



MORNING BRIEFING

August 28, 2018

What If . . . ?

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

(1) Six bullish “what if” scenarios. (2) What if the trade war results in less protectionism? (3) Trade war escalating with China, deescalating with Mexico. (4) Our guess is that deregulation boosts S&P 500 earnings by \$4 a share. (5) Small is beautiful: S&P 600 up 50% since Election Day! (6) Productivity growth could make a comeback. (7) Rapid pace of technological disruption keeping a lid on inflation. (8) Distressed asset funds are acting as shock absorbers. (9) If we are all minimalists now, this expansion may have a ways to go.

Video Podcast. Does the stock market have a breadth problem? The stock market rose to new record highs at the end of last week. There is some concern about the narrow breadth of the recent advance. I'm not concerned. Instead, I'm encouraged by the broad rally in Small Caps. Click [here](#) to view my short podcast.

Strategy: The Difference This Time. What if Trump's trade war leads to less protectionism and more global prosperity? What if Trump's deregulation of business unchains the animal spirits of businesses, especially smaller ones that arguably have been more stymied by regulations than large ones? What if jobs actually do come back to the US?

What if the pace of technological innovation is increasing, disrupting business models in ways that keep a lid on inflation and finally boost productivity? What if the growth of distressed asset funds has created a shock absorber in the capital markets, reducing the severity of credit crunches? What if Baby Boomers downsize, while Millennials remain minimalists?

I can go on, but we have enough to work with in this list of “what ifs.” So let's explore the implications of these mostly bullish possibilities:

(1) *What if Trump's trade war leads to less protectionism and more global prosperity?* I wrote about this scenario again last week in the 8/21 [Morning Briefing](#) titled “Superpower.” I observed: “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.”

I observed that Trump could just as quickly deescalate as escalate his trade skirmishes with our major trading partners, depending on the progress made in negotiations. I'm convinced that our side is pushing for fairer trade with fewer trade barriers, not higher tariffs, which Trump is using as a tactical negotiating tool. I reviewed the latest developments last week, but there have been more since then.

Two days of low-level negotiations between the US and China in Washington concluded last Thursday with no concrete steps toward ending the bilateral trade war that started last month. The trade war continued its escalation on Thursday, as the US enacted punitive tariffs of 25% on \$16 billion of Chinese imports (following a similar move a few weeks ago on \$34 billion of such imports, to total \$50 billion), an action that was immediately mirrored by China. Last week, the USTR held an unprecedented six-day public hearing ahead of further tariffs on \$200 billion of Chinese goods, expected to go into effect in September. Initially proposed at 10%, the duties could be raised to as much as 25%, at Trump's direction. The additional tariffs effectively would slap levies on half of all Chinese exports to the US, or roughly double what China imports from the US ([Fig. 1](#)).

The US and Mexico reached an agreement on Monday to enter a new trade deal, ending months of talks on a replacement for the North American Free Trade Agreement. The talks with Mexico have been focused on creating new rules for the auto industry. Details remain scant. The new trade pact will be called "The United States Mexico Trade Agreement," Trump said when announcing the deal from the Oval Office, adding that the previous name would be scrapped. The US imported \$329 billion from Mexico over the past 12 months through June ([Fig. 2](#)).

(2) What if Trump's deregulation of business unchains the animal spirits of businesses, especially smaller ones that arguably have been more stymied by regulations than large ones? It's impossible to measure the impact of Trump's deregulation of business on S&P 500 earnings. Yesterday, Joe and I raised both our 2018 and 2019 S&P 500 earnings estimates by \$4 per share ([Fig. 3](#)). We've been bullish on earnings, but they've been stronger than the impact implied by the cut in the corporate tax rate at the end of last year. Our guess is that deregulation, which started early last year, might very well amount to \$4 per share in additional earnings.

We've noted that the stock prices of small corporations have been outperforming the larger ones since Trump was elected on November 8, 2016. Since then through Friday, the S&P 600 SmallCaps stock price index is up 50.3%, outpacing the 34.4% of the S&P 500 LargeCaps and 34.5% of the S&P400 MidCaps ([Fig. 4](#)). Many observers have attributed this to the fact that smaller companies are less exposed to damage from a trade war than larger ones.

Joe and I have suggested that there might be another important reason why SmallCaps are doing so well: Small companies may be getting a bigger after-tax earnings boost from Trump's tax cuts than larger corporations that have had the means to dodge taxes better ([Fig. 5](#)).

That still begs the question of why small companies' revenues are so strong on a relative basis, as we have noted previously ([Fig. 6](#)). Perhaps Trump's deregulation policies benefit smaller companies more than larger ones. After all, regulations are often promoted by large companies to keep small competitors at bay. The monthly survey conducted by the National Federation of Independent Business (NFIB) shows that significantly fewer small business owners have been reporting concern about government regulation and taxes since Trump was elected ([Fig. 7](#) and [Fig. 8](#)).

No wonder the earnings component of the NFIB survey is the highest on record since the start of the data during 1974 ([Fig. 9](#)). This series is highly correlated with the NFIB "expecting to increase employment" series, which is also at a record high.

(3) What if jobs actually do come back to the US? Since November 2016, payroll employment is up 3.9 million, including 412,000 manufacturing jobs. The unemployment rate has dropped from 4.6% back then to 3.9% during July. Trump obviously relishes taking credit for all this. It has long been my view that Washington doesn't create jobs; companies do that, especially small ones. Washington's policies can make it easier or harder for companies to hire. Trump's policies are certainly helping.

In any event, the ADP payroll employment data show that small, medium, and large companies have increased their head counts by 1.0 million, 1.6 million, and 1.2 million since November 2016 ([Fig. 10](#)). The smaller ones represented in the NFIB survey are running into staffing problems. During July, a record 37% of small business owners reported having job openings ([Fig. 11](#)). At the same time, 52% reported few or no qualified applicants for their job openings.

To relieve this pressure, the best solution would be for a bipartisan congressional agreement on migration that would allow more legal immigrants to enter the US to fill job openings. Of course, of all the “what ifs,” this one is the most farfetched given the political divide in Washington. More likely is that companies will continue to reach out to able-bodied workers who have dropped out of the labor force. Even more likely is that companies will accelerate their use of technology to boost productivity.

(4) What if the pace of technological innovation is increasing, disrupting business models in ways that keep a lid on inflation and finally boosts productivity? The rebound in manufacturing employment mentioned above augurs well for manufacturing production, and possibly for productivity ([Fig. 12](#)).

Not widely recognized is that since China entered the World Trade Organization at the end of 2001, both manufacturing production and capacity in the US have been flat ([Fig. 13](#)). Obviously, lots of manufacturers moved their operations to China, and didn't spend much on enhancing their productivity in the US. So while it is widely believed that the slow pace of productivity growth in the US is mostly attributable to the services sector, the fact is that the five-year annualized growth rate of manufacturing productivity peaked at 6.0% during Q3-2003 and plunged to zero in recent years ([Fig. 14](#)).

If Trump succeeds in bringing production back to the US, then manufacturers might be hard pressed to find enough workers and turn to boosting their productivity instead of raising their wages.

Meanwhile, the rapid pace of technological innovation continues to disrupt business models in both the manufacturing and services sectors. This is forcing all businesses to focus on innovations to remain competitive. Raising wages and prices in this highly competitive technology-driven business environment may be a sure way to fall behind.

(5) What if the growth of distressed asset funds has created a shock absorber in the capital markets, reducing the severity of credit crunches? If you blinked, you might have missed the mini-recession of 2015. It was more of a growth recession than an actual drop in business activity. The credit markets saw it coming as the credit quality yield spreads between corporate high-yield bonds and the 10-year Treasury bond soared from a low of 253 bps on June 23, 2014 to a high of 844 bps on February 11, 2016 ([Fig. 15](#)). That was attributable to the collapse in commodity prices, led by a 76% plunge in the price of a barrel of Brent.

There was an immediate credit crunch for commodity producers. But it ended remarkably quickly without turning into a contagion. The credit quality spread dropped back down to 362 bps by the end of 2016 and has fluctuated around there since then. That's because distressed asset funds jumped in and restructured the balance sheets of distressed commodity producers by converting debt into equity. Joe calculates that just in the S&P 500 Energy sector, the share count rose from 17.2 billion during Q4-2015 to 18.3 billion during Q4-2017 ([Fig. 16](#)).

Distressed asset funds certainly acted as an important shock absorber for the credit markets during 2015. They are likely to do so again during the next credit shock.

(6) What if Baby Boomers downsize, while Millennials remain minimalists? The current economic

expansion will be the longest on record next year during July. It is likely to achieve that milestone and exceed it partly as a result of demographic trends. This year, the number of singles outnumbered the number of married people for the population aged 16 years or older. The percentage of singles has risen from 37.7% during 1977 to 50.8% last month ([Fig. 17](#)).

This trend has been mostly driven by “never married” singles ([Fig. 18](#)). Many of them are Millennials who are postponing getting married if they ever do so at all. They are minimalists who aren’t big earners or spenders because they need only support themselves. The Baby Boomers were big spenders when they were getting married and having kids. They too are turning into minimalists as they trade down to smaller houses and apartments now that they are empty nesters.

These demographic trends suggest that the pace of consumer spending growth will remain lower than during the heydays of the Baby Boomers. If so, this may keep a lid on economic growth and reduce the likelihood of a boom. If there is no boom, there is less likelihood of a bust.

(7) *Conclusion*. Why not . . . ?

CALENDARS

US. Tues: Consumer Confidence Index 126.5, Advance Merchandise Trade Balance -\$69.1b, Richmond Fed Manufacturing Index 19, S&P CoreLogic Case-Shiller HPI 0.2%_{m/m}/6.5%_{y/y}. **Wed:** GDP & PCE 4.0%/3.9%, GDP Price Deflator 3.0%, Corporate Profits, Pending Home Sales 0.0%, EIA Petroleum Status Report. (Econoday estimates)

Global. Tues: None. **Wed:** Germany GfK Consumer Confidence 10.6, France GDP 0.2%_{q/q}/1.7%_{y/y}, Japan Consumer Confidence 43.3, Japan Retail Trade -0.3%_{m/m}/1.2%_{y/y}, Mexican Central Bank Inflation Report. (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 third week—to 0.5% below its record high in early August. Forward earnings activity has been relatively strong in the past 12 months: LargeCap’s and MidCap’s forward earnings have risen in 50 of the past 52 weeks, and SmallCap’s in 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 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 23.7% from 23.1%, 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 fell w/w to 34.2% from an eight-year high of 34.8%, 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 22.8% and 10.2%, MidCap 21.7% and 12.1%, and SmallCap 28.2% and 16.0%.

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios were mostly higher last week, but LargeCap and MidCap valuations were at levels that are not much above their recent post-election lows. LargeCap’s weekly forward P/E improved to a 23-week high of 16.6 from 16.5, which is up from a post-election low of 16.0 in late March and down from 18.6 on January 26—the highest since May 2002. That compares to the post-Lehman-meltdown P/E of 9.3 in October 2008, but is well below the tech-bubble record high of 25.7 in July 1999. MidCap’s forward P/E remained steady at a nine-week high of 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 rose to a 23-week high of 18.3 from 17.9, 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' daily forward price/sales (P/S) ratios, most were higher w/w but remain at levels well below January highs: LargeCap's P/S rose w/w to 2.08 from 2.06, but is down from a record high of 2.19 on January 26; MidCap's improved to 1.35 from 1.33, which compares to its record high of 1.40, also on January 26; and SmallCap's rose to 1.06 from 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 5 cents w/w to \$40.65. That's down 1.0% since the end of Q2, but up 7.7% ytd and 8.4% since the passage of the TCJA. The \$40.65 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 22.3%, down from 22.4% a week earlier and up from 22.1% at the end of Q1. That compares to Q2-2018's blended 24.7%, 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, Q3-2018 estimates are higher for just one sector, down for eight, and steady for two. The Q3 forecast has risen for Financials (up 0.2%), and is unchanged for Health Care and Industrials. Real Estate is the biggest decliner, with its Q3-2018 forecast down 1.6% since the end of Q2, followed by Consumer Discretionary (-1.2), Utilities (-0.4), Telecom (-0.3), Consumer Staples (-0.3), Energy (-0.3), Materials (-0.2), and Tech (-0.1). The S&P 500's Q3-2018 forecasted earnings gain of 22.3% 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—nine at a double-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 22.3%, 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 (99.0% in Q3-2018 vs 123.1% in Q2-2018), Financials (45.5, 27.2), Materials (32.2, 40.0), S&P 500 (22.3, 24.7), Telecom (23.1, 16.4), Industrials (17.4, 20.3), Tech (16.6, 26.2), Consumer Discretionary (15.7, 22.9), Health Care (11.0, 18.1), Consumer Staples (7.4, 13.8), 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 19.3% y/y in Q3, down from a blended 21.7% 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

Regional M-PMIs ([link](#)): Three Fed districts have reported on manufacturing activity for August so far—New York, Philadelphia, and Dallas—and show growth remains hearty. We average the composite, orders, and employment measures as data become available. The composite index eased to 22.8 this month from 26.9 last month, continuing to fluctuate in a flat trend just below last October's 28.4 peak—averaging 27.2 the past 10 months. The New York (to 25.6 from 22.6) region's composite index rose to within 2.5 points of last October's 37-month high of 28.1, while Dallas' (30.9 from 32.3) was not far from its near 14-year high of 38.4 recorded in February; meanwhile, Philadelphia's (11.9 from 25.7) sank to a 21-month low, down sharply from May's 12-month high of 34.4. The new orders gauge (17.0 from 24.3) showed growth eased to a seven-month low, as Philly (9.9 from 31.4) billings slowed dramatically during the month; orders growth in the New York (17.1 from 18.2) and Dallas (23.9 from 23.3) regions virtually matched July's robust pace. The employment measure (18.8 from 21.0) also eased this month, as manufacturers in both the Philly (14.3 from 16.8) and New York (13.1 from 17.2) regions showed

slower, but still healthy, jobs growth, while Dallas factories (unchanged 28.9) matched their best hiring pace in 13 years.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): Business confidence increased for the first time in nine months as this month's survey hints at "strong domestic activity," according to Ifo President Clemens Fuest. "The second factor is, we have a truce in the trade war with the U.S. The fact that tariffs on cars have at least been postponed and may not come at all is very important." German business confidence rebounded to 103.8 this month after falling from a record-high 105.3 in November to a 16-month low of 101.7 last month. Of the four sectors—manufacturing, services, trade, and construction—confidence among construction and services companies posted impressive gains this month, with the former jumping to a new record high. Manufacturing confidence edged up after a six-month slide, while trade's showed little change. August's present situation component recovered to 106.4 after falling fairly steadily from its record high of 108.6 in January to 105.4 in June/July. Meanwhile, the expectations component recorded its biggest one-month gain since February 2013, rebounding 3.0 points to 101.2—to within 2.4 points of November's recent peak of 103.6. Ifo's expectations component correlates closely with German factory orders and production, while the overall index tracks exports more closely. Recent Ifo data suggest growth in Germany's economy could accelerate from its recent slowdown, as does the jump in August's M-PMI to a six-month high of 55.7.

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

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).