MORNING BRIEFING
October 23, 2018

Crouching Tiger, Hidden Dragon

See the collection of the individual charts linked below.

(1) Trump is a tiger. (2) China's dragon has lots of secrets hidden in plain sight. (3) China's most obvious syndrome is aging demographics. (4) China's Q3 real GDP growth at 5.8%, (saar), lowest since Q4-2008. (5) Getting less bang per yuan. (6) Real retail sales growth showing China's aging demographics. (7) Breaking China: Trump team rooting for and getting lower Chinese stock prices. (8) Trump's policies boosting US, while depressing the rest of the world. (9) Good as gold?

China: On the Ropes. Under President Donald Trump, the United States is the crouching tiger. China is the hidden dragon.

Trump has already slapped a 25% tariff on $50 billion of imports from China and a 10% tariff on $200 billion Chinese imports. He is threatening to raise the tariff rate on the latter to 25% too by January 2019. He has also warned about a "phase 3" plan to place a 25% tariff on all the rest of US imports (about $267 billion) from China. (See Peterson Institute's 9/20 summary.)

As I wrote in the 10/1 *Morning Briefing* titled "China's Syndromes," Trump's beef with China is about much more than trade. It's about China's ambition to become a superpower at the expense of US interests:

"The Trump administration's overarching policy goal vis-à-vis China, therefore, may be first and foremost to use America's economic power to slow, or even halt, the ascent of China into a superpower, which will challenge America's interests around the world. If so, then any concessions that the Chinese make on trade and technology are likely to be rejected by the Trump administration. In other words, they have nothing to offer that would satisfy Trump other than an unconditional retreat from their geopolitical expansion plans, which they will never do voluntarily."

In the 10/9 *Morning Briefing* titled "Trump's Poison Pills," I discussed the 10/4 speech about China by Vice President Michael Pence. It comprised a long list of complaints about China's unfair trade practices and belligerent foreign policy. The speech even attacked the Chinese Communist Party's totalitarian domestic policies. In other words, the speech confirmed my view that America's relationship with China is likely to remain rocky for the foreseeable future.

It was interesting to note Pence mentioning that the Chinese stock market had taken a dive in response to the Trump administration's pushback. The latest data out of China suggest that the country's economy has some signs of structural weakness, which Trump's policies are likely to exacerbate. Consider the following:

(1) *Real GDP.* During Q3, China's real GDP rose 6.5% y/y (*Fig. 1*). It's been hovering at this pace since Q1-2016. Hidden in the latest y/y growth rate is the implied quarterly growth rate of 5.8% (saar), which is the lowest since Q4-2008. The Chinese government doesn't provide that information; our friends at

Haver Analytics derive it from the y/y growth rate.

(2) *Bank loans and production.* Also visible has been the relatively stable y/y growth around 6.0% in China's industrial production index since 2015 (*Fig. 2*). It rose 5.8% during September.

Hiding in plain sight is that China is getting less bang per yuan from the rapid expansion of bank loans, which has been rising around 13.0% y/y since mid-2016 (*Fig. 3*). The ratio of Chinese industrial production to bank loans has dropped by roughly 50% since late 2008 (*Fig. 4*).

(3) *Real retail sales.* Every month, the Chinese government reports the growth rate in nominal retail sales and the y/y percent change in the CPI (*Fig. 5*). The former rose 9.2% and the latter 2.5% during September.

It dawned on me only recently that the difference between the two measures—i.e., the growth rate in inflation-adjusted retail sales—would be telling. As soon as I saw the chart of this series—especially its 12-month smoothed version—the conclusion was obvious: Aging demographic factors, which were exacerbated by China's one-child policy, may already be weighing on Chinese consumer spending (*Fig. 6*). During September, the smoothed growth rate fell to 7.4%, the lowest since the end of 1999.

(4) *Stock prices and earnings.* The major Chinese stock price indexes have certainly tumbled so far this year (*Fig. 7* and *Fig. 8*). The China MSCI stock price index is down 19.9% ytd in local currency and 20.2% ytd in US dollars through last Friday.

Both the forward revenues and forward earnings of the China MSCI have been trending lower this year (*Fig. 9* and *Fig. 10*). The composite's Net Earnings Revisions Index has been moving deeper into negative territory over the past three months through September (*Fig. 11*).

Chinese stock prices rallied on Monday and Tuesday following assurances by the government that policies will be implemented to stimulate the economy. However, it's way too late to stimulate more procreation.

(5) *Currency and capital flows.* Along with aspiring to be a superpower, the Chinese government has been trying to raise the stature of its currency, the yuan, to a reserve currency comparable to the dollar, the euro, and the yen. That ambition may get derailed for awhile if the yuan continues to come under pressure as a result of Trump's escalating trade war with China.

The Chinese currency has dropped from a peak of 6.512 yuan/dollar at the start of this year to 6.937 yuan/per dollar yesterday (*Fig. 12*). Our monthly proxy for implied capital outflows for China shows that these are increasing again this year (*Fig. 13* and *Fig. 14*).

(6) *Debt-trap diplomacy.* CNBC reported yesterday that Mike Pompeo, the US Secretary of State, warned about China's "predatory economic activity" last Thursday in Mexico City. "When they show up with a straight-up, legitimate investment that's transparent and according to the rule of law, that's called competition and it's something that the United States welcomes," said Pompeo. "But when they show up with deals that seem to be too good to be true it's often the case that they, in fact, are." He took issue with how Chinese "state-owned enterprises show up in a way that is clearly not transparent, clearly not market-driven, and is designed … to benefit the Chinese Government."

Stocks: On the Ropes. Among the hardest hit stocks during the latest selloff in the US have been the ones of companies most exposed to the global economy. That makes sense since US regulatory, tax, trade, monetary, and foreign policies have pushed up the dollar, interest rates, and the price of oil. This has been a triple whammy for emerging market economies. The fourth whammy for the global economy has been Trump's escalating trade war with China. Now consider the following:

(1) *EM stock prices.* Debbie and I track the daily CRB raw industrials spot price index to monitor the strength of the global economy. The index is down 6% ytd through Friday (*Fig. 15*). The Emerging Markets MSCI stock price index (in local currency), which is highly correlated with this index, is down 11.4% ytd.

(2) *Materials stock prices.* The weakness in industrial commodity prices has been weighing on the S&P 500 Materials stock price index (*Fig. 16*). It is down 12.1% ytd, while the S&P 500 is up 3.5% through Friday.

(3) *Stock prices of PPG and CAT.* I asked Joe to run the CRB index versus the stock prices of PPG (which is in the S&P 500 Materials sector) and CAT (which is in the S&P 500 Industrials sector) (*Fig. 17* and *Fig. 18*). They are both highly correlated with the index, which explains their recent weakness.

(4) *Jobless claims vs commodity prices.* Our Boom-Bust Barometer (BBB) is the ratio of the CRB raw industrials spot price index to initial unemployment claims. It is highly correlated with both the forward earnings and the stock price index of the S&P 500 (*Fig. 19* and *Fig. 20*). The BBB hit a record high during the May 12 week. It has stalled since then, as weakening commodity prices have been offset by falling jobless claims. The stock market rally has also stalled since late September, as investors have fretted about whether the strength of the US economy (thanks to Trump's fiscal policies) will offset the weakness in the global economy (thanks to Trump's trade policies).

Gold: On the Ropes. Given the recent volatility in global stock markets, I am fielding more questions about whether this might be a good time to own some gold. The short answer is "no." Here's why:

(1) Over the years, I've found that the price of an ounce of gold tends to follow the trend of the CRB raw industrials spot price index, which has been downwards this year, as noted above (*Fig. 21*). Gold serves a number of purposes, including as a hedge against inflation, an alternative to the dollar, and ornamental jewelry. First and foremost, it is another commodity. The weakness in the global economy is depressing commodity prices across the board, including gold but excluding oil, which has been boosted by Trump's sanctions against Iran.

(2) Furthermore, there is a good inverse correlation between the price of gold and the 10-year US Treasury TIPS yield (*Fig. 22*). That's because rising (falling) real interest rates increase (decrease) the cost of leveraged positions held by speculators in gold, causing the price of gold to decrease (increase). The TIPS yield has increased from 0.49% a year ago to 1.09% last Friday.

CALENDARS

US. Tues: Richmond Fed Manufacturing Index 24, Bostic. **Wed:** C-PMI, M-PMI, and NM-PMI Flash Estimates 54.1/55.5/54.0, New Home Sales 625k, FHFA Home Price Index 0.3%, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Bostic, Mester, Bullard. (Econoday estimates)

Global. Tues: Eurozone Consumer Confidence. **Wed:** Eurozone C-PMI, M-PMI, and NM-PMI Flash Estimates 53.9/53.0/54.5, Germany C-PMI, M-PMI, NM-PMI Flash Estimates 54.8/53.4/55.5, France C-PMI, M-PMI, and NM-PI Flash Estimates 53.9/52.4/54.7, BOC Rate Decision 1.75%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to record highs for LargeCap and MidCap last week, but SmallCap's fell for the first time since mid-August when it dropped for three straight weeks. LargeCap's gain was its third straight following its first decline in 18 weeks at the end of September. 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 dropped to 22.5% y/y from 22.9%. 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 24.1% from 23.8% a week earlier, matching mid-September's highest level since April 2011, and compares to a six-year low of -1.3% in December 2015. SmallCap's dropped to 33.6% from 34.3% and is down 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%, 9.5%), MidCap (21.6, 12.4, 11.0), and SmallCap (29.2, 15.4, 12.1).

S&P 500/400/600 Valuation (*link*): Forward P/E ratios were mostly steady last week at post-election lows after falling during the prior week at the fastest rate since March 23. LargeCap's weekly forward P/E of 15.8 is the lowest since February 2016 and down from 16.5 in early October, 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 edged down to 15.0 last week from 15.1, and is now the lowest since December 2012. 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. 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 was steady at 15.7 last week after falling from 16.7 a week earlier, 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).

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With Q3 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 blended Q3-2018 EPS forecast jumped 20 cents w/w to $40.68. That's down 0.9% since the end of Q2, but up 7.8% ytd and 8.5% since the passage of the Tax Cut and Jobs Act. The $40.68 estimate represents a forecasted pro forma earnings gain for Q3-2018 of 22.2%, up from 21.5% a week earlier and 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 22.2% 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 blended Q3-2018 earnings growth rates vs their Q2-2018 growth rates: Energy (99.4% in Q3-2018 vs 124.0% in Q2-2018), Financials (44.5, 27.5), Materials (25.4, 40.6), S&P 500 (22.2, 24.9), Tech (20.5, 29.0), Industrials (17.0, 20.2), Communication Services (14.8, 18.1), Consumer Discretionary (12.0, 21.5), Health Care (11.5, 18.4), Consumer Staples (8.8, 13.9), Utilities (5.7, 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). Looking ahead, the Q4 estimates have risen for 2/11 sectors since the end of Q3 and dropped for 8/11. Real Estate is the best performer, with its Q4-2018 forecasts rising 0.7%, ahead of Energy (0.5%) and Industrials (0.0). Utilities is the biggest decliner, with its Q4-2018 forecast down 2.0% since the end of Q3, followed by Materials (-0.7), Consumer Staples (-0.5), and Communication Services (-0.4).

S&P 500 Q3 Earnings Season Monitor (*link*): With nearly 18% of S&P 500 companies finished reporting earnings and revenues for Q3-2018, the y/y revenue and earnings growth metrics remain very strong compared to Q2's stellar results, but companies are recording a smaller revenue and earnings surprise beat. We're not seeing signs of a sharp slowdown. Of the 88 companies in the S&P 500 that have reported through mid-day Monday, 80% exceeded industry analysts' earnings estimates by an average of 4.2%; they have averaged a y/y earnings gain of 24.0%. On the revenue side, 63% of companies beat their Q3 sales estimates so far, with results coming in 0.4% above forecast and 7.6% higher than a year earlier. At the same point during the Q2-2018 reporting period, a higher percentage of companies (84%) in the S&P 500 had beaten consensus earnings estimates by a higher 5.0%, and earnings were up a slightly higher 24.4% y/y. With respect to revenues, a much higher 74% had exceeded revenue forecasts at this point in the Q2 season by a higher 1.4%, and sales rose a greater 10.5% y/y. Q3 earnings results are higher y/y for 93% of companies, vs a slightly higher 95% at the same point in Q2, and Q3 revenues are higher y/y for 86% vs a greater 92% a quarter ago. These figures will change markedly as more Q3-2018 results are reported in the coming weeks. The early results on revenues are very encouraging, particularly the percentage of companies growing revenues y/y. Q3-2018 should mark the ninth straight quarter of positive y/y earnings growth and among the highest since Q4-2010; y/y revenue growth should be positive for a tenth straight quarter, with its pace slowing somewhat but remaining well above the historical trend. The strong results are mostly due to lower tax rates and improved business conditions, but cost pressures are increasing.

US ECONOMIC INDICATORS

Existing Home Sales (*link*): Existing home sales in September fell to the lowest level since November 2015. "A decade's high mortgage rates are preventing consumers from making quick decisions on home purchases. All the while, affordable home listings remain low, continuing to spur underperforming sales activity across the country," according to Lawrence Yun, NAR chief economist. Existing-home sales fell for the sixth straight month, by -3.4% in September and -8.0% over the period, to 5.15mu (saar). On an annual basis, this result represented the sixth straight month of decline, down -4.1% y/y—the longest string of declines in four years. Regionally, sales dropped the sharpest in the West (-12.2% y/y) and Northeast (-5.6) over the past 12 months, with the Midwest (-1.5) showing only a modest decline and the South (-0.5) basically flat with a year ago. Single-family sales fell -8.2% during the six months through September to a 34-month low of 4.58mu (saar), while multi-family sales dropped for the second time in three months, by -8.1%, to 570,000 units (saar)—the lowest level since January 2015. The number of existing single-family homes on the market at the end of September slipped to 1.66mu, 1.2% above a year ago. According to Yun, "There is a clear shift in the market with another month of rising inventory on a year over year basis, though seasonal factors are leading to a third straight month of declining inventory. Homes will take a bit longer to sell compared to the super-heated fast pace seen earlier this year."

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