



MORNING BRIEFING

January 9, 2019

The Dark Side of the Moon

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

(1) China's lunar landing to collect moon's fairy dust. (2) China's Xi has problems back on Earth. (3) Wilbur Ross disagrees with Tim Cook. (4) China's M-PMIs are below 50.0. (5) China's real retail sales growth slowing. (6) Getting harder to sell autos and apartments in China. (7) Trump and Ross believe China needs a deal badly. (8) The talks are going "well." (9) The end of the ceasefire is approaching. (10) PBOC cutting reserve requirements.

China I: In a Dark Place. China landed a probe on the "dark side" of the moon last Thursday. The landing "heats up competition with U.S. to become the first country in half a century to land astronauts on moon," [observed](#) the 1/3 WSJ. A rover deployed from the probe will gather samples intended to provide insights into the moon's composition. The successful space effort won favorable publicity for Chinese President Xi Jinping, who had personally endorsed the mission.

Xi needs all the positive limelight that he can get. Back at home, China has a serious homegrown economic problem. "China's one-child policy has created a demographic nightmare for the country," I noted in a 12/13 [presentation](#) that I gave to senior members of Trump's economic advisers at the White House. I pointed to slowing retail sales growth as an indicator of the country's economic health. "Hiding in plain sight is that China is seeking to become a super-power before it turns into the world's largest nursing home," I explained. The country is still heavily dependent on trading with the rest of the world. So the Chinese government will likely make an acceptable trade deal with the Trump administration, I predicted.

I anticipated China's recent economic weakness in our 10/1 [Morning Briefing](#): "I'm coming around to a new working hypotheses on the outlook for China's economy. I think it could be much weaker much sooner than widely recognized. A significant slowing in the growth rate of inflation-adjusted retail sales over the past couple of years suggests that the aging demographic factor—attributable to the government's previous population control measure—may be hitting consumer spending significantly already. As a result, Trump's escalating trade war with China may very well hurt China's economy much harder than widely realized."

Lately, it seems to have gotten so bad for China domestically that it may have no choice but to make a trade deal in favor of the US, which could be a boon to US and global equity markets.

China II: Dimming Domestic Economy. More evidence recently has confirmed my earlier hypothesis about China's weakness. Last week, following Apple's announcement that it had lowered its fiscal Q1 revenue guidance, the company's CEO Tim Cook told CNBC: "If you look at our results, our shortfall is over 100 percent from iPhone, and it's primarily in greater China." He added: "It's clear that the economy began to slow there for the second half, and what I believe to be the case is the trade tensions between the United States and China put additional pressure on their economy."

Macroeconomic trends in China are indeed weak. However, Melissa and I agree with Commerce Secretary Wilbur Ross that China's soft economic data may have less to do with the trade dispute and more to do with China's domestic economic problems. "I don't think Apple's earning miss had anything to do with the present trade talks," Ross [said](#) on CNBC's *Squawk Box* on Monday. "Think about it, there have been no tariffs put on Apple products. So that's not it."

As more corporate earnings announcements are released, we expect more multinationals to cite China's economic deterioration. However, we aren't overly concerned about a slowdown in China spilling over to the US because we think that any impact on US multinationals from China's slowdown could be offset by the benefit of more favorable trade terms with China.

Reviewing China's weak trends amid the softening domestic economy and pressure from US tariffs, Ross said: "You look at this morning's paper: Rate of growth in GDP heading down; rate of growth in retail sales heading down; rate of growth in capital investment heading down." Let's have a look at China's latest macroeconomic data:

(1) *Manufacturing contracting*. The official M-PMI, which focuses on larger companies, showed a slowdown in activity for December at a reading of 49.4. It contracted below 50.0 for the first time in 29 months ([Fig. 1](#)).

China's manufacturing activity tends to slow down before the Lunar New Year holiday, which starts in early February. But the concern is that these softening trends don't just reflect seasonal factors but also signify weak demand. The new orders component of the M-PMI was down to 49.7 compared to 53.4 at the same time last year.

The Caixin/Markit Manufacturing Purchasing Managers' Index, a private survey focusing on small and medium companies, also dropped in December, to 49.7 from 50.2 in November.

(2) *Retail sales declining*. Every month, the Chinese report retail sales and the consumer price index (CPI). We've been monitoring the yearly percent changes in both for many years ([Fig. 2](#)). The difference between the two is the growth rate in real retail sales. It has been on a downtrend since 2008-2010, when it typically exceeded 15%. During November, it was down to 5.9%, the lowest reading since May 2003. It is down from 10.0% during March 2017.

(3) *GDP*. China's economic growth slowed to 6.5% y/y in Q3 from 6.7% during Q2 and 6.8% during Q1 ([Fig. 3](#)). The Q3 number was the weakest pace since Q1-2009, according to official Chinese data released during October.

(4) *Auto sales stalling*. "Car sales have been shrinking for the first time since 1990, when most of the country was pedaling bicycles," [observed](#) the *1/3 WP*. The 12-month sum of China's auto sales dropped 4.1% during November since peaking in June ([Fig. 4](#)). Auto production, which is highly correlated with auto sales, also declined, by 4.3%, over the same period.

The downturn in China's car market has left foreign automakers with idle factories. The 12/25 *WSJ* [reported](#) that the lack of production at "one Peugeot factory" has meant that "skilled workers spend their days washing floors or attending Communist Party political study sessions at work. At a Ford plant, workers' shifts have been reduced to a few days a month, according to employees."

(5) *Apartments not selling*. A 12/30 NYT [article](#) titled "Empty Homes and Protests: China's Property Market Strains the World" discussed dropping property sales in China. Unwanted and unsold apartments are "weighing on China's economy." Lots of developers who made big bets on China's

property market are deep in debt.

China III: Bright Spot for the US. On Friday, President Trump told reporters at the White House that he thinks that “China wants to get it resolved. Their economy’s not doing well. I think that gives them a great incentive to negotiate,” [reported](#) Reuters. After a previous call with China’s President Xi on 12/29, Trump [tweeted](#): “Deal is moving along very well. If made, it will be very comprehensive, covering all subjects, areas and points of dispute.”

Beijing is learning how much it depends on the US, Ross [said](#) in the *Squawk Box* interview. Ross added that China’s economic slowdown is a “big problem in their context of having a very big need to create millions of millions of jobs to hold down social unrest coming out of the little villages.” He argued that Chinese workers are migrating to cities to find jobs but are coming back home empty-handed. That’s “a very disgruntled group of people,” he said. He also said that companies are moving manufacturing out of China.

Reuters [wrote](#) on Monday that US venture-backed tech companies are “staying on the safe side of the fence,” avoiding making deals with Chinese investors for “optical reasons.” Considering China’s economic and social ills, the latest round of talks appears to be going quite well for the US. Let’s discuss:

(1) *Where there’s a will.* Beijing and Washington have “expressed a will to work together,” [reported](#) CNBC according to Lu Kang, a representative of China’s foreign ministry on Monday. The Chinese official’s comments were made amid US-China trade talks led by Deputy US Trade Representative (USTR) Jeffrey Gerrish in China. The two-day round of talks ended yesterday.

(2) *China taking this seriously.* A photo posted on Twitter of Liu He, Chinese vice premier and top trade negotiator, at the talks prompted Scott Kennedy, a China expert at the Center for Strategic and International Studies, to comment that Liu He’s attendance and the number of people in the room were “good signs” that “serious working-level discussions” were happening. Also sanguine about the talks is Larry Kudlow, the administration’s chief economic adviser, who told Bloomberg TV on Friday that preliminary discussions were “a little more optimistic than usual.”

Liu’s appearance signals that China is attaching high importance to the talks. On 1/7, Bloomberg [reported](#): “Liu is the top economic adviser to Chinese President Xi Jinping, who led previous negotiations in Washington that produced a deal that President Donald Trump then repudiated. China had previously said the talks would be led by a lower-ranking official from the Ministry of Commerce.”

(3) *So far, so good.* As we write this, the talks in China are carrying on and expected to continue into Wednesday for an [unscheduled](#) third day. Yesterday’s *WSJ* [reported](#): “‘Talks with China are going very well!’ President Trump wrote in a tweet while the negotiations were wrapping up for the day Tuesday after 9 p.m. Beijing time. A Chinese official with knowledge of the talks described the conversations as ‘constructive.’”

More senior-level discussions are anticipated later this month with Liu, USTR Robert Lighthizer, and US Treasury Secretary Steven Mnuchin meeting soon after in Washington, [reported](#) the 12/29 *WSJ*.

The goal of the talks is to ensure that Beijing makes good on promises made since previous talks in early December. US negotiators want specifics from China, like what goods and services it will purchase from the US by specific dates. The US side also wants assurance from Beijing that it won’t use government authority over licensing and environmental regulation to hinder US companies if further access is granted to Chinese markets, [explained](#) the 12/31 *WSJ*. China previously has resisted giving

details around these pledges, having a “poor follow-up record.”

China IV: The End Is Near. China has until March 1 to work out a deal with the US or it will face the higher tariffs. Last year, the US imposed 25% tariffs on \$50 billion of Chinese imports in two phases: \$34 billion (effective July 6, 2018) and \$16 billion ([effective](#) August 23, 2018). Further tariffs of 10% were imposed on an incremental \$200 billion in Chinese imports [effective](#) September 24, 2018. (See our [chart](#) as well as this helpful [timeline](#) from Peterson Institute for International Economics.) On September 17, the White House released a [Statement from the President](#) stating that the tariffs on the \$200 billion were set to rise to 25% on January 1.

On September 7, President Trump [threatened](#) to impose tariffs on all Chinese imports to the US, which amounts to about \$500 billion in total. During December, Trump softened on the matter following trade meetings with Chinese leadership. According to a 12/1 White House [press release](#), Trump agreed to leave the tariffs on the \$200 billion at 10% for a 90-day grace period until a deal is reached. If no deal is reached by 3/1, the 10% tariffs will be increased to 25%.

The 1/1 NYT [reported](#) that Lighthizer has taken a consistently harsh stance in negotiations with China. Lighthizer “has warned Mr. Trump that the United States may need to exert more pressure through additional tariffs in order to win true concessions.”

Lighthizer [said](#) on *Face the Nation* on 12/9 that March 1 is a hard deadline. He explained: “When I talked to the President of the United States, he’s not talking about going beyond March. He’s talking about getting a deal. If there is a deal to be gotten, we want to get it in the next 90 days.”

China V: Not So Easy. China will likely need to do something more to reinvigorate its darkening economic outlook. On Friday, the People’s Bank of China (PBOC) [cut](#) bank reserve requirements by a full percentage point to support China’s slowing economy amid pressure from US tariffs on imports of Chinese goods ([Fig. 5](#)).

The PBOC’s reserve cut was the first for 2019 but the fifth in a year. The PBOC introduced a new tool in December, the targeted medium-term lending facility, to encourage commercial banks to give out more loans to smaller firms. The government has said it will step up other policy support as well, such as infrastructure spending and tax cuts.

Late in December, Chinese leaders had pledged to keep monetary policy prudent, striking an “appropriate” balance between tightening and loosening in 2019. It dropped “neutral” as a policy description. Bloomberg [observed](#) that the new language, along with moves to boost private-sector funding, prompted speculation that cuts to bank reserve-ratio requirements or benchmark interest rates would be forthcoming in 2019.

Meanwhile, China’s M2 measure of money supply has been declining since reaching a 14.0% y/y growth rate in January 2016, falling to 8.0% in November—the lowest rate in the history of the series going back to January 2000 ([Fig. 6](#)). Significantly, China’s real retail sales growth is highly correlated with China’s real M2 ([Fig. 7](#)). Both have been trending in the wrong direction for China.

Staving off China’s economic slowdown would likely take further action from the central bank as well as significant concessions in the trade talks with the US.

CALENDARS

US. Wed: MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Minutes, Bostic, Evans,

Rosengren. **Thurs:** Jobless Claims 222k, EIA Natural Gas Report, Powell, Barkin, Clarida, Bullard, Evans. (Econoday estimates)

Global. Wed: Eurozone Unemployment Rate 8.1%, Germany Trade Balance €24.8b, Mexico CPI 4.85% y/y, BOC Rate Decision 1.75%, Carney. **Thurs:** China New Yuan Loans (CNY) 825.0B, China CPI & PPI 2.1%/1.6% y/y, China Aggregate Financing (CNY) 124.5B, Japan Trade Balance -¥612.6b, Japan Leading & Coincident Indexes 99.5/103.0, ECB Publishes Account of December 12-13 Governors Council Meeting. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): All of these price indexes are up so far in 2019, but remain in a correction or a bear market from their record highs near the end of Q3. After leading for much of 2018, SmallCaps have struggled mightily since late August. Here's how they rank ytd through Monday's close, along with their percentage changes since SMidCap's record highs in late August and LargeCap's on September 20: Russell SmallCap 2000 (4.2% ytd, -19.3% from record high), S&P SmallCap 600 (3.5d, -20.4), S&P MidCap 400 (2.4, -16.9), Russell LargeCap 1000 (1.8, -13.2), and S&P LargeCap 500 (1.7, -13.0). However, forward revenues and earnings are at or near record highs now for all the S&P and Russell indexes, but have flattened in recent weeks. Forward earnings momentum remains healthy compared to the past due to the boost from the Tax Cuts and Jobs Act (TCJA), as the yearly change in forward earnings is up from six-year lows in early 2016, but has clearly peaked. In the latest week, the rate of change in LargeCap's forward earnings fell to an 11-month low of 17.3% y/y from 18.1%. 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 was down to a 12-month low of 18.8% from 19.4%, 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 a nine-month low of 25.4% from 26.3%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts are dropping now. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 7.2%, 11.1%), MidCap (21.6, 9.4, 11.2), and SmallCap (22.6, 14.6, 15.5).

S&P 500 Growth vs Value ([link](#)): The S&P 500 Value index is up 1.8% ytd through Monday's close, slightly ahead of the 1.6% gain for its Growth counterpart. However, both of these indexes are in a correction now. Growth is now 14.0% below its October 1 record high, while Value is 14.8% below its record high on January 26. Since the election in late 2016, Growth's 27.9% gain is nearly triple the 9.4% increase logged by Value. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) than Value over the next 12 months, but forward earnings growth (STEG) is lower for Growth. Specifically, 7.1% STRG and 3.1% STEG are projected for Growth, respectively, vs 5.0% and 7.1% for Value. Prior to the selloff in February 2018, Growth's P/E of 21.8 on January 26, 2018 was its highest since May 2002, while Value's 16.6 on January 3, 2018 was its highest since April 2002. Through Monday, Growth's P/E was back up to 19.6 from its 50-month low of 15.9 on December 24, and Value's 12.0 was up from a six-year low of 11.5 on January 3. Regarding NERI, Growth's was negative in December for the first time in 20 months, as it fell to -3.2% from 0.1%; that compares to a record high of 22.3% in March 2018 and a five-year low of -16.2% in April 2015. However, Value's NERI was negative in December for a second month and at a 33-month low as it fell to -4.6% from -0.5%; that compares to a record high of 21.2% in March 2018 and five-year low of -20.3% in April 2015. The TCJA sharply boosted the consensus forward earnings estimate and the forward profit margin for both Growth and Value. Growth's forward profit margin of 16.6% is up from 14.4% prior to the TCJA's passage, but down slightly from its record high of 16.7% during mid-September. Value's forward profit margin is at a record high of 10.5%, up from 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): “Recently, we’ve seen two themes promoted in the public discourse: first, the economy is going to overheat and cause inflation and second, the economy is slowing and the Federal Reserve should not raise interest rates,” said NFIB Chief Economist Bill Dunkelberg. “However, the NFIB surveys of the small business half of the economy have shown no signs of an inflation threat, and in real terms Main Street remains very strong, setting record levels of hiring along the way.” The NFIB Small Business Optimism Index (SBOI) fell for the fourth month since reaching a record high of 108.8 in August, slipping to 104.4 at the end of last year—still a historically high reading. The SBOI is still 9.5 points above its reading just before the November 2016 election. Last month, four of the 10 components of the SBOI rose, while six fell. Job openings (to 39% from 34%) set a new record high, while job creation plans (23 from 22) moved back toward August’s record high of 26%. Meanwhile, current inventory (-1 from -5) and inventory investment plans (8 from 2) both posted solid gains. On the downside, the main drags came from economic expectations (16 from 22), expected business conditions (24 from 29), and plans to make capital outlays (25 from 29), though the first two remain well above their historical averages. Finding qualified workers, at 23%, continued to be the single most important business problem reported by small businesses.

JOLTS ([link](#)): Job openings in November fell for the second time in three months, but remained near August’s record high of 7.293 million. Openings fell -243,000 in November, and -405,000 since August, to 6.888 million. (Yesterday, NFIB reported that a record 39% of small business owners had job openings they could not fill in December.) Meanwhile, hirings also fell for the second time in three months, following a record high of 5.906 million in August, contracting -196,000 to 5.710 million. Total separations have dropped 272,000, to 5.507 million, since August’s peak of 5.779 million—which was the highest level since January 2001. The latest hiring and separations data yielded an employment advance of 203,000 for November, 27,000 above November’s payroll increase of 176,000—overstating the increase for the second month. Job quitters fell for the third month since reaching a record high in August, sliding -241,000 to 3.407 million. November’s private industry job-opening (4.7%) rate once again was little changed from August’s record high of 4.9%, while the quit (2.5) rate fell further below its cyclical high of 2.7%, recorded during all three months of Q3. The total hire rate (4.2) is in a volatile flat trend around its cyclical high. November’s ratio of unemployed workers per job opening was below 1.00 for the ninth month—at 0.87—barely budging from August’s record low of 0.85.

GLOBAL ECONOMIC INDICATORS

Germany Manufacturing Orders ([link](#)): Orders in November fell for the first time in four months, led by a double-digit decline in billings from within the Eurozone, as well as a drop in aircraft orders—after a sizeable jump in October. November billings sank a larger-than-expected -1.0%, as foreign orders from within the Eurozone plummeted -11.6%—the largest decline since December 2008—after a two-month jump of 8.7%. Meanwhile, foreign orders from outside the Eurozone expanded for the third time in four months, by 2.3% m/m and 8.1% over the period. Domestic orders also rose in November, by 2.4%, after a -3.8% loss and a 2.8% gain the previous two months. Orders for the main industry groupings are mixed. Capital goods billings are the strongest, soaring 6.8% during the four months through November, led by a 14.0% surge in foreign demand from outside the Eurozone, along with a 2.8% advance in domestic orders; foreign billings from inside the Eurozone were flat over the four-month span. Meanwhile, intermediate goods orders fell for the third time in four months, by a total of -5.7%, with both foreign (-6.6%) and domestic (-4.9) demand in the red over the period. Consumer goods orders dropped -5.0% during the two months ending November, driven by declines in foreign orders from both outside (-9.8) and inside (-8.4) the Eurozone; domestic demand rose 1.4% over the two-month period.

Germany Industrial Production ([link](#)): Output in November fell for the third month, to its lowest level since January 2017. Germany's headline production—which includes construction—sank -1.9% m/m and -2.7% over the three months through November. Excluding construction, output contracted for the fifth time in six months, by -1.9% m/m -4.8% over the six-month span. Factory production has contracted -4.7% since reaching a record high in May. The main industrial groupings show consumer nondurable (-9.7%), consumer durable (-4.7), capital (-4.4), and intermediate (-3.4) goods output all in the red over the six-month period. Germany's M-PMI for December fell to a 33-month low of 51.5—posting its 11th decline since December's 2017's record high of 63.3. According to the report, the performance of the manufacturing sector continued to be undermined by falling inflows of new orders. December's decrease was the third in as many months and the steepest since November 2014—with new export orders showing the steepest fall in six years, as a number of firms reported lower sales to China. Output, however, rose slightly in December, and at a marginally quicker rate than in both October and November.

Eurozone Economic Sentiment Indicators ([link](#)): The Economic Sentiment Index (ESI) fell markedly in both the Eurozone (-2.2 points to 107.3) and the EU (-2.0 to 107.6) in December, with the former down -7.9 points and the latter down -7.4 points since reaching 17-year highs of 115.2 and 115.0, respectively, during December 2017. It's the lowest reading since January 2017 for the Eurozone and November 2016 for the EU. ESI's deteriorated significantly in four of the five largest Eurozone economies last month—Spain (-3.0 points to 104.1, 28-month low), France (-2.0 to 102.8, 26-month low), Germany (-1.9 to 109.9, 19-month low), and Italy (-1.4 to 104.5, 24-month low), while the Netherlands' (-0.3 to 108.0, 19-month low) fell marginally. At the sector level, sentiment fell in four of the five industries included in the ESI: industry (-2.3 points to 1.1, 23-month low), consumer (-2.3 to -6.2, 22-month low), services (-1.4 to 12.0, 25-month low), and construction (-1.0 to 7.2, 4-month low), while confidence in the retail trade (+0.5 to 0.0, 3-month high) sector ticked up.

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