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MACROCOSM

One Sell-Off, So Many Causes

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From mid-terms to China, a quick tour of everything that is (and isn't) wrong in the world.

Unlike February's violent 11.8% correction in the S&P 500 over just 10 market days (and nights) – a flash-crash with no fundamental cause, only a technical one (see "Inside the VIX Engine of Destruction" February 8, 2018) – *October's (so far) 7.8% correction over (so far) 14 days has been (so far) a relatively orderly affair, and one with no shortage of plausible fundamental causes*. As we meet with and talk to clients and other investors, we hear a wide variety of explanations – in many cases reflecting some degree of entirely natural confirmation bias, assigning blame to whatever risk factor one happened to be most worried about beforehand. We can't lay exclusive claim to objectivity, but we have our own views as to the causes. *Here's our quick tour of everything that is, and isn't, going wrong in the world.*

FED TIGHTENING FEARS Yes, President Donald J. Trump last week called the Fed "crazy," "loco," "ridiculous," and "too cute," saying its rate increases are "too aggressive," and "a big mistake." Many clients share this view, though they don't tend to use all the exact same terms. We won't belabor the matter here, because we have already dealt with it in great detail in our prior two reports (see "On the September Jobs Report" October 5, 2018 and "Our Knife at China's Throat" October 8, 2018).

- *Let us only repeat that we think gradual rate hikes, and continued*

Update to strategic view

US MACRO, US STOCKS, ASIA MACRO, ASIA STOCKS, EUROPE MACRO, EUROPE STOCKS, FX, US BONDS, US FED: Unlike February, the current global equities correction has real causes. We dismiss concerns about Fed tightening. The US mid-term elections are moving in the right direction for continued growth, except that this emboldens Trump to prolong the trade war with China. Every day is another day with tariffs…

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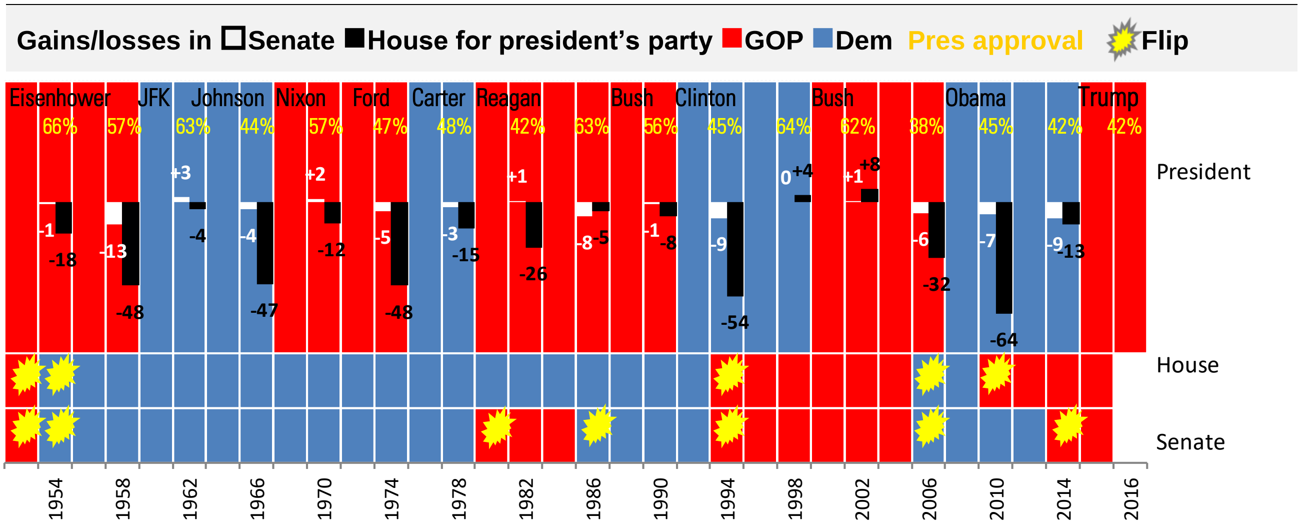

Source: Senate and House Clerks, 538, TrendMacro calculations *gradual balance sheet runoff, are perfectly appropriate for a normalizing growth and inflation environment – and this has been ratified by the 10-year Treasury which, with its recent yield back-up, has happily kept the yield curve from inverting.* Gold, by breaking out from its year-long downtrend, also ratifies that financial conditions are not critically tight.

- If normalization doesn't continue to materialize, neither will the rate hikes. Indeed, already this week, against the backdrop of heightened equity market volatility, the money-market curve has already backed out a half rate-hike from the three implied over three years at last Monday's peak.

MID-TERM ELECTIONS FEARS Virtually every client is attuned to the anti-growth policy and sentiment implications of a possible "blue wave" at the mid-term elections now just three weeks away, and we are constantly asked for an update on our predictions. *At this point we pretty much stand by our predictions of one month ago: that the GOP will keep Senate control and likely add a couple seats, but narrowly lose House control* (see "Mid-terms: Animal Spirits on the Ballot" September 11, 2018).

- *But it would seem that the Brett Kavanaugh confirmation hearings have served to energize Republican voters, who might otherwise have stayed home – and mid-terms are all about turn-out.* In fact the GOP might wish that Jeff Flake had delayed the vote for two weeks, not one, to bring the crescendo closer to election day.
- *So our Senate prediction now seems virtually certain.* The GOP's two weakest candidates – Dean Heller (NV) and Martha McSally (AZ) – have taken the lead in the polls for the first time, which means that any GOP pick-ups – likely Kevin Kramer over Heidi Heitkamp (ND) and Josh Hawley over Clair McCaskill (MO), in both cases opposing Democrat incumbents who voted "no" on Kavanaugh – fall straight to the bottom line.
- *The House still leans Democratic, but is edging toward being a toss-up.* The GOP hanging on to House control would speak well for the health of "animal spirits" animating the economy. But as a practical matter, today's GOP House with its narrow majority hasn't been very effective, and would likely not be more effective with an even narrower majority.
- For conservatives who want a reason to hope, note that at the 2014 mid-terms, Obama's popularity rating was the same as Trump's today (please see the chart on the first page). The Democrats' loss of 13 seats then would not be a sufficient number today to gain control from the GOP.
- *If we are correct that solid GOP performance in the mid-terms points to pro-growth policy and sentiment, that wouldn't be a trigger for the sharp correction in stocks that has occurred at the same time as the GOP's prospects have improved. Or would it?* This brings us to…

US/CHINA TRADE WAR FEARS We have noted that Trump would like to have a trade deal with China to brag about going into the mid-terms, which effectively puts a deal "on sale" from China's perspective and "Our

Update to strategic view

Continued from first page

…acting as a corporate income tax hike, and every day is another day with China being backed closer to a systemic cliff. It's a game of pressure, so Trump has to be willing to scare investors or he's not going to scare China. China is isolated, and will have to make a deal, and we think Trump does want a deal rather than a prolonged Cold War. The Italeave threat is upon us. It will likely end with compromise, but already pro-growth tax cuts have been mostly abandoned. Security issues continue to dog the FANG stocks, raising existential angst in the bull market's leadership group. Some of these – especially China – are real and persistent issues. But altogether, we're regarding this as only a correction, not the onset of a new bear market.

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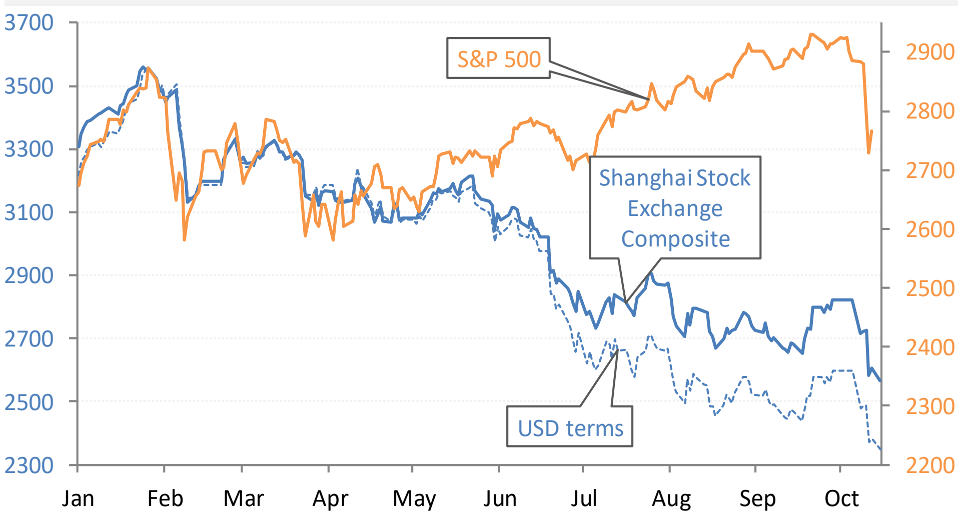
Knife at China's Throat" October 8, 2018). *But the importance of a deal for Trump recedes when it looks like the GOP will do well in the mid-terms without one.* Not just the victory in the Kavanaugh circus, but also trade deals with Canada and South Korea, the lowest unemployment rate in half a century, and now the release of an American pastor from Turkish prison, has added up to what even "enemy of the people" CNN has had to admit is "Trump's winning streak." Besides, Trump can still score points just by vilifying China – the media is only too happy to go along, with stories about spy-chips that look like a "grain of rice" (*those oriental fiends!*).

- The problem is that every day we don't have a deal, the US tariffs on imports from China exact a greater and greater corporate income tax upon the US economy, and we get closer to additional tariffs scheduled to kick in automatically at year-end.
- At the same time, every day we don't have a deal, and the US tariffs act as "a knife at the throat" to China, China gets pushed backwards, blindly, toward an economic cliff which, if it falls off, would have unpredictable and possibly grave implications for its own social coherency and for the global economy (see "On the Margin: China's Scariest Fragility" August 6, 2018).
- Trump was asked on "60 Minutes" last night if he intends to throw China into a depression. He replied, "they're down 32 percent in four months, which is 1929" (please see the chart below). "No, I don't want that. I want them to negotiate a fair deal with us. I want them to open their markets like our markets are open."
- *Still, time is not on anyone's side here. Especially China, for whom the cultural stereotype is that they "think in terms of centuries" and so can out-last Trump. Being backed up to a systemic cliff that may be weeks or months away, they just don't have centuries to wait.*

US and Chinese equities as the tariff war gets started



Source: Bloomberg, TrendMacro calculations

- *Some evidence that this is what equity markets are most worried about is the reaction to a leaked story right after the closing bell on Thursday that the Treasury would not find China to be a "currency*

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manipulator" in the upcoming semi-annual Report on Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States. US equity futures rebounded sharply, presaging a day of relief Friday for markets world-wide.

- Under the authorizing statute, the penalties for China if it were judged to be a "currency manipulator" are trivial. But apparently markets were nevertheless relieved by any relaxation in the escalation of strident US threats. This one would have been particularly strident, considering that Treasury has failed to tag China a "manipulator" in the three semi-annual reports already released by the Trump administration (last April, Switzerland was found to be worse).
- To be sure, the Chinese yuan *has* been very weak against the dollar over the last six months. But just in case the Treasury is interested in the truth, or at least *our* version of it, that weakness is because US sanctions are already weakening the Chinese economy and triggering dangerous capital flight. Indeed, to shore up the yuan, China has now five times, including once more over the weekend, had to reassure markets with the embarrassing confession that yuan weakness is not the intentional result of policy (see, first, "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018).
- Also on Thursday and Friday there were leaks, rumors and emanations of an on-again off-again meeting between Trump and Chinese President Xi Jinping on the sideline of the G-20 meeting in late November.
- *These signs of potential reconciliation are set against a background of increasing pressure against China.* We think it is especially noteworthy that the Belgian authorities captured, and then turned over to the United States, alleged spy Yanjun Xu on charges of stealing trade secrets from GE and other US companies. It sends a strong message to China that we see this as a crime worthy of formal prosecution – but the deeper signal is that Belgium would cooperate with us in it. If China had any illusions is could team up with cowardly Europe against the US in this trade war, it has better reconsider (see "On the US/EU Trade Deal" July 26, 2018). *China is isolated.*
- *Many clients are asking us whether we are worried that China might threaten to dump its $1.36 trillion holding of US Treasury securities as a form of economic blackmail against the US.* We think that's highly unlikely if China fears capital flight. Those securities represent collateral underlying the vast "total-return swap" that China has done with the developed world over the last two decades. If China is, as we believe, concerned about capital flight, it would not dare to fail to retain this collateral.
- *And almost all clients ask us whether Trump even wants a deal with China – is he not, instead, willing to endure a tariff-driven US recession for the sake of a new Cold War designed to break China the way we broke the Soviet Union?*
- Vice President Michael Pence's China-bashing speech two weeks ago, at the onset of the present equities correction, would certainly give that impression. We don't pretend to read Trump's mind, so

we can't say for sure what his real game is. But we note that Pence gave that speech, not Trump – so Trump still has room to negotiate with no burnt bridges.

- And at the same time, Treasury Secretary Steven Mnuchin plays good-cop by basically using the same talking point Trump had used on "60 Minutes": "Our objective is to increase exports and have a more balanced, fair relationship where our companies can do business there on terms similar to how they do business in the US."
- *Remember, if China wanted to reform its trading practices it would have already done so. It will only do so as the result of extreme pressure.* It has admitted the US holds "a knife to our throat." Over the weekend, its new Peoples Bank of China Governor Yi Gang admitted "we prepare for the worst." *These are not signs of strength. They are confessions of fear.*
- *It should be no surprise that US markets are afraid, too. After all, if Trump doesn't scare investors, he's not going to scare China. But this is an absolutely necessary step, just as it was in the campaign to bring North Korea's Kim Jung-un to the negotiating table. Peace talks only happen at the brink of war. But if that's what this correction is about, then it probably has longer to run – the pressure isn't sufficient yet, so it's going to have to get greater.*

EARNINGS FEARS This is not entirely unrelated to concerns that this earnings season is going to be a disappointment, driven in part by cost-pressures imparted by both inflation and tariffs. We recall the same fears gripped markets one quarter ago, and they turned out to be unfounded – but then again there are more tariffs now, and they've been in place a little longer.

- *We believe that all that matters is forward earnings.* The information imparted in reports in earnings season concerning a quarter now in the rear-view mirror is nearly irrelevant except for what it says about expected future earnings.
- *Analysts are fully aware of the tariffs, and are fully capable of having already built them into their forward estimates.* Guidance by companies can certainly affect that, but at the same time we have to be careful to not let tariffs or other penumbra of the trade situation become a credible excuse for CFO's trying to alibi a weak quarter.
- *One thing to bear in mind about tariffs is that they are, to a large extend, avoidable – in fact they are specifically designed to be avoidable.* If a company doesn't want to pay a 25% tariff on a widget imported from China, it can get it from, say, Thailand. The whole idea of a tariff on Chinese goods is to create incentives for finding alternate sources – what amounts to a boycott. To be sure, if a firm wanted Thai widgets, it would have already chosen them. There would be a cost to accept the second-best widget, and to reorganize the supply-chain. But the 25% tariff need never be paid in full – it can always be reduced to some extent.
- *So when we say that the worst-case tariff on Chinese goods would be enough to completely reverse the corporate tax cuts in the Tax Cuts and Jobs Act passed last December, we're just talking about*

the headline value of the tariffs – and omitting the potential for importers to substantially ameliorate them.

- *As to cost-pressures imparted by inflation, we just don't see that as a relevant factor.* For one thing, recent changes in inflation are trivial. But most fundamentally, even if the change were substantial, it is fundamentally a zero-sum game as far as earnings are concerned. One man's "cost pressure" is another man's "pricing power." And let's remember that for all these years of sub-standard inflation, it was the *lack* of it that motivated pessimism about earnings – now that we have just a little inflation, *that's* a problem, too.
- *With all that in mind, we note that forward earnings growth has in fact slowed somewhat over the last month.* There's no particular sign of a reversal. But on a 30-day moving average basis, upgrade growth is now 8.89% per annum across the S&P 500. That's down from the unsustainably blistering rate around 20% that we saw over the last couple months, but it's still well above the historical average of about 6%. *We'll be watching.*

EURO FEARS Our long-standing warnings about a potential break-up of the Euro currency – driven by Italy's threat to leave it, as a weapon in its budget negotiations with the European Union – is coming to a head (see, first, "USD, Euro and the Risk of Italeave" May 25, 2018).

- This week will see Italy's formal submission of a budget to Brussels, and Brussels will likely reject it. There will be angry recriminations on both sides, Italian bond yields will rise, and there will be talk about Italy leaving the European Union and the euro currency. If the politicians are left to themselves, at some point over the next couple weeks, there will be an all-night summit meeting, likely on a weekend, from which all parties will emerge bleary-eyed with an incomprehensible joint communique that solves the problem along lines that nobody really understands.
- The risk is that if, along the road to that happy conclusion, markets become sufficiently worried that Italy might really leave the euro, there could be a speculative attack against the common currency – or simply the synchronized exodus of millions of savers, acting independently but from the same fear – which would trigger a run on the euro across Europe, destabilizing a banking system that's not in the best possible shape to begin with.
- Unfortunately, for all the risk, it appears now as if it will not lead to the pro-growth policy we have initially expected (see "On the Margin: Powell the Non-Independent, Pro-Growth Italeave" July 16, 2018). It seems the Italian budget is using deficits primarily to fund welfare payments and roll-back of entitlement reform, rather than to fund supply-side tax cuts.
- *It's just a "black swan" risk, and we have no reason to think that it underlies the global correction in equities. But it is upon us. If it is going to happen, it's going to happen soon. We've been telling clients for months: "have a plan!"*

FANG FEAR We continue to have the intuition that a large fraction of the emotional energy behind the global equities correction is a generalized loss of confidence in the so-called "FANG" stocks and other faddish stocks in their orbit – which has provided market leadership for several years.

- In every bull market there is a leadership group. It's continued good performance instills confidence in equities generally. Its CEOs become messianic symbols of confidence and growth.
- It is not helpful to confidence to have Tesla CEO Elon Musk smoke dope on TV and get in a tweet-war with the Securities and Exchange Commission after it has, quite appropriately, ejected him from the chairmanship of his company.
- It is not helpful to have Bloomberg's story about the "grain of rice" spy-chip in circuit boards used by Amazon and Apple.
- Similarly, it is especially unhelpful to have Google drop its Google+ social network business citing security breaches which it has concealed from customers for months.
- It's one thing for use data to be abused by business partners, as was the case with Facebook and Cambridge Analytica (see "DeFANGed" March 28, 2018). That, at least, was a choice – a matter of business practice. The spy-chips and the Google+ breach show that massive global businesses on which other massive global businesses depend are fundamentally out of control of their most important bedrock asset – their security infrastructure.
- The challenge here, obviously enough, will be for CEOs to adopt the right combination of *mea culpa* and reassurance so that confidence can be restored. Big earnings beats would help, too.

Bottom line

Unlike February, the current global equities correction has real causes. We dismiss concerns about Fed tightening. The US mid-term elections are moving in the right direction for continued growth, except that this emboldens Trump to prolong the trade war with China. Every day is another day with tariffs acting as a corporate income tax hike, and every day is another day with China being backed closer to a systemic cliff. It's a game of pressure, so Trump has to be willing to scare investors or he's not going to scare China. China is isolated, and will have to make a deal, and we think Trump does want a deal rather than a prolonged Cold War. The Italeave threat is upon us. It will likely end with compromise, but already pro-growth tax cuts have been mostly abandoned. Security issues continue to dog the FANG stocks, raising existential angst in the bull market's leadership group. Some of these – especially China – are real and persistent issues. But altogether, we're regarding this as only a correction, not the onset of a new bear market.