



MORNING BRIEFING

May 15, 2019

The Recession Question

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

(1) US economy dwarfs trade flows. (2) Higher tariffs on Chinese goods not likely to boost inflation much. (3) Iran launches a proxy war against the US and its Gulf allies. (4) No recession for earnings during Q1. (5) Expecting double-digit earnings growth in 2020. (6) Remarkably optimistic outlook for S&P 500 revenues. (7) Profit margin getting squeezed, but remains historically high. (8) The Fed is monitoring financial stability. (9) A few signs of stress in credit system, but no cracks.

Geopolitics I: China Risk. Could the escalating trade war between the US and China cause a recession in the US? Debbie and I doubt it. The US economy is huge. US trade with China is relatively small, as we reviewed on Monday.

US nominal GDP totaled a record \$21.1 trillion (saar) during Q1 ([Fig. 1](#)). During the same quarter, US nominal exports of goods and services totaled \$2.5 trillion (saar), while US nominal imports of goods and services totaled \$3.1 trillion (saar) ([Fig. 2](#)). Over the 12 months through March, US merchandise exports to China totaled \$114 billion, while imports from China totaled \$522 billion ([Fig. 3](#)).

But wouldn't a 25% tariff on everything that the US imports from China boost inflation in the US and depress consumer spending? It's unlikely that the Fed would raise interest rates in response to what would be a one-shot boost to the inflation rate from higher-priced Chinese goods. However, those higher prices could reduce the purchasing power of American consumers. We doubt that will happen. The tariff may not be fully passed onto US consumers. Importers might absorb some of the increased cost of doing business with China, which would squeeze their profit margins. Some might respond by moving their supply chain away from China to other countries that don't have the tariff burden. The Chinese yuan might continue to fall, offsetting some of the tariff cost.

Despite the 10% tariff imposed on \$200 billion of Chinese imports last year, the US import price index for Chinese goods fell 1.1% y/y through April ([Fig. 4](#)). The yuan is down 8% y/y ([Fig. 5](#)).

Geopolitics II: Iran Risk. We actually see more risk for the world economy brewing in the Middle East than in Trump's trade war with China. Consider the following recent developments:

(1) The United Arab Emirates said that four ships were damaged on Sunday in its coastal waters near the Strait of Hormuz, the vital waterway to the Persian Gulf, through which much of the world's oil flows. On Monday, the Saudi government said two of the ships damaged in this apparent act of sabotage were Saudi tankers. The US and its Gulf allies suspect that Iran was behind the attacks.

(2) Yesterday, a Saudi oil pipeline was attacked by drones, causing "limited damage," according to the Saudi energy minister. The announcement came shortly after Iranian-aligned Houthi rebels in Yemen claimed, in a report on a TV station run by the Houthis, to have carried out an attack with seven drones that "targeted vital Saudi facilities."

(3) The Pentagon recently moved an aircraft carrier, B-52 bombers, a Patriot missile interceptor battery, and more naval firepower to the Gulf region. That was in response to new intelligence reports indicating that Iran is building up its proxy forces' readiness to fight and was preparing them to attack American forces in the region.

(4) The 5/13 *NYT* [reported](#): "At a meeting of President Trump's top national security aides last Thursday, Acting Defense Secretary Patrick Shanahan presented an updated military plan that envisions sending as many as 120,000 troops to the Middle East should Iran attack American forces or accelerate work on nuclear weapons, administration officials said."

So far, the impacts of all these developments on the price of oil have been muted. The risk is that the situation could deteriorate significantly and cause oil prices to soar. There's a history of rapidly rising oil prices causing global recessions ([Fig. 6](#)).

S&P 500 Earnings & Revenues: A Heck of a Hook. Notwithstanding the geopolitical risks discussed above, we think that the US economy will continue to grow without experiencing a recession over the rest of this year and all of next year. We remain bullish on the stock market, recognizing that the rally since 12/26 could stall for a while until these geopolitical risks either diminish or turn into background noise, as we expect. We continue to focus on weekly developments for S&P 500 revenues and earnings, which remain constructive, in our opinion. Consider the following:

(1) *Catching a whale.* We can catch a whale with the earnings "hook" that occurred during the Q1 earnings reporting season. We've previously observed that industry analysts have this bizarre tendency to lower their earnings estimates in the weeks before earnings seasons begin. More often than not, the results turn out to be better than they expected. Déjà vu all over again: During the 4/11 week, they estimated a 2.5% y/y decline in S&P 500 earnings, the first since H1-2016 ([Fig. 7](#) and [Fig. 8](#)). With 90% of S&P 500 companies having reported, the Q1 result rose to a solid increase of 4.8% during the 5/9 week. That's a big hook.

On the other hand, Q2-Q4 estimates were lowered, presumably in response to cautious guidance by company managements during their latest conference calls. Indeed, the Q2 growth estimate is now down to -0.4%, while Q3 is just 1.7%. Earnings hooks should prevail again during those two quarters, thus ruling out an earnings recession over the rest of this year.

(2) *2020 vision.* Next year, barring an economic recession, comparisons will be easier, resulting in faster earnings growth. Consensus earnings growth expectations may be bottoming for this year at 3.4% during the 5/2 week ([Fig. 9](#)). The expectations for next year have been relatively steady in recent weeks around 11.0%.

(3) *Record-high forward revenues.* Joe and I remain amazed by the strength in analysts' consensus expectations for S&P 500 forward revenues. While their estimates for both 2019 and 2020 have edged lower in recent weeks, reflecting macroeconomic evidence of a global slowdown, forward revenues (the time-weighted average of the estimates for this year and next year) continued to rise to a record high during the 5/2 week ([Fig. 10](#)).

We aren't sure why this is happening. Perhaps industry analysts were starting to discount a US-China trade deal. That's unlikely. We doubt that they succumbed to the Trump administration's siren song, which turned out to be prematurely optimistic based on the apparent setback to the trade talks last week.

In any event, we note that the weekly S&P 500 forward earnings series is a very good coincident indicator of the actual quarterly data for S&P 500 revenues ([Fig. 11](#)).

(4) *Falling profit margin*. Similarly, S&P 500 forward earnings tends to be a good year-ahead leading indicator of actual S&P 500 operating earnings ([Fig. 12](#)). The former has turned up over the past 11 weeks through the 5/9 week, but remains slightly below the record high during the 10/26 week.

As a result, the weekly consensus expected S&P 500 profit margin continues to fall. We calculate it using the consensus expected earnings and revenues weekly series. The margin estimate for 2019 at 11.6% just dropped below the 12.0% reading for 2018 ([Fig. 13](#)). The 2020 estimate is also falling, but remains high at 12.3%.

The forward profit margin is a good coincident indicator of the actual quarterly margin ([Fig. 14](#)).

The Fed: Monitoring Risks to Financial Stability. Asset valuations remain elevated, and corporate debt is historically high, warned the Fed in its recently released May 2019 [Financial Stability Report](#). We knew that already from the previous—and first—[issue](#) of this publication, dated November 2018. The publication was designed to promote financial stability, in keeping with the Fed’s dual mandate.

Neither issue of the report presented any surprise risks, but the May issue—while cautionary on a couple of counts—provided even less reason to worry. Asset valuations have eased since November, borrowing among households remains modest, large US banks are well capitalized, financial-sector leverage is healthy, and funding risks remain low. The upshot is good news: Financial stability remains markedly improved versus the years leading up to the financial crisis. But let’s dig a bit deeper into the Fed’s financial stability risk watch-list:

(1) *Corporate debt elevated, but not-to-worry conclusion holds for now*. Elevated leverage in the nonfinancial business sector is worth watching. May’s issue again noted a pickup in the issuance of risky debt and the continued deterioration in underwriting standards on leveraged loans. But this didn’t change our prior not-too-worried conclusion (see our [3/12/19](#) and [11/27/18 Morning Briefings](#)).

Total corporate business credit amounted to \$9.7 trillion as of year-end 2018. It has grown 5.0% on average annually from 1997 to 2018. The red flag is that this debt has “expanded more rapidly than output for the past several years, pushing the business-sector credit-to-GDP ratio to historically high levels.” The growth has been characterized by “large increases in risky forms of debt” (i.e., institutional leveraged loans and high-yield and unrated bonds).

That said, business-sector debt growth slowed in 2018 to 3.0%. Also, notwithstanding a deterioration in credit standards, the default rate on leveraged loans dipped down to a historically low level as of Q1-2019. Broader corporate credit performance “remained favorable,” supported by the strong economy and low interest rates.

(2) *Corporate bond mutual fund liquidity a worry, but functioning for now*. Primarily, the Fed remains concerned that corporate bond mutual funds’ “holdings of corporate debt have grown notably in recent years.” If a downturn were to occur, corporate distressed debt investors could take a big hit. But we doubt that would result in a wider systemic bust.

These holdings have grown substantially since November, when they were “estimated to hold about one-tenth of outstanding corporate bonds, and loan funds purchase about one-fifth of newly originated leveraged loans.” As of May’s report, the first figure had grown to a one-sixth share, while the latter

remained at one-fifth.

In total, US corporate bonds held by mutual funds as of Q4-2018 amounted to \$1.4 trillion, triple a decade ago. Riskier high-yield corporate bond mutual funds “more than doubled over the past decade to over \$350 billion.” However, total assets under management for these funds experienced large outflows in late 2018, recovering a bit in early 2019.

Lapses in liquidity in this market, which promises daily redemptions, could put additional “pressure on market functioning” if investors increase their redemptions due to liquidity concerns. That said, when this market experienced significant volatility and outflows last year, “the strong economic fundamentals and healthy state of the financial system” supported market functioning.

The Fed emphasized that while the ratings distribution of nonfinancial high-yield corporate bonds has been roughly stable over the past several years, the distribution of ratings among nonfinancial investment-grade corporate bonds has deteriorated. But see our reasons not to be too worried about BBB-rated bonds (i.e., the lowest-investment-grade class) going south in our 11/27/18 [Morning Briefing](#).

(3) *Leveraged loans rising, but represent a small share of debt.* Outstanding leveraged loans total \$1.1 trillion as of Q4-2018 (Table 1 of May’s report). That is just 11.3% of the \$9.7 trillion nonfinancial corporate debt market (including corporate bonds, bank C&I loans, and leveraged loans) detailed in the box on page 22.

Importantly, the ownership base for leveraged loans (specifically, collateralized loan obligations, or CLOs) has stabilized: Before the financial crisis, CLOs were commonly held by investors who relied on short-term funding, whereas CLOs now mostly are held by investors with stable funding.

Supporting our not-to-worry case is this fact in May’s report: “Issuance volumes of ‘private label’ securities have risen in recent years but remain well below the levels seen in the years ahead of the financial crisis.” The security of these issuances isn’t guaranteed by either a government-sponsored enterprise or the federal government.

(4) *Asset valuations historically high.* Our key takeaway from the Fed’s May discussion on elevated asset valuations remains the same as November’s. Asset valuations are high because investors have a high appetite for risk: Spreads on high-yield corporate bonds and leveraged loans over benchmark rates are near the lows seen during the financial crisis. Equity forward P/E ratios have generally been rising since 2012 (excluding the year-end 2018 drop during the market volatility) and were above the median values tracked over the past 30 years (of about 15x) as of April 2019 (about 17x). The returns on commercial real estate have declined steadily since 2010 to historically low levels now.

(5) *Equity asset valuations.* The Fed characterized equity asset valuations as high based on prices relative to forecast earnings, which “remain above the median value over the past 30 years.” True, equity valuations were above the median as of the latest report, but not that far above. And the action in the equity markets since the US-China trade dispute recently took a wrong turn certainly has hit prices.

Overall, our take on the Fed’s Figures 1-8 is that the ratio is nowhere near the levels of the late 1990s tech bubble (around 26x). Sure, the ratio is slightly above where it was leading up to the financial crisis (around 15x), but it wasn’t an equity bubble that caused that meltdown. It was household mortgages, an area that has significantly strengthened since the crisis.

Notably, as of April 2019, the “gap between the forward earnings-to-price ratio and the 10-year real

Treasury yield, a rough measure of the premium investors require for holding equities” remained lower than the post-crisis range premium but well above the dot-com era lows.

CALENDARS

US. Wed: Retail Sales Total, Ex Autos, Ex Autos & Gas, Control Group 0.2%/0.7%/0.4%/0.3%, Business Inventories 0.0%, Headline & Manufacturing Production 0.0%/0.1%, Capacity Utilization 78.7%, Empire State Manufacturing Index 8.0, NAHB Housing Market Index 64, MBA Mortgage Applications, Treasury International Capital, DOE Crude Oil Inventories, Quarles. **Thurs:** Jobless Claims 221k, Housing Starts & Building Permits 1.209mu/1.287mu, Philadelphia Fed Manufacturing Index 9.0, EIA Natural Gas Report, Kashkari. (DailyFX estimates)

Global. Wed: Eurozone GDP 0.4%q/q/1.2%y/y, Eurozone Employment, Germany GDP 0.4%q/q/0.7%y/y, Canada CPI 0.4%m/m/2.0%y/y, China Retail Sales 8.4% y/y, China Industrial Production 6.5% y/y, China Fixed Assets (ytd) 6.4% y/y, Coeure. **Thurs:** Eurozone Trade Balance €19.0b, Australia Employment Change & Unemployment Rate 15k/5.0%, BOC Financial System Review, Coeure, Praet, Guindos. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): All of these price indexes are up so far in 2019, but only the SmallCap indexes are still in a correction. Here’s how they rank ytd through Monday’s close, along with their percentage changes since LargeCap’s record highs in recent weeks and SMidCap’s in late August: Russell SmallCap 2000 (12.9% ytd, -12.5% from record high), S&P MidCap 400 (12.8, -8.5), Russell LargeCap 1000 (12.5, -4.6), S&P LargeCap 500 (21.2, -4.5), and S&P SmallCap 600 (10.6, -14.9). Forward earnings rose w/w for all of the S&P market-cap indexes for a fourth week, possibly signaling an end to the downtrend that began in late October. The forward EPS for LargeCap and MidCap are just 0.6% and 0.9% below their respective record highs, while SmallCap’s is 6.2% below. During October, analysts had been expecting double-digit percentage earnings growth for 2019. While those forecasts have dropped sharply since then, they are stabilizing now. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 3.2%, 11.7%), MidCap (22.7, 3.1, 13.5), and SmallCap (22.4, 4.4, 18.6).

S&P 500 Growth vs Value ([link](#)): The S&P 500 Growth index is up 13.8% ytd through Monday’s close, ahead of the 10.4% gain for its Value counterpart. Growth has risen 21.9% since the bottom on December 24, ahead of the 17.1% gain for Value. Both of these indexes are out of a correction now: Growth is now 4.4% below its April 30 record high, while Value is 7.7% below its record high on January 26, 2018. Since the election in late 2016, Growth’s 43.3% gain is more than double the 18.6% increase logged by Value. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Specifically, 8.5% STRG and 9.0% STEG are projected for Growth, respectively, versus 4.3% and 6.0% 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 20.3 from its 50-month low of 15.9 on December 24, and Value’s 13.2 was up from a six-year low of 11.5 on January 3. Regarding NERI, Growth’s was negative in April for a fifth month after 19 straight positive readings, but improved to -0.8% from -2.6%; that compares to a 25-month low of -4.4% in February and a record high of 22.3% in March 2018. Value’s NERI was negative in April for a sixth month, but up to -6.7% from -8.7%; that compares to a 34-month low of -9.8% in February and a record high of 21.2% in March 2018. The Tax Cuts and Jobs Act (TCJA) sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value, but Growth’s margin is falling now. Growth’s forward profit margin of 15.3% is up from 14.4% prior to the

TCJA's passage, but down from its record high of 16.7% during mid-September. Value's forward profit margin of 10.3% is down from a record high of 10.5% in December, but up from 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): "America's small and independent businesses are rebounding from the first quarter 'shut down, slow down' and don't appear to be looking back," said NFIB President and CEO Juanita D. Duggan. The Small Business Optimism Index (SBOI) rose in April for the third month, to 103.5, after sliding from a record high of 108.8 in August to 101.2 in January—which was the lowest since November 2016. The SBOI is at a historically very strong level, according to the report, "consistent with solid growth, keeping the economy at full employment. There is no recession in sight this year." In April, eight of the 10 components rose, while only one fell, job openings (to 38% from 39%)—though remained at record levels; capital spending plans (27) were unchanged for the second month. Pushing the index higher was a very solid advance in earnings trends (-3 from -8), while the inventory (2 from -1) soft spot in March's report changed course in April. Meanwhile, hirings (20 from 18) remained strong, and sales expectations (20 from 19), business conditions (25 from 23), and credit conditions (-4 from -7) all improved.

Import Prices ([link](#)): Import prices in April rose for the fourth month after dropping sharply the last two months of 2018. Prices advanced 0.2% in April and 2.0% ytd, after sinking 3.0% during the two months through December. Petroleum prices soared 32.7% the first four months of the year after plunging 28.0% the final two months of last year, while nonpetroleum import prices sank 0.6% during April, matching January's decline—which was the steepest decline in four years. These prices had ticked up 0.2% during both February and March. Versus a year ago, import prices held around zero, narrowing from -1.5% in January—which was the biggest yearly decline since August 2016. The yearly rate for petroleum prices turned positive in March for the first time since November, accelerating 7.0% y/y in April; it was at -16.6% at the end of last year. The rate for nonpetroleum prices was -1.0% y/y in April, after holding just below zero the first three months of this year. The rate for capital goods imports (-1.2% y/y) fell further into negative territory in April, while the rate for industrial materials & supplies (1.4) remained in positive territory, after moving above zero in March after three months below. Prices for consumer goods ex autos (-0.6) remained below year-ago levels, though barely, while the yearly change in auto prices were fractionally below zero for the fourth month. The rate for food prices (1.2) turned positive in April for the first time since last May. Looking at our Asian trading partners, we're importing more deflation than inflation, with import prices for goods from China (-1.1% y/y) and the NICs (-0.6) falling, while Japan's were flat with a year ago. Meanwhile, there's no sign of inflation in EU (0.1% y/y) import prices, decelerating sharply from last May's 4.2%, while import prices for goods from Latin America (-1.1) were negative for the fourth month.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators ([link](#)): In March, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—continued to anticipate an easing of growth momentum in most major economies, with the OECD's CLI (99.0) sinking to its lowest level since September 2009. Easing growth momentum remained the assessment for the US (98.8), Canada (98.7), Japan (99.4), the UK (98.5), and the Eurozone (99.1) as a whole—including Germany (99.0) and Italy (99.1)—while France's CLI (99.1) now anticipates stable growth momentum. Among emerging economies, growth gaining momentum remains the assessment in Brazil (102.4), while signs of stable growth momentum in Russia's CLI (100.0) are emerging, an upgrade from February's sign of easing growth momentum. Meanwhile, India (100.8) continues to anticipate stable growth momentum, with China's (98.7) industrial sector joining the group, lifted by more positive signals from the chemicals and construction sectors, as well as from share prices.

Eurozone Industrial Production ([link](#)): Output in the Eurozone contracted in March for the sixth time in seven months, though remains at a relatively high level. Industrial production (excluding construction) edged down 0.3% in January and 1.2% over the seven-month period, with January's 2.0% jump tempering the downturn. In March, three of the five main industrial groupings recorded gains: Production of consumer durable goods climbed for the third time in four months, by 0.7% m/m and 2.0% over the period, with intermediate goods following suit, up 0.1% and 1.0% over the comparable periods. Meanwhile, capital goods output rose two of the first three months of the year, advancing 0.4% in March and 2.1% ytd. Consumer nondurable goods production contracted 1.0% in March, though had rebounded 3.3% the first two months of the year, while energy output fell 3.7% during the two months ending March, more than reversing January's 3.0% rebound. Both remain in volatile flat trends, though output of consumer nondurable goods is near the top of its recent range, while energy is at the bottom of its range. March data are available for the top four Eurozone economies, and only Germany was in the black, edging up 0.4% after falling seven of the prior nine months, by 3.5%; output is 2.5% below a year ago. Meanwhile, output in Spain fell for the second month, by a total of 2.2%, while production in both France and Italy contracted in March, by 1.0% and 0.9%, respectively, after climbing 1.6% and 2.6% the first two months of the year.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).