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MACROCOSM

2019 Outlook: Confidence Rots from the Head Down

Monday, December 31, 2018

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Stocks are cheapest since 2013, driven by Trump's high-risk games with China and Powell.

There's no denying it. We were too optimistic coming into 2018 (see "2018 Outlook: From Denial to Acceptance" December 29, 2017). But at least we were right before we were wrong. US stocks were making all-time highs as recently as late September. But now, from the intraday S&P 500 peak on September 21, there's already been what amounts to a bear market, carried out within the span of just a little more than three months – a drop of 20.21% to the morning low on December 26 (please see the chart on the following page). In S&P 500 futures, the bear market has been 21.33%, starting from a peak on October 3 (when the cash market missed new highs by 5 bp) to a panic bottom on Christmas day (right when the night session opened).

- *The most salient fact about markets now is that equity valuations have substantially cheapened. Stocks are on sale.*
- *At the close on Christmas Eve, the S&P 500 equity risk premium set a post-Global Financial Crisis record wide – wider than at the equity bottom in February 2016* (please see the chart below).
- The ERP widening of the last three months is due to both falling stock prices and falling Treasury yields. *But over the scope of the year, the ERP has widened as much as 160 bp from near cycle tights, and that's due mostly to equities (30-year Treasury yields*

Update to strategic view

US MACRO, US STOCKS, ASIA MACRO, ASIA STOCKS, OIL, US BONDS, US FED: 2018 ended in a quarter marked by risk aversion, driven by loss of confidence at the very top – by the fright imparted by Trump's deliberately aggressive and unpredictable approach to high-stakes brinksmanship with US/China trade and Iran. Markets have lost confidence in Powell as well, heightened by the ambiguities of Trump's approach to managing him. The bear market in…

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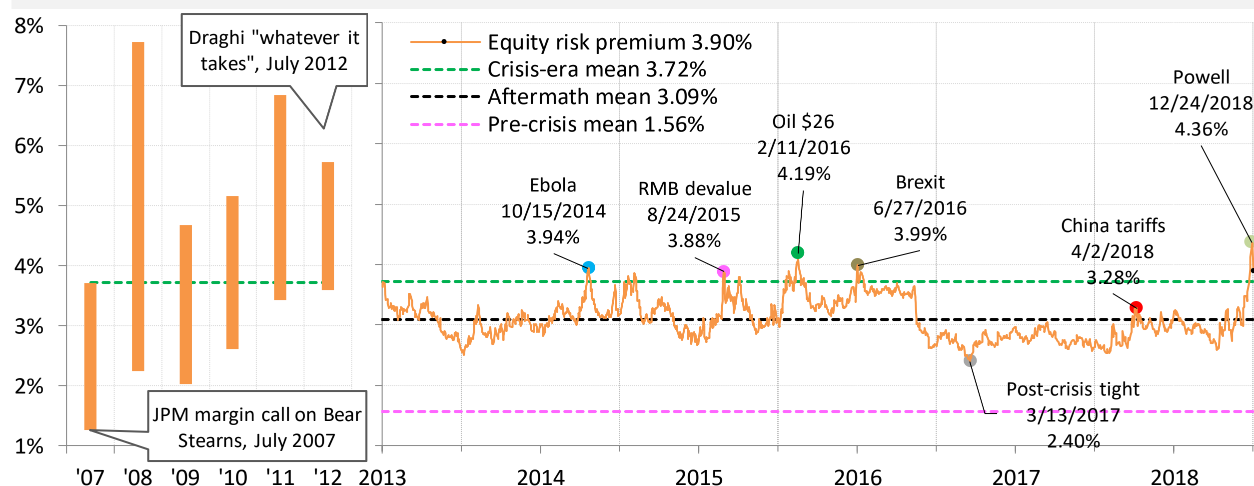
S&P 500 equity risk premium in the Global Financial Crisis and after



Source: Bloomberg, TrendMacro calculations

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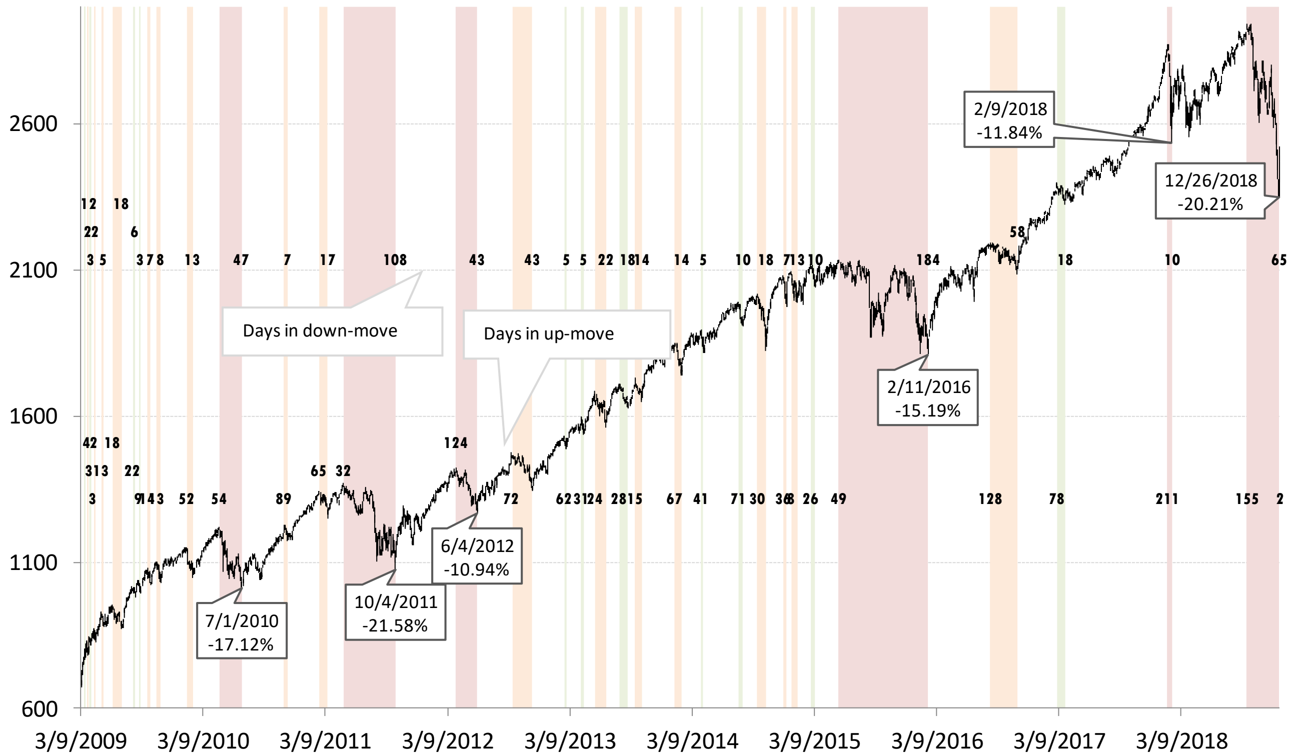
S&P 500 bull market after the Global Financial Crisis   Corrections: >3% >5% >10%

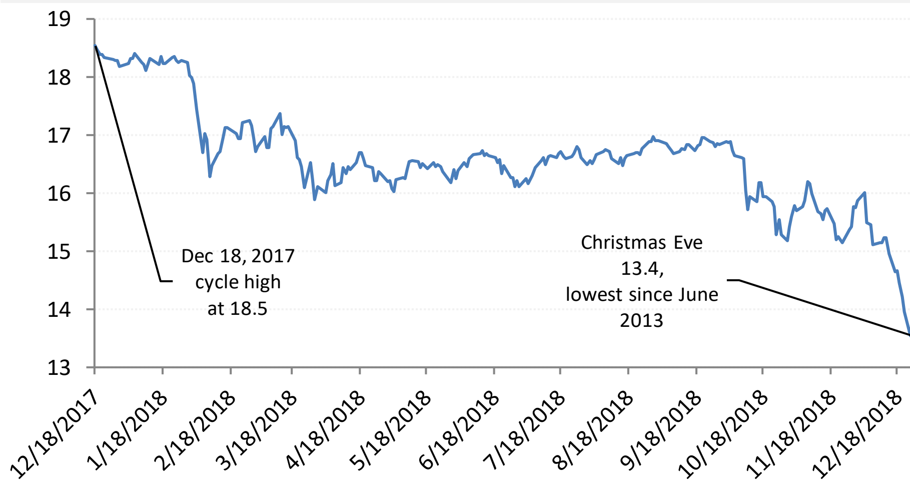


Source: Bloomberg, TrendMacro calculations

are only lower by about 25 bp year-on-year).

- Equities have experienced the paradox of falling prices (the S&P 500 total return will be something like negative 4.5% this year) at the same time as forward earnings have risen about 15%.
- From its cycle high on December 18 2017, the S&P 500 forward earnings yield has risen from 5.45 to 7.0%. *Turned upside-down, that means the forward price/earnings multiple has contracted from*

S&P 500 forward price/earnings multiple   Bottoms-up, consensus



Source: Bloomberg, TrendMacro calculations

Update to strategic view

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… oil has put risk into credit markets, and that has grown into a generalized fear of leverage. The consequence is the highest US equity risk premium, and the lowest forward P/E multiple, since 2013. We predict the US/China trade war will be settled favorably in Q1, and that a deal has already been cut with Powell. OPEC cuts should at least put a floor under oil, which will alleviate some credit stresses. As fear clears in 2019, the “dot plots” may end up being right, with further Fed hikes fully justified by improving growth and inflation, higher long-term yields and a wider yield curve.

a cycle high of 18.4 to 14.5. At the worst, at the close on Christmas Eve, the forward multiple got as low as 13.5 – a level not seen since June 2013 – bringing the total contraction from the cycle peak one year and six days earlier to 26.9%, a serious bear market in anyone's book (please see the second chart on the previous page).

What was the catalyst for this sharp correction in values? We don't think anything actually happened, but rather it was an accumulation of little things that pointed to larger potential risks and acted cumulatively to erode confidence.

- This is very subjective, but we think it holds the key, so we will nevertheless start with it: *investors are experiencing a crisis of leadership.*
- *It starts at the top, with President Donald J. Trump.*
- But we don't mean that the way you hear everywhere else. *We mean only that Trump's controversial high-volatility personal style was not an objective risk for investors in 2017, when his economic policy initiatives were limited to low-hanging fruit like deregulation and tax cuts. Then, the only risks were that he would get in his own way and the policies would fail to materialize. But his high-volatility approach did create risks for investors in 2018 when he turned to high-risk initiatives like the trade war with China, and re-imposing sanctions against Iran, as we pointed out in March* (see "On the China Tariffs" March 22, 2018).
- *The big one is the US/China trade war, where a positive outcome could create superlative value for generations by having forced China, now tied for the world's largest economy, to become less protectionist and more open to the world. But a negative outcome could drive US disengagement from China, shattering supply chains nurtured over a decade, and throwing China into a systemically disorderly recession that could spill over into the entire global economy.*
- In the negotiation, the only way to coerce China toward the positive outcome is to threaten them with the negative outcome – and China will only agree with US terms to the extent that the threat is credible (see "Our Knife at China's Throat" October 8, 2018). Indeed, the recent outpouring of concessions to the US from China before formal negotiations have even begun (see, for example: "China allows first-ever U.S. rice imports in 'goodwill gesture' ahead of trade talks" *Reuters*, December 28) is on the one hand wonderful news. But on the other hand, it necessarily reflects the recession risks that China must believe it is already facing here and now (see, for example: "China Slowdown Continues With Factory Gauge at Lowest Level Since 2016" *Bloomberg*, December 31).
- Investors will all have their own opinions about whether this undertaking has a likely positive outcome, and if so, whether the risk/reward ratio makes it worth pursuing. Be that as it may, we are pursuing it. And we are pursuing it in Trump's aggressive "art of the deal" style, by which he acquires negotiating advantage by creating uncertainty in the minds of his adversaries – but along the way creates uncertainty in the minds of investors, too. As we have said

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before, he's not going to scare China's president-for-life Xi Jinping if he's not going to scare *you* (see "One Sell-Off, So Many Causes" October 15, 2018).

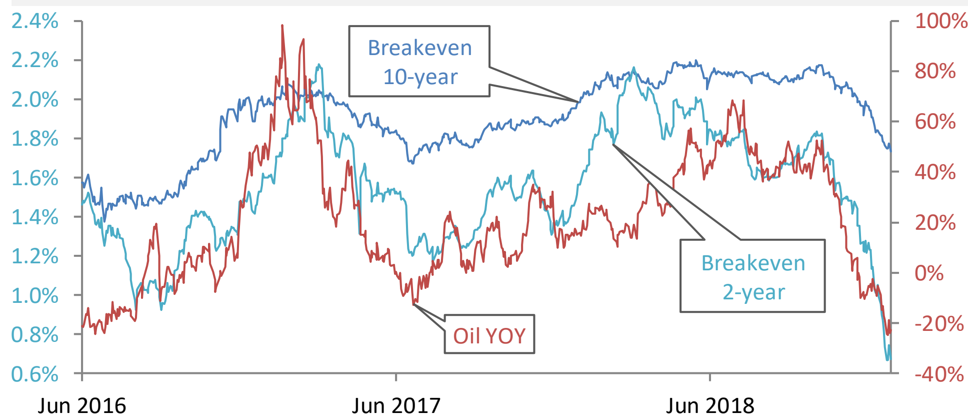
- Make no mistake about it – it's working. Less than a month ago the consensus was minimizing the importance of the Trump-Xi Buenos Aires summit, calling the breakthrough a mere "truce" and claiming that there was no actual consensus among the presidents (see "On the US/China Trade Breakthrough" December 2, 2018).
- But since then China has removed its retaliatory tariffs, cut tariffs in general, resumed buying soybeans and other commodities from the US, and started liberalizing laws governing forced technology transfers – while the US has given up precisely nothing, except to delay *additional* tariffs. Some "truce."

- On Saturday Trump tweeted that he had talked to Xi and that "Deal is moving along very well... Big progress being made!" Despite the usual tut-tutting from the media that "the president may be overstating how close the two sides are to an agreement," China affirmed it in an official statement.
- Chinese media reported, "Xi said Saturday that officials from both countries have been working actively and hopes the teams can meet each other halfway." Now do you see why Trump has made so many demands, so many "big asks"? Now do you see why, literally while Trump and Xi were dining in Buenos Aires, Canada arrested at the US's behest Meng Wenzhou, the CFO of Huawei, virtually Chinese royalty? You remember how the markets reacted to the arrest – with "shock" that it would "upend the Trump-Xi trade truce." The opposite happened – after Trump captured China's queen, China took a couple of Canada's pawns – and that's about it, except for the global revulsion against Huawei that has arisen in the aftermath, earning for Trump allies against China who had been on the sidelines previously. But it didn't have to turn out that way. It was in fact a risky move, and the fact that it seems to have worked doesn't make it not risky.
- *When a negotiator takes it as far as Trump has in all these dimensions, "meet each other halfway" ends up being a very favorable outcome that he wouldn't have obtained otherwise.*
- The problem is that it is a "maximax" game theory approach that is highly unusual in US diplomacy – it is pure brinksmanship, and in this case the economic stakes are the highest imaginable (see "Is Trump Really Bluffing on Tariffs?" June 22, 2018). *Only Trump would dare to try it, and only Trump's style would make it possible – but, again, that style requires at its essence that everyone's fear and uncertainty is maximized – and Trump's whole whacky tweet-driven communications style does that to a fault.*
- We think – as we have all along – that China will have to capitulate (see "Did China Just Run Up the White Flag in the Trade War?" July 10, 2018). In the meantime, Trump's approach necessarily maximizes uncertainty, while China's economy continues to dangerously weaken as its own internal fragilities come under

stress due to the exogenous pressure Trump is applying. *So even as markets endure the headline-risks on the way to "yes," the very real risk of China imploding continues to tick in the background* (see "Death by China on the Way to Yes" December 17, 2018).

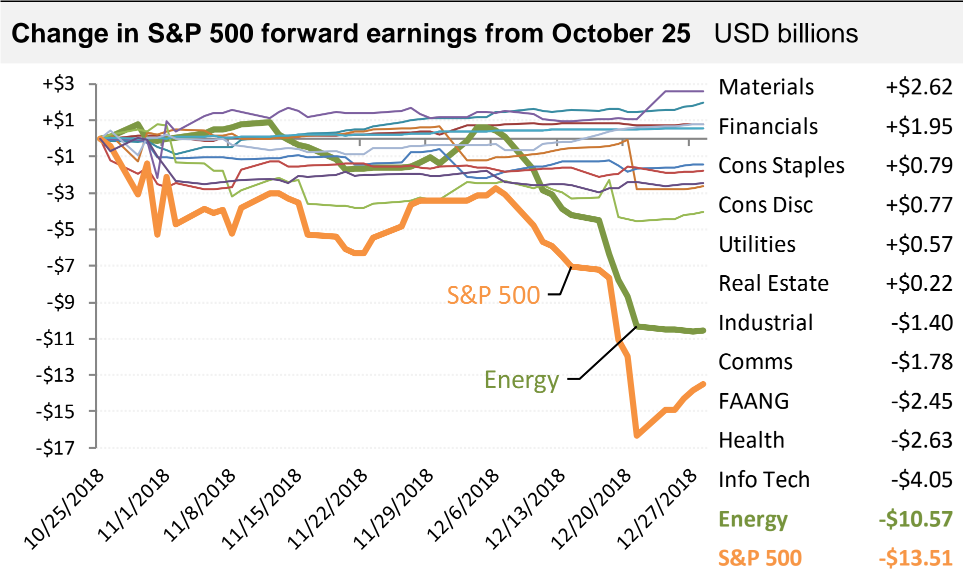
- The same dynamic of increasing risk aversion has been in play over the last two weeks in the aftermath of the December FOMC. We warned at the very beginning that Jerome Powell was a terrible appointment for Fed chair (see "On Powell for Fed Chair" November 2, 2017) – the first non-economist to run the Fed since the disastrous and short-lived chairmancy of G. William Miller in 1978 and 1979. *The December FOMC was his first real test as chair, and he failed it miserably* (see "On the December FOMC" December 19, 2018) – *and that test was integrally tied up with another case of Trump's high-stakes style.*
- Some history by way of background… After Trump had pulled the US out of the Iran nuclear deal, the threat of secondary sanctions on non-US buyers of Iranian oil threatened to throw the global crude oil market into shortage, with global inventories offering no cushion – having been returned to normal levels after 18 months of OPEC production limits (see "Iran Deal: More Fire, More Fury, Pure Trump" May 9, 2018). But the alleged murder of so-called "journalist" Jamal Khashoggi by Saudi Arabia set in motion a chain of political events that led Trump to waive most sanctions just before the US mid-term elections – which abruptly switched the global crude oil market from fear of a shortage to fear of a glut (see "OPEC's Gifts to Trump" November 14, 2018). In the less than three months since the October 3 top – literally the same day as Khashoggi's death – crude oil has been in a severe bear market, extending at the worst to more than 45% last week.
- *That, in turn, led to a sharp drop in market-implied inflation expectations* (please see the chart below), which in turn led to a sharp drop in long-term Treasury yields, which flattened the yield curve to near-inversion (see "The Yield Curve: The World's Worst Indicator, But…" December 6, 2018).
- *At the same time, the crude oil price collapse has caused wholesale downgrades in forward earnings for the US energy*

TIPS-implied inflation compensation versus oil price



Source: Bloomberg, TrendMacro calculations

sector – enough to almost entirely explain a gentle rollover in overall S&P 500 earnings (please see the chart below, and "Recession Risk at Last?" November 20, 2018).



Source: Bloomberg, TrendMacro calculations

- The near-inversion of the yield curve, the fall of inflation expectations, and a corporate earnings rollover gave the FOMC three powerful reasons – and that doesn't even include what was already by then a powerful equity market correction – not to hike the funds rate in December – but they did anyway (see "On the December FOMC" December 19, 2018).
- That hike was generally expected and doesn't in and of itself mean much one way or the other. But the FOMC inexplicably and disturbingly broke the promise it had made to markets in the minutes of the November meeting to introduce more cautious statement language (see "Data Insights: FOMC Minutes" November 29, 2018).
- Then Powell delivered a clownishly bad performance at the post-meeting press conference, where he was weirdly unresponsive to legitimate, probing questions about why the FOMC made the decision it made in light of some fairly compelling reasons to have waited (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018). Powell left markets with the impression that the Fed was willfully ignoring some obvious risks – and gave markets no idea what was next, or on what basis it would be decided. *Is there a "Powell put" or not? What would make him exercise it?*
- …*And then the rumors that Trump would fire Powell*, which moved the uncertainties about Powell up to a meta-level. Should markets fear that Trump will go berserk and interfere with a so-called "independent agency," or should markets fear that he *won't*, leaving damaged goods he himself appointed in charge of the world's most important financial institution? *There's so much uncertainty we can't even be certain what to be uncertain about.*

- Just as with China, despite the media's fear-mongering coverage of it, and despite the market's self-evident and justifiable fright about it, *our point-estimate for the actual outcome is very positive*. It involves some tea-leaf reading to be sure, but we're quite confident in our interpretation of events: *Powell has cut a deal with Trump – via his sponsor Treasury Secretary Steven Mnuchin, and surely helped along by the markets' vote of no confidence – to either clarify a more market-friendly policy framework, or resign with dignity at some point* (see "Did Powell Just Cut a Deal?" December 23, 2018).
- At the same time, while these games are being played at the high-stakes table, the erosion of confidence they impart has showed up in other ways, smaller-stakes perhaps, but closer to home for investors.
- Don't underestimate the effects on market psychology of the loss of market leadership by the FAANG stocks, companies that investors believed until recently were quite literally going to take over the world (again, see "One Sell-Off, So Many Causes"). Consider the tone-change in the market's regard for Facebook's Sheryl Sandberg, who until recently seemed capable not only of creating infinite shareholder and personal wealth, but also of coaching a whole generation of women on how to "lean in" and do the same themselves. It seems that all it took was a user-privacy scandal peripherally touching the Trump campaign – and Sandberg's getting on the wrong side of highly influential political operative George Soros – to utterly destroy her reputation and severely damage that of her company.
- *There's lots of this going around – some version of "how are the mighty fallen", or more specifically, loss of confidence in the very top*: the arrest in Japan of iconic auto mastermind Carlos Ghosn on what amount to fraud charges; criminal charges in Malaysia against financial superpower Goldman Sachs; the collapse of Bitcoin; even the slowdown in seemingly invulnerable China.
- *For many of our clients, it has settled on a belief that there is an impending debt crisis in the US economy.* To be sure, credit spreads have widened from cycle tights just a couple months ago – this is connected in large part to the collapse of the oil price (again, see "One Sell-Off, So Many Causes") – but they've been a lot wider several times in this business cycle, and they're still below average. And the absolute level of yields remains quite low by historical standards. Other than the recent agonies of General Electric – another idol fallen – we don't see much actual evidence that anyone is really in trouble. And we've never yet heard a really good reason why the gradual normalization of the Fed's balance sheet ought to have anything to do with it (again, see "It's Not 'Quantitative Tightening' – It's Powell").
- *But the debt story is in some sense irresistible, because everyone can agree that excess leverage is a sufficient condition for a self-reinforcing crash – so merely talking about it evokes still-fresh memories of the Global Financial Crisis, and certainly matches the risk-off mood.*

Markets are scared of lots of things, and that's made stocks cheap. Markets aren't stupid, so there's at least a plausible story associated with all the things markets are scared of. Being scared causes risk premia to be impounded in risk-asset prices, which is to say that prices of risk-assets will fall, as they indeed have. If you think entirely probabilistically then all you can do about this is quibble about whether the exact level of the risk premium is exactly right. But we are thinking in terms of outcomes, not probabilities. We fully acknowledge the risks – it is risky to conduct a trade war with China, and it is risky to have a less-than-credible captain at the helm of the Fed. The potential downsides are truly horrible. But we just don't think those downsides are going to materialize.

- *We are betting that a trade deal gets done with China in Q1-2019 (and that China won't blow up before that), and that a deal has already been done with Powell. We think when those upside outcomes are known, the risk premium will narrow, and then all the other small-bore things that concern investors just won't seem so daunting.*
- *This is a great set-up for equities in the US and worldwide. The biggest winner in a resolution of the US/China trade war will be China, and the emerging markets in its orbit. They have already significantly outperformed the US since the Buenos Aires summit.*
- *If we are right about Powell, then, ironically, the FOMC's "dot-plots" may turn out to be true, despite the market now forecasting no hikes at all in 2019. But that won't be because the Fed becomes more hawkish – only that when the present patch of risk-aversion is overcome, causing growth and inflation expectations to improve, long-term yields will rise, and the yield curve will widen out a bit.*
- *We are betting that we've seen the lows in oil, that the OPEC cuts will be enough for at least that, given the very normal state of global inventories, and that the Iran sanctions will click in next year, sopping up any excesses. That will impart relief to debt markets, where there is some overexposure to the energy sector; and it will stop the decline in S&P 500 forward earnings.*
- *We do respect the risks – we could be wrong about positive outcomes materializing, and for that matter, while we wait to find out, risk-aversion can be self-feeding, so self-fulfilling prophecies on the downside can't be ruled out. We aren't forecasting a recession in 2019, but we are on the lookout for the first time in many years* (again, see "Recession Risk at Last?").
- *But we do not see any "excesses" of the type typically associated with large-scale bear markets. We've just got real risks driven by actual risk-taking – and our best prediction is that the admittedly very bad worst-case scenarios simply won't materialize, but rather that the risk-taking will be well rewarded.*

Bottom line

2018 ended in a quarter marked by risk aversion, driven by loss of confidence at the very top – by the fright imparted by Trump's deliberately aggressive and unpredictable approach to high-stakes brinksmanship with

US/China trade and Iran. Markets have lost confidence in Powell as well, heightened by the ambiguities of Trump's approach to managing him. The bear market in oil has put risk into credit markets, and that has grown into a generalized fear of leverage. The consequence is the highest US equity risk premium, and the lowest forward P/E multiple, since 2013. We predict the US/China trade war will be settled favorably in Q1, and that a deal has already been cut with Powell. OPEC cuts should at least put a floor under oil, which will alleviate some credit stresses. As fear clears in 2019, the "dot plots" may end up being right, with further Fed hikes fully justified by improving growth and inflation, higher long-term yields and a wider yield curve.