Trend Macro™

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MACROCOSM

Can This Year Just Please Be Over?

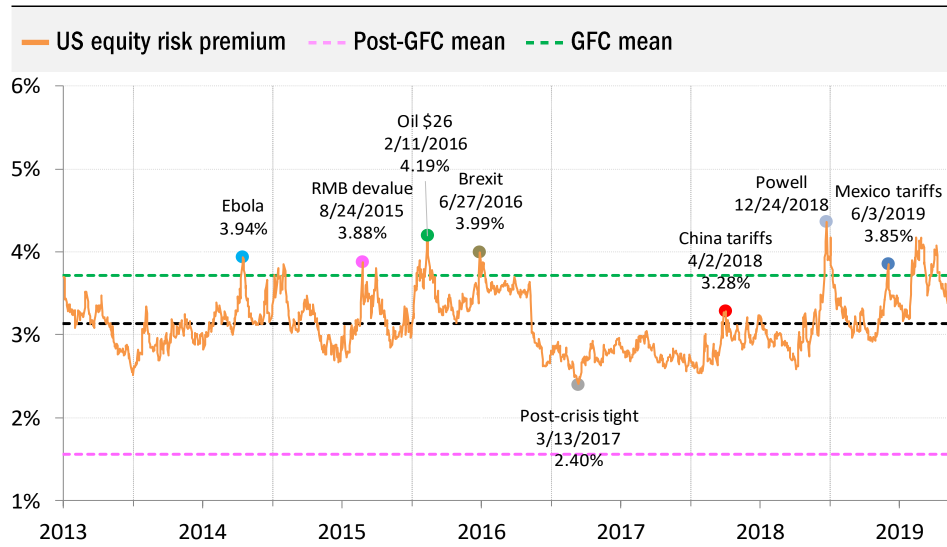
Wednesday, December 4, 2019
Donald Luskin

Sadly, no. In December, three risk events: OPEC, the Fed, and new tariffs on China.

We'll get to the hot topic *du jour* – the status of the US/China trade talks – toward the end of this report. We'll begin with some general context into which that, and other important matters, now fit as we head into year-end.

Over 18 years and thousands of client meetings and phone calls, there's one question that we are always asked more than any other: *"What are all your other clients saying?"* With 81 clients around the world, there's rarely a consensus, but there is one today. It seems to us that *everyone is feeling just plain lucky that 2019 has been as weirdly good as it has* – the total return year-to-date for the S&P 500 has been 25.7%, and that of the 10-year Treasury has been 9.9% – against the background of stagnant earnings and decelerating growth. It's cognitive dissonance, or at least it all feels too good to be true, like it can't last. *So there's a near-universal wish that the year could just be over – right now! – so these gains can get booked before something goes terribly wrong.*

- Such a wish encodes not complacency, but fear. *If bull markets climb a wall of worry, it means there's more upside to come*. At the same time, after December's high-volatility first couple of days, this wish seems to mean *investors are on a hair-trigger in the near term – participating with no conviction, ready to head for*



Source: Various, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, OIL, US FED, ASIA MACRO, FX: There is a strong consensus among clients that 2019 has been too good to be true, and a wish that it could be over right now so that gains could be booked before they slip away. But US equity gains from the September 2018 top have actually been substandard, and stock/bond relative valuations are in equilibrium. Three risk events must be endured before year-end. At tomorrow's OPEC meeting, the cartel has the opportunity to insulate oil prices from a shale-driven global glut, by tightening quotas. Failure to do so could usher in a deflationary collapse. The Fed won't change rates next week, but markets will be looking for guidance that could point to a steepening of the yield curve. New tariffs on imports from China kick in on December 15 unless a "phase 1" deal is done or strongly indicated. China has a political incentive to delay negotiations, and Trump is scaring them back to the table with bellicose rhetoric.

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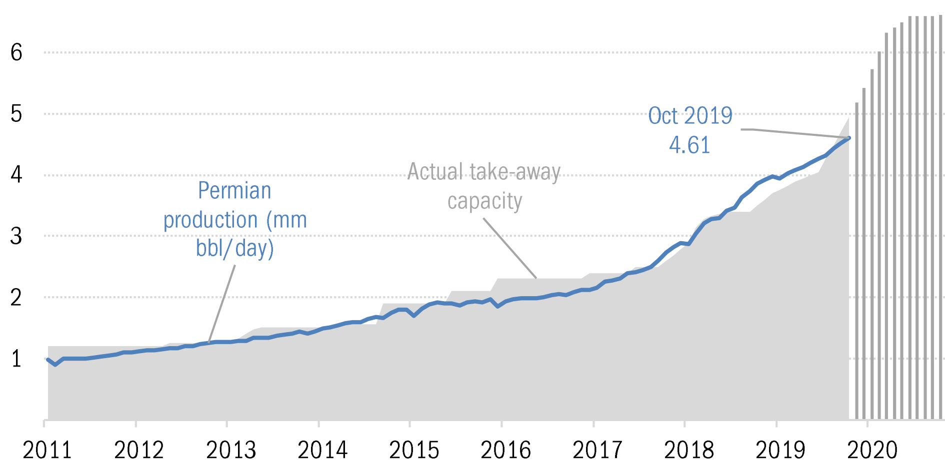
the exits over the slightest tape-bomb.

- Some of the cognitive dissonance about 2019 is just a timing coincidence. *2019 is, in large part, a snapback from the 20%-plus bear market in US equities in Q4-2018, which ended just a week before the turn of the year*. The 25.7% total return for equities year-to-date can be recontextualized in that light – it's actually only a gain of 8.1% above the 2018 highs achieved on September 20, before the bear market set in. That 8.1% over 14-1/2 months definitely doesn't feel too good to be true.
- Another calming thought is that *markets are pretty much in valuation equilibrium at the moment*. The US equity risk premium – the spread between the forward earnings yield of the S&P 500 and the 30-year Treasury yield – is slightly above its mean value for the post Global Financial Crisis years. That means stocks are objectively a little cheap relative to bonds, but nothing extraordinary one way or the other (please see the chart on the previous page).
- Putting all the foregoing together, we have to conclude that the widespread sense of apprehension among our clients about the wrap-up to 2019 is of interest as a short-term sentiment indicator – perhaps pointing to some fragility over December, as we've already seen this week. But it's not itself determinative – we are left having to do the usual hard work of looking at the big macro issues that overhang the markets through year-end.
- **COMING UP FIRST IS OPEC'S MEETING ON THURSDAY IN VIENNA.** We believe the global crude oil market is in a supply glut, which will only get worse as the US consolidates the position it earned, last week for the first time in 70 years, as a net exporter of petroleum. *The oil glut could become quite intense over the next year, as production in the Permian grows by up to 2 million barrels a day* to fill massive new pipeline takeaway capacity now coming into service (see the chart below, and "The Oil Glut Even Drones Couldn't Fix" September 16, 2019).
- Global demand can't possibly expand to consume this new supply, and exports by Iran and Venezuela have already been

Production and takeaway capacity in the Permian



Source: DOE EIA, TrendMacro calculations

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Recommended Reading

Section 301 Investigation Report on France's Digital Services Tax
US Trade Representative
December 2, 2019

Letter of Recommendation: 'Penn & Teller: Fool Us'
Brett Martin
New York Times Magazine
December 1, 2019

How Kamala Harris's Campaign Unraveled
Jonathan Martin, Astead W. Herndon and Alexander Burns
New York Times
November 29, 2019

The Modern Life of Origami, an Art as Old as Paper
Kathleen Massara
New York Times
November 28, 2019

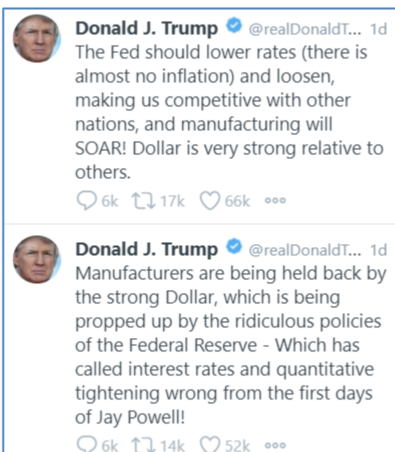
The Campaign Data Arms Race
Karl Rove
Wall Street Journal
November 20, 2019

What if Trump was right about Ukraine?
Byron York
Washington Examiner
November 19, 2019

[Reading home]

effectively zeroed out by US sanctions. The only safety valve is OPEC production quotas – which, if the cartel is smart, it will tighten at Thursday's meeting. There has been a conflicting series of rumors – including tightening the quotas, maintaining the *status quo*, and effectively loosening the quota by redefining its terms.

- Curtailing production is smart for the cartel. Yes, it concedes market share to the US. But we think the resulting increase in price would be favorably disproportionate to the magnitude of the production cut. After all, the point of a cartel is to maximize revenue, not market share for its own sake.
- OPEC made the mistake of chasing market share five years ago, when confronted for the first time with the threat of the fracking revolution (see "Oilmageddon" December 16, 2014). The result was a two-thirds collapse in the oil price over the following five quarters, which came near to triggering a global recession (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- *Rapidly falling oil prices are a boon to consumers, to be sure. But they sharply tighten financial conditions* by (1) reducing inflation expectations, which raises real interest rates; (2) reducing corporate earnings, with each dollar of the WTI price translating into a billion dollars in S&P 500 earnings; and (3) infectiously widening credit spreads, because heavily indebted frackers are responsible for a commanding 17% of face value of US non-investment grade bonds.
- *So it would be good for OPEC to cut production, and good for the world. We expect the cartel will do it, or at least issue a communique with forward guidance pointing in that direction.*
- *But there's a catch. Saudi Arabia's long-awaited IPO of Saudi Aramco prices on Thursday* – and it will have been a long and difficult birth. It's possible that *Saudi won't want to cut production on the same day, effectively signaling to buyers the truth that they are acquiring a stake in an enterprise doomed to decades of market share losses* (a risk which, at least, the issuer did disclose in the prospectus).
- We'll know more on Thursday. *Of all the risks facing the global economy – for all the endless talk of impending recession, which we've been hearing for years now – this risk is one that clients always tell us they hadn't considered.*

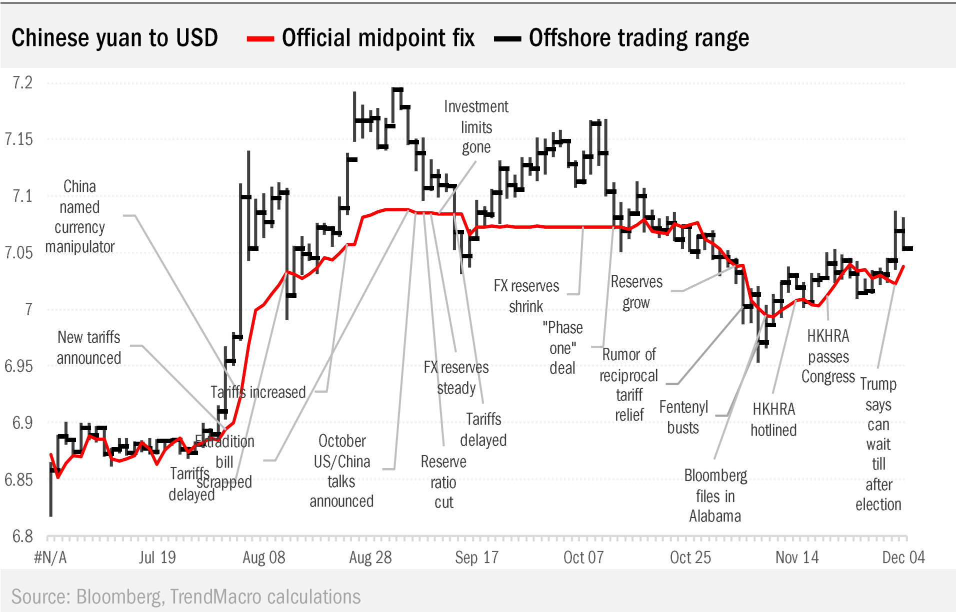


- **COMING UP NEXT IS THE DECEMBER FOMC ON DECEMBER 11.** This really isn't very much of a risk event, at least as a first-order matter – *it's a cinch there will be no change in policy rates*.
- But we mention it because markets are still expecting one more rate cut – somewhere in the middle of next year. President Donald J. Trump is demanding it, and more.
- The market – and the president – are right. Sure, the Powell Fed finally managed to un-invert the yield curve (see "On the October FOMC" October

30, 2019). But while it's great that we no longer have an inverted yield curve, there's nothing great about having a flat one. The economy needs more – yet Chair Jay Powell keeps endlessly repeating that "the economy is in a good place" (see "Video: What you're not hearing about this week's FOMC" October 28, 2019). *What's so "good" about the place where the US economy grows at less than 2% -- which is the present forecast for Q4-2019? What's so "good" about falling inflation and inflation expectations?*

- *So the risk on December 11 isn't a policy rate surprise – that's just not possible at this point. The risk is that Powell will do what he did at last year's December FOMC with his unconscionable remark about policy being "on automatic pilot"* (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018, and see "On the December FOMC" December 19, 2018).
- Remember, in 2018, the S&P 500 total return for days on which Powell spoke was negative 10.2%. If it weren't for him, the total return for the S&P 500 last year would not have been negative 4.4%, but rather positive 6.4%.
- After the Christmas-weekend emergency intervention of Trump and Treasury Secretary Steven Mnuchin (see "Did Powell Just Cut a Deal?" December 23, 2018), Powell upgraded his catastrophically poor performance as Fed chair in 2018 to merely insufficient in 2019. So this year, days on which Powell spoke explain 8.6% so far out of the S&P's total return of 25.7%. Seems to us like he still owes the stock market 1.6%.
- *On this point, we're with our clients – rather than have an FOMC meeting on December 11 – and give Powell another chance to put his foot in his mouth, and then shoot himself in the foot – can't we just end the year right now?*
- **FINALLY, COMING UP ON DECEMBER 15 IS THE POTENTIAL ONSET OF 15% TARIFFS ON ABOUT $150 BILLION OF IMPORTS FROM CHINA, INCLUDING CONSUMER-SENSITIVE APPLE PRODUCTS** (see "On the New China Tariffs" August 1, 2019). We had increased our confidence that US and Chinese politics were aligning in favor of a "phase 1" trade deal that could avert the tariffs (see "China Votes Trump 2020" November 7, 2019). But it seems we were right to change our view somewhat with the arrival of China-dove Michael Bloomberg in the 2020 presidential race (see "The Bloomberg Threat" November 12, 2019). His presence in the mix creates an incentive for China to slow negotiations down in order to consider revising their calculus of political advantage – which we said at the time would usher in something of a risk-off period.
- China may also want to drag its feet a bit while it watches the presidential impeachment melodrama play out. But in our view it would be unwise for China to overweight that factor – even if Trump gets driven from office before the election, and even if that leads to a Democratic president getting elected, China still has to live with the fact that Democrats, other than Bloomberg, and especially Elizabeth Warren (D-MA), are all as "tough on China" as Trump is (see "Trump♥Muslims (In China)" October 9, 2019).

- And surely China *has* to slow things down a bit, at least for a short while, in the wake of Congress's passage, and Trump's signing, of the Hong Kong Human Rights Act – which, on the face of it, is an embarrassing dressing down of China by the US. But longer term, HKHRA demonstrates US political unanimity across party lines for being "tough on China," and reduces any hope that Chinese President-for-life Xi Jinping can outlast Trump, and then deal with a more compliant president (see "Hong Kong Human Rights Act: Another Weapon for Trump" November 21, 2019).
- Slowing down the negotiations at this particular moment puts Trump in the uncomfortable position of having to go ahead on December 15 and implement tariffs that will, at the least, generate a great deal of negative press about him as the Grinch that took your children's iPhone 11's out from under the Christmas tree (or worse, back down, and be accused of "caving to China").
- This is why he said yesterday, in improvised remarks at a press gaggle, that "In some ways I like the idea of waiting until after the election for the China deal." ***He's sending the message to China that he isn't afraid of the December 15 deadline – indeed, he'd relish pulling the trigger. This is entirely consistent with our view that Trump has decided that his re-election chances are improved by running as a "trade war president"*** (again, see "China Votes Trump 2020").
- This is why, for the last couple weeks, he has been telling the media that whether or not a trade deal gets done is entirely up to him (in a very funny moment in an interview with conservative icon Bill O'Reilly, Trump was asked what is holding up the trade deal; he answered, "Uhhhh… me!").
- But another dimension of this political calculus explains why there has been so much bellicosity from Trump on trade this week. He's trying to coerce China back to the table. ***Yes, he wants to run in 2020 as a "trade war president," but ideally he'd like to run as one who is winning.***
- This is why Trump stretched the enabling statute under which



Source: Bloomberg, TrendMacro calculations

steel and aluminum tariffs were levied in 2018, re-imposing them on Brazil and Argentina on the grounds that they had artificially increased their competitiveness in agricultural exports by cheapening their currency. The audience for this is China, doubly so: Brazil and Argentina have been the beneficiaries of China's boycott of US agricultural exports, and the Trump administration has determined that China is a "currency manipulator" (see "China the Currency Manipulator, and So What?" August 6, 2019). Ag purchases, and currency, are both front and center in the "phase 1" negotiations, so this was a shot across China's bow.

- *Judging by the behavior of the Chinese yuan, which we think is the most sensitive market indicator of expected tariff levels, "Mr. Market" is respectful of the risks implied by the heated-up rhetoric of the last several days, which if nothing else points to a risky delay in negotiations* (please see the chart on the previous page). *RMB stopped strengthening, coming out of its August crisis, the very day Bloomberg made it clear he was running for president – which clearly pointed to a delay in negotiations. It's been weakening somewhat ever since, especially yesterday with Trump's remarks in focus, but so far not back to the August crisis levels.*

Hu Xijin 胡锡进 @HuXijin_GT 3h
I predict there is a high probability that President Trump or a senior US official will openly say in a few hours that China-US trade talks have made a big progress in order to pump up the US stock markets. They've been doing this a lot.😀

- *As of this writing, much of yesterday's weakness has been reversed on stories that negotiations are making progress, despite all the rhetoric. Chinese state-controlled media downplayed these stories.*

- *We continue to believe that rational political calculus on both sides calls for a "phase 1" deal, even if it has to be quite modest. A modest deal would be sufficient to give Trump cover to "delay" the December 15 tariffs, which in turn would give China cover to make the deal in the first place. A return to past levels of ag purchases by China will certainly be part of even the most modest deal, and there could be vague promises of more. China could easily give cosmetic concessions on intellectual property issues, having already declared two weeks ago that it will be strengthening penalties on IP theft. So Trump could give relief from tariffs that don't even exist yet, and China could buy ag products they need anyway, and concede on IP by citing an existing law. Everyone wins. Everyone saves face.*
- *The problem for markets is that there is probably some degree of asymmetry here. If RMB is any guide, markets are not braced for a complete negotiating failure. We're not expecting that – but neither is the consensus, which is what makes it so risky. Now if only this year could be over right now…*

Bottom line

There is a strong consensus among clients that 2019 has been too good to be true, and a wish that it could be over right now so that gains could be booked before they slip away. But US equity gains from the September 2018 top have actually been substandard, and stock/bond relative valuations are in equilibrium. Three risk events must be endured before

year-end. At tomorrow's OPEC meeting, the cartel has the opportunity to insulate oil prices from a shale-driven global glut, by tightening quotas. Failure to do so could usher in a deflationary collapse. The Fed won't change rates next week, but markets will be looking for guidance that could point to a steepening of the yield curve. New tariffs on imports from China kick in on December 15 unless a "phase 1" deal is done or strongly indicated. China has a political incentive to delay negotiations, and Trump is scaring them back to the table with bellicose rhetoric.