.9%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to 23.7% from 23.6%, 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 rose w/w to an eight-year high of 32.2% from 31.5%, which 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 22.3% and 10.2%, MidCap 20.5% and 12.7%, and SmallCap 29.6% and 15.4%.

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios were mostly lower last week to levels that are not much above their recent post-election lows. LargeCap's weekly forward P/E was steady at 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 dropped to 16.4 from 16.6, which compares to a 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 fell to 17.5 from 17.8, 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 mostly fell w/w for all three indexes, and

remain at levels well below January highs: LargeCap's P/S of 2.05 is down from a record high of 2.19 on January 26; MidCap's 1.31 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 Q2 results beginning to be released at a faster pace, analysts are digesting the news and starting to adjust future expectations. The S&P 500's Q3-2018 EPS forecast rose a penny w/w to \$40.96. That's down 0.2% since the end of Q2, but up 8.5% ytd and 9.2% since the passage of the TCJA. The \$40.96 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 22.9%, down from 23.1% a week earlier and up from 22.1% at the end of Q1. That compares to Q2-2018's blended 22.6%, 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, Q3-2018 estimates are higher for three sectors, down for five, and steady for three. The Q3 forecast has risen for Telecom (up 2.9%), Health Care (0.5), and Materials (0.4). Consumer Discretionary is the biggest decliner, with its Q3-2018 forecast down 1.8% since the end of Q2, followed by Energy (-1.4), Industrials (-1.3), Consumer Staples (-0.9), and Tech (-0.3). The S&P 500's Q3-2018 forecasted earnings gain of 22.9% 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 eight are expected to rise at a double- or triple-digit percentage rate compared to nine during Q2. However, just three are expected to beat the S&P 500's forecasted y/y earnings gain of 22.9% 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 (103.2% in Q3-2018 vs 123.0% in Q2-2018), Financials (45.1, 24.9), Materials (33.2, 36.4), S&P 500 (22.9, 22.6), Telecom (22.6, 16.3), Industrials (17.9, 18.7), Consumer Discretionary (17.7, 19.6), Tech (16.6, 23.9), Health Care (11.4, 15.9), Consumer Staples (9.0, 11.6), Utilities (6.3, 5.9), and Real Estate (4.3, 4.0). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 19.8% y/y in Q3, up from a blended 19.5% 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).

S&P 500 Q2 Earnings Season Monitor ([link](#)): With over half of S&P 500 companies finished reporting earnings and revenues for Q2-2018, the percentage of companies with positive surprise results is higher compared to the same point during the Q1 earnings season and their y/y growth rate metrics remain close to Q1's historically high levels, but companies' overall percent surprise for Q2 is lower. Of the 270 companies in the S&P 500 that have reported through mid-day Monday, 83% exceeded industry analysts' earnings estimates by an average of 5.2%; they have averaged a y/y earnings gain of 26.7%. At the same point during the Q1-2018 reporting period, a lower percentage of companies (80%) in the S&P 500 had beaten consensus earnings estimates by a higher 8.0%, and earnings were up a lower 26.0% y/y. On the revenue side, 72% of companies beat their Q2 sales estimates so far, with results coming in 1.1% above forecast and 10.3% higher than a year earlier. At this point in the Q1 season, a higher 74% of reporting companies had exceeded revenue forecasts by a higher 1.5%, and sales had risen by a lower 10.0% y/y. Q2 earnings results are higher y/y for 87% of companies, vs a higher 88% at the same point in Q1, and Q2 revenues are higher y/y for 86% vs a higher 92% a quarter ago. These results are very encouraging, particularly the percentage of companies growing revenues y/y. Q2-2018 should mark the eighth straight quarter of positive y/y earnings growth and among the highest growth since Q4-2010. The strong results are mostly due to lower tax rates and improved business conditions.

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): Five Fed districts now have reported on manufacturing activity for July—New York, Philadelphia, Richmond, Kansas City, and Dallas—and there wasn't a weak link among them. We average the composite, orders, and employment measures as data become available. The composite index slipped to 24.7, not far from June's record high of 26.1—it has averaged 25.4 the past three months and 22.5 the past 11 months. The Philadelphia (to 25.7 from 19.9) region accelerated back toward May's (34.4) vigorous pace—which was the fastest in a year, while the Dallas (32.3 from 36.5), Kansas City (23 from 28), and New York (22.6 from 25.0) regions eased only slightly from their robust readings in June; Richmond's (20 from 21) virtually matched its June pace. The new orders (23.2 from 23.6) gauge remained within striking distance of May's record high of 27.7. A sharp acceleration in orders in the Philadelphia (31.4 from 17.9) region more than offset a slight deceleration in growth in the Dallas (23.3 from 29.6), New York (18.2 from 21.3), and Kansas City (21 from 27) regions, which all remained high; Richmond's (22) gauge matched June's pace. The employment barometer (22.2 from 24.1) was little changed from June's record reading. The Kansas City (26 from 24) gauge was back up at its record high recorded earlier this year, while Dallas' (28.9 from 23.9) rebounded to its highest reading since 2005. Richmond (22 from 23) factories hired at roughly the same healthy pace as they did in June, while manufacturers in both the Philly (16.8 from 30.4) and New York (17.2 from 19.0) regions showed slower, but still robust, jobs growth—though Philly's was about half June's rate.

Pending Home Sales ([link](#)): The Pending Home Sales Index (PHSI)—measuring sales contracts for existing-home purchases—advanced in June for the first time in three months, by 0.9%. However, the result fell short of year-ago levels for the sixth straight month, contracting -2.5% y/y. Regionally, all four regions rose during the month but fell y/y—here's the tally: Northeast (1.4%m/m & -4.1%y/y), South (1.1 & -0.3), West (0.7 & -5.6), and Midwest (0.5 & -2.1). NAR's Chief Economist Lawrence Yun noted: "The positive forces of faster economic growth and steady hiring are being met by the negative forces of higher home prices and mortgage rates. Even with slightly more homeowners putting their home on the market, inventory is still subpar and not meeting demand. As a result, affordability constraints are pricing out some would-be buyers and keeping overall sales activity below last year's pace." Heading into the second half of the year, Yun now forecasts existing-home sales will decrease 1.0% this year to 5.46mu, down from 5.51mu in 2017.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators ([link](#)): July's Economic Sentiment Index (ESI) for the Eurozone (-0.2 point to 112.1) registered a marginal decrease for the fourth month, while the EU's (+0.1 to 112.3) ticked up for the second time in three months. The report notes both the Eurozone (-0.7 points) and EU (-0.4) have posted only minor declines the past four months—after falling -2.4 points and -2.3 points, respectively, the first three months of the year. Both measures remain at elevated levels, not far from their December 17-year highs of 115.2 and 115.0, respectively. Among the Eurozone's five largest economies, only Germany's ESI (+0.9 to 112.8) posted an increase, while the Netherlands was flat at 109.9 and France's (-0.1 to 109.5) was relatively stable; ESIs for both Spain (-1.7 to 107.7) and Italy (-0.6 to 109.0) fell. At the sector level, only services (+0.9 to 15.3) confidence recorded an increase, while industry (-1.1 to 5.8), retail trade (-0.8 to -0.1), and construction (-0.2 to 5.4) confidence were in the red; consumer confidence was unchanged at -0.6.

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