



MORNING BRIEFING

October 22, 2019

Shiller's Bullish Trump Scenario

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

(1) The biggest risk to longest economic expansion may be political rather than financial. (2) Shiller's odd theory: Consumers want to take after Trump. (3) Trump has given consumers more after-tax income with more uncertainty. (4) Big increase in personal saving since Trump was elected president. (5) No boom, no bust. (6) LEI stalls; may be running out of room to improve. (7) No surprise: Economic Surprise Index improves during second half of most years. (8) More upside surprises in US than in Eurozone. (9) Forward earnings better here than over there. (10) More bargains over there than over here. (11) Waiting for commodity prices to bottom. (12) China continues to slow.

US Economy I: Lifestyle of the Rich & Famous President. The US economy continues to grow despite recurring recession scares. By our count, they've triggered 65 panic attacks in the stock market since the start of the bull market during March 2009. (See our *S&P 500 Panic Attacks Since 2009* [chart](#) [book](#) and [table](#).) The panic attacks—which include both corrections and mini-selloffs—have been followed by relief rallies. As a result, on Friday, the S&P 500 was only 1.3% below its record high of 3025.86 on 7/26 ([Fig. 1](#)).

The current economic expansion became the longest one on record during July of this year. It has now lasted 124 months. Debbie and I expect it will continue through 2020. The main risk might be a radical regime change if President Donald Trump is defeated by one of the Democratic socialist candidates come the November 2020 election. Then again, our Founders reduced the chances that a radical president could be too radical by designing a constitutional system based on checks and balances.

We were intrigued and puzzled by the strange [interview](#) on CNBC with Nobel Prize-winning economist Robert Shiller on Friday. He said a recession may be years away due to Trump's bullish impact on the economy. Shiller is a behavioral finance expert who apparently believes that consumers are following the President's lead: "I think that [strong consumer spending] has to do with the inspiration for many people provided by our motivational speaker president who models luxurious living." That's certainly a different spin on the Trump presidency than we've heard before.

Shiller also said that the next recession may not hit for another three years, and it could be mild. If the economy remains strong, Shiller expects Trump to be re-elected.

Shiller coined the phrase "irrational exuberance" and correctly anticipated the bear market of 2000 because his CAPE valuation ratio was too high. He also correctly predicted the bear market in home prices that led to the Great Financial Crisis. His CAPE ratio is bearish again, yet he is bullish on the economy and the stock market.

In our opinion, consumers are doing what they do best because their real disposable incomes are growing along with employment and real wages. Consider the following:

(1) *Growing wages driving consumer spending.* Our Earned Income Proxy for private-sector wages and salaries rose 4.2% y/y to a new record high during September, while retail sales rose 4.1% ([Fig. 2](#)). Trump's policies of deregulation and tax cuts undoubtedly contributed to the strength in personal income.

(2) *Trade wars and impeachment hearing causing uncertainty.* On the other hand, Trump's trade wars have created lots of economic uncertainty. So has his eccentric style of governing, which has led the House Democrats to start an impeachment hearing. The Democratic candidates all seem to favor higher taxes, including taxes on wealth.

(3) *Consumers saving more.* As a result, personal saving has soared. The 12-month sum of personal saving jumped by \$335 billion from \$969 billion during November 2017, when Trump was elected, to a record \$1.3 trillion during August ([Fig. 3](#)). Over that same period, the personal saving rate rose from 6.5% to 8.1% ([Fig. 4](#)).

(4) *Income growing faster than spending.* Real disposable personal income has been growing faster than real personal consumption expenditures since May 2017 ([Fig. 5](#)). Since then through August, the former is up 7.8%, while the latter is up 6.6%.

We don't disagree with Shiller on the longevity of the current economic expansion. However, we doubt that Trump's lavish lifestyle is the role model for 99% of American consumers. The wealthiest 1% may be cutting back on their extravagant lifestyles and doing most of the saving, figuring that if Trump loses, they will be paying lots more in taxes.

US Economy II: No Big Surprises. If consumers were emulating Trump's lifestyle, the US economy would be booming, which would set the stage for a bust. Our mantra remains the same when it comes to the economic outlook: "No boom, no bust." The Atlanta Fed's 10/17 [GDPNow](#) model is currently estimating a 1.8% (saar) growth rate for Q3's real GDP, with real residential investment up 6.2% and business fixed investment down 1.2%. Here's some more on the performance of the economy:

(1) *Leading indicators.* September's Index of Leading Economic Indicators (LEI) fell for the second consecutive month since reaching a new record high in July. It slipped 0.1% last month following a 0.2% downtick in August. The LEI was up only 0.4% y/y, slowing steadily since peaking at 6.6% a year ago ([Fig. 6](#) and [Fig. 7](#)).

Last month, five components of the LEI contributed positively and four negatively, with the average workweek unchanged. The ISM new orders index (-0.17ppt) recorded the biggest negative contribution, followed by building permits (-0.08), the interest rate spread (-0.04), and consumer expectations (-0.01). Stock prices (0.11), the leading credit index (0.09), and jobless claims (0.06) were the biggest positive contributors.

During September, the Index of Coincident Economic Indicators held steady at August's record level. It was up 1.5% y/y, suggesting that real GDP continues to grow around 2.0% y/y ([Fig. 8](#)).

Should we worry about the stall in the LEI over the past 12 months? Debbie and I have some misgivings about this index. Many of its components are cyclical. That makes sense in the context of forecasting the business cycle. However, some may have run out of room to improve given that this has turned out to be the longest economic expansion on record. For example, jobless claims are so low that they probably can't go much lower. Building permits have been moving sideways at their cyclical high since 2017.

(2) *Economic surprise*. The good news is that the Citigroup Economic Surprise Index (CESI) soared from this year's low of -68.8 on 4/25 to this year's high (so far) of 45.7 on 9/25 ([Fig. 9](#)). That's not as exciting as it sounds because, since 2009, the CESI has had a funky tendency to be weak during the first half of the year and strong during the second half. Furthermore, it is volatile, and it dropped back down to 8.0 at the end of last week.

By the way, we found that the 13-week change in the 10-year TIPS yield is highly correlated with the CESI ([Fig. 10](#)). That helps to explain the upward pressure on the yields of both the 10-year TIPS and comparable Treasury bond since mid-year.

Global Strategy: US vs Them. Over the past couple of weeks, Joe and I having been paying closer attention to the Go Global alternative to the Stay Home investment strategy. We are suffering from cabin fever and looking for opportunities to venture out into the world.

The main attraction abroad is lower valuation multiples than in the US. On the other hand, it's hard to get excited about the fundamentals over there versus over here:

(1) *Comparing CESIs*. While the CESI for the US has recovered nicely since mid-year, the comparable measure for the Eurozone remains solidly in negative territory, as it has all year ([Fig. 11](#)). The spread between the two was 75 on Friday ([Fig. 12](#)).

(2) *Comparing the Blue Angels*. The forward earnings of the S&P 500 has been rising into record-high territory since early this year through the 10/10 week. When we multiply this series by forward P/Es of 10.0 to 19.0, the resulting Blue Angels framework shows that the S&P 500 has been trading between 16.0 and 17.0 most of this year ([Fig. 13](#)).

The comparable Blue Angels chart for the All Country World ex-US MSCI stock price index shows that forward earnings abroad has been heading lower this year, but may possibly be starting to bottom ([Fig. 14](#)). This index's forward P/E has been trading around 13.0 in recent weeks.

(3) *Missing ingredient*. We would get much more excited about taking a portfolio trip abroad if commodity prices firmed and the dollar weakened. Historically, there has been a good inverse correlation between these two variables ([Fig. 15](#)). That's because broad-based global economic growth would push up commodity prices, while weakening the dollar. When the global economy is relatively weak, commodity prices tend to fall while the dollar strengthens.

Previously, we've often observed the close correlation between the CRB raw industrials spot price index and the Emerging Markets MSCI stock price index (in dollars) ([Fig. 16](#)). Again, we would be more gung-ho about Go Global if we saw an upturn in the commodity index, which remains MIA for now.

(4) *China still slowing*. Weighing on commodity prices is the economic slowdown in China. The country's real GDP growth rate fell to 6.0% y/y during Q3-2019 ([Fig. 17](#)). The quarterly rate was 5.2% (saar), down from 5.4% during Q2. The y/y growth rates of both industrial production and real retail sales remain on downward trends, with the former at 5.8% and the latter at 4.8% during September ([Fig. 18](#)).

CALENDARS

US. Tues: Existing Home Sales 5.45mu, Richmond Fed Manufacturing Index -7. **Wed:** Home Price Index 0.4%, MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

Global. Tues: ECB Publishes Bank Lending Survey, Canada Retail Sales 0.5%. **Wed:** Eurozone Consumer Confidence -6.7, Japan PMI Flash Estimates, Australia PMI Flash Estimates. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings edged lower for all three of these indexes last week. These indexes began a forward-earnings uptrend during March, but only LargeCap is near a record high. LargeCap's forward earnings has risen during 28 of the past 36 weeks, MidCap's 18 of the past 32 weeks, and SmallCap's 17 of the past 30 weeks. LargeCap's is less than 0.1% below its record high two weeks ago, while MidCap's and SmallCap's are 3.8% and 8.2% below their October 2018 highs. MidCap's forward earnings is near a 14-month low now, while SmallCap's forward earnings is near a 15-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. At their bottoms earlier in 2019, LargeCap's forward EPS had been the most below its record high since June 2016 and MidCap's was the lowest since May 2015. During mid-September, SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings dropped to a 37-month low of 1.3% y/y from 1.6%. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's -3.8% y/y change is down from -3.3% and is the lowest since December 2009. That compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -8.1% y/y change is up from -9.6% in mid-September, which was the lowest since December 2009, and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 0.6%, 11.1%), MidCap (22.7, -5.0, 12.9), and SmallCap (22.4, -16.7, 38.4).

S&P 500/400/600 Valuation ([link](#)): Valuations rose last week for all three of these S&P market-cap indexes, and continue to improve from their three-month lows during the late summer. LargeCap's forward P/E rose 0.1pt w/w to 16.8 and is down 0.4pt from a 17-month high of 17.2 at the end of July. That compares to a five-year low of 13.9 during December and a 16-year high of 18.6 during January 2018—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 was up 0.2pt w/w, to 16.2 from 16.0. That's down from a seven-month high of 16.3 in early April, but up 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 rose 0.3pt w/w to 16.8 from a six-week low of 16.5, but is down from a 12-month high of 17.8 in mid-September. That's well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is now a tad above LargeCap's again primarily due to substantially lower forward earnings for Frontier Communications. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q3 books closed and earnings reports trickling in, Q3's blended estimate/actual began to improve in the latest week. The S&P 500's Q3-2019 EPS forecast rose 8 cents w/w to \$41.01. That represents an earnings decline of 3.9% y/y compared to the prior week's forecasted earnings drop of 4.1%. While the consensus Q3 EPS estimate is below our forecast of \$43.00 and is now below the \$41.31 reported for Q2, we are expecting slightly positive y/y earnings growth of 0.8%. On a pro forma basis, Q3 earnings are expected to decline 3.1% y/y, which

would be the first drop in 13 quarters and compares to y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Six of the 11 sectors are expected to record positive y/y earnings growth in Q3-2019, with none rising at a double-digit percentage rate. That compares to seven positive during Q2, when three rose at a double-digit percentage rate. However, eight sectors are expected to beat the S&P 500's Q3 growth rate, up sharply from just three beating the S&P 500 during Q2. Industrials, Materials, Real Estate, and Utilities are the only sectors expected to post better (or less worse) growth on a q/q basis during Q3. On an ex-Energy basis, the consensus expects earnings to fall 0.6% y/y in Q3. That compares to ex-Energy gains of 3.9% in Q2 and 3.0% in Q1, and is well below the 14.2% y/y gain in Q4-2018. Here are the latest blended Q3-2019 earnings growth rates versus their Q2-2019 growth rates: Real Estate (3.9% in Q3-2019 versus 3.1% in Q2-2019), Health Care (3.6, 10.3), Financials (2.9, 10.0), Utilities (2.8, 1.1), Industrials (0.9, -9.5), Consumer Staples (0.4, 1.7), Communication Services (-0.6, 17.6), Consumer Discretionary (-0.8, 2.7), Information Technology (-7.8, -2.2), Materials (-11.8, -12.7), and Energy (-39.2, -8.9).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With 15% of the S&P 500 companies finished reporting revenues and earnings for Q3-2019, revenues and earnings are beating the consensus forecasts by 1.0% and 4.4%, respectively. Those are about the same rates as during the same point in Q2, but the percentages of companies showing a positive revenue surprise and positive y/y revenue growth are weaker. Of the 75 companies in the S&P 500 that have reported through mid-day Monday, 81% exceeded industry analysts' earnings estimates. Collectively, the small sample of reporters has a y/y earnings decline of 0.5%, primarily due to Micron Technology's earnings deceleration. On the revenue side, 61% of companies beat their Q3 sales estimates so far, with results 3.0% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps to 3.6% from -0.5% and revenue growth improves to 3.8% from 3.0%. Overall, Q3 earnings growth results are positive y/y for 71% of companies, and revenues have risen y/y for 79%. These figures will change markedly as more Q3-2019 results are reported in the coming weeks, but what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors' main focus.

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