



MORNING BRIEFING

February 7, 2017

A Winning Scenario

See the [collection](#) of the individual charts linked below.

(1) Second place is for losers. (2) Might “America First” be a winning strategy for the world? (3) America’s gift to the world: \$700bn trade deficit. (4) Group hug overseas? (5) Time for emerging economies to emerge. (6) Remarkable recovery for commodity prices. (7) Emerging market currencies stable over past year despite Fed’s rate hikes. (8) EM stock prices rallying. (9) Global PMIs were solid in January. (10) Is owning gold a bet for or against Trump?

Global Economy: In Second Place. Coming in second in the Super Bowl isn’t the same as winning it. The Patriots returned home covered in glory as the winners. The Falcons came close to winning it during the first half of the game, then abysmally lost it completely during the second half. The Super Bowl is all about coming in first, not second. This also seems to be the attitude of President Donald Trump, who favored the Patriots and also favors an “America First” approach to running the country.

When our team at YRI reassessed our outlook for 2017 and beyond following Election Day, among our initial reactions to Trump’s victory was that his approach must be good for our “Stay Home” investment posture, and all the more reason not to “Go Global.” However, we are having second thoughts, or at least thinking some more about this all-too-obvious conclusion.

It’s very possible that countries in the rest of the world will rise to the challenge posed by Trump’s America First policies by concluding that they can no longer count on the US. They can’t assume that the US market will remain wide open to their exports. The US has been running a large merchandise trade deficit, which amounts to the rest of the world’s trade surplus ([Fig. 1](#)). Over the past 12 months through December, it totaled \$731 billion. The main beneficiaries of this surplus over this period have been the following countries and regions: China (\$347bn), European Union (\$148bn), Japan (\$69bn), Mexico (\$63bn), and Canada (\$11bn) ([Fig. 2](#)).

Trump’s protectionist sentiments and pledge to renegotiate trade agreements on a bilateral, rather than a multilateral, basis is the immediate uncertainty confronting America’s biggest trade partners, i.e., all those countries that have enjoyed a wide open market for their exports in the US. They won’t have much choice but to negotiate the best deal they can get from the Trump administration, which isn’t likely to be as good as what they have now.

They are also likely to respond by seeking to do more business with one another and to develop more domestic demand to stimulate their economic growth, as exports to the US may be a less dependable source of growth going forward. If so, such responses to America First by other countries could have big positive consequences for the rest of the world. The Second and Third Worlds could finally break their reliance on the US and contribute more to global growth.

The latest data and market actions suggest that they may be on that path. Consider the following:

(1) *Commodities*. The CRB raw industrials stock price index continues to recover from its freefall during the second half of 2014 and 2015 ([Fig. 3](#)). It’s really quite a remarkable comeback. It is up 28% since it

bottomed on November 23, 2015 to the highest level since October 2014.

When it was plunging, Debbie and I concluded that it confirmed that the commodity super-cycle bubble, which inflated after China joined the World Trade Organization at the end of 2001, had burst. Commodity producers scrambled to reduce their capacity and debt. The rebound in commodity prices so soon after the bubble burst suggests that it wasn't just a bubble. There is fundamental demand out there for the stuff. That's good.

(2) *Currencies*. The rebound in commodity prices since late 2015 is even more impressive considering that the J.P. Morgan trade-weighted dollar remained strong last year and early this year ([Fig. 4](#)). Since the mid-1990s through 2015, a strong (weak) dollar has been associated with weak (strong) commodity prices.

Another interesting development since last year is that most of the strength in the dollar is attributable to weakness in the currencies of developed world countries based on the composite MSCI currency index for them ([Fig. 5](#)). What's surprising is how well the Emerging Markets MSCI currency index has performed ([Fig. 6](#)). It is up 6.9% since it bottomed on January 20, 2016. That may not seem like much, but it is impressive in the face of the Fed's rate hikes at the end of 2015 and again at the end of 2016, with widespread expectations of two or three more hikes this year.

(3) *Emerging Markets*. In other words, emerging economies may be emerging from their hypersensitivity to US monetary policy. That's confirmed by the relative strength of the Emerging Markets MSCI stock price index in both local currencies and in dollars ([Fig. 7](#)). The former is up 24.9% since January 21, 2016, while the latter is up 33.5%.

From 2001 through 2012, there was a strong inverse correlation between the Emerging Markets MSCI stock price index (in local currencies) and the trade-weighted dollar ([Fig. 8](#)). They've diverged since then as the former has traded in a volatile range, while the latter has soared.

While the relationship between emerging markets stocks and the dollar isn't what it used to be, the Emerging Markets MSCI stock price index in both local currencies and in dollars is still highly correlated with commodity prices ([Fig. 9](#) and [Fig. 10](#)). This suggests that they still depend too much on commodity exports, and that their middle-class consumers haven't emerged enough to drive their economies.

(4) *PMIs*. As Debbie reports below, January's composite PMIs confirm the better tone of global economic activity. The C-PMI for advanced economies rose to 54.6, the best reading since November 2015 ([Fig. 11](#)). The M-PMI for them rose to 54.2, the highest since February 2014, while the NM-PMI rose to 54.5, the best level since November 2015.

For emerging economies, the C-PMI edged up to 51.9, the highest since February 2015 ([Fig. 12](#)). Interestingly, their M-PMI edged down to 50.8, but their NM-PMI jumped to 52.1, the best reading since December 2014. Seeing relative strength in service-producing industries is an encouraging sign that more middle-class consumers may be emerging in the emerging economies. If this continues to be the case, they should be less dependent on exporting commodities as their domestic economies prosper.

In other words, Trump's World isn't necessarily going to be a bad one for the rest of the world. It would be a welcome development if more of the "developing" world loses that adjective and becomes part of the "developed" world. A world in which every nation pursues its own interests first and foremost--including free, but fair, trade--could be a happier one if national leaders focus on promoting more prosperity for their countries. That can only happen in a world of free, but fair, trade. To paraphrase John Lennon, "All we are saying is give fair trade a chance."

Gold: The Anti-Trump? We've seen some market strategists recommend owning gold in the event that Trump causes World War III. Unlike potassium iodide, gold isn't an antidote to radiation exposure. But it might provide great protection from a number of lesser calamities that Trump's detractors believe he might cause, including a global trade war or a domestic civil war.

The price of gold is down 4.3% since Election Day, but seems to have firmed up during the first two weeks of the Trump administration ([Fig. 13](#)). Our new president has hit the ground running, but there's probably more mud than he expected.

Gold might rally if he stumbles badly. Or else it might rally because Trump's policies boost economic growth, as he promised. If so, the rebound in commodity prices that started at the end of 2015 may continue. As we've shown before, the price of gold tends to follow the underlying trend of industrial commodity prices ([Fig. 14](#)).

Since Election Day, the 10-year expected inflation rate embodied in the yield spread between the 10-year US Treasury bond and the comparable TIPS has risen from 1.73% to 2.05% on expectations that Trump's policies will be stimulative. In recent years, that spread has been highly correlated with both the CRB raw industrials spot price index and the price of gold ([Fig. 15](#) and [Fig. 16](#)).

If we see gold soaring while other commodity prices are crashing, then we'll start to worry about the end of the world as we know it. If they both rise in a leisurely fashion, we'll stay bullish on the future.

CALENDARS

US. Tues: Merchandise Trade Balance -\$44.9b, JOLTS, Consumer Credit \$20.0b. **Wed:** MBA Mortgage Applications, EIA Petroleum Status Report. (Bloomberg estimates)

Global. Tues: Germany Industrial Production 0.3%*m/m*/2.5%*y/y*, Japan Leading & Coincident Indexes. **Wed:** China Direct Investment 2.8% *y/y*, Japan Machine Orders 3.1%*m/m*/4.5%*y/y*. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index ([link](#)): Our Weekly Leading Index (WLI)--a good coincident indicator that can confirm or raise doubts about stock market swings--rose for the sixth week during the week of January 28 to another new record high, up 0.2% *w/w* and 5.0% over the period. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB slipped 0.3% after a five-week surge of 8.6% to a new record high. Jobless claims rose to 248,000 (4-wa) after falling the prior five weeks from 263,750 to 245,750, which was the lowest reading since November 1973. The CRB raw industrials spot price index--another BBB component--moved higher during the week; meanwhile, the WCCI rebounded 3.1% after falling three of the prior four weeks by 3.2%.

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose to record highs last week for MidCap and SmallCap, but LargeCap's declined for the first time in 16 week to 0.4% below its prior-week record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as *y/y* comparisons have eased. In the latest week, LargeCap's forward earnings edged down to 7.3% *y/y* from a 27-month high of 7.5%, which compares to a six-year low of -1.8% in October 2015; MidCap's jumped to a 25-month high of 8.1% from 7.1%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's fell to 10.0% from a 27-month high of 10.2%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap

0.8% and 11.4%, MidCap 2.3% and 12.3%, and SmallCap 6.6% and 14.7%.

S&P 500/400/600 Forward Valuation ([link](#)): Valuations rose last week, but most remain slightly below recent multi-year highs. LargeCap's forward P/E rose to an 11-year high of 17.2 from 17.1. That's up from a 15-month low of 14.9 in January 2016 and well below the record high of 25.7 in July 1999. MidCap's forward P/E improved to 18.9 from 18.8; that's below early December's 15-year high of 19.2 and compares to a three-year low of 15.0 in January 2016 and a record high of 20.6 in January 2002. SmallCap's rose to 19.8 from 19.7; that's up from a three-year low of 15.5 in February 2016, and compares to a 15-year high of 20.5 in early December and record high of 20.9 in April 2002.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Q1 earnings estimate revision activity picked up last week for the S&P 500 sectors as more companies reported Q4 earnings. The Q1 consensus rose w/w for four of the 11 S&P 500 sectors and fell for four. Real Estate rose 0.9% for the week, followed by a 0.3% gain for Consumer Discretionary. Sectors with the biggest w/w declines in their Q1 forecasts: Energy (-1.5%), Materials (-0.4), and Industrials (-0.3). The S&P 500's Q1-2017 EPS forecast fell 34 cents w/w to \$30.07, and is down 1.7% from \$30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 11.5% y/y, the strongest growth since Q3-2011, with the forecast down from 13.0% a week earlier and 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are higher for 1/11 sectors and lower for 9/11. The Q1 forecast for Consumer Discretionary has risen 1.8%, while Real Estate's is unchanged. Industrials is down the most (-5.7), followed by Materials (-2.1), Telecom (-1.3), and Consumer Staples (-1.0). The S&P 500's Q1-2017 forecasted earnings gain of 11.5% y/y would be its third straight gain after four declines and compares to Q4-2016's blended 8.0%, Q3-2016's 4.3%, Q2-2016's -2.1%, Q1-2016's -5.0%, Q4-2015's -2.9%, Q3-2015's -0.8%, Q2-2015's 1.3%, and Q1-2015's 2.2%. Four of the 11 sectors are expected to beat the S&P 500's y/y earnings gain of 12.9% in Q1-2017, with analysts expecting Energy to report a profit relative to a year-ago loss and thinking Industrials and Telecom will record y/y earnings declines. That's an improvement from the 7/11 sectors rising in Q4-2016, and compares to 9/11 rising in Q3 and 6/10 rising during the quarters from Q4-2015 to Q2-2016. The latest forecasted Q1-2017 earnings growth rates vs. their blended Q4-2016 growth rates: Energy (returning to a profit in Q1 from a year-ago loss vs. -1.3% in Q4), Financials (15.7% vs. 20.3%), Materials (14.5 vs. 7.3), Tech (13.0, 11.4), S&P 500 (11.5, 8.0), Consumer Staples (5.8, 6.3), Health Care (4.9, 6.4), Real Estate (3.0, 0.1), Consumer Discretionary (2.6, 1.6), Utilities (1.1, 11.3), Telecom (-1.9, -2.4), and Industrials (-4.1, -1.5).

S&P 500 Earnings Season Monitor ([link](#)): With nearly 55% of S&P 500 companies finished reporting Q4-2016 results, their revenue and earnings surprise metrics are mostly weaker than at the comparable point of the Q3 season. On a positive note, their y/y revenue and earnings growth comparisons are stronger. Of the 274 companies in the S&P 500 that have reported, 69% exceeded industry analysts' earnings estimates by an average of 3.9%; they have averaged a y/y earnings gain of 9.1%. At the same point in Q3-2016, a higher percentage of companies (74%) in the S&P 500 had beaten consensus earnings estimates by a larger 6.6% and earnings were up a smaller 2.1% y/y. On the revenue side, 52% beat sales estimates so far, coming in 0.2% above forecast and 4.0% higher than a year earlier. During Q3, a higher 56% were above forecasts, results exceeded estimates by a smaller 0.1%, and results rose a smaller 1.5% y/y. Q4 earnings results are higher for 72% of companies versus 69% at the same point in Q3, and revenues are higher for 73% versus 72%. These figures will continue to change markedly as more companies report Q4 results, but early data suggest Q2-2016 was indeed the bottom for y/y earnings growth.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs ([link](#)): Global economic activity in January grew at its best pace in 22 months, as both output and new orders accelerated. The J.P. Morgan Global Composite Output Index climbed

for the fifth month from 51.5 in August to 53.9 in January--the best reading since March 2015. The index has now signaled expansion for 52 consecutive months. By nation, the acceleration in the rate of increase in all-industry output was led by Russia (to 58.3 from 56.6) and the US (55.8 from 54.1)--representing Russia's best growth in over eight and a half years and the US' best since November 2015. The Eurozone (54.4) saw output growth match December's 67-month high, while growth slowed in Japan (52.3 from 52.8) and the UK (55.5 from 56.7). Output growth contracted at a slower pace in India (49.4 from 47.6) and a faster pace in Brazil (44.7 from 45.2). Global job creation held steady at December's 19-month high, increasing in the US, the Eurozone, Japan, the UK, Russia, and India; it fell further in Brazil. Inflationary pressures continued to build at the start of 2017, reflecting steeper input prices for both manufacturers and service providers, although the rate of increase was much sharper for the former.

Global Non-Manufacturing PMIs ([link](#)): The global service sector in January expanded at the fastest pace in 17 months as rates of expansion in output, new orders, and employment all improved, providing a boost to business confidence. The J.P. Morgan NM-PMI has accelerated steadily from August's 51.2 to 53.9 last month--the highest since August 2015. Service-sector growth accelerated in Ireland (to 61.0 from 59.1), Russia (58.4 from 56.5), the US (55.6 from 53.9), France (54.1 from 52.9), and Italy (52.4 from 52.3) last month, while it eased in the UK (54.5 from 56.2), Spain (54.2 from 55.0), Germany (53.4 from 54.3), and Japan (51.9 from 52.3). Growth continued to contract in India (48.7 from 46.8), though at a slower pace, and Brazil (unchanged at 45.1).

US Non-Manufacturing PMI ([link](#)): The US service sector in January virtually matched December's pace--which was a high for last year--according to the ISM survey; it recorded its best growth in 14 months according to Markit's. ISM's NM-PMI ticked down to 56.5 in January after climbing from 54.6 in October to 56.6 in December. The employment (to 54.7 from 52.7) and supplier deliveries (52.5 from 52.0) gauges moved higher, with the latter at a seven-month high. While both the business activity (to 60.3 from 60.9) and new orders (58.6 from 60.7) measures fell last month, activity remained robust--with the former's reading just above 60 and the latter's just below 60. Markit's NM-PMI rebounded from a three-month low of 53.9 at the end of last year to 55.6 at the start of this year, the best performance since November 2015. According to January's survey, the rate of expansion in new work was the fastest since July 2015, with job creation holding around December's 15-month peak. January data signaled that services companies are more confident about their growth prospects than at any time since May 2015.

Germany Manufacturing Orders ([link](#)): German factory orders in December blew past forecasts to a new cyclical high, posting the best growth in two and a half years. Billings rebounded 5.2% (vs. a 0.7% consensus estimate) after contracting 3.6% and expanding 5.0% the prior two months. Both domestic (6.7%) and foreign (3.9) orders posted robust gains last month, driven by a surge in investment-goods demand. December's jump in foreign orders was entirely from within the Eurozone (10.1), driven by a 19.5% surge in investment goods orders; intermediate (-0.4) and consumer (-1.0) goods orders moved lower. Billings from outside the Eurozone were flat as gains in consumer durable (6.2), intermediate (0.7), and investment (0.5) goods orders offset a big drop in nondurable consumer (-11.5) goods ones. Domestic billings rebounded 6.7%, after a 2.8% drop in November, led by a 14.7% surge in investment goods orders to a new cyclical high. Consumer goods orders rose for the third month, by 1.7% m/m and 5.2% over the period; intermediate goods orders slipped 1.4% at the end of last year.

US Manufacturing Orders ([link](#)): Business investment finished 2016 on an up note. Nondefense capital goods shipments ex aircraft (used in calculating GDP) rose four of the last five months of 2016, while the comparable orders measure (a proxy for future business investment) rose six of the last seven months. In December, they rose 1.0% and 0.7%, respectively. These core shipments expanded 3.4% (saar) during Q4, the first quarterly advance since Q3-2015 and the strongest since Q3-2014.

Real core orders increased 5.2% (saar) last quarter, the strongest in over a year. Headline factory orders in December increased for the fifth time in six months, jumping 1.3% m/m and 4.2% during the last half of 2016. Orders were up 3.6% y/y, the best growth rate since July 2014.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823

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