



MORNING BRIEFING

August 21, 2018

Superpower

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

(1) Trump, the newsmaker. (2) The Great Disruptor continues to do what he does best. (3) Nations have interests, not friends and enemies. (4) Method in the madness: Flexing America's muscle. (5) What if he wins? (6) Trade war goes bilateral with ceasefires and some deal-making progress. (7) Trump talks loud and carries a big stick. (8) Tariffs and sanctions as economic artillery.

Geopolitics I: Trump's World Order. President Donald Trump is great for the news business. His daily firestorms of Tweets immediately generate firestorms of news reports, which are overwhelmingly editorial in nature. On a regular basis, I drive from my home office on Long Island to visit our accounts in NYC. Along the way, while grinning and bearing the traffic on the Long Island Expressway, I listen to the news on SiriusXM. I flip between CNBC, Bloomberg, CNN, and Fox. The latter two seem to reside on different planets when it comes to reporting about Trump, which they do on a 24x7 basis these days.

The cacophony is so bad that I've started to watch *Blue Planet* after the evening news for a little bit of rest from the noise. It's a wonderful series of BBC nature documentaries narrated by David Attenborough.

There is nothing natural in the political world these days. Trump is the Great Disruptor when it comes to the business-as-usual approach in Washington, DC. He has single-handedly upended the old order, not only at home but also on a geopolitical basis.

I have often observed that there is method in Trump's madness. He clearly believes strongly in his "America First" campaign. The flip side of that view is that Trump sees global governmental organizations as threats to America First. These include NATO, the UN, and the World Trade Organization. He prefers bilateral deals to multilateral ones.

Trump firmly ascribes to the old British adage: "Nations have no permanent friends and no permanent enemies, only permanent interests." In pursuit of those interests, as he perceives them, Trump is flexing America's economic power all over the world. He has done so at an accelerating pace so far this year. First came threats to impose tariffs on imports, which were implemented. They have been followed by numerous more threats. More recently, Trump's might-is-right approach has led to sanctions against North Korea, Iran, Turkey, and Russia.

Before launching his economic wars, Trump bolstered the home front's economy with deregulation and tax cuts. He figures that strength will allow the US to win his wars without much, if any, pain at home.

So far, the US stock market seems to be siding with Trump's approach. The message from the markets seems to be: "What if Trump wins his trade wars and if his sanctions work?" Investors are giving quite a bit of weight to the possibility that this all will lead to less protectionism and greater global prosperity. I agree with this prognosis.

Geopolitics II: Free & Fair Trade. One of the main themes of my book, [Predicting the Markets: A Professional Autobiography](#), is that I am an investment strategist, not a preacher. I don't do good or bad. I do bullish or bearish. As a conservative-leaning fellow, that approach helped me to stay bullish during the bull market under the Obama administration from 2009-2016 ([Fig. 1](#) and [Fig. 2](#)). During those eight years, the Fed's ultra-easy monetary policies were much more important and bullish for stocks than were the policies coming out of the White House ([Fig. 3](#) and [Fig. 4](#)).

When Donald Trump won the presidential race on November 8, 2016, I remained bullish. Prior to his surprise win, Joe and I argued that the global economy was showing signs of recovering from the 2015 energy-led mini-recession. We figured that no matter who won, the strong recovery in earnings would push stock prices higher. After Trump won, I began to monitor the remarkable rebound in animal spirits, as evidenced by numerous surveys of business and consumer confidence. I argued that Trump's pledge to deregulate business and cut taxes would be bullish for stocks.

Everything remained on that bullish track as Trump followed through with deregulation and a package of tax cuts, which was enacted late last year. Stocks soared to new record highs through January 26 of this year, when the S&P 500 peaked at 2872.87. Then Trump started a trade war with our major trading partners. In my book, I opined:

"Donald Trump's election as the 45th President of the United States on November 8, 2016 posed potential new challenges to globalization, given his campaign promises suggesting a more anti-trade stance for the incoming administration. While it is too soon to tell, Trump seems to be advocating free-trade agreements on a more bilateral basis than the multilateral approach that emerged after World War II. If so, that alternative approach might actually blunt the forces of protectionism."

I noted that a similar outbreak of protectionist sentiments occurred under President Ronald Reagan. The Reagan administration imposed "voluntary restraints" on Japanese exports of autos to the US. During April 1987, Reagan placated the chorus of protectionists with a 100% tariff placed on selected Japanese electronics products. I reiterated:

"[Trump's] policies could pose a threat to global trade. However, the threat level seems more like what it was during the Reagan years than the debacle of the Hoover administration. Reagan succeeded in promoting fairer trade and bringing back lots of jobs in the auto industry as foreign manufacturers moved some of their production facilities to the United States. Trump might also succeed in forcing some of America's trading partners to eliminate unfair trade practices. His approach is bilateral rather than multilateral, which is a different approach to negotiating free trade deals than the one that has prevailed since World War II. That's alright by me as long as the result is free trade. All the better if it is also fair trade."

Here is a brief review of the status of Trump's trade war:

(1) *China*. The resumption of trade talks between Beijing and Washington begins sometime before the end of this month. It will be the first meeting between the two sides since June 3. So far, the US has slapped a 10% tariff on \$34 billion of Chinese imports, and threatened to slap a 25% tariff on all Chinese imports. China is not winning the trade war according to the China MSCI stock price index, which is down 11.9% ytd in yuan (12.2% in US dollars) through Friday ([Fig. 5](#)). Over this same period, the US MSCI is up 6.8%. The Chinese index is highly correlated with the price of copper, which is down 20.3% since June 8. (For more, see our 8/15 [Morning Briefing](#) titled "Trump vs Xi: Tiger vs Dragon?")

(2) *NAFTA*. Yesterday, CNBC [reported](#): "Trump economic advisor Kevin Hassett told CNBC on Monday

that Canada is going to want in on the trade deal that U.S. negotiators are on the verge of crafting with Mexico. 'We're even closer' to reaching a trade deal with Mexico after Mexican negotiators were in Washington for most of last week, the chairman of the Council of Economic Advisors said. Canada has not been part of the most recent talks to rework the 24-year-old North American Free Trade Agreement, which were expected to continue this week. ... On Friday, Mexico's economic minister said outstanding bilateral issues with the U.S. could be resolved midweek, adding that Canada could then rejoin negotiations."

The Mexican peso has been holding up remarkably well all year despite concerns that a new government would be more left-leaning and less likely to work out a deal with Trump ([Fig. 6](#)). We covered this subject in a story titled "Mexico: Let's Be Neighborly" in the 7/23 [Morning Briefing](#). Andres Manuel Lopez Obrador's (a.k.a. "AMLO") won a landslide victory in Mexico's July 1 presidential election. We wrote:

"So far, President-elect AMLO is proving to be more conciliatory than candidate AMLO. Since the election, AMLO and his cabinet members have sought to reassure financial markets that his administration will exercise fiscal discipline, maintain the autonomy of the central bank, and honor government contracts. Also, his administration will support continued talks to renegotiate the North American Free Trade Agreement (NAFTA)."

(3) *Europe*. The 7/25 *NYT* [reported](#): "The United States and the European Union stepped back from the brink of a trade war on Wednesday, after President Trump said the Europeans agreed to work toward lower tariffs and other trade barriers, and to buy billions of dollars of American soybeans and natural gas." The two sides agreed to hold off on further tariffs, and to work toward dropping the existing ones on steel and aluminum, while hammering out a deal to eliminate tariffs, nontariff barriers, and subsidies on industrial goods excluding autos.

Geopolitics III: The Big Stick. The 8/18 *New York Post* included an interesting [column](#) by Michael Walsh titled "Trump is proving America's power through economic warfare." Walsh does a very good job of showing how Trump is using tariffs and sanctions to reorder the world order. He is using US economic strength to pursue not only America's economic interests but also our geopolitical interests. Here are a few key excerpts:

(1) *Iran*. "In Iran, the rial is down 40 percent in the wake of Trump's canceling of Obama's nuclear agreement in May. America has been hindering Iran's ability to conduct financial transactions in dollars and gold, and has hit its automotive and commercial airline sectors hard. Still to come in November: more punishing sanctions on oil and banking. As a result of the cratering of the Iranian economy, the country's huge cohort of restive young people has been launching widespread protests that may yet bring down the regime, and Trump's actions could accelerate that."

(2) *China*. "In China, America's foremost geopolitical challenger, Trump's approach has been more stick than carrot lately, imposing tariffs and threatening a major trade war, unnerving the Chinese communist leadership, which is beginning to think he may just be crazy enough to do it. The Chinese yuan is down 9 percent against the dollar since April and its stock market is slumping. For all their defiant talk, however, the prospect of an economic war with the US is not something the Chinese leaders want right now, since they can't afford to have access to the lucrative American market restricted. But both growth and consumer spending have slowed, and even ordinary Chinese are now publicly criticizing president-for-life Xi Jinping."

(3) *Turkey*. "Meanwhile, in Turkey, where the tinpot dictator Recep Erdogan is trying to revive the lost glory of the Ottoman Empire, the country's currency, the lira, has lost 45 percent of its value this year."

This is a direct result of American-imposed tariffs and sanctions against the Islamic regime, in part over the continued imprisonment of American evangelical pastor Andrew Brunson, whom Turkey has accused of spying. In 'retaliation,' Erdogan has announced a boycott of US electronics. Good luck with that."

(4) *North Korea*. Walsh didn't mention economic sanctions imposed on North Korea by the United Nations Security Council at the end of last year. They were proposed by the US and adopted by a vote of 15 to 0 in an escalating effort to force the North to reverse course on its nuclear weapons program. North Korea has made some moves to placate Washington, including suspending its nuclear and missile tests, demolishing its underground nuclear test site, and tearing down a missile engine test site.

(5) *Russia*. Also not mentioned by Walsh: On August 9, the Trump administration announced new sanctions on Russia in retaliation for the nerve-agent attack on a former Russian spy and his daughter in March. Russia is already under US sanctions for its 2014 invasion of Crimea, and the Trump administration has expelled 60 Russians from the US and shuttered the Russian consulate in Seattle in response to the failed assassination attempt. Under the new sanctions, which will take effect in two weeks, requests by American companies to sell to Russia items with a potential national-security purpose will be automatically denied, with few exceptions.

CALENDARS

US. **Tues:** None. **Wed:** Existing Home Sales 5.425mu, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Minutes. (Econoday estimates)

Global. **Tues:** RBA Meeting Minutes. **Wed:** Canada Retail Sales -0.2%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose to record highs for the LargeCap and MidCap indexes last week, but fell again for SmallCap—for a second week—to 0.1% below its record high in early August. Forward earnings activity has been relatively strong in the past 12 months: LargeCap's forward earnings has risen in 53 of the past 55 weeks, MidCap's in 52 of those weeks, and SmallCap's in 47. 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 remained steady at a seven-year high of 22.6% y/y, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to 23.1% from 22.8%, 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 34.8% from 34.5%, 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 22.9% and 10.1%, MidCap 21.2% and 11.8%, and SmallCap 29.2% and 15.8%.

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios were broadly higher last week to levels that are not much above their recent post-election lows. LargeCap's weekly forward P/E edged up to 16.5 from 16.4, 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 rose to 16.6 from 16.5, 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 rose to 17.9 from 17.7, 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 the three indexes' forward price/sales (P/S) ratios, most were higher w/w but remain at levels well below January highs: LargeCap's P/S rose to 2.07 from 2.04, but is down from a record high of 2.19 on January 26; MidCap's edged up to 1.33 from 1.32, which compares to its record high of 1.40, also on January 26; and SmallCap's was steady at 1.03, 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 essentially complete except for the remaining retailers, analysts are taking a break from adjusting future expectations. The S&P 500's Q3-2018 EPS forecast fell 2 cents w/w to \$40.70. That's down 0.9% since the end of Q2, but up 7.8% ytd and 8.5% since the passage of the TCJA. The \$40.70 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 22.4%, unchanged from a week earlier and up from 22.1% at the end of Q1. That compares to Q2-2018's blended 24.6%, 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 Tech (up 0.2%), Financials (0.1), and Health Care (0.1). Real Estate is the biggest decliner, with its Q3-2018 forecast down 1.6% since the end of Q2, followed by Consumer Discretionary (-0.4), Utilities (-0.4), Telecom (-0.4), and Industrials (-0.1). The S&P 500's Q3-2018 forecasted earnings gain of 22.4% 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—eight at a double- or triple-digit percentage rate compared to nine during Q2. Four sectors are expected to beat the S&P 500's forecasted y/y earnings gain of 22.4%, matching Q2's measure. 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 (98.8% in Q3-2018 vs 123.1% in Q2-2018), Financials (45.4, 27.2), Materials (32.1, 40.0), S&P 500 (22.4, 24.6), Telecom (23.1, 16.4), Industrials (17.4, 20.3), Tech (16.8, 26.1), Consumer Discretionary (16.5, 22.2), Health Care (11.1, 17.9), Consumer Staples (7.7, 13.7), Utilities (5.3, 8.7), and Real Estate (4.3, 3.0). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 19.5% y/y in Q3, down from a blended 21.6% 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 Q2 earnings now in hand for 93% of the S&P 500 companies, we're beginning to see retailers' results stream in, completing the picture. We're finding a higher percentage of companies reporting positive surprises than at the same point during the Q1 earnings season but a lower overall percentage surprise. Year-over-year growth rate metrics for the Q2 reporters to date are close to Q1's historically high levels. More specifically, of the 465 companies in the S&P 500 that have reported through mid-day Monday, 80% exceeded industry analysts' earnings estimates by an average of 5.2%; they have averaged a y/y earnings gain of 26.5%. At the same point during the Q1-2018 reporting period, a lower percentage of companies (79%) in the S&P 500 had beaten consensus earnings estimates by a higher 7.2%, and earnings were up a lower 24.8% y/y. On the revenue side, 72% of companies beat their Q2 sales estimates so far, with results coming in 1.5% above forecast and 9.8% higher than a year earlier. At this point in the Q1 season, a higher 76% of reporting companies had exceeded revenue forecasts by a lower 1.1%, and sales had risen by a lower 8.2% y/y. Q2 earnings results are higher y/y for 84% of companies, vs a higher 86% at the same point in Q1, and Q2 revenues are higher y/y for 86% vs a higher 87% a quarter ago. These results are very encouraging, particularly the percentage of companies growing revenues y/y and their Q2 surprise. Q2-2018 marks 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.

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