Yardeni Research

MORNING BRIEFING
January 22, 2020

Happy Chinese New Year

See the collection of the individual charts linked below.

(1) Pigs, rats, and politicians. (2) Pandemics and plagues. (3) China rapidly becoming the world's largest nursing home as a result of ongoing urbanization and previous one-child policy. (4) Real retail sales growth cut by over two-thirds in past 10 years. (5) Less bang per yuan of monetary easing. (6) Soaring food prices depressing retail sales too. (7) China's PPI is a good indicator of global growth, and is deflating slightly. (8) Vehicle sales weak in China. (9) Trump's trade deal with China looks good on paper. (10) Tariffs won't be eliminated until Phase 2 deal is done. (11) IMF sees modest pickup in global economic growth ahead. (12) Commodity prices are showing signs of life, as are European auto sales.

Strategy: The Year of the Rat. Last year was the Year of the Pig in the Chinese Zodiac. It wasn't a good year for pigs. The swine flu decimated China's hog population in 2019. The country's production of pork might have been halved last year, according to one estimate. That's roughly 300 million to 350 million pigs lost in China, which represents almost a quarter of the world's pork supply.

This year is the Year of the Rat. This rodent has a long history of spreading diseases. There are plenty of rats in America's political system. They are spreading bitter partisanship along with divisive hatred. We will find out later this year which will, and which won't, thrive following the 2020 elections. Identifying which of our politicians are pesky pests has turned into a very partisan exercise. Many Democrats tend to view all Republicans as pests, while many Republicans feel the same about Democrats.

I think we can all agree that corrupt politicians are the worst pests of them all. Politicians from both sides of the aisle have demonstrated that neither side is squeaky clean. Political corruption is a phenomenon that has been around since politicians became history's second oldest profession. It doesn't follow any calendar, Zodiac or other. Nevertheless, as American politics has turned increasingly partisan, the year preceding presidential elections seems to have become increasingly ugly.

So far, this development hasn't been noticeably unsettling for the stock market. This could be the year that tests the market's resilience in the face of extreme political partisanship.

This will also be the year that tests whether the Chinese will abide by the Phase 1 trade deal with the US. As discussed below, they've agreed to behave more fairly in their trade relations with the US. If they do so, then the Trump administration is likely to negotiate Phase 2 with them, most likely after the presidential election near the end of this year. That assumes, of course, that Trump wins a second term, which seems likely for now.

China I: Soaring CPI, Falling PPI. No matter the animal featured in the Zodiac calendar, China's economy has been slowing in recent years, and is likely to continue doing so this year. That wasn't immediately apparent in December's retail sales, which rose 8.0% y/y, up from a recent low of 7.2% during October 2019 (*Fig. 1*). However, the Consumer Price Index (CPI) inflation rate jumped from a February 2019 low of 1.5% y/y to 4.5% at the end of last year, led by soaring pork prices. As a result, inflation-adjusted retail sales rose just 3.5% y/y during December, remaining near October's 3.4%, which was the lowest since the end of 1997.

On a 12-month average basis, the growth rate of real retail sales was just 5.1% y/y during December, the lowest on record and down from a record high of 17.0% during mid-2009 (*Fig. 2*). Keep in mind that this extraordinary downtrend occurred over 10 years. Melissa and I recognize that economic growth rates tend to slow as economies expand over time. But we believe that the rapidly aging demographic profile of China's population is also a major contributor to the significant slowing of China's growth rate over the past decade. China is rapidly emerging as the world's largest nursing home as a result of urbanization (which is depressing fertility rates around the world) and the effects of government's one-child policy (which lasted from 1979-2015).

Here's more on the slowdown in real retail sales growth:

(1) *Easy money*. The growth rate in China's real M2 closely tracks real retail sales growth (*Fig. 3*). The former was up only 4.2% y/y during December despite the efforts of the People's Bank of China (PBOC) to provide lots of easy money. The PBOC has cut banks' required reserve ratios 15 times since they peaked during 2011 (*Fig. 4*).

That has fueled a remarkable surge in Chinese bank loans. Since the start of 2010 through the end of 2019, they are up $16.0 trillion to a record $21.8 trillion (*Fig. 5*). By comparison, over the same period, US bank loans are up just $3.5 trillion to $10.0 trillion, which is also a record for the US. China has clearly been getting less bang per yuan from the PBOC's easy monetary policies. That's evident in the ratio of China's industrial production to bank loans, which is down by approximately 50% since 2008 (*Fig. 6*).

(2) *Food prices.* While China's headline CPI was up 4.5% y/y through December 2019, the rate excluding food was up just 1.3% (*Fig. 7*). The CPI component for meat, poultry, and related products was up a whopping 66.4% over the same period. A 1/1 *NYT* article titled "Why Did One-Quarter of the World's Pigs Die in a Year?" explained that the swine flu epidemic was caused by unsound government policies. The article did not mention whether those policies were being reassessed.

By the way, China's 2003 outbreak of severe acute respiratory syndrome, a coronavirus known as "SARS," was believed to have originated through animal-to-human transmission in a marketplace. In recent days, there has been a similar outbreak of a version of the virus that can be transmitted by both animals and humans. The latest episode seems to have started in Wuhan, a city in China's Hubei province. Unsanitary conditions in China's food industry have the potential to cause serious health problems, providing the opportunity for viruses to cross species. (But no one is expecting another Bubonic Plague, which was caused by the bite of rat flies that infested rats and other rodents—even though this is the Year of the Rat.)

(3) *Auto sales.* It's not so obvious why auto sales have turned sickly in China over the past year. The 12-month sum of such sales peaked at a record 29.6 million during mid-2018 (*Fig. 8*). It was down to 25.8 million units during December of last year. Granted, this drop coincides with uncertainties related to Trump's escalating trade war with China. Now that he has deescalated it, car sales may improve if trade uncertainty weighs on purchases of large durable goods in China, particularly autos. More likely is that the transition from fuel to electric vehicles (EVs) may cause buyers to postpone auto purchases until they decide whether EVs are the way to go. Melissa and I believe that China's rapidly aging demographics are tapping the brakes on car sales as well.

(4) *PPI.* While China's CPI soared last year, the country's Producer Price Index (PPI) was relatively weak, falling 0.5% y/y through December (*Fig. 9*). China's PPI inflation rate has actually been a very good indicator not only of the country's economy but also of the growth

rate in global industrial production (*Fig. 10*).

(5) *Production and trade.* On the more upbeat side, industrial production rose 6.9% y/y through December (*Fig. 11*). However, it is hard to see this growth rate getting better if the downward trend in real retail sales growth persists.

Then again, if the Phase 1 trade deal revives China's trade activity, that might help to offset the slowdown in consumer-spending growth. The sum of China's merchandise exports plus imports (both on a 12-month average basis) has been essentially flat since mid-2018 (*Fig. 12*). This series tends to correlate well with the 12-month average of China's railways freight traffic, which rose to another record high during November.

China II: Slicing & Dicing US Trade Deal. The US scored a big win in Phase 1 of the trade deal with China. At least that's our initial impression after reading the agreement signed on 1/15. In the text are 105 instances of "China shall" versus just five instances of "the United States shall," as well as 27 instances of "the United States affirms" and 59 instances of "the Parties shall." At the signing, President Trump described the deal as "righting the wrongs of the past." But is the 94-page document all for show?

Critics claim the deal is too vague, too weak, or covered by previous announcements and the pre-existing agreement. Melissa and I say that what the deal lacks in substance it gains in achievement of a huge milestone: getting China to acknowledge that it has persistently engaged in unfair trade practices and to address these issues with the US.

The agreement, according to the US Trade Representative's fact sheet, "requires structural reforms and other changes to China's economic and trade regime in the areas of intellectual property, technology transfer, agriculture, financial services, and currency and foreign exchange." It also includes China's commitment to make substantial incremental purchases of US goods and services and a "strong dispute resolution system." In turn, the US has "agreed to modify its Section 301 tariff actions in a significant way."

Let's have a closer look at some of the important elements in (and not in) this first phase of the trade deal:

(1) *Tariffs still on the table*. During his remarks, Trump said that "people are shocked" but

"we're leaving the tariffs on." Trump explained that China's lead trade negotiator Vice Premier Liu He is "very tough," and keeping the tariffs in place provides "cards" for the negotiating table. Before the deal's signing, the tariffs were 25% and 15% on $250 billion and $120 billion of imports from China to the US, respectively. Combined, the imports tariffed represented nearly 70% of the $540 billion in total Chinese imports to the US.

Upon China's signing of the deal, the US agreed to reduce the tariffs on the $120 billion in Chinese goods from 15.0% to 7.5% within about a month and agreed not to implement any additional planned tariffs. However, this contingency is not included in the deal text. Further tariff reductions, or eliminations, will be at stake in the Phase 2 agreement that is set to cover "Chinese subsidies to domestic companies and Beijing's oversight of Chinese state-owned firms," reported the 1/15 *WSJ*. Phase 2 talks are "expected to begin fairly soon but not conclude" until after the US presidential election in November.

(2) *Lip service for IP and tech transfer.* "Under this deal, transfers and licensing of technology will be based on market terms that are fully voluntary and reflect mutual agreement," Trump remarked on deal day. For example, the agreement states: "Neither Party shall require or pressure persons of the other Party to transfer technology to its persons in relation to acquisitions, joint ventures, or other investment transactions."

The *WSJ* observed: "The two pages on technology transfer go beyond other agreements China has signed that dealt with that issue. … However, the section doesn't require China to change any law or regulation to fulfill its obligations." Further, China agreed to more stringently protect trade secrets and to review its criminal penalties for "willful trade secret misappropriation," but specific rules on intellectual property were lacking, the article's authors commented.

(3) *Closing the trade deficit TBD.* China agreed to increase its imports from the US by approximately $200 billion (from a baseline of 2017 exports) over two years to make the balance of trade between the two countries more equitable. The planned purchases are split into $77 billion in 2020 and $123 billion in 2021. Categories of planned purchases include manufactured goods, energy, services, and agriculture. However, it's questionable whether fulfilling this aspect of the agreement is feasible. In 2017, the US exported $130.3 billion and $56.0 billion of goods and services, respectively, to China (on a balance-of-payments basis), so the planned purchases represent an unprecedented 107% increase over the baseline.

The newly managed trade goals with China could also face obstacles if they result in external challenges to the deal. Last week, the European Union warned that a complaint could be bought to the World Trade Organization if Phase 1 puts Europeans at an unfair disadvantage.

(4) *Opening market access*. The deal should be a win for financial services firms seeking to grow in Chinese markets, as Jackie and I discussed in our 1/16 *Morning Briefing*. Mastercard, Visa, and American Express are expressly listed in the deal, which requires China to quickly accept applications from bank cards and payments systems looking for access, noted the *WSJ*. In addition to planned incremental purchases for agriculture, China has agreed to permit more market access for US agricultural products, including dairy, poultry, beef, fish, and rice.

China also recommitted (as stipulated under the International Monetary Fund Articles of Agreement) not to devalue its currency or intervene regularly in its currency market, as well as to routinely disclose its foreign-exchange holdings.

The bottom line: It's a good deal for the US, on paper.

Global Economy: Signs of Life. Debbie and I continue to expect that a modest "peace dividend" will boost global economic activity this year as Trump wins his trade wars, or at least deescalates them as the presidential election approaches. The International Monetary Fund's *World Economic Outlook* (*WEO*) released on 1/9 came to the same conclusion. The latest *WEO* projects that global growth will rise from an estimated 2.9% in 2019 to 3.3% in 2020 and 3.4% for 2021—a downward revision of 0.1ppt for 2019 and 2020 and 0.2ppt for 2021 compared to those in the October *WEO*.

The latest *WEO* observes: "On the positive side, market sentiment has been boosted by tentative signs that manufacturing activity and global trade are bottoming out, a broad-based shift toward accommodative monetary policy, intermittent favorable news on US-China trade negotiations, and diminished fears of a no-deal Brexit, leading to some retreat from the risk-off environment that had set in at the time of the October WEO. However, few signs of turning points are yet visible in global macroeconomic data."

Here are a couple of signs of revived global economic growth:

(1) *Commodity prices.* Our favorite indicator for tracking global economic activity on a daily basis is the CRB raw industrials spot price index (*Fig. 13*). It recently bottomed at 433.89 on 12/3. It is up 8% since then, to 468.36 on 1/17.

(2) *European car sales.* New passenger car registrations in the European Union improved significantly late last year. The 12-month sum bottomed at 14.8 million units during August 2019 and rose to 15.3 million units in December (*Fig. 14*).

CALENDARS

US: Wed: Existing Home Sales 5.43mu, MBA Mortgage Applications, Chicago Fed National Activity Index 0.15. **Thurs:** Leading Indicators -0.2%, Jobless Claims 215k, Kansas City Fed's Manufacturing Index -6, DOE Crude Oil Inventories, EIA Natural Gas Storage. (DailyFX estimates)

Global: Wed: Canada CPI 0.0%m/m/2.3%y/y, Japan Trade Balance -¥170.0b, Australia Employment Change & Unemployment Rate 11k/5.2%, BOC Rate Decision 1.75%, Poloz. **Thurs:** Eurozone Consumer Confidence -7.8, Japan CPI Headline, Core, and Core-Core 0.7%/0.7%/0.9% y/y, ECB Rate Decision 0.00%, ECB Marginal Lending & Deposit Facility Rates 0.25%/-0.50%, BOJ December Meeting Minutes, Lagarde. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose to a second straight record high last week and its first since 9/20/19. SmallCap's rose for a ninth week in a row, and MidCap's was up for the eighth time in nine weeks. These indexes began a forward-earnings uptrend during March but stumbled from July to November. LargeCap's forward earnings has risen during 35 of the past 49 weeks, MidCap's 27 of the past 45 weeks, and SmallCap's 26 of the past 43 weeks. While LargeCap's is at a record high now, MidCap's and SmallCap's are 3.1% and 4.5% below their October 2018 highs. Index changes for the SMidCaps at the end of 2019 helped MidCap's forward earnings improve from November's 18-month low, while SmallCap's is up from September's 17-month low. 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 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings rose to a six-month high of 3.3% y/y from 2.9% and is up from a 38-month low of 1.0% in early December. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's improved w/w to -1.8% y/y from -2.2%, and compares to -5.5% in mid-November, which was the lowest since December 2009. That also compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -0.2% y/y reading improved w/w from -1.1%, and is up markedly 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 during late 2018, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, -0.2%, 9.6%), MidCap (22.7, -6.1, 11.9), and SmallCap (22.4, -3.0, 16.0).

S&P 500/400/600 Valuation (*link*): Valuations rose last week for these three indexes. LargeCap's forward P/E rose w/w to an 18-year high of 18.7 from 18.4. That compares to a five-year low of 13.9 during December 2018 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 compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E rose w/w to 17.4 from 17.0, and now matches its 22-month high of 17.4 in mid-December. That's up from 13.0 during December 2018, 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 w/w to 17.7 from 17.3, but remains below mid-December's 16-month high of 18.1. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is back below LargeCap's again. 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 Q4 earnings season about to accelerate, earnings revisions activity is in its typical quiet period as analysts await the release of results. The Q4 EPS forecast rose 7 cents w/w to $40.55. That represents a decline of 1.5% on a frozen actual basis and a drop of 0.8% y/y on a pro forma basis. That compares to a 0.3% decline in Q3 and 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). If the y/y earnings decline comes to pass in Q4-2019, it would be the second straight decline and the first drop since earnings fell y/y for four straight quarters through Q2-2016. However, seven of the 11 sectors are expected to record positive y/y earnings growth in Q4, with two rising at a double-digit percentage rate. That compares to seven positive during Q3, when none rose at a double-digit percentage rate. The same seven sectors are expected to beat the S&P 500's 0.8% decline in Q4 as in Q3; that's up sharply from just three beating the S&P 500 during Q2. Four sectors are expected to post improved growth on a q/q basis during Q4: Communication Services, Financials, Tech, and Utilities. On an ex-Energy basis, the consensus expects earnings to rise 1.9% y/y in Q4. That compares to ex-Energy gains of 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1 but is well below ex-Energy's 25.0% and 14.2% y/y gains in Q3-2018 and Q4-2018, respectively. Here are the latest Q4-2019 earnings growth rates versus their final Q3-2019 growth rates: Utilities (13.5% in Q4-2019 versus 6.7% in Q3-2019), Financials (11.6, 2.6), Health Care (6.6, 8.8), Real Estate (3.9, 5.9), Communication Services (1.8, -1.4), Consumer Staples (1.1, 3.7), Information Technology (0.6, -1.7), Industrials (-6.4, 3.4), Materials (-12.4, -10.9), Consumer Discretionary (-11.2, 1.8), and Energy (-42.0, -37.8).

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