



MORNING BRIEFING

November 14, 2018

Volatile Situations

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

(1) Stock market volatility reflects bullish and bearish mix of Trump's policies. (2) Meanwhile, Fed still tapping on the brakes. (3) An escalating trade war with China and an increasingly uncivil war at home. (4) Curbed enthusiasm. (5) Meet trade warrior Peter Navarro again. (6) "Globalists" to the rescue? (7) Lots of homegrown problems in China. (8) Lots of debt turning bad fast. (9) 50 million empty apartments. (10) Capital flight remains a big risk. (11) M2 confirming slowdown in real retail sales, which may be reflecting rapidly aging population. (12) One-day shopping spree.

Strategy: Getting Messier. This certainly has been a volatile year for stocks, and it isn't over yet. The volatility has mostly been attributable to the tug of war between President Trump's bullish and bearish policies. On the bullish side are deregulation and tax cuts. On the bearish side are widening federal deficits and an escalating trade war with China.

On balance, Trump's policies have boosted economic growth and further tightened the labor market. As a result, Fed officials—who did a good job of prepping the financial markets for a gradual course of hikes in the federal funds rate, aiming for a "neutral" 3.00% level by the end of next year—have recently been chattering about even higher rates, i.e., turning restrictive. Consequently, the trade-weighted dollar has soared. The combination of higher US interest rates and a stronger dollar is suppressing US inflation while depressing commodity prices as well as the global economy, particularly emerging market economies. The situation is akin to driving a car with the left foot bearing down on the accelerator while the right foot taps the brakes, as we've noted frequently this year.

The outlook for 2019 is most likely for more volatility. That's assuming that tensions between the US and China continue to mount, as discussed below. On the bullish side, the latest FOMC statement did hint faintly that a pause in the Fed's quarterly rate hiking might be possible next year. Meanwhile, the global economy continues to weaken. In any event, the growth rates of both S&P 500 revenues and earnings will certainly be slower in 2019 than this year.

It's widely believed that the stock market likes gridlock, which now is assured for the next two years given the mid-term election results. However, the country has been experiencing an escalating uncivil war between the Left and the Right. It will only get worse, as explained in the cover story of the latest *Bloomberg BusinessWeek* titled "[Republicans Weaponized the House. Now, Democrats Will Use It Against Trump.](#)" That may contribute to more stock market volatility next year.

Joe and I curbed our enthusiasm for the stock market's upside in the 10/30 [Morning Briefing](#). We lowered our outlook for earnings growth over the next two years, as we reviewed yesterday. At the end of last month, we also reduced our target for the S&P 500 from 3100 to 2900 for the end of this year and from 3500 to 3100 by year-end next year. We aren't bearish because we expect that the US economy will continue to grow over the next two years. Furthermore, we remain open to the possibility that productivity will make a long-awaited comeback.

In my meetings with our accounts in Toronto last Thursday, one seasoned equity investment strategist suggested that, given the slowdown in global growth, perhaps it's time to overweight value and underweight growth ([Fig. 1](#) and [Fig. 2](#)). That was a good call based on nature of Monday's stock market rout.

What about the "Panic-Attack-Relief-Rally" model that has worked so well for us, reassuring us that downdrafts in this bull market are typically short-lived? It worked because in all of the first 60 episodes, there tended to be just one major frightful concern that turned out to be a false alarm. This year's panic attacks #61 and #62 share common concerns about several issues that might linger into next year ([Fig. 3](#)). (See our [S&P 500 Panic Attacks Since 2009](#).) The alarm has yet to be proven false.

China I: Hardline on China. "Economic security is national security. If you think about everything the Trump administration has been doing in terms of economic and defense policy, you understand this maxim really is the guiding principle," said Peter Navarro in an 11/9 [speech](#) at the Center for Strategic and International Studies. The White House National Trade Council Director has advised that the US take a hardline with China, calling the country out as a "strategic rival."

During the speech, Navarro commended United States Trade Representative (USTR) Robert Lighthizer for invoking his department's Section 301 power on China. The Section 301 [report](#) should be required reading for everyone in this country, Navarro said, because—per its title—the report outlines "China's [Unfair] Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation." (In March and April, we devoted portions of several *Morning Briefings* to providing an overview of the 215-page Section 301 report. See our *Morning Briefings* dated [3/19](#), [3/26](#), [3/27](#), [3/29](#), and [4/5](#). And for more on Navarro's perspective, see our 3/8 [Morning Briefing](#) titled "Meet Peter Navarro.")

One comment Navarro made during his speech stuck out to us, because it implied that without stealing US technologies, China's economy would fall apart. Navarro stated: "If they make the kind of structural reforms that are necessary for them to be reasonable, fair, responsible citizens of the global trading system, they will not be able to compete." He might be right.

The USTR report details the ways in which China has unfair advantages. Navarro explained that Chinese companies don't have to incur the typically heavy R&D costs required to develop new technologies because Chinese companies are usurping US technology at little to no cost. That creates an obvious strategic low-cost advantage over US companies, which do incur these costs, says Navarro.

The implication is that there is no end game for a US-China trade deal, because it's a lose-lose for China. Navarro pointedly asks: How can you negotiate with someone who won't even acknowledge the issues you bring to the table? He cites instances where the Chinese government repeatedly made empty promises to change its practices, then failed to deliver.

Trump is meeting with President Xi Jinping of China late this month at the Group of 20 (G20) leaders' summit in Buenos Aires. So far, the US has [imposed](#) tariffs on \$250 billion of China-made goods, and has [threatened](#) to do the same on the remaining \$267 billion of imports from China. So far, the tariffs don't seem to be breaking the backs of US companies or consumers.

The question is: Will the Trump administration's hardline on trade break China? If the matter were as simple as two free-market economies working together to develop free, fair, and reciprocal trade deals (which is the administration's goal), then the answer would probably be that China will be fine. In reality, the escalating dispute with the US is over national security as well, not just trade, and it might push

China over the edge if Navarro has his way.

Navarro's battle is not just an external one with China; there is a domestic dispute too. During his speech, Navarro railed against the so-called "shuttle diplomacy that is now going on by a self-appointed group of Wall Street bankers and hedge fund managers between the US and China." Under the influence of the Chinese government, "globalist billionaires are putting the full court press on the White House in advance of the G20," Navarro said. He called on these "globalist elites" to "stand down," adding that Trump has done an "amazing job" addressing this issue and doesn't need Wall Street's help to solve it.

Navarro's "comments reflect the ongoing divisions inside the Trump administration between free traders—including those with Wall Street backgrounds like Treasury Secretary Steven Mnuchin and economic adviser Larry Kudlow—and the so-called nationalists, who hew to the 'America First' stance laid out during the campaign and early months of Trump's presidency by former chief strategist Steve Bannon," an 11/9 CNN [article](#) observed. Navarro has said that he isn't a protectionist but a proponent of "fair" trade.

In any event, we are anxious to learn the outcome of the G20 meeting. We doubt any sort of clear-cut "win-win" deal will be made with China. But it's possible that the "globalists" will smooth US-China trade tensions over, at least temporarily.

China II: Mounting Stress Cracks. China's economy is showing more and more homegrown problems that have nothing to do with Trump's tariffs. On the contrary, China's latest merchandise exports and imports rose to record highs during October ([Fig. 4](#)). Then again, China's M-PMI has been weakening in recent months, led by declines in its overall and export orders indexes ([Fig. 5](#)).

Meanwhile, the government's efforts to transform the Chinese economy from export-led to consumer-led growth aren't going so well. As we've previously discussed, China's rapidly aging demography (stemming from the country's longstanding one-child policy, which has only recently been lifted) is starting to weigh heavily on the Chinese economy.

Several areas of the Chinese economy are showing stress cracks. Here are a few examples in the media over just the past week:

(1) *Big debt pile showing more signs of distress.* Bloomberg ran a story on 11/7 [titled](#) "China Has More Distressed Corporate Debt Than All Other EMs." Reportedly, the distressed debt has built up in a span of just 11 months. Before that, China had no distressed dollar-denominated corporate bonds, according to a Bloomberg Barclays index.

A 9/11 *MoneyWeek* [article](#) provided this backdrop: "The latest move [from China] to try to help buoy the economy without embarking on full-blown stimulus was for the government to tell banks exactly how much they have to lend to the private sector. ... The problem is, if you set targets for lending like this (particularly when failure to meet government targets in a country like China is not a recipe for a long and happy life), then you are creating a huge incentive for yet more bad loans to be written. And it also smacks of desperation."

"Property developers in particular are facing surging borrowing costs as refinancing pressures intensify amid the government's effort to rein in real estate prices," observed the Bloomberg article. At least four property-related firms defaulted on debt this year. There could be more to come. China's second-largest builder (by sales) priced a dollar bond at "the highest interest rate it has ever paid on a dollar issue." Many are rightly concerned that the Federal Reserve's hikes will increase borrowing costs on

dollar-denominated debt.

(2) *Property speculators own lots of empty apartments.* Bloomberg ran a [story](#) on 11/8 titled “A Fifth of China’s Homes Are Empty. That’s 50 Million Apartments.” That’s the highest vacancy rate of any country, according to the article. It’s not because these apartments are unsold or wanting for tenants. Rather, they’re owned by lots of real estate speculators.

The article observed: “The nightmare scenario for policy makers is that owners of unoccupied dwellings rush to sell if cracks start appearing in the property market, causing prices to spiral. The latest data, from a survey in 2017, also suggests Beijing’s efforts to curb property speculation—considered by leaders a key threat to financial and social stability—are coming up short.”

It also noted: “There’s an economic cost to vacancies too because they’re a drag on supply, which puts upward pressure on prices and crowds young buyers out of the market, according to Kaiji Chen, who co-authored a Federal Reserve Bank of St. Louis working paper called ‘The Great Housing Boom of China.’”

(3) *Capital flight may be increasing again.* Trump’s escalating trade war, the Fed’s rate hikes, and China’s weakening economy have caused the yuan to fall 10% against the dollar since this year’s peak on February 7 through Friday ([Fig. 6](#)). The weaker currency should offset some of the damage to Chinese exports from US tariffs. The problem is that when the yuan has fallen in the recent past, as it did in 2015 and 2016, global investors pulled capital out of China, fearing that the yuan had further to fall ([Fig. 7](#)). Beijing was forced to step in and prop up the yuan and take measures to reduce capital outflows.

An 11/9 CNN [article](#) quoted Manu Bhaskaran, the founder of Singapore-based research firm Centennial Asia, saying that a “rapidly falling yuan could become a vicious cycle.” And “a huge capital outflow” from China “could feed on itself.”

(4) *M2 confirming retail sales slowdown.* On Friday, the People’s Bank of China released its quarterly monetary policy [report](#), which stated: “External conditions are undergoing profound changes, downward pressures are increasing, some companies are seeing more difficulties in their operations, risks accumulated over the long term are being exposed.” The bank will “preemptively adjust and fine-tune policies according to the changing conditions.”

The bank’s efforts may be running into China’s great wall of demography. Previously, we’ve noted that the significant slowing in China’s retail sales growth may be showing the effects of the population’s aging. Retail sales growth has been highly correlated with the growth in M2 growth, both on a y/y basis ([Fig. 8](#)). Of course, the same can be said about the inflation-adjusted versions of both metrics ([Fig. 9](#)). During September, real retail sales growth was down to 6.9%, while real M2 growth was down to 5.6%. For the former, it was among the weakest readings going back to 2004; for the latter, it was the weakest in the history of the series going back to 2001.

(5) *Happy Singles’ Day cheering up depressed shoppers?* A glimmer of hope came from Alibaba’s early [results](#) for its decade-old annual Singles’ Day sales event. The company reported that the kickoff beat last year’s record sales. Perhaps having lots of single friends to mingle with is a rare bright spot for cash-strapped Chinese consumers.

The event was started as a tongue-and-cheek way to mend all the lonely hearts of China’s single bachelors. Because of the only-child policy, the country’s bachelors significantly [outnumber](#) the bachelorettes. That will make it difficult for all of these men to form couples, get married, and have

children. And that will only worsen China's aging demographic problem. Peter Navarro wants to kick the country when it is down.

CALENDARS

US. Wed: Headline & Core CPI 2.5%/2.2% y/y, Atlanta Fed Business Inflation Expectations, MBA Mortgage Applications, Powell, Quarles. **Thurs:** Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.5%/0.5%/0.4%/0.3%, Business Inventories 0.3%, Jobless Claims 215k, Philadelphia Fed Manufacturing Index 20.5, Empire State Manufacturing Index 20.0, Import & Export Prices 0.0%/0.1%, EIA Natural Gas and Petroleum Status Reports, Powell, Quarles, Bostic. (Econoday estimates)

Global. Wed: Eurozone GDP 0.2%q/q/1.7%y/y, Eurozone Industrial Production -0.4%m/m/0.3%y/y, Germany GDP -0.1%q/q/1.3%y/y, UK Headline & Core CPI 2.5%/1.9% y/y, Japan Industrial Production, China Retail Sales 9.2% y/y, China Industrial Production 5.8% y/y, China Fixed Assets Ex Rural (ytd) 5.5% y/y. **Thurs:** Eurozone Trade Balance €16.3b, UK Retail Sales Including & Excluding Auto Fuel 2.8%/3.4% y/y, Australia Employment Change & Unemployment Rate 20k/5.1%, Mexico Overnight Rate 8.00%. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): Nearly all of these price indexes were in a correction at their recent bottom in late October after being at record highs at the end of August for the first time since January. SmallCaps have struggled mightily since late August, and LargeCaps have closed the ytd performance gap. Here's how they rank ytd through Monday's close, along with their percentage changes since their record highs in August and September: S&P SmallCap 600 (2.0% ytd, -13.0% from record high), S&P LargeCap 500 (2.0, -7.0), Russell LargeCap 1000 (1.6, -7.3), Russell SmallCap 2000 (-1.1, -12.8), and S&P MidCap 400 (-2.5, -9.7). Forward revenues and earnings are at record highs now for all the S&P and Russell indexes, but have flattened in recent weeks. Earnings momentum remains healthy, as the yearly change in forward earnings is up from six-year lows in early 2016, but is looking peaky. In the latest week, the rate of change in LargeCap's forward earnings fell to 21.6% y/y from 22.2%. 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 dropped to 22.7% from 23.0% a week earlier, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's dropped to 31.2% from 32.3% and is down from an eight-year high of 35.3% in early October, 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: S&P LargeCap 500 (23.2%, 9.0%, 9.9%), S&P MidCap 400 (21.6, 11.3, 10.8), and S&P SmallCap 600 (28.2, 13.7, 12.6).

S&P 500 Growth vs Value ([link](#)): The S&P 500 Growth index is up 6.3% ytd through Monday's close, well ahead of the 2.6% decline for its Value counterpart. During Q3, however, Growth tumbled 8.1% versus a 5.5% drop for Value. At the market's recent bottom on October 29, Growth was down 11.3% and in a correction, but Value was down just 9.2%. Since then, Value has risen 3.8% and is outperforming Growth's 2.9% rise. Growth is now 8.7% below its October 1 record high and no longer in a correction, while Value is 8.2% below its record high on January 26. Since the election in late 2016, Growth's 35.8% gain is double the 17.9% increase logged by Value. Looking at the fundamentals, Growth is expected to deliver nearly than double the rate of revenue growth (STRG) that Value does over the next 12 months, but forward earnings growth (STEG) is only slightly higher for Growth. Specifically, 8.1% STRG and 10.7% STEG are projected for Growth, respectively, vs 4.5% and 9.9% for Value. Prior to February's selloff, Growth's P/E of 21.8 on January 26 was its highest since May

2002, while Value's 16.6 on January 3 was its highest since April 2002. Through Monday, Growth's P/E was back up to 18.4 from its 23-month low of 18.0 on October 29, and Value's 13.3 was up from its 53-month low of 12.9 on October 26. Regarding NERI, Growth's was positive in October for an 18th straight month, but dropped to a 10-month low of 7.4% from 8.9% in September; that compares to a record high of 22.3% in March and a five-year low of -16.2% in April 2015. Value's NERI was also positive in October for an 18th month (following 33 months of negative readings), but fell to a 10-month low of 3.7% from 5.3%; that compares to a record high of 21.2% in March and five-year low of -20.3% in April 2015. The Tax Cuts and Jobs Act (TCJA) has boosted the consensus 2018 earnings estimate and the forward profit margin for both Growth and Value. Growth's 2018 estimate has risen 10.9% vs Value's 9.0% gain. Growth's forward profit margin has jumped to 16.6% from 14.4% prior to the TCJA's passage, and is down slightly from its record high of 16.7% during mid-September. Value's forward profit margin was at a record high of 10.2% in October for the first time since its pre-financial-crisis record high during August 2007, and is up from 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): "For two years, small business owners have expressed record levels of optimism and are proving to be a driving force in this rapidly growing economy," said NFIB President and CEO Juanita Duggan. "The October optimism index further validates that when small businesses get tax relief and are freed from regulatory shackles, they thrive and the whole economy prospers." The NFIB Small Business Optimism Index (SBOI) continued its historic two-year streak of record highs, with a reading of 107.5 in October—not far from August's 108.8, which was the highest in the 45-year history of the survey. According to the report, "Overall, small businesses continue to support the 3 percent-plus growth of the economy and add significant numbers of new workers to the employment pool." Last month, only one component contributed positively to October's SBOI—though there wasn't much movement within any of the 10 components—with all remaining at elevated levels. Plans to increase inventories (to 5% from 3%) was the sole positive contributor, while five contributed negatively—though by slim margins—now is a good time to expand (30 from 33), earnings trends (-3 from -1), sales expectations (28 from 29), plans to increase employment (22 from 23), and current inventory (-2 from -1). The remaining four showed no change, with current job openings (38%) holding at its record high, followed by expect the economy to improve (33), capital spending plans (30), and expected credit conditions (-5).

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