



MORNING BRIEFING

February 26, 2019

From MOU to MAMU?

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

(1) Extending the deadline. (2) Open issues include how to enforce a deal. (3) Trump has a tiff with Lighthizer. (4) Both Xi and Trump need a deal. (5) Once again, "it's the economy, stupid." (6) Diverging labor markets: Strong in US, weak in China. (7) The Cheerleader-in-Chief: Trump likes meltdowns more than meltdowns in the stock market. (8) Global stock and commodity markets discounting a trade deal and better global growth. (9) The forex and bond markets are sitting on the fence. (10) No recession in credit yield spreads.

Strategy I: Let's Make a Deal. President Donald Trump said on Friday there was a "good chance" a US-China trade deal would emerge soon. On Monday, he extended the March 1 deadline for the talks between the two nations. He expects to meet with Chinese President Xi Jinping during March to seal a deal. Extending the deadline strongly suggests that progress has been made, and should continue to be made, toward a final agreement. Extending the deadline puts on hold a scheduled increase in tariffs to 25% from 10% on \$200 billion worth of Chinese imports into the US.

The negotiations over the weekend focused on changes to China's treatment of state-owned enterprises, subsidies, forced technology transfers, and cyber theft, according to a 2/24 Reuters [story](#). The two sides are still discussing an enforcement mechanism. Washington obviously wants a tough one, while the Chinese are talking about a "fair and objective" process.

Last Wednesday, Reuters reported that both sides were drafting memorandums of understanding (MOUs) on cyber theft, intellectual property rights, services, agriculture, and non-tariff barriers to trade, including subsidies. However, Trump said he did not like MOUs because they are short-term, and he wanted a long-term deal.

On Friday, in front of China's top negotiator and assembled US officials and journalists, Trump dressed down his own top negotiator, Robert Lighthizer, the US Trade Representative (USTR), saying: "I don't like MOUs because they don't mean anything." In defense of MOUs, Lighthizer responded: "An MOU is a binding agreement between two people. It's detailed. It covers everything in great detail. It's a legal term. It's a contract."

Ticked off at being corrected by his USTR, Trump snapped: "By the way I disagree. We're doing a memorandum of understanding that will be put into a final contract, I assume. But to me, the final contract is really the thing, Bob ... is really the thing that means something. A memorandum of understanding is exactly that; it's a memorandum of what our understanding is. The real question is, Bob ... how long will it take to put that into a final binding contract?"

Lighthizer quickly retreated, saying: "From now on, we're not using the word 'memorandum of understanding' anymore. We're going to use the term 'trade agreement.' We're never going to use 'MOU' again."

Whatever the final agreement is called, both sides need a deal, as Melissa and I have argued many times before. For both the Chinese and American presidents, it's about "the economy, stupid":

(1) *President Xi needs a deal.* China's economy has been slowing rapidly over the past year. We think that the underlying problem is mostly homegrown, i.e., rooted in China's rapidly aging demographic profile caused by the disastrous one-child policy from 1979-2015. A trade war with the US would only exacerbate China's economic woes.

According to a 2/2 [article](#) in *The Diplomat*, "Judging from the recent developments, the risk of unemployment in China is increasing and the unemployment rate is approaching a dangerous level." China's manufacturing industry is showing signs of stress. For example, Foxconn, the contract manufacturing giant, is reportedly set to cut 340,000 jobs worldwide and cut around \$3 billion in spending in 2019. In November, a study of Tencent Technology found that Foxconn had less overtime work.

A 2/11 [article](#) in *South China Morning Post* reported: "Employment has also fallen at firms in once-booming sectors, including the internet, hi-tech and online game start-ups, and even at those with famous domestic brands, according to industry insiders. Small businesses are increasingly struggling with shrinking foreign orders due to US tariffs, tight cash flows, a depreciating yuan that raises the cost of imported materials and soaring domestic costs for energy, taxes, rent and labour, causing the entire venture capital community to become very cautious about investing."

China's official M-PMI has been just below 50.0 (i.e., in contraction territory) for the past two months through January ([Fig. 1](#)). The employment component was at the 50.0 mark during March 2017, and has been trending lower since then, falling to 47.8 in January ([Fig. 2](#)).

Chinese President Xi warned on January 21 that the Communist Party needed to pay particular attention to the risks to social stability posed by rising economic problems, as evidence increasingly suggests that the nation's employment situation is deteriorating rapidly, particularly among small and medium-sized businesses.

(2) *President Trump needs a deal.* While his Chinese counterpart is worrying about employment in China, Trump can take solace in the strength of the US labor market. However, Trump also gives a lot of weight to the stock market. He was obviously distressed by the plunge in US stock prices during December. So he frequently tried to revive the market by suggesting that US trade negotiations with China are going well.

His cheerleading seems to be working, notwithstanding his MOU tiff with his USTR. The year-end 2018 stock-market meltdown has already been followed by a significant meltup. Stock prices have recovered almost all of what was lost during last year's 19.8% correction from September 20 through December 24. Trump would love to get a deal done that would spark the Mother of All Meltups (MAMU).

Here is the performance derby of the S&P 500 and its 11 sectors since Election Day (November 8, 2016) through Monday's close: Information Technology (55.5%), Consumer Discretionary (39.1), Health Care (35.6), Financials (32.6), S&P 500 (30.7), Industrials (27.8), Materials (18.6), Utilities (14.9), Real Estate (14.7), Consumer Staples (3.2), Communication Services (-1.4), and Energy (-5.2) ([Fig. 3](#)). The 12/24 close last year for the S&P 500 showed a gain of only 9.9% since the election. Since then, through Monday's close, the S&P 500/400/600 are up 30.7%, 27.7%, and 35.6% ([Fig. 4](#)).

Strategy II: Impact of a Deal on Markets. It's not too hard to predict the likely impact of a China-US

trade deal on financial markets. That's because markets are doing what markets usually do, namely discounting the most likely scenario. Will they reverse course on the news? Probably not, unless the outcome is unexpected—like no deal triggering more US tariffs. That conclusion doesn't really depend on the specifics of the deal. All the markets want is to hear Trump declare victory, whether the US actually is victorious or not. In other words, the markets want this issue put in the past. Of course, Trump might then escalate his trade war with Europe, but negotiating a deal with that region might be easier after a deal is done with China.

The message from the markets recently has been that a deal should lift global economic growth. It probably will do so. However, our research at YRI has increasingly identified aging global demographic trends as a more structural weight on global growth. For now, let's review what the markets are saying:

(1) *Global stock markets.* Notwithstanding weak global economic activity, the US stock market isn't the only one in rally mode. Here is the ytd performance derby of the major MSCI stock prices indexes in local currency terms through yesterday's close: United States (11.8%), World (10.8), EMU (9.9), Emerging Markets (9.6), Japan (8.6), and the United Kingdom (6.7) ([Fig. 5](#)). The US MSCI has been outperforming these other major indexes since late last year, both in dollars and in local currencies ([Fig. 6](#)). Joe and I remain in the Stay Home camp, recommending overweighting the US relative to a Go Global investment strategy.

The stock market rally in emerging markets this year has been triggered by the Fed's pivoting from gradually hiking rates to pausing the normalization of monetary policy. Mounting signs of a China-US trade deal have also boosted EM stock markets, and should continue to do so if and when a deal is announced. The China MSCI is up 21.5% in yuan since its October 30 trough last year ([Fig. 7](#)). The Shanghai-Shenzhen 300 is up 19.9% since then ([Fig. 8](#)).

(2) *Commodity markets.* The recent rebound in the nearby futures price of copper is confirming the rally in the China MSCI, since the two tend to be highly correlated, not surprisingly ([Fig. 9](#)). So too is the rebound in the nearby futures price of a barrel of Brent crude oil, which is also highly correlated with the copper price ([Fig. 10](#)).

While the prices of copper and oil are signaling better global economic activity, the CRB raw industrials index, which includes the former but not the latter, seems to be bottoming rather than pointing to a significant rebound in global economic growth ([Fig. 11](#)).

(3) *Currency markets.* Also on the fence is the US trade-weighted dollar ([Fig. 12](#)). It tends to weaken (strengthen) when the global economy is strong (weak) relative to the US economy. It was very strong last year, rising 5.0%. So far this year, it is down 1.3% through last Friday, but still up 6.1% y/y.

The euro, the pound, and the yen all are weighed are down by lackluster growth in their respective home economies, where central banks seem to be likely to ease again. While there has been some chatter suggesting that the Fed's next move might be to lower, rather than to raise, the federal funds rate, it's more likely that the other major central banks will ease up before the Fed does so.

By the way, Melissa and I also track the Emerging Markets MSCI currency ratio (in dollars per local currency). It fell 5.0% last year, and is up 0.9% ytd through Monday's close ([Fig. 13](#)). So it too is only tentatively confirming better global growth ahead.

(4) *Global bond markets.* The global bond markets are also on the fence. The yields on 10-year bonds issued by governments in developed nations certainly aren't anticipating a global boom: Japan -0.04%, Germany 0.11%, Sweden 0.31%, France 0.52%, and the UK 1.07% ([Fig. 14](#)). The US yield stands out

at 2.67%, but remains well below the growth of nominal GDP at 5.5% y/y during Q3-2018.

On the other hand, credit quality yield spreads, which widened late last year, have narrowed since the start of this year as fears of an impending recession have dissipated.

CALENDARS

US. Tues: Consumer Confidence Index 124.5, Housing Starts & Building Permits 1.256mu/1.280mu, Richmond Fed Manufacturing Index 1, S&P Corelogic Cash-Shiller HPI 4.5%, FHFA Price Index 0.4%, Powell. **Wed:** Factory Orders 0.6%, Advanced Merchandise Trade, Pending Home Sales 0.9%, MBA Mortgage Applications, EIA Petroleum Status Report. (Econoday estimates)

Global. Tues: Germany Gfk Consumer Confidence 10.8, Carney, Ramsden, Vlieghe, Haskel at Parliament Committee. **Wed:** Canada CPI 0.1%*m/m*/1.4%*y/y*, Japan Industrial Production - 2.5%*m/m*/1.3% *y/y*, Japan Retail Trade -0.9%*m/m*/1.5%*y/y*. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell w/w for all three of these indexes, continuing the trend that began in late October. LargeCap's forward EPS is now 2.3% below its record high of \$175.48 in late October, while MidCap's and SmallCap's are now 2.6% and 6.3% below their mid-October highs, respectively. LargeCap's forward EPS is the most below its record high since June 2016, while MidCap and SmallCap have not been this far below since March 2016 and December 2010, respectively. The yearly change in forward earnings remains healthy compared to the past due to the boost from the Tax Cuts and Jobs Act (TCJA), but is tumbling now as y/y comparisons become more difficult. In the latest week, the rate of change in LargeCap's forward earnings fell to a 25-month low of 6.9% y/y from 7.5%. 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 24-month low of 8.3% from 8.8%, 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 14-month low of 11.5% from 12.8%, 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 have been dropping since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 4.0%, 11.8%), MidCap (22.7, 4.3, 12.2), and SmallCap (24.5, 6.8, 16.5).

S&P 500/400/600 Valuation ([link](#)): Forward P/E ratios rose across the board w/w for all three of these indexes, which are up now from multi-year lows in late December. LargeCap and MidCap are at their highest levels since early October, and the SmallCaps is the highest since late September. LargeCap's weekly forward P/E of 16.3 is up from 16.2 a week earlier and from a five-year low of 13.9 during December. That compares to a six-month high of 16.8 in mid-September and 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. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E of 15.9 is up from 15.8 last week and from 13.0 during December, which was the lowest reading since November 2011. 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, 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 of 17.2 is up from 16.9 a week earlier and from 13.6 during December, which had also marked its lowest reading since November 2011. 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). SmallCap's P/E was higher than LargeCap's P/E for a

sixth week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q4 earnings season nearly 90% finished, analysts are essentially done revising their Q1 forecasts. Last week saw the S&P 500's Q1-2019 EPS forecast drop 17 cents w/w to \$37.76. That's down 8.8% since the end of Q3. The \$37.76 estimate represents a forecasted pro forma earnings decline for Q1-2019 of 0.8%, compared to -0.5% a week earlier and 5.3% at the end of Q4. If it comes to past, Q1's y/y decline would be its first after 10 straight gains, and down from 16.3% in Q4 and 28.4% in Q3 (which marked the peak of the current earnings cycle). Just four of the 11 sectors are expected to record positive y/y earnings growth in Q1-2019, with none rising at a double-digit percentage rate. That compares to 10 positive during Q4, when six rose at a double-percentage rate. Five sectors are expected to beat the S&P 500's Q1 growth rate, compared to just three during Q4. Utilities is the only sector expected to post better growth on a q/q basis during Q1. Here are the latest forecasted Q1-2019 earnings growth rates versus their blended Q4-2018 growth rates: Health Care (5.7% in Q1-2019 versus 13.3% in Q4-2018), Industrials (5.6, 27.2), Financials (4.2, 14.6), Real Estate (2.6, 7.1), Utilities (0.0, -10.5), Consumer Staples (-1.3, 4.5), Consumer Discretionary (-2.6, 14.6), Communication Services (-5.5, 26.4), Information Technology (-6.3, 9.9), Materials (-12.4, 3.3), and Energy (-14.4, 82.8). On an ex-Energy basis, analysts expect S&P 500 earnings to drop 0.2% y/y in Q1, well below the 13.6% in Q4.

S&P 500 Q4 Earnings Season Monitor ([link](#)): With over 88% of the S&P 500 companies finished reporting earnings and revenues for Q4-2018, y/y revenue and earnings growth remains strong, but the surprise metrics have weakened relative to Q3's results due to Q4's trading turmoil and slowing growth in China. Of the 444 companies in the S&P 500 that have reported through mid-day Tuesday, just 70% exceeded industry analysts' earnings estimates. Collectively, the reporters have exceeded forecasts by an average of 3.5% and averaged a y/y earnings gain of 14.4%. If those results hold until the end of the quarter, it would mark the smallest earnings beat since Q2-2014 and the slowest y/y growth since Q3-2017. On the revenue side, just 60% of companies beat their Q4 sales estimates so far, with results coming in 0.6% above forecast and 5.9% higher than a year earlier. That marks the smallest revenue beat since Q4-2016, and revenue growth is the slowest in five quarters. Earnings growth is positive y/y for 72% of companies, versus a higher 87% at the same point in Q3, and Q4 revenues have risen y/y for 75% versus a higher 82% during Q3. Looking at earnings during the same point in the Q3-2018 reporting period, a higher percentage of companies (77%) in the S&P 500 had beaten consensus earnings estimates by a greater 6.9%, and earnings were up a higher 28.1% y/y. With respect to revenues at this point in the Q3 season, a similar 60% had exceeded revenue forecasts by a higher 1.5%, and sales rose a greater 9.2% y/y. Excluding the Financials' sector, the earnings surprise improves to 4.6% from 3.5%, but the revenue beat edges down to 0.6% from 0.7%. With just over 10% of the companies left to report, the Q4 results are not likely to change drastically. Q4-2018 should mark the tenth straight quarter of positive y/y earnings growth and the 11th of positive revenue growth, but the slowdown in revenue and earnings growth from Q3 is readily apparent.

US ECONOMIC INDICATORS

Regional M-PMIs ([link](#)): Three Fed districts have now reported on manufacturing activity for February—Philadelphia, New York, and Dallas—and show only modest growth, as the Philly area contracted for the first time since May 2016. We average the composite, orders, and employment measures as data become available. The composite (to 5.9 from 7.3) index this month nearly matched December's 5.2 pace—which was the slowest since October 2016; this index peaked at 27.6 a year ago. The Philadelphia region's composite (-4.1 from 17.0) index shows growth collapsed this month, down from a recent peak of 32.3 just nine months ago. Gauges for both New York (8.8 from 3.9) and Dallas (13.1 from 1.0) accelerated—with the latter continuing to rebound from its dip into negative territory at the end of last year. The new orders gauge (4.0 from 12.1) grew at its slowest pace since

September 2016—moving closer to the breakeven point of zero. Billings in the Philadelphia (-2.4 from 21.3) region contracted for the first time since summer 2016, while New York's (7.5 from 3.5) showed a slight acceleration and Dallas' (6.9 from 11.6) posted its slowest growth since November 2016. Meanwhile, hiring accelerated according to the employment (10.4 from 7.9) measure, with Philadelphia's (14.5 from 9.6) and Dallas' (12.6 from 6.6) factories adding to payrolls at a faster pace this month, and New York's (4.1 from 7.4) at a slower pace. In the meantime, inflationary pressures remained on an easing trend according to prices-paid indexes for the three regions, while the prices-received measures were a mixed bag. Here's a look at the prices-paid indexes for February versus their respective peaks during 2018: Philadelphia (to 21.8 from 60.0), New York (27.1 from 54.0), and Dallas (21.8 from 54.4). Meanwhile, Dallas' prices-received index continued to ease from June 2018's peak of 26.2, falling to 5.2 this month, while New York's measure accelerated for the second month from 12.8 in December to 22.9 this month—nearly matching its recent peak of 23.3 last June. The prices-received index for the Philly region has hovered in a flat trend around 27.5, still below its peak of 35.0 last July.

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