



MORNING BRIEFING

October 16, 2018

Stepping on the Accelerator and the Brakes

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

(1) A most bullish and bearish fellow. (2) The accelerator: deregulation plus tax cuts. (3) The brakes: deficits, interest rates, oil prices, and tariffs. (4) A very big bet on supply-side economics. (5) A 15% boost to earnings. (6) Small business sentiment soars on deregulation and tax cuts. (7) A big boost to corporate cash flow from Trump's expansion of depreciation allowance. (8) Monetary and fiscal policies clashing. (9) A long-term conflict with China. (10) Bad news for emerging economies. (11) Still recommending "Stay Home."

Trump's World: Head-Spinning Policies. I've said it before: There has never been a President with policies so simultaneously bullish and bearish as Donald Trump! He is stepping on the economy's accelerator and brakes at the same time.

Deregulation and tax cuts are bullish for the US economy as well as for corporate earnings and stock prices. On the other hand, the ballooning federal deficit—attributable to the tax cuts and spending increases—is putting upward pressure on bond yields at the same time that the Fed has moved to raise interest rates and taper its balance sheet.

No President has ever provided this much fiscal stimulus at this stage of the business cycle. In the past, such stimulus was provided during recessions or early recoveries, when the unemployment rate was at a cyclical high, not when it was near previous cyclical lows as it is today. Trump is making a very big bet on supply-side economics. The idea is that tax cuts will boost growth by boosting productivity, so inflation should remain subdued. That could work as long as growth isn't weighed down by rising interest rates. If inflation does come back, then the latest supply-side experiment will end very badly indeed. (I expect that inflation will remain subdued, and I am open to the possibility that supply-side economics might work as advertised by its promoters.)

Trump's geopolitical policies may eventually be bullish. But for now, they are bearish. His sanctions against Iran have caused oil prices to rise. The higher cost of gasoline will offset some of the benefits of Trump's tax cuts for consumers. Higher energy costs will also squeeze profit margins, which were significantly boosted by Trump's corporate tax cut.

Also on the bearish side, Trump's worldwide tariffs on aluminum and steel and on Chinese imports may be disrupting US multinational supply chains and earnings, especially in the short term. But longer term, Trump's policies may force more companies to move their production out of China and into the US or countries that have signed bilateral trade deals with the US.

On the whole, Melissa and I continue to believe that Trump's policies are bullish for the US economy. We remain optimistic on the outlook for earnings and expect the stock market to recover from its latest selloff and make new highs next year. Nevertheless, we are very aware of the downside risks attributable to Trump's head-spinning policy initiatives. Let's update some of the top effects of Trump's policies so far:

(1) *Bullish corporate tax cut boosting earnings.* S&P 500 earnings got a big boost from Trump's tax bill passed at the end of last year. The Tax Cut and Jobs Act (TCJA) lowered the federal statutory corporate tax rate to 21% from 35%. Since its enactment, analysts have continued to raise their earnings expectations for this year and next: Forward earnings—i.e., the time-weighted average of analysts' consensus 2018 and 2019 earnings expectations—for the S&P 500/400/600 are up 20.1%, 20.2%, and 32.3%, respectively, since the week of December 15. They rose to record highs during the 10/11 week ([Fig. 1](#)).

During Q1 and Q2 of this year, S&P 500 operating earnings in aggregate jumped 25.9% y/y to \$1.25 trillion and 25.3% y/y to \$1.31 trillion, respectively ([Fig. 2](#)). For Q1 and Q2, S&P 500 operating earnings per share (using Thomson Reuters data) jumped 23.2% y/y and 25.8% y/y, respectively. S&P 500 revenues per share increased impressively for the same periods, by 9.4% and 10.3%. Looking at the difference in the revenues-per-share and earnings-per-share growth rates for Q2-2018 implies that Trump's tax cut might have added as much as 15 percentage points to earnings growth ([Fig. 3](#)).

This effect can also be seen in the profit margin, which jumped from a record 10.9% during Q4-2017 (before Trump's tax cut) to a new record high of 12.3% during Q2-2018 ([Fig. 4](#)).

(2) *Bullish deregulation boosting small business confidence.* It's impossible to measure the impact of Trump's deregulation of business on S&P 500 earnings. Our guess is that deregulation, which started early last year, might amount to \$4 per share in additional earnings.

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. 5](#) and [Fig. 6](#)). After all is said and done, the earnings component of the NFIB survey is the highest on record since the start of the data during 1974. This series is highly correlated with the NFIB's "expecting to increase employment" series, also at a record high ([Fig. 7](#)).

(3) *Bullish depreciation allowances boosting capital spending.* Thanks in part to Trump's tax reform, there has been plenty of cash flow to finance capital spending, share buybacks, and dividends. Progressives have argued that corporations are not making productive use of their resources. They say that firms are using incremental cash flow for the short-term benefit of shareholders rather than investing in future earnings potential. It is true that buybacks and dividends have been about the same as after-tax operating profits for the S&P 500 in recent years ([Fig. 8](#)).

However, focusing on this fact overlooks the record amount of corporate cash flow, provided by depreciation allowances, that has been fueling corporate capital spending. The data show that nonfinancial corporations' (NFCs) capital expenditures are at a record high ([Fig. 9](#)). Private nonresidential fixed investment in real GDP rose solidly by 8.7% (saar) during Q2, following an 11.5% gain during Q1. Thanks in part to Trump's tax cuts, there has been plenty of cash flow to finance capital spending, share buybacks, and dividends. In addition, TCJA helped to boost NFC's capital consumption allowance by 19.4% y/y during Q2 to a record high ([Fig. 10](#)).

(4) *Bearish federal deficits worsened by Fed's monetary normalization.* In addition to gradually raising interest rates, the Fed started tapering its balance sheet during October 2017. Since the start of that month through September, the Fed's holdings of Treasuries and mortgage-backed securities have dropped by \$152 billion and \$86 billion, respectively ([Fig. 11](#)). The pace of tapering was upped this month for Treasuries from \$25 billion per month to \$30 billion. In effect, the Fed is adding \$360 billion at an annual rate to the federal budget deficit. In the past, I've found that a supply/demand analysis of

bond yields isn't very useful. However, given that the Congressional Budget Office is projecting federal deficits averaging roughly \$1.0 trillion per year, deficits may be starting to weigh on the bond market.

(5) *Bearish impact of higher oil prices resulting from sanctions on Iran.* Although they may be earning more lately thanks to Trump's tax cuts, consumers are also paying more at the gas pump. The price of a barrel of Brent crude has been soaring ever since President Trump withdrew from the Iran nuclear accord on May 8 ([Fig. 12](#)). At that time, the US announced it would reinstate sanctions against Iran and any companies doing business in Iran, leading to potential oil production decreases from Iran in the future. Iran is the third-largest OPEC producer, behind Saudi Arabia and Iraq. That's bad news for consumers and businesses that must pay more for fuel. Of course, higher oil prices may also depress economic growth around the world, which seems to be happening already among emerging economies.

(6) *Bearish superpower rivalry between US and China.* Our 10/1 [Morning Briefing](#) was titled "China's Syndromes." I wrote that the Chinese government is scrambling to expand its overseas military and economic power to counter structural weaknesses at home, mainly related to aging demographics. I argued that President Donald Trump is implementing policies aimed at either slowing or halting China's drive to become a superpower. Trump's endgame is that the US would no longer be financing China's ascent with our trade deficit and providing technological knowhow that has been either stolen or extorted. To that effect, I covered recent harsh words and accusations spoken against China by the President and Vice President in the 10/9 [Morning Briefing](#).

The bottom line is that the US's relationship with China is not good and might get worse. In a worst-case scenario, Trump could up the ante by placing 25% tariffs on *all* imports from China indefinitely. That would be bad for US multinationals, depending on Chinese supply chains, especially in the short term. But I expect that US companies will reconfigure their supply chains outside of China accordingly, which would be bad for China's foreign-demand-fueled economy.

Trump also has the power to limit US trading partners' ability to do business with China. As I've noted before, the so-called "new NAFTA" agreement gives Washington the ability to veto any of Canada's and Mexico's trading partners that don't abide by free-market principles—a veritable "poison pill" aimed at China. He could place such limits on other US trading partners as well.

Even though the escalating trade dispute with China is getting uglier by the day, I doubt it will be the event that ends the bull market in the US. However, it may mark the beginning of a severe and prolonged bear market in China.

(7) *Bearish consequences for emerging economies.* Most signs point to a "Stay Home" investing strategy right now. That's because capital will likely continue to flow away from emerging economies. When that happens, greater demand for dollars relative to emerging market currencies raises the relative value of the dollar. Emerging market economies with lots of dollar-denominated debt get hit with a one-two-punch: weakening local currencies and rising interest rates.

Furthermore, China could fall hard because of the escalating trade dispute. That could contribute to further challenges for other emerging economies that depend on China for trade. It's no wonder that the IMF recently warned about a potential slowdown in global growth. For some time, the IMF has been warning about the vulnerabilities in emerging economies as interest rates rise in advanced economies.

CALENDARS

US. Tues: Total & Manufacturing Industrial Production 0.2%/0.2%, Capacity Utilization Rate 78.2%, Job Openings 6.900m, Housing Market Index 67, Treasury International Capital. **Wed:** Housing Starts

& Building Permits 1.216mu/1.272mu, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Minutes. (Econoday estimates)

Global. Tues: Eurozone Trade Balance €14.7b, Germany ZEW Current Situation & Expectations Indexes 74.4/-12.0, UK Employment Change (3m/3m) & Unemployment Rate (3m) 11k/4.0%, UK Average Weekly Earnings (3m) 2.6% y/y, China CPI & PPI 2.5%/3.6% y/y, RBA Meeting Minutes (Oct 2). **Wed:** European New Car Registrations, Eurozone Headline & Core CPI 2.1%/0.9% y/y, UK Headline & Core CPI 2.6%/2.0% y/y, Japan Trade Balance ¥43.3b, BOE FPC Minutes .(DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose to record highs for all three indexes last week. LargeCap's gain was its second straight following its first decline in 18 weeks at the end of September. A w/w decline in forward earnings has occurred at the start of earnings seasons in the past, but will be watched closely this time around as the impact of the China trade war could be starting to roost in US profit forecasts. Forward earnings activity has been relatively strong in the past 12 months: LargeCap's forward earnings have risen in 49 of the past 52 weeks, MidCap's in 50, 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 edged up to 22.9% y/y from 22.8%. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's y/y change rose to 23.8% from 23.4% a week earlier, down from mid-September's 24.1%, which had been the highest since April 2011 and compares to a six-year low of -1.3% in December 2015. SmallCap's dropped to 34.3% from an eight-year high of 35.3% the week before, which compares to a six-year low of 0.3% in December 2015. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.6%, 10.3%, 9.6%), MidCap (21.2, 12.5, 11.6), and SmallCap (29.6, 15.5, 12.1).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios fell broadly again last week to new post-election lows and dropped at the fastest rate since the week ended March 23. LargeCap's weekly forward P/E of 15.8 is the lowest since February 2016 and down from 16.5 a week earlier, a six-month high of 16.8 in mid-September, a multi-year high of 18.6 on January 26 (highest since May 2002), and of course is well below the tech-bubble record high of 25.7 in July 1999. However, last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E fell to 15.1 last week to 15.9, and is now the lowest since January 2016. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002; however, it is barely above the 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 dropped to 15.7 from 16.7 last week, and is now the lowest since January 2013. That's well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). Looking at the three indexes' daily forward price/sales (P/S) ratios, all were lower w/w to levels well below their January highs: LargeCap's P/S fell w/w to 1.97 from 2.06, which is the lowest since mid-March and down from a record high of 2.19 on January 26; MidCap's was down to a post-election low of 1.21 from 1.28, which compares to its record high of 1.40, also on January 26; and SmallCap's fell to 0.94 from 0.99, which is the lowest since August 2017 and 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 the books now closed on Q3 and earnings reports set to pick up this week, analysts are finished making last-minute adjustments to their Q3 forecasts. Indeed, last week, the S&P 500's Q3-2018 EPS forecast dropped just two cents w/w to

\$40.48. That's down 1.4% since the end of Q2, but up 7.2% ytd and 7.9% since the passage of the TCJA. The \$40.48 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 21.5%, unchanged from a week earlier and down 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 and likely to mark the peak of the current earnings cycle), Q4-2017's 14.8%, Q3-2017's 8.5%, Q2-2017's 12.3%, and Q1-2017's 15.3%. The S&P 500's Q3-2018 forecasted earnings gain of 21.5% 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, with eight at a double-digit percentage rate. That compares to all 11 positive during Q2, when nine rose at a triple- or double-percentage rate. Three sectors are expected to beat the S&P 500's forecasted y/y earnings gain of 21.5% during Q3, down from four beating the S&P 500's 24.9% gain during Q2. 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 (99.4% in Q3-2018 vs 124.0% in Q2-2018), Financials (41.3, 27.5), Materials (26.9, 40.6), S&P 500 (21.5, 24.9), Tech (20.4, 29.0), Industrials (16.8, 20.2), Communication Services (14.4, 18.1), Consumer Discretionary (12.2, 21.5), Health Care (11.0, 18.4), Consumer Staples (7.3, 13.9), Utilities (5.2, 8.7), and Real Estate (4.2, 3.3). On an ex-Energy basis, analysts expect S&P 500 earnings to rise 18.5% 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). Looking ahead, the Q4 estimates have risen for 1/11 sector since the end of Q3 and dropped for 8/11. Energy is the best performer, with its Q4-2018 forecasts rising 2.0%, ahead of the unchanged readings for Financials and Health Care. Materials is the biggest decliner, with its Q4-2018 forecast down 1.3% since the end of Q3, followed by Industrials (-1.2%), Utilities (-0.7), Real Estate (-0.7), Consumer Staples (-0.5), Communication Services (-0.4), Tech (-0.2), and Consumer Discretionary (-0.1).

US ECONOMIC INDICATORS

Retail Sales ([link](#)): Consumers spent at their slowest pace in seven months during the two months through September, though retail sales still reached a new record high. Sales edged up 0.1% for the second month, after average monthly gains of 0.6% the prior five months. It was the eighth straight gain this year, climbing 3.3% ytd. Meanwhile, core retail sales rebounded 0.5% after a slight dip of -0.1% in August and a solid 0.8% advance in July. (The BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) We estimate September real retail sales climbed 0.3% after a -0.2% loss and a 0.6% gain the previous two months, while real core retail sales jumped 0.6% after a -0.3% decrease and a 0.7% increase the prior two months. Growth in both real headline (to 3.9% from 6.7%, saar) and core (3.6 from 6.0) retail sales slowed last quarter from their Q2 rates, though still posted robust gains; both had declined during Q1. In September, nine of the 13 major nominal sales categories rose, while only three fell—food services & drinking (-1.8), gasoline (-0.8), and health & personal care (-0.3) establishments. The biggest gains were recorded by nonstore (1.1), furniture (1.1), electronic & appliance (0.9), sporting goods (0.7), and clothing (0.5) retailers, with the rest posting gains from 0.1% to 0.3%.

Business Sales & Inventories ([link](#)): Both nominal business sales in August and real business sales in July reached new record highs, yet again. Nominal manufacturing & trade sales (MTS) advanced for the 14th time in 15 months, rising 0.5% in August and a healthy 9.5% over the period; inflation-adjusted MTS expanded 0.2% in July and 4.2% since April 2017. Real sales of retailers climbed to a new record high in July, while sales of wholesalers remained stalled at their record high, and manufacturers' continued to bounce around their cyclical high. Except for a temporary blip earlier this year, the real inventories-to-sales ratio has been on a fairly steady downtrend since reaching a cyclical high of 1.47 in early 2016, holding at 1.42 in July. August's nominal inventories-to-sales ratio was unchanged at 1.34, after falling from a seven-year high of 1.43 two years ago to 1.33 in June—which was the lowest since

November 2014.

Regional M-PMI ([link](#)): The New York Fed—the first district to report on manufacturing for this month—reveals business activity continued to grow at a heady pace. The composite index climbed to 21.1 from 19.0 in September—averaging 22.2 the past six months; it was at a 10-month high of 25.6 in August. Measures for both new orders (to 22.5 from 16.5) and shipments (26.3 from 14.3) accelerated sharply this month, posting the best growth in 13 and seven months, respectively. Delivery times (5.0 from 6.5) continued to lengthen, while inventories (0.8 from 8.9) held steady. Labor market indicators pointed to a modest increase in employment (9.0 from 13.3) and no change in hours worked (0.2 from 11.5). Price indexes edged lower though remained elevated, suggesting ongoing significant increases in both input (42.0 from 46.3) and selling (14.3 from 16.3) prices. As for the six-month outlook, firms remained moderately optimistic as the index for future business conditions was little changed at 29.0, and the indexes for future new orders and shipments pointed to continued solid growth at 35.1 and 33.8, respectively.

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