



## MORNING BRIEFING

September 5, 2018

### US vs Them

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

(1) Trump vs Hamlet. (2) Strong US M-PMI bodes well for S&P 500 revenues growth. (3) Consumer Optimism Index is strong, led by current conditions component. (4) Jobless rate on the way to 3.0%. (5) Less exuberance in China. More pain in emerging economies. (6) Stay Home! (7) Sandra goes to Europe. (8) From Greek crisis to an Italian one. (9) Brexit is hard to do. (10) Trump rejects Europe's generous offer. (11) Weighing on Europe: Italy, immigration, Brexit, and Trump.

**Trump's World.** I've said it before, and I'll say it again: "There is method in Trump's madness." Hamlet said it first in 1602: "Though this be madness, yet there is method in it." The difference this time is that I expect a happier ending than in Shakespeare's play. President Donald Trump's policies are boosting US economic growth despite his escalating trade war, which is depressing economies in the rest of the world. This is putting pressure on the rest of the world to come to terms with Trump's demands for fairer and more bilateral trade. The risk is that Trump's policies may be causing a widespread emerging markets crisis. We live in interesting times:

(1) *US*. Real GDP rose by 4.2% (saar) during Q2, and is on track to grow by 4.7% during Q3, according to the 9/4 [GDPNow](#) estimate, up from 4.1% on August 30. Nonfarm productivity rose 2.9% (saar) during Q2, and may be on track to do about the same during Q3. The long-awaited productivity rebound may be underway. If so, supply-siders should rejoice, and I will join them in their celebration.

For now, we can rejoice in yesterday's M-PMI, as August readings exceeded 60.0 for the overall index (61.3), production (63.3), and new orders (65.1). Employment was solid at 58.5. The overall index was the highest since May 2004 ([Fig. 1](#))!

This is great news for the y/y growth rate of S&P 500 revenues per share, which is highly correlated with the M-PMI ([Fig. 2](#)). The former was up 10.3%, the best reading since Q3-2011. As Joe and I have noted before, this is the kind of strength that typically occurs during recoveries, not this late into an economic expansion.

Also rejoicing are American consumers. Debbie and I average the Consumer Sentiment Index and the Consumer Confidence Index to derive our Consumer Optimism Index (COI), which remained at a cyclical high during August. The current conditions component of the COI rose to the highest reading since December 2000 ([Fig. 3](#)).

Consumers are happy because their "jobs hard to get" response plunged to 12.7% in August, the lowest since March 2001, implying that the unemployment rate may be on the way to falling to 3.0% ([Fig. 4](#) and [Fig. 5](#))!

(2) *China*. There's much less exuberance in China, which is feeling some pain from Trump's trade war.

This is most visible in the recent plunge in the price of copper, which is highly correlated with the China MSCI stock price index (in yuan), which has been in a bear market since early August and is down 21.1% since January 26 ([Fig. 6](#)). There isn't that much pain yet in China's M-PMI, but there isn't any exuberance either ([Fig. 7](#)).

(3) *Emerging market economies*. The pain is mounting among several emerging market economies (EMEs). That explains why the CRB raw industrials index has been falling this summer despite the boom in the US ([Fig. 8](#)). Also falling sharply is the Emerging Markets MSCI stock price index in both dollars and local currencies, as well as the All Country World MSCI index currency ratio in dollars per local currencies ([Fig. 9](#) and [Fig. 10](#)). Trump's fiscal stimulus has increased the likelihood that the Fed will continue to raise interest rates, which is contributing to capital outflows from EMEs.

All of the above supports our Stay Home investment strategy. Perhaps once Trump declares victory in his trade war with the rest of the world, it will be time to Go Global. But what about Europe? I asked Sandra Ward, our contributing editor, to have a look. It's not pretty over there.

**Europe I: State of the Union.** No sooner did one financial crisis in the European Union (EU) come to a symbolic end this summer than the prospect of another began to loom large.

Greece emerged from eight years of fiscal oversight on August 20, marking the finale of a financial rescue program that totaled \$331 billion in emergency loans from the European Central Bank and the International Monetary Fund. It was the biggest bailout of a country in history, as an 8/20 [article](#) in the *WSJ* pointed out. The EU and its single currency came through intact. Despite the tremendous economic toll on its citizenry from higher taxes, fewer public services, lower pensions, and high unemployment, Greece decided it was better to be in the EU than out.

Yet Greece's recent milestone received little more than glancing attention as investors focused on a fresh threat to the EU: Italy. The fourth-largest economy in Europe has a new coalition populist government that's chafing at budget constraints despite the country's precarious financial state, with government debt equaling 132% of GDP. Rome and Brussels appear to be on a collision course over spending levels ahead of Italy's 2019 budget announcement later this month. Italian bond yields have spiked sharply on fears of a potential crisis.

Other challenges face the EU too. Anti-immigration sentiment and a new nationalism sweeping the continent threaten to tear the fabric that binds the union. A form of "civil war" is how French President Emmanuel Macron characterized the political divisions among the EU's member countries in his inaugural speech to the European Parliament, as highlighted in a 4/17 [article](#) in *The Guardian*.

Brexit, the UK's plan to exit the EU, continues to weigh heavily on European markets. Increasingly, the talk is of a "hard Brexit," also being called a "no-deal Brexit," in which the split occurs without a formal agreement in place. The UK is scheduled to leave the EU on March 29, 2019. Fears have resurfaced of a domino effect from Brexit, leading other countries to depart, according to an 8/30 [article](#) on Bloomberg.

As if all that weren't enough, escalating trade tensions with the US are undermining economic growth and creating added uncertainty. And US President Donald Trump continues to lob denigrating Twitter bombs at our European allies and the NATO alliance.

The EMU MSCI share price index fell 2.7% (in euros) in August, tying Latin America for the worst-performing regional index last month. The Italy MSCI share price index dropped 9.0% in August, and the Greece MSCI slumped 9.5%. The Stoxx Europe 600 Index turned in its weakest performance since

March, slumping 2.40% in August, according to an 8/30 [piece](#) in MarketWatch. Economic growth in the Eurozone continues to be subdued, and the revised 1.5% (saar) expansion during Q2 matches Q1's rate, which was the weakest since Q3-2016 ([Fig. 11](#)).

Let's take a closer at Europe and what ails it.

**Europe II: Italy First.** Italy is hurtling toward a showdown with the EU over its ability to keep its budget in check and reduce its gargantuan debt load, raising concerns about the eurozone's financial stability. Some details:

(1) *Promises, promises.* Reassurances by Italy's pro-euro finance minister that EU budget deficit rules would be respected were at odds with outlooks presented by the two deputy prime ministers representing the populist ruling coalition.

Finance Minister Giovanni Trillo urged the governing parties to keep the budget deficit below 2% of GDP. Deputy Prime Minister Matteo Salvini said next year's budget will double, bumping up against the deficit ceiling limit of 3%. "The government will 'try to respect all the hurdles Europe imposes, but the well-being of Italian citizens comes first,'" Salvini said, according to a 9/3 Bloomberg [report](#). His counterpart, Luigi Di Maio, is promising that a citizens' poverty relief plan and income tax cuts will be included in the 2019 budget.

A nationwide infrastructure investment program planned in the aftermath of the Genoa bridge collapse could push the deficit above the ceiling, a senior official warned on Friday, noted an 8/31 Reuters [report](#).

(2) *Bond selloff.* Borrowing costs on 5-year and 10-year Italian debt surged to the highest levels in four years last Thursday as investors grew concerned about rising debt levels, according to an 8/30 [report](#) on Reuters ([Fig. 12](#) and [Fig. 13](#)). Demand was strong for the two fixed-rate bonds and two floating rate bonds, and the Treasury raised €7.75 billion (\$9.06 billion).

(3) *Fitch downgrade.* Fitch Ratings downgraded Italy's debt outlook to negative last Friday, noting in the 8/31 [report](#) that its "fiscal loosening" combined with already high debt levels make the country vulnerable to potential shocks. Fitch maintained its triple-B rating on Italian debt.

(4) *More threats.* Italy's coalition government threatened to withhold €20 billion in budget contributions to the EU as a negotiating tactic to force other member countries to take some of the 140 migrants on a Coast Guard vessel docked in a Sicilian harbor, according to a 8/24 [report](#) in the *FT*. Eventually, the Catholic Church brokered a deal under which Albania, which is not in the EU, and Ireland took in about 20 each, with the church itself harboring the rest.

**Europe III: Hard Brexit.** Two years after British voters agreed to leave the EU, there is still no agreement on the form such an exit will take. The lack of agreement is reviving concerns that other countries will follow the UK's lead, especially at a time when nationalist forces are on the rise in Europe, the benefit of EU membership is being questioned, and the EU's democratic values are getting tested, an 8/30 [piece](#) on Bloomberg pointed out. A couple of key points:

(1) *Deadline looming.* With time running out on an October deadline for negotiating and a scheduled March 29, 2019 departure date, concern is growing about the upheaval that will result if no deal is struck. "In a no-deal scenario, and without a transition phase, we would end up with a border and customs regime that no one is prepared for," Joachim Lang, director-general of Germany's BDI industry federation, told the *FT* according to a 9/2 [piece](#). "There would be considerable uncertainty, there would

be interruptions to the supply chains and the UK industrial base would take a hit.”

(2) *Sticking points*. The UK proposal envisions the free trade of goods but not of people, capital, or services. The EU's chief Brexit negotiator, Michel Barnier, opposes the British proposal, rejecting the notion that goods and services can be separated in the modern economy, according to a 9/2 BBC [article](#). Barnier is also concerned about the precedent that would be established if Britain were allowed to choose the EU rules it will abide by. Another thorny issue concerns the border between the British province of Northern Ireland and the Republic of Ireland, which would be the only land border with the rest of the EU. Would EU or UK law take precedence? Ireland would like the border to stay open and accessible, according to a 6/26 [report](#) on Marketplace.org.

**Europe IV: Trade.** The Eurozone has not escaped Trump's obsession with tariffs:

(1) *Non-autos*. Last month, President Trump met with the European Commission President Jean-Claude Juncker, and the two agreed to work toward eliminating tariffs for non-auto industrial goods.

(2) *Autos*. Last Thursday, EU Trade Commissioner Cecelia Malmström went a step further, saying that the EU was willing to bring its “car tariffs to zero, all tariffs to zero, if the US does the same.” The EU imposes a 10% tariff on all passenger vehicles. The US imposes a 25% tariff on light trucks and pickups and a 2.5% tariff on smaller cars.

(3) *A smaller version of China*. Trump rejected the EU no-tariff offer, saying it wasn't “good enough,” according to an 8/30 CNBC [story](#). He noted that Europeans tend to buy European-made vehicles and not “our cars.” He added that the EU is “almost as bad as China, just smaller.”

**Europe V: Slowing Growth.** With deadlines fast approaching for Italy's budget proposals and Brexit negotiations, investors soon should be getting a clearer sense of what's in store for the EU. For now, expansion continues in the region, but uncertainty about global trade and tariffs is resulting in a slower rate of growth, as evidenced by:

(1) *Manufacturing PMI*. The IHS Markit Eurozone M-PMI reading fell from 55.1 during July to 54.6 in August, the slowest since November 2016 and six points lower than December's record high, according to the most recent 9/3 [report](#) ([Fig. 14](#)). Growth in new orders hit a two-year low on worries about the outlook, according to Chris Williamson, chief business economist at IHS Markit. Weaker gains in new export orders were seen in Germany, Italy, and Spain.

(2) *Economic sentiment*. August's Economic Sentiment Index (ESI) for the Eurozone fell for the eighth time this year during August, sinking from December's 17-year high of 115.2 to 111.6, its lowest level in a year ([Fig. 15](#)). This index closely tracks y/y real GDP growth in the region, which rose 2.2% in Q2, down from 2.5% in Q1, and 2.8% in the previous two quarters.

(3) *UK indicators*. The bungled Brexit strategy is weighing heavily on the outlook for business in the UK, with sentiment sinking to a 22-month low, according to the 9/3 IHS Markit/CIPS [survey](#) of manufacturers.

While manufacturing continued to expand in the UK in August, the reading of 52.8 was the lowest registered in 25 months ([Fig. 16](#)). Job creation was practically nil in the sector as job cuts at big companies offset gains at smaller companies. Manufacturing production rose at the slowest pace in 17 months on weak new order flows. Despite weakness in the pound, foreign demand decreased for the first time since April 2016 ([Fig. 17](#)).

The latest PMI report suggests the manufacturing sector is unlikely to provide any meaningful support to the broader UK economy in Q3, according to Ron Dobson, director at IHS Markit.

As they say in HBO's *Game of Thrones*, "Winter is coming."

## CALENDARS

**US. Wed:** Total & Domestic Motor Vehicle Sales 16.9mu/13.0mu, Merchandise Trade Balance -\$50.2b, MBA Mortgage Applications, Williams, Bostic. **Thurs:** ADP Employment 182k, Jobless Claims 213k, Challenger Job-Cut Report, Productivity & Unit Labor Costs 3.0%/-1.0%, Factory Orders -0.7%, ISM & HIS Markit NM-PMIs 56.8/55.2, EIA Natural Gas Report, Williams. (Econoday estimates)

**Global. Wed:** Eurozone Retail Sales -0.1%*m/m*/1.3%*y/y*, Eurozone, Germany, France, and Italy C-PMIs 54.4/55.7/55.1/52.2, Eurozone, Germany, France, and Italy NM-PMIs 54.4/55.2/55.7/53.1, UK C-PMI & NM-PMI 54.1/53.9, China Caixin NM-PMI 52.6, Australia GDP 0.7%*q/q*/2.8%*y/y*, BOC Rate Decision 1.50%. **Thurs:** Germany Factory Orders 1.8%*m/m*/1.9%*y/y*. (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, and SmallCap's rose for the first time in four weeks to 0.3% 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 rose to a seven-year high of 22.7% *y/y* from 22.6%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to 23.8% from 23.7%, 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 fell *w/w* to 34.0% from 34.2%, which compares to an eight-year high of 34.8% in mid-August and 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 10.3%, MidCap 21.5% and 12.3%, and SmallCap 28.0% and 16.0%.

**S&P 500/400/600 Valuation ([link](#)):** Forward P/E ratios rose last week, but LargeCap's and MidCap's valuations still didn't get much above their recent post-election lows. LargeCap's weekly forward P/E improved to a 24-week high of 16.7 from 16.6, 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 a 10-week high of 16.7 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 has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E rose to a 24-week high of 18.3 last week, 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 2.10 from 2.08, but is down from a record high of 2.19 on January 26; MidCap's dropped to 1.34 from 1.35, which compares to its record high of 1.40, also on January 26; and SmallCap's rose to 1.07 from 1.06, 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, analysts are taking a break from adjusting future expectations. The S&P 500's Q3-2018 EPS forecast was steady w/w at \$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 22.4%, up from 22.3% a week earlier and up from 22.1% at the end of Q1. That compares to Q2-2018's blended 24.9%, 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 Materials. Real Estate is the biggest decliner, with its Q3-2018 forecast down 1.6% since the end of Q2, followed by Consumer Discretionary (-1.5), Utilities (-0.6), Consumer Staples (-0.4), Energy (-0.4), Telecom (-0.3), Tech (-0.3), 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—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 22.4%, 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 (100.0% in Q3-2018 vs 123.1% in Q2-2018), Financials (45.5, 27.2), Materials (32.1, 40.0), S&P 500 (22.4, 24.9), Telecom (23.0, 16.4), Industrials (17.4, 20.3), Tech (16.8, 26.9), Consumer Discretionary (15.5, 23.1), Health Care (11.0, 18.1), Consumer Staples (7.3, 13.8), Utilities (5.1, 8.7), and Real Estate (4.5, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 19.3% y/y in Q3, down from a blended 21.9% 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

**Construction Spending** ([link](#)): Construction spending in July remained stalled at its record high. Total spending ticked up 0.1% after falling a revised -0.8% (from -1.1%) in June; before June's decline, spending had increased eight of the prior nine months by 7.0%. Public construction spending increased 0.7% in July after falling -1.7% in June—which was half the preliminary estimate of a -3.5% decline; it has increased 10 of the last 11 months by a total of 9.6%. Private construction spending ticked down for the second straight month by a total of -0.6% after jumping the prior seven months by 5.7%. Within private construction, nonresidential investment was stalled at record highs in July, falling -1.0% after gains of 0.1% and 0.7% the previous two months. Meanwhile, residential investment increased 0.6% after falling -1.2% during the two months through June, as home-improvement spending rebounded 2.1% after a two-month slide of -3.3%. Single- and multi-family investment dropped -0.7% and -2.9%, respectively, during the two months through July, though all three measures of residential investment remain around recent highs.

## GLOBAL ECONOMIC INDICATORS

**Global Manufacturing PMIs** ([link](#)): Global manufacturing activity grew in August at its slowest pace in 21 months. According to the report, "Although output growth ticked higher, rates of expansion in new orders and employment slowed, while confidence regarding the outlook for one year's time dipped to a near two-year low." August's JP Morgan M-PMI fell for the seventh time in eight months, after reaching a seven-year high of 54.5 at the end of last year, sinking to 52.5 last month. Developed nations (to 53.8 from 54.0) continued to record much stronger growth than emerging ones (50.8 from 51.0), though both have slowed since late last year—to the weakest readings since June 2017. Among the larger industrial nations, M-PMIs show that growth in the US (to 54.7 from 55.3) and Eurozone (54.6 from 55.1)

remained robust in August, despite easing to nine- and 21-month lows, respectively. Within the Eurozone, there remained a notable divergence between the strongest- and weakest-performing manufacturing sectors at the country level: The Netherlands (59.1, 2-month high) and Ireland (57.5, 7-month high) led the way, with growth rates accelerating, while Austria (56.4, 20-month low) and Germany (55.9, 2-month low) saw a slowing in growth, though both continued to enjoy healthy rates of expansion. Meanwhile, M-PMIs for Greece (53.9, 3-month high), France (53.5, 3-month high), and Spain (53.0, 3-month high) all turned in solid growth performances. In contrast, Italy (50.1, 24-month low) registered its worst M-PMI reading in two years, virtually dropping to the breakeven point of 50.0—down sharply from 59.0 in January. Meanwhile, rates of expansion improved in Japan (52.5 from 52.3) and Australia (53.2 from 52.4), but slowed in the UK (52.8 from 53.8) and Canada (56.8 from 56.9), though the latter's registered a further above-global-average rate of expansion. Among the largest emerging nations, China's (50.6 from 50.8) M-PMI was only marginally above the 50.0 no-change mark, falling to a 14-month low, while India's (51.7 from 52.3) eased to a three-month low; Brazil's (51.1 from 50.5) accelerated to a four-month high.

**US Manufacturing PMI** ([link](#)): Manufacturing activity accelerated in August at the fastest pace in 14 years, according to the ISM measure, while IHS Markit's gauge sank to a nine-month low. The ISM M-PMI rose for the third time in four months, from 57.3 in April to 61.3 last month—surpassing the previous cyclical high of 60.8 posted in February. The new orders index (to 65.1 from 60.2) rebounded to a seven-month high—its 16th straight reading of 60.0 or above, while the production index (63.3 from 58.5) jumped back above 60.0 again. Meanwhile, the new export orders sub-index (55.2 from 55.3) sank for the fifth time in six months since reaching a seven-year high of 62.8 in February. The employment index (58.5 from 56.5) accelerated for the second month to a six-month high, while the supplier deliveries (64.5 from 62.1) gauge moved back toward its 14-year high of 68.2 recorded in June; inventories (55.4 from 53.3) continued to accumulate at a faster rate. The price index eased for the third month, to 72.1, since climbing to a seven-year high of 79.5 in May. IHS Markit's M-PMI fell for the fourth month to 54.7, a new low for this year, though remained well above the long-run series average. According to the survey, "The upturn was supported by further rises in output and new orders, and a renewed increase in export sales. That said, production rose at the weakest rate for almost a year."

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