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Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Chinese Tariff Torture

Monday, October 29, 2018

Donald Luskin

Great GDP, great earnings season, great valuations. All falls flat as Trump lets China suffer.

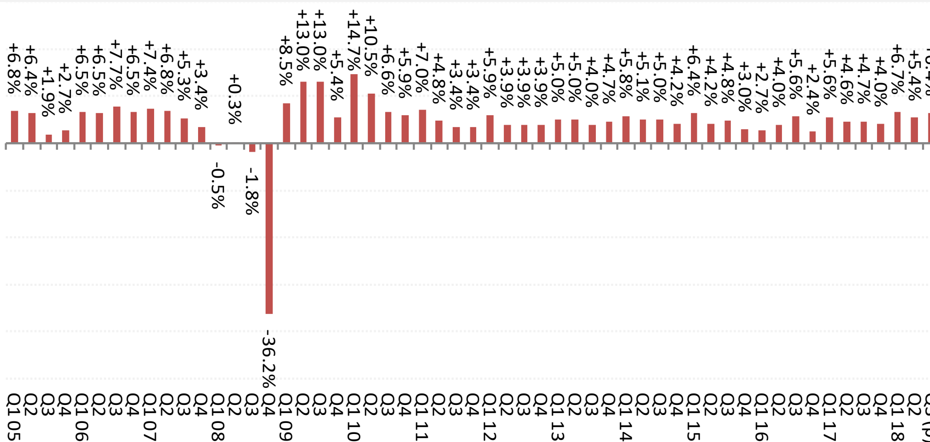
It's a wonderful world, isn't it? Things must be pretty great when Q3-2018 GDP growth comes in at 3.5% – beating consensus expectations for 3.3% – and other than Q2's 4.2%, the strongest quarter in four years – and yet commentators call it "disappointing," which captures the mood of most of the clients we talked to about it. The *New York Post*'s headline takes the prize for the most devious bearish slant: "US economic growth slows less than expected in third quarter."

And things must be pretty great when so far this earnings season the average surprise for the S&P 500 is a beat of 6.4% – tied for the second best over 7-1/2 years (please see the chart below) – and yet commentators call it a "flop." Yes, things don't *feel* great when you're in a steep stock market correction. So far it's been 10.6% over 25 market days for the S&P 500, and it seems that so much is going wrong in the world all at once (see "One Sell-Off, So Many Causes" October 15, 2018).

Once again, we'll do a world tour and look at all the various disasters – real and imagined – that are in play (and some good things, too). China remains the elephant in the room, and we will get there in due course.

MID-TERMS AND PIPE-BOMBS We stand by our view that the GOP will keep control of the Senate – likely gaining two seats – and that House

S&P 500 earnings surprise factor



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US FED, US MACRO, EUROPE MACRO, ASIA MACRO, ASIA STOCKS, OIL: US The mid-terms remain a lock for the GOP in the Senate, and a toss-up in the House. GDP was helped by inventories and hurt by imports – which offset each other, and will offset again when eventually unwound. The weak-spot was the fall-off in CAPEX. Earnings season has been stellar, except that market leadership by the FANG stocks has come into doubt. Equity risk premia are attractive globally, and US PE multiples have almost corrected to bear market territory. The curve is now discounting a less aggressive Fed, and Clarida has emerged as "adult supervision" to Powell. The Saudi alleged murder puts pressure on oil prices, as does slackening demand in emerging markets and China. The Italian "October surprise" is here, but new growth prospects are dead. Trump is letting China suffer while its economy weakens, with the consequence of global spillovers as in 2015-16. The biggest global risk is an outright recession in China.

[Strategy dashboard]

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control is a toss-up that slightly favors the Democrats (see "Mid-terms: Animal Spirits on the Ballot" September 11, 2018, and again, "One Sell-Off, So Many Causes"). We think that is pretty much the consensus impounded in the market, and it's just fine for growth prospects.

- We note that Friday's sharp sell-off in equities bottomed *precisely* at the moment when CNN broke the story that authorities had arrested a suspect for the rash of mailed pipe-bombs.
- We try not to read too much into such coincidences. But it occurred to us that the arrest not only took out of circulation a murderous madman working on a national scale, but also put a limit on the sympathy that voters might extend to Democratic candidates in next week's election. Too much sympathy, and GOP control of the Senate would be at risk – and setting one's subjective politics aside, as strategists we think that would be an anti-growth surprise to markets (again, see "Mid-terms: Animal Spirits on the Ballot").
- After the Kavanaugh confirmation fiasco – which we think locked in the Senate for the GOP by killing the chances for re-election of red state Democratic senators Heitkamp (ND), McCaskill (MO) and Donnelly (IN), all of whom voted "nay" – it is at least a relief for Democrats to have a Republican wannabe-killer reset the news cycle.
- *But it doesn't reverse the news cycle, so we are not altering our mid-term predictions because of this.*
- Previously apathetic GOP voters, now galvanized by perceived over-reach in the Kavanaugh confirmation by highly professional and highly organized Democratic authority figures, won't be demobilized because of the actions of a criminal – already under arrest, and known to be a lone nut-job who lives in his van. Oh – and he was at least smart enough not to send a bomb to Heitkamp, McCaskill or Donnelly.

GDP *Again, Q3-2018 GDP growth at 3.5% was a big number for the first quarter of the tenth year of an expansion, and a big beat.* But the mood is sour – and just before an election politics inserts itself – so there was no shortage of overwrought headlines like "Trump's trade war took a stunning bite out of the US economy." That said, there are a number of factors beneath the GDP headlines that do deserve some examination (see "Data Insights: GDP" October 26, 2018).

- One widely-heard critique is that 2.07% of Q3's 3.50% GDP growth came from inventory accumulation.
- Usually when inventories surge, the troubling implication is that consumption hasn't kept pace, and warehouses are starting to bulge with unwanted goods. That definitely is not the case this time. Q3 consumption growth at 4.0% was the strongest since Q4-2014, and inventory/sale ratios are unalarmingly right in the middle ground that is normal for expansions (see "Data Insights: A Few of Our Favorite Things" October 24, 2018).
- Another widely-discussed flaw in Q3 GDP – the surge in imports of 9.1%, which computationally subtracted 1.34% from the quarter's

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

Recommended Reading

Apple CEO Condemns 'Data-Industrial Complex'
Sam Schechner and Emre Peker
Wall Street Journal
October 25, 2018

Is Cash Still King?
Tim Sablik
Federal Reserve Bank of Richmond
Second Quarter 2018

The Crisis in U.S.-China Relations
Richard N. Haass
Wall Street Journal
October 20, 2018

Why Is Khashoggi Being Made The Defining Issue Of U.S. Foreign Policy?
Ben Weingarten
The Federalist
October 19, 2018

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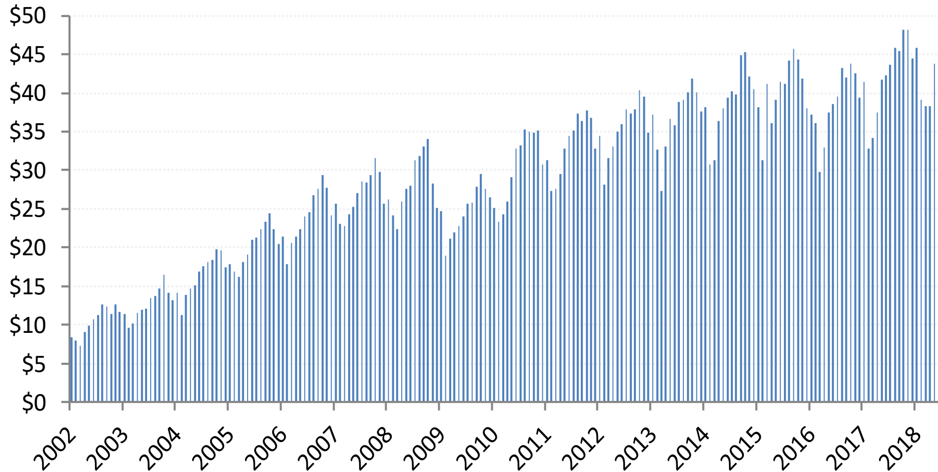
growth. One sensible explanation is that US buyers snapped up Chinese goods ahead of the imposition of new tariffs that took effect on October 1. That's all to the good as far as we're concerned – it's just tax-optimal corporate behavior.

- It is consistent with the granular underlying data showing US imports from China hitting $47.9 billion in August, almost a record (please see the chart below).

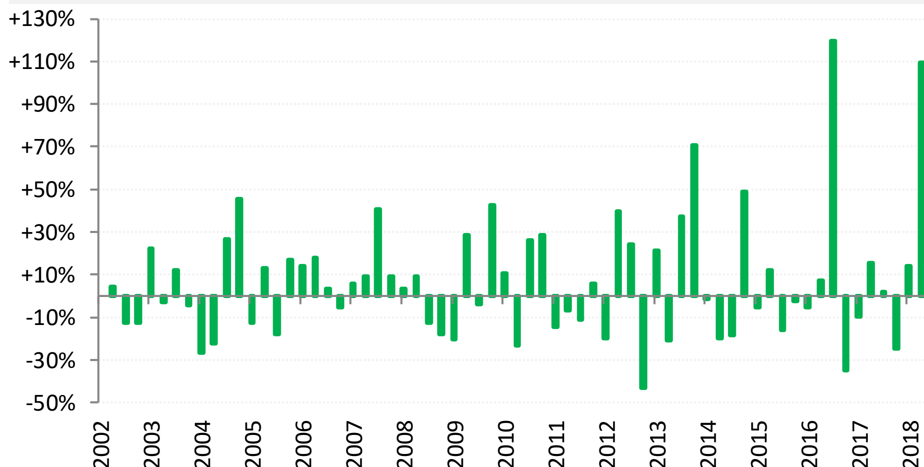
US imports from China Monthly, USD millions, not seasonally adjusted



Source: Department of Commerce, TrendMacro calculations

- And it makes sense that US buyers would have to put these accelerated imports into inventory. *So these two factors – a surge in imports that seemed to subtract from GDP, and a surge in inventories that seemed to inflate GDP – explain and mostly offset each other. And all else equal, over the coming quarters when both unwind, they will harmlessly offset each other again.*
- The US/China trade war is supposedly also reflected in Q3's 18.5% drop in exports of foods, feeds and beverages (please see the chart below), which shaved 0.62% off GDP – presumably due to

US exports of food, feeds and beverages QOQ growth, SAAR



Source: Bureau of Economic Analysis, TrendMacro calculations

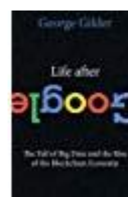
China's boycott of US soybeans and sorghum. Maybe – but there is only so much supply-elasticity, and China's shifting its sourcing to some other producer nation in the sort term can, at most, only shift demand from the buyer nations that China displaces to US markets – so it's not clear to us that this will be of lasting damage. And the business is highly seasonal – and therefore subject to highly dubious seasonal adjustment factors. Note that Q3's 18.9% contraction followed Q2's 110% gain (similar to the back-to-back boom-bust quarters of Q3 and Q4-2016, when there wasn't any trade war going on with anyone). We'll be talking a lot more about the US/China trade war in a moment – we take it very seriously as a risk factor, but we caution against reading too much into a single line-item in the GDP report.

- *The element of Q3 GDP that does worry us is the surprising and disappointing drop-off in non-residential fixed investment – that is, corporate capital expenditures.* After Q1's and Q2's blistering growth of 11.5% and 8.5% respectively, Q3's breakeven 0.8% growth rate could be interpreted as quite a let-down – *we'd been tracking this as evidence of the emergence of second-order effects of the corporate tax cuts enacted last December, which create incentives for more CAPEX by raising the after-tax earnings that flow from it*.
- We need to be careful not to make excuses and fall prey to confirmation bias here, just because we have had the strong conviction that the tax cuts would lead to CAPEX growth. We note that consensus forward CAPEX for the S&P 500 grew at an annual rate of 12% in Q3, considerably higher than the 0.8% growth reported in GDP. But that was slower than the prior two quarters, and so far October has been slower still.
- *It would send an alarming signal about the diminution of animal spirits and risk tolerance if, despite the strong incentives for CAPEX, it failed to further materialize after such a good start earlier this year. This deserves careful and realistic watching.*

EARNINGS SEASON As we said at the outset, the earnings season, that boasts a 6.4% positive surprise factor, tied for second-best over 7-1/2 years, has been a real winner (again please see the chart on the first page).

- A great deal of attention was paid to Amazon's and Google's earnings reports on Thursday – both were big headline beats, but both contained disappointing elements that dominated the markets' reaction, at least so far.
- This is a crisis of the intangible magic of market leadership, not the reality of earnings. Investors have believed that these companies will, quite literally, take over the world. That is being reappraised (see "DeFANGed" March 28, 2018, and again "One Sell-Off, So Many Causes"). Once again, we highly recommend clients read George Gilder's provocative new book *Life After Google*, which argues these companies are built on fundamentally vulnerable technology and business platforms that are ripe for disruption.

Recommended Reading



Life After Google
George Gilder

Please contact Thomas Demas
tdemas@trendmacro.com
if you would like us to send you a copy.

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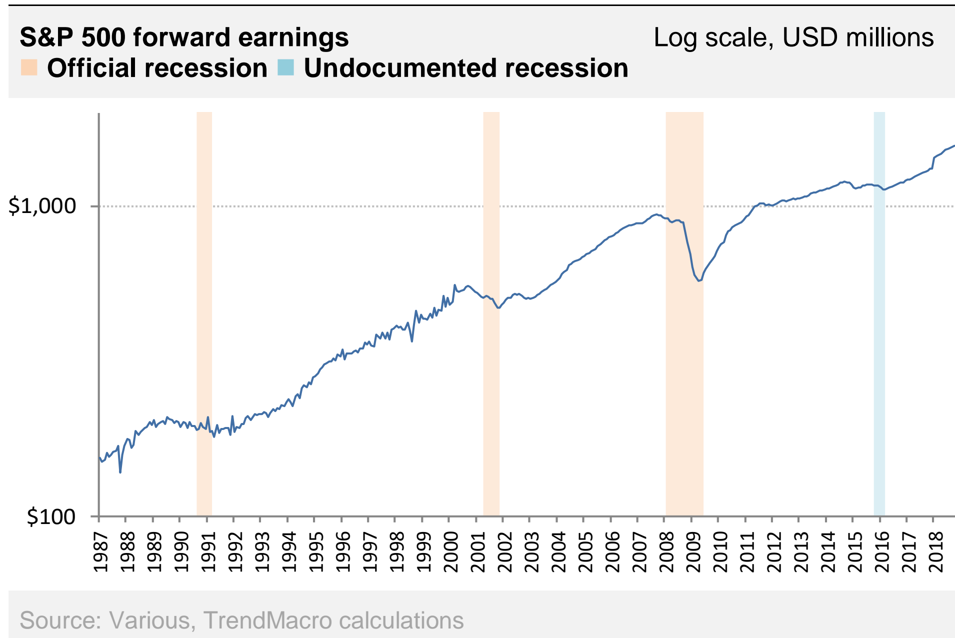
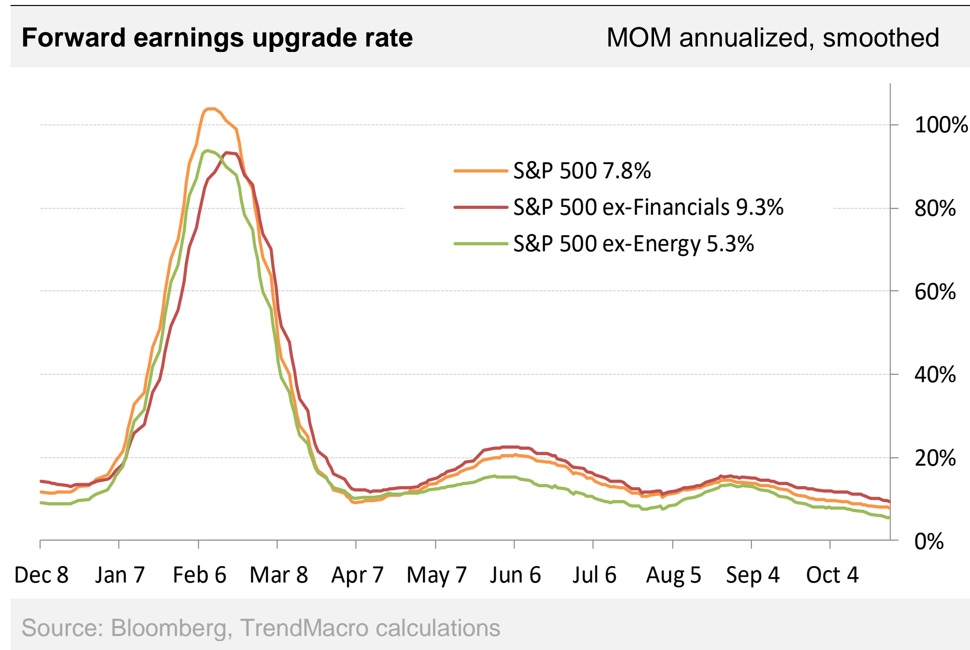
- *In the more objective realm, overall, the earnings metric we look at most carefully – the growth of consensus S&P 500 forward earnings – remains in good shape* (please see the chart below).



Source: Various, TrendMacro calculations

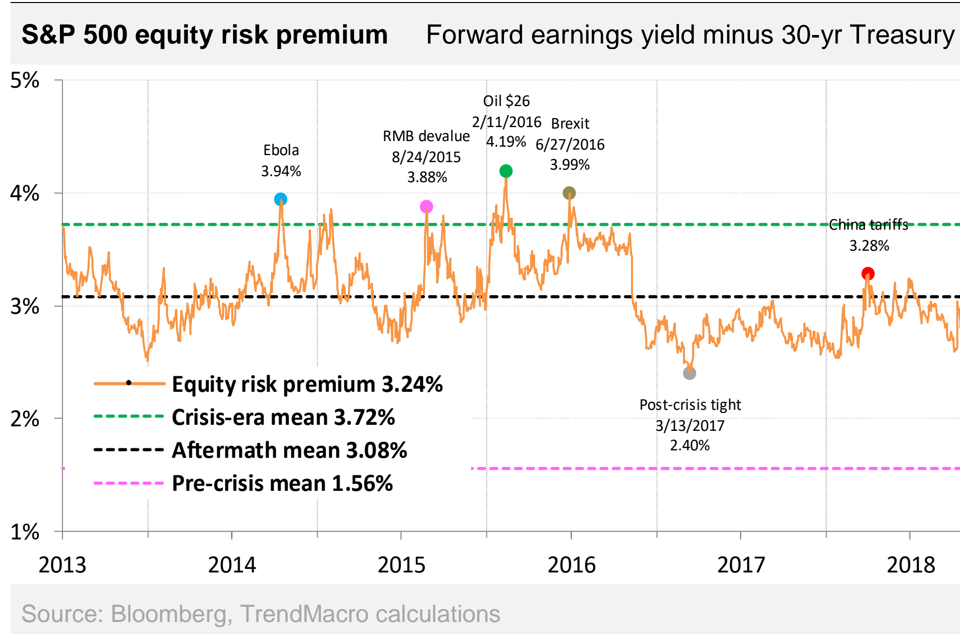
- *The momentum of forward earnings upgrades has slowed considerably from its unsustainably hot pace of the first half of the year, especially in the early first quarter when the corporate tax cuts drove a 10%-plus one-time step function higher* (please see the chart below)*. But today's upgrade rate remains above the historical norm. It is by no means rolling over and going negative – which historically has always been a reliable recession warning* (again, please see the chart above).

VALUATION Equity risk premia around the world have become



Source: Bloomberg, TrendMacro calculations

extremely attractive, widening to challenge the highs of the post-crisis period (for a global sample, see “Weekly Investment Strategy Summary” October 29, 2018). US equities are the least attractive, relatively, by this standard. But the S&P 500 equity risk premium has widened to exceed its post-crisis mean, and *on Friday was just basis points below the peak in early April – a point when stocks were an excellent buying opportunity* (please see the chart below).



S&P 500 equity risk premium Forward earnings yield minus 30-yr Treasury

Source: Bloomberg, TrendMacro calculations

- But while the correction from the September 21 S&P 500 high has so far been only 10.6%, in value terms it is been far deeper. *The S&P 500 forward price-earnings multiple of the S&P 500 topped at 18.5 on December 18, and is now only 15.3. By modern standards that’s smokin’ cheap – and it represents a 17.6% correction, practically a bear market.*

THE FED President Donald J. Trump has a way of wearing his critics down. Now with a deep stock market correction upon us even our friends on the *Wall Street Journal* editorial page are admitting that Trump’s critique of the Fed has merit. We’ve always thought so (see “Like It or Not, Trump is Right about the Fed” July 20, 2018) – but it hasn’t worried us because we’ve assumed that new Fed chair Jerome Powell, whom we do not believe is politically independent, would get the message to back off on rate hikes unless the economy continued to accelerate.

- The market seems to have been with us on this one. *Over the month of October as the equities correction has intensified, an entire rate hike has come out of the expectations structure.* At this point, the curve is anticipating only two more hikes this cycle, peaking at about 2.66% a year out – never even touching the “longer run” dot-plot at 2.87%. *The market isn’t even assuming a hike at the December FOMC is an absolutely sure thing anymore.*
- The December FOMC is still a long time off, and we’ll know more then about the direction of the economy. At the moment, when

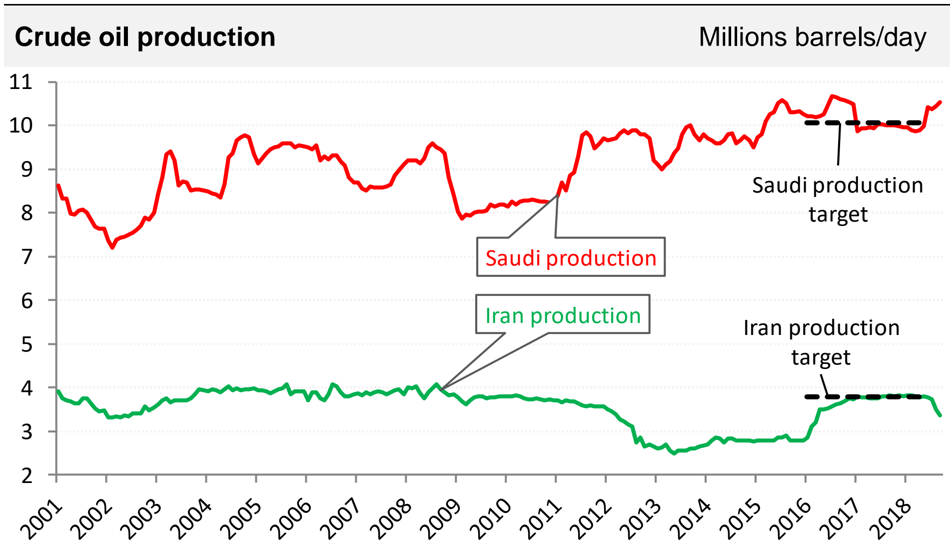
even a strong GDP quarter that beats consensus expectations is regarded as weak and disappointing, *it's not hard to imagine the Fed might have to pass. But we'd be surprised, because we think last week's mood is something of a panic, and we expect it will dissipate.* The reality is that other than a poor year so far for housing, it's hard to point to any macro signals that aren't looking quite robust.

- *As a signal, we suggest watching the 10-year Treasury yield.* At 3.11% now, it has pulled back from the highs at 3.25% three weeks ago. That's a little bit of risk-off, and we can understand why. But it has held on to the majority of the 45 bp back-up from 2.80% in late August. If it gives that up, *we'll have an inverted 2-10 curve, and we guarantee you that will get Powell's attention, and block a December rate hike for sure*. We know from his July congressional testimony that he watches it as a warning that policy is excessively tight.
- With all last week's tumult, some Fed-watchers might have missed the debut public speech last week by new Fed Vice Chair Richard Clarida, which we found nothing less than thrilling. It is the perfect complement to Powell's debut Jackson Hole speech, in which the chair distanced himself from the false precision of weaponized models that depend on non-stationery estimates of r-star, u-star and π-star (see "On Powell's Debut at Jackson Hole" August 24, 2018 see "The Fault is in R-Star" September 17, 2018).
- Clarida directly acknowledges Powell's skepticism about the models, but resolutely defends the importance for robust policy of the underlying *concepts*. The gap in Powell's critique was that when he threw away such *concepts* simply because they are imprecise, he left himself – and the market – with no stars at all by which to navigate. *As Clarida points out, how can a central bank operate at all if it doesn't have at least some notion of whether the policy rate is above or below the neutral rate?*
- Clarida seems to be the perfect partner for Powell – hopefully the same kind of "adult supervision" we predicted (correctly) that prior vice chair Stanley Fischer would provide for prior chair Janet Yellen (see "Stanley Fischer: Game of Chairs" December 12, 2013).

OIL We haven't explicitly dealt with oil as part of our universe of elements contributing to the present correction. So far this year, crude has almost magically stayed within the bounds of our expected trading range from $65 to $75 (see "Oil's Bullish Bottlenecks" April 24, 2018). As the November onset of the Trump administration's secondary sanctions against Iran draws near (see "Iran Deal: More Fire, More Fury, Pure Trump" May 9, 2018), we might have feared that oil would break out to the upside, and impose a drag on global growth – especially upon the emerging economies whose currencies have weakened versus the US dollar, which doubly hikes the oil price for them (see "No Pardon for This Turkey" August 14, 2018).

- As nations such as Japan and India begin to turn away from Iran's oil in anticipation of sanctions, Iran's crude production is already down by almost 500,000 barrels/day from its recovery highs earlier

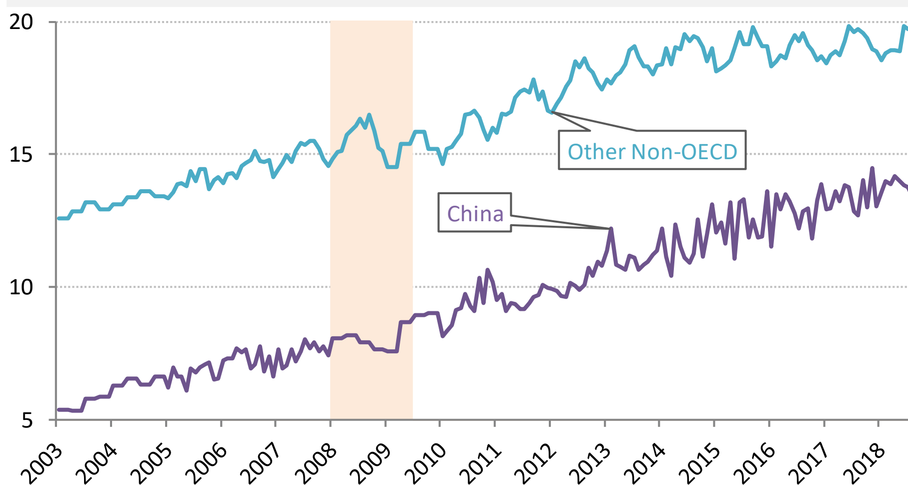
this year. That's been perfectly offset by Saudi Arabia's increased production since the lifting of production quotas (please see the chart below, and "OPEC Eases (Or So It Claims)" June 25, 2018).



Source: Bloomberg, OPEC, TrendMacro calculations

- *It has been a gift to Saudi – a gift of Iran's market-share, a gift of power over a regional rival, and a gift of effective control over global oil prices by acting as the emergency swing producer.*
- *But now the world-wide outcry against Saudi's alleged murder of a journalist has changed the dynamic. Suddenly it is unseemly for Trump to bestow so many gifts upon Saudi as a side-effect of the Iran sanctions – so there is talk that the US will back off sanctions on Europe aimed at disrupting its trade with Iran. Suddenly it has become incumbent upon the Kingdom to act like an especially noble citizen of the world – and that means, among other things, having to pledge to not opportunistically squeeze oil prices.*

Crude oil consumption Millions barrels/day **Recession**



Source: Dept of Energy, Energy Information Administration, TrendMacro calculations

- At the same time, ongoing struggles in emerging economies have taken some of the growth out of crude oil demand. Non-OECD nations other than China have, collectively, been as great a source of demand growth as China over the last 15 years – but that growth has quietly stalled out since mid-2015 (please see the chart on the previous page). Demand growth in China itself this year has been stagnant, as the Chinese economy has slowed under pressure from the US trade reform initiative – despite high profile efforts by authorities to stimulate consumer demand (see, among many, "Our Knife at China's Throat" October 8, 2018). We'll have much more to say about China in a moment.
- But for now, the point is that a newly cooperative Saudi Arabia, and some pressure on demand growth, seem to be conspiring to keep a lid on oil prices despite looming sanctions against Iran. So *we are not especially concerned by rising oil prices as a potential global macro headwind.*

EUROPE Precisely as we've been predicting, the "October surprise" arising from Italy's high-stakes budget stand-off with the European Union is upon us (see, most recently, "On the Margin: The Italian October Surprise is Here" October 2, 2018). The Italian parliament managed to actually produce a budget and submit it to Brussels; Brussels rejected it; Rome said there "is no Plan B"; Moody's downgrades Italy; Standard and Poors' "lowered its outlook" on Italy; feces-flinging concerning Italy leaving the euro currency (by professing to not want to leave it) – which could trigger a EU-wide run-on-the-bank with potentially globally systemic consequences – ensues.

- Oh, and have we mentioned that all this brinksmanship is for nothing at this point? The Italian government has pretty much abandoned its plan for a pro-growth tax cut.
- At the same time, the new Socialist Party-led Spanish government is moving to take back the tax cuts that have made Spain the fastest growing large eurozone economy.
- It is probably slightly useful that German Chancellor Angela Merkel has stepped down as leader of her Christian Democratic party over the weekend, in the wake of another regional election disappointment. She'll likely stay on as chancellor till 2021, but probably won't have the stomach right now to sign on for an all-out confrontation with Italy over a couple percentage points of deficit.
- *We'll likely make it through the Italian budget crisis without a global systemic event – but there is, say, a 3% chance of it, and you'd never get on an airplane that had a 3% chance of crashing.*
- *But this is ridiculous. It's all risk for no gain. We officially give up on Europe as anything but a trading opportunity.*

CHINA *The present equities correction is about many things, but we think China is the elephant in the room – and a stinky one at that* (again, see "One Sell-Off, So Many Causes").

- A lot of the pressure on the stock market comes from the

cumulative corrosive effects of US tariffs on imports from China, which by year-end would have a notional value that would about half-cancel the corporate tax cuts enacted last December.

- But the notional value of the tariffs won't be paid, for the same reason that almost nobody pays the notional value of the federal inheritance tax – it's relatively easy to avoid it. Indeed, the whole purpose of tariffs is to get you to avoid paying them by not buying things from certain countries. Just buy the same things from other countries and you can avoid the tax, except for the non-zero frictional cost of shifting your sourcing.
- Some US companies are already doing this. To be sure, in the meantime, the tariffs bite – indeed, this has been an ongoing narrative this earnings season, even though the tariffs have barely taken effect at this point.
- But in our view the more substantive risk from the US/China trade war is, first, that it has obviously caused the Chinese economy to slow considerably already – even though tariffs have only been in place for a period best measured in weeks – and *this could have important spillover effects on the US and other developed economies.*
- The US endured a substantive dip in corporate earnings and a near-recession – and the longest, deepest correction in the present bull market – in late 2015 and early 2016, the last time China faced macroeconomic stress (please again see the chart on page 4). Now Chinese GDP growth was just reported at 6.5%, the second-slowest in the history of the data, and slower than in 2015-16. The Chinese stock market is lower now than when it crashed in 2015-16. The yuan hasn't quite weakened this year as much as it did in 2015-16, but it's close, and this time the weakening has been far more sudden.
- *Our concern is not so much for US companies faced with tariffs – they can avoid them by finding other sources. Our concern is more for US companies for whom China is a weakening customer, because it's not as simple to find other customers.*
- *If this goes on long enough, China will be plunged into its first serious recession, which could have unpredictable internal social consequences, and severe global spillovers* (see "On the Margin: China Sees the Cliff" October 19, 2018, and "On the Margin: China's Scariest Fragility" August 6, 2018).
- We think what triggered the present equities correction was the surprising outcome of the Kavanaugh confirmation, which was to lock in GOP Senate control at the mid-terms, removing any incentive for Trump to rush a trade settlement with China as a trophy before the elections.
- *Now Trump seems to want to let China suffer – to sit back and wait for it to negotiate against itself by presenting settlement terms, setting the stage for a face-to-face meeting, now confirmed, with President Xi Jinping at the G20 meeting in Buenos Aires on November 30 and December 1.*
- To be sure, twice now the administration has leaked rumors of progress with China on particularly difficult days for the stock market, and both times it turned things around (until the next day).

But mostly Trump's aim seems to be for China to think that he blames the Fed for this correction, to suggest he has no awareness at all that the costs and risks of the trade war are of any concern to the US economy.

- *We continue to believe that China will have to capitulate.* Clearly they know there is a problem, which is why they keep announcing various forms of stimulus, such as the reduction in auto purchase taxes announced this morning, which as of this writing are lifting stock prices.
- *But until this is solved, every day is a bad day, because time isn't on anyone's side. The US and China are fighting each other right at the edge of a cliff, and the risk of falling off is cumulative.*

Bottom line

US STOCKS, US FED, US MACRO, EUROPE MACRO, ASIA MACRO, ASIA STOCKS, OIL: US The mid-terms remain a lock for the GOP in the Senate, and a toss-up in the House. GDP was helped by inventories and hurt by imports – which offset each other, and will offset again when eventually unwound. The weak-spot was the fall-off in CAPEX. Earnings season has been stellar, except that market leadership by the FANG stocks has come into doubt. Equity risk premia are attractive globally, and US PE multiples have almost corrected to bear market territory. The curve is now discounting a less aggressive Fed, and Clarida has emerged as "adult supervision" to Powell. The Saudi alleged murder puts pressure on oil prices, as does slackening demand in emerging markets and China. The Italian "October surprise" is here, but new growth prospects are dead. Trump is letting China suffer while its economy weakens, with the consequence of global spillovers as in 2015-16. The biggest global risk is an outright recession in China.