US Watch

TRUMP'S TARIFFS SET TO TRIP GROWTH

Steven Blitz / Andrea Cicione

Economy: Tariffs nipping at growth?

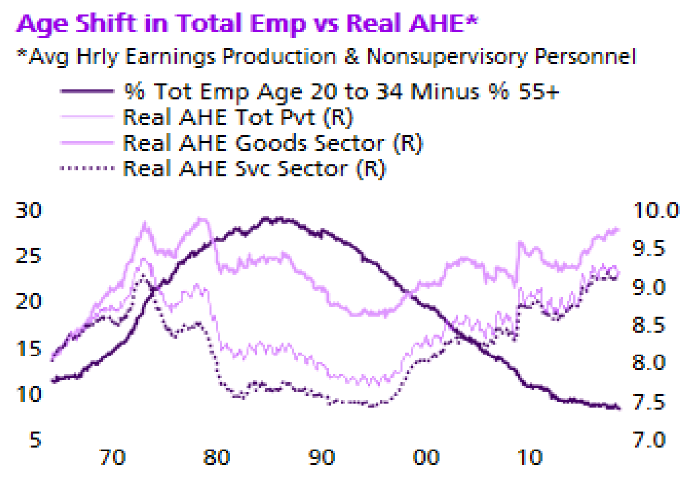
- Goods economy starts to slow; ages and wages
- Growth giving Fed room to raise rates

Markets: Tighter liquidity starting to bite

- Equity multiples are falling, as is typically the case when liquidity tightens
- Equity returns to stay flattish as earnings growth slows down too

Politics: Democrats lock onto Trump, little else

- Democratic control is not predetermined -- the strong economy counters Trump's negatives
- Obama enters the fray - not a good sign for Democrats in 2020



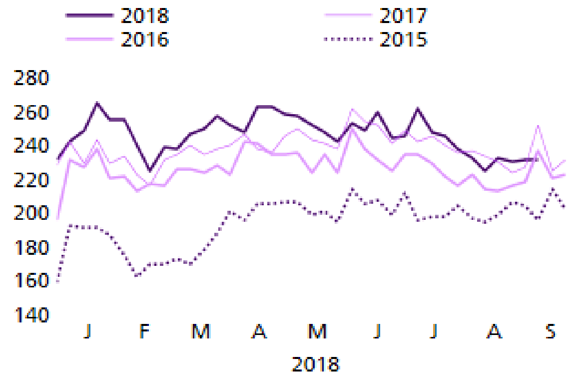
Source: Thomson Reuters Datastream, TS Lombard

Economy: Tariffs nipping at growth

- **Good economy starts to slow, retail set for a strong holiday season**
- **Ages and wages**
- **Growth giving Fed room to tighten policy**

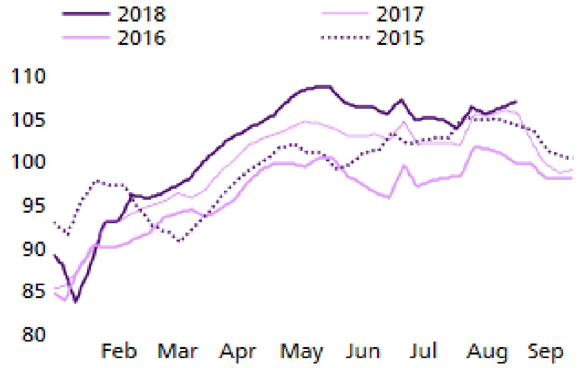
Looking afor the weakness in the August jobs data – and there are signs – is an still an exercise in hunting for the cloud inside the silver lining. The biggest negatives are the combined 50,000 downward revision to jobs in June and July and the sharp drop of 423,000 employed in the household survey. Downward revisions are often a sign of weakening growth. There is increasing softness in housing, as indicated by mortgage applications for purchase, and YoY growth in railcar loadings of cyclical cargo has dropped to zero (see charts below).

MBA Mtg Applications Index for Purchase
vs Conventional Mtg Contract Rate for 30Y FRM



Source: Thomson Reuters Datastream, TS Lombard

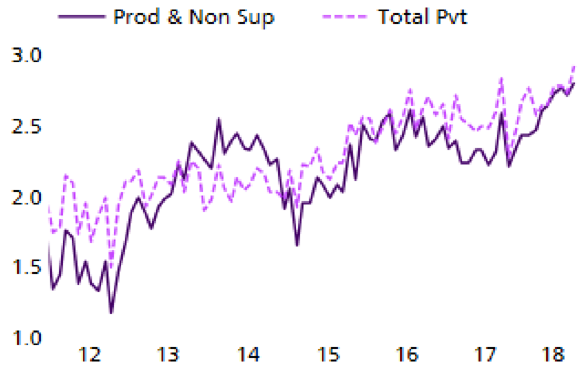
Railcar Loadings Cyclical Cargo (000s)
Chemicals, Metal, Nonmetallic & Forest Prod -- 4Wk Mov Avg



Source: Thomson Reuters Datastream, TS Lombard

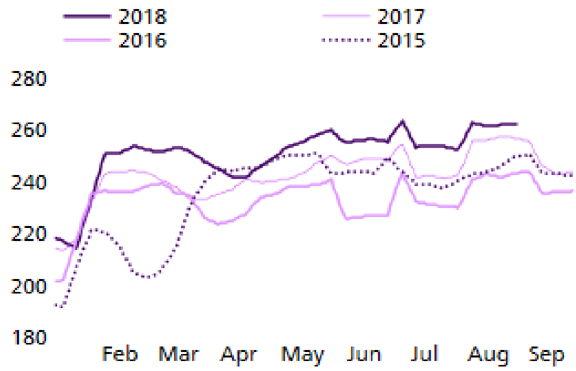
Fraying eventually spreads, this time aided and abetted by the self-inflicted wound created by piling on tariffs. Until then, monthly job gains averaging just under 200,000 and stronger wage growth (chart below) bode well for the holiday season. Retailers' confidence is reflected in the YoY growth in containers riding the rails (chart below). These are consumer goods heading for inventory. Interestingly, there is no evidence of buying in advance of threatened tariffs.

Average Hourly Earnings
YoY %Ch



Source: Thomson Reuters Datastream, TS Lombard

Railcar Loadings of Containers
(4W Mov Avg, 000s of Carloads)

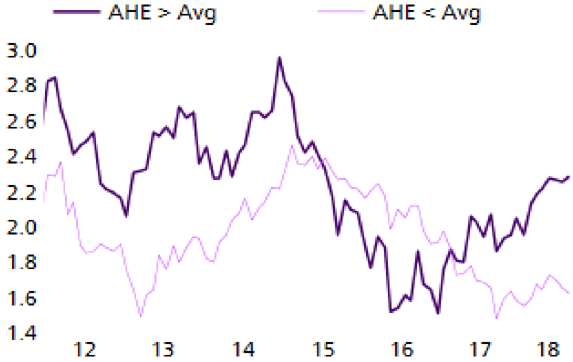


Source: Thomson Reuters Datastream, TS Lombard

Labour market tightness is contributing to the acceleration in wage setting, but this is all too easy an answer for an economic cycle that has been anything but easy to decipher. The chart below left shows that one factor driving up the averages is that job sectors beating the national average are growing faster than underperforming sectors. For a long time, growth in low-wage service sector jobs outpaced the total. Even within those sectors there has been a shift to lower-paying positions, perhaps not all of it voluntary. The "Amazon economy" has expanded employment for couriers and in warehouses, non-store retailers and the like while jobs in bricks-and-mortar retailing has fallen. As the need for workers in the new economy has risen, average hourly earnings have fallen relative to the national average.

YoY Growth in Employment by AHE*

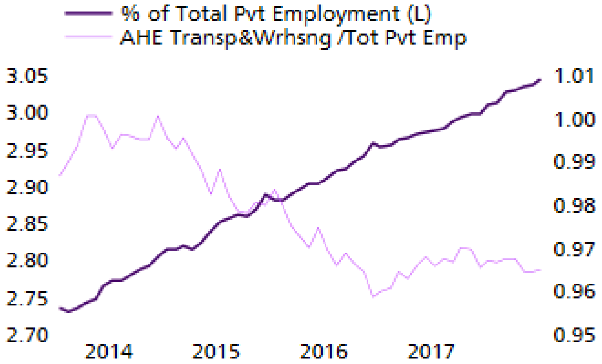
*Average Hourly Earnings for All Employees



Source: Thomson Reuters Datastream, TS Lombard

Employment & AHE for the Just-in-time Economy*

*Nonstore retailers, trucking, couriers, warehousing



Source: Thomson Reuters Datastream, TS Lombard

Then there is the issue of ages and wages. The narrative of late is that the rise in new entrants to the workforce in combination with ageing baby boomers heading into retirement will naturally depress average wage growth. Our chart on the front page serves up some facts to confuse the issue. From the early 1970s until the mid-1980s or so, the percentage of the workforce aged 20 to 34 increased a lot faster than the share of those aged 55 and over, which actually declined. During this period, real average hourly earnings fell, most notably in the service sector (in the goods sector unions likely kept wages higher for longer).

From the 1990s onwards, as the percentage of those aged 55 and over increased both in absolute terms, and relative to the percentage aged 20 to 34, so real average hourly earnings rose. Of late, real wages have regained the peaks reached in the early 1970s. At the same time, a much greater share of today's income goes to pay for necessary services such as rent, insurance, medical care and education. Discretionary income, real and nominal, is consequently lower.

Since the recession ended, the difference between these two age groups has flattened, but the 55-and-over group is still a marginally faster-rising percentage of the workforce. Late retirement will consequently keep real average wages from falling as it did in the 1970s and early 1980s. Further, the 14% increase in the share of the population aged 25 to 34 in the current decade is projected to drop to zero in the next decade. On the other hand, as supply outstrips demand, the percentage increase in nominal wages for those 55 and over is generally less than it is for those in the prime employment ages of 25 to 54 (see chart below). Real average hourly earnings have grown slowly for a number of reasons, but age is not a strong one.

What we can take from the acceleration in wages- and the three-month rate of growth is ahead of the YoY pace for near every sector, with retail being the major exception - is that the Fed will grab onto it and keep to its trajectory of higher rates. The complicating factor is that employment follows growth (the economy turned back up in mid-2016 and monthly job gains reaccelerated in mid-2017) and wages follow employment (wages began to pick up in the middle of this year).

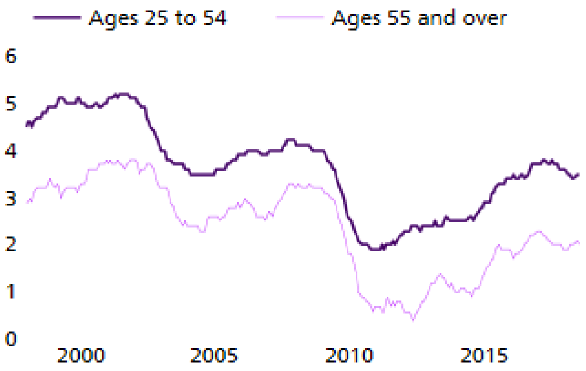
Using wages as guide for setting policy means basing forward rates on an echo of past growth in real activity. The Powell Fed, or at least Chairman Powell and a few other FOMC members, seem to understand this and will still focus first on what the market is telling them about prospects for growth (an echo chamber of a different sort).

It will be up to the market to determine the forward balance between improved employment and income on the one hand and the negative impact of tariffs on the other. The spread between the two-year Treasury yield and the federal funds rate (expressed as interest on excess reserves, see chart below), widened in reaction to the August employment data, and to strong ISM reports on the manufacturing and non-manufacturing sectors. The two-year is back to increasingly pricing in the path for policy rates that the Fed has been promoting and we have been forecasting. More important in practice is that the wider spread gives the Fed the runway to raise rates without threatening to invert the yield curve, something it has no interest in doing.

The Fed will raise rates this month and in December. *From there, we will have to see whether the fraying of growth now evident around the edges of the economy spreads as a result of Trump's tariffs.*

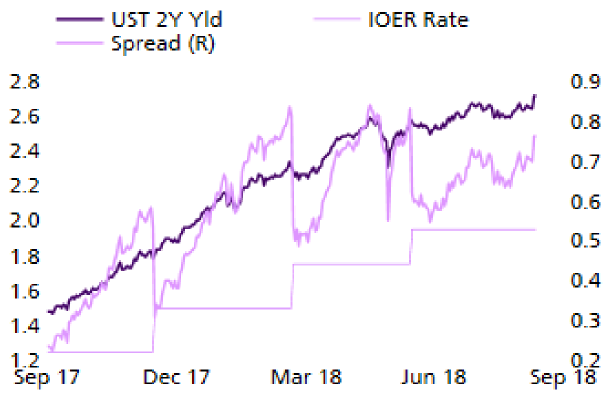
Atlanta Fed Wage Growth Tracker

Three-Month Moving Average



Source: Thomson Reuters Datastream, TS Lombard

2Y Tsy Yld vs Interest on Excess Reserves



Source: Thomson Reuters Datastream, TS Lombard

Markets: Tighter liquidity starting to bite

- **Equity multiples are falling, as is typically the case when liquidity tightens**
- **This should continue even if the Fed pauses in 2019, as QT will carry on**
- **Equity returns to stay flattish as earnings growth slows down too**

Equity valuations still well short of 2018 peak. US equities have recently made new highs but valuations remain much lower than they were in early 2018. On a 12-month blended forward basis, p/e's for the MSCI US declined from a cyclical peak of 18.6x to a low of 16.2x, since when they have recovered some of the lost ground to reach 16.8x recently (bottom-left chart).

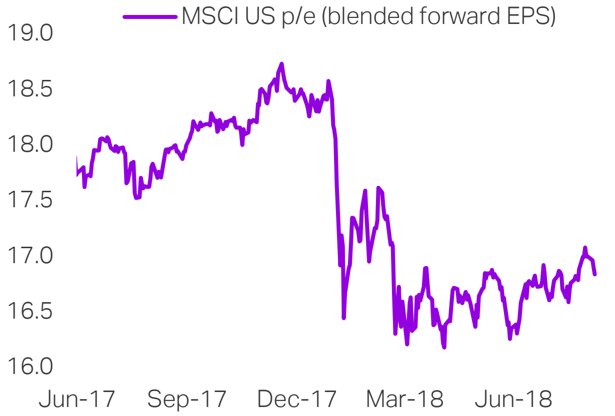
Falling multiples are not unusual during periods of policy tightening. The current cycle has been special in many ways, which is to be expected as it followed a global banking and credit crisis of unprecedented magnitude. Several of its features stand out, but not the fact that equity valuations are declining. As the bottom-right chart shows, this is exactly what happened, on average, during the past nine monetary policy tightening episodes.

A long but shallow tightening cycle. The Fed first hiked interest rates in December 2015, making the current tightening cycle 34 months old – pretty long by historical standards. However, it's been an unusually shallow one. In the first year the Fed raised interest rates by only 25bp, and by only 25bp a quarter thereafter – in line with the shallowest of past tightening episodes (top-left chart on the next page).

Monetary policy still accommodative after nearly three years of hikes. Not only has the Fed been very restrained in its tightening, the starting point for the fed funds rate was the lowest on record, meaning that policy has been very accommodative throughout. And arguably it remains so, with real rates still negative to this day.

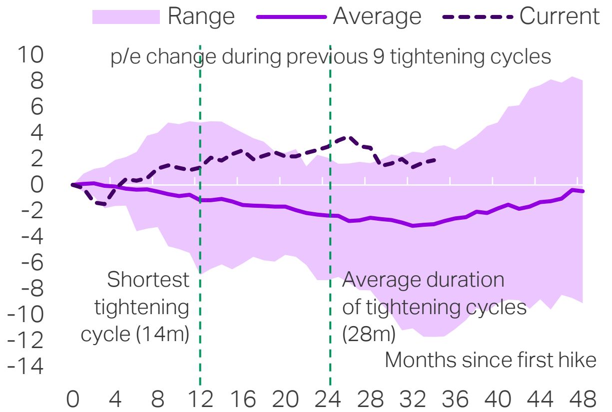
Faster EPS growth more than offset higher interest rates. The low starting point for rates and the very gradual pace of increase are perhaps the reasons why equity valuations continued to climb in the first two years of the tightening cycle. Intuitively, higher rates should mean lower multiples, all else equal, as a higher discount rate results in a lower present value for expected future free cash flows. But all else has not been equal. As the top-right chart on the next page shows, earnings growth has been faster since Q1 2016 than in the previous five years. Expectations of higher earnings have more than compensated for higher interest rates, leading to rising, rather than falling, multiples – until recently, that is.

Valuations lower than early in the year



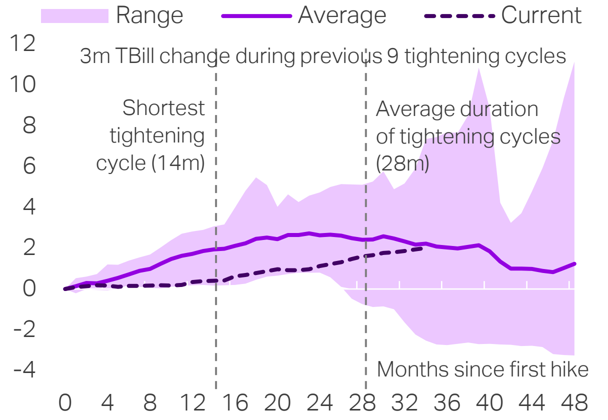
Source: Bloomberg, TS Lombard

P/e's typically fall as Fed tightens policy



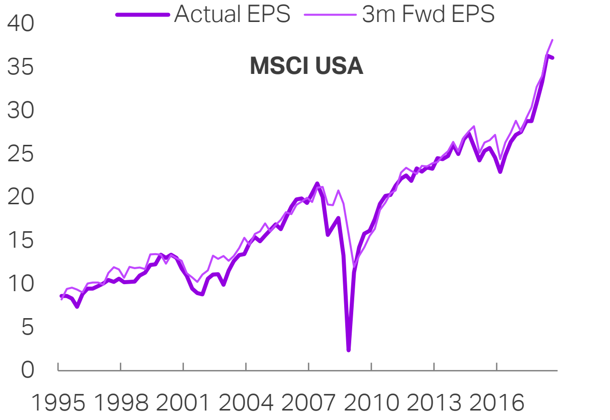
Source: Bloomberg, TS Lombard

A long but shallow tightening cycle



Source: Bloomberg, TS Lombard

EPS growth accelerated in 2016



Source: Bloomberg, TS Lombard

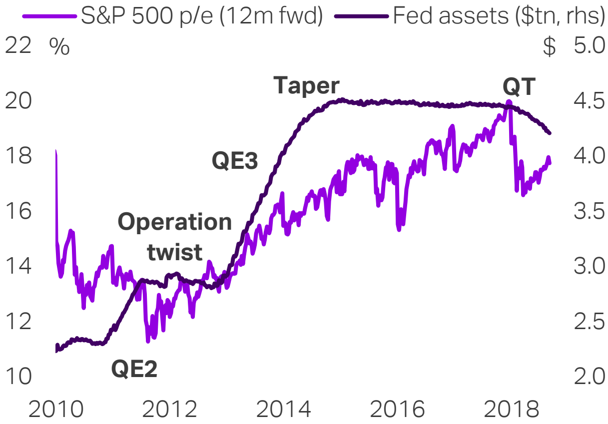
Tighter liquidity finally starting to bite. So what has changed to cause p/e's to finally start falling? Two things. First, fed funds at nearly 2%, and three-month T-bill yields at 2.7%, are starting have a meaningful impact on companies' funding costs, even if in real terms they remain very low. In other words, the fall in equity multiples may be a delayed response to tighter policy – simply because policy wasn't quite restrictive enough until very recently.

QT taking its toll too. The second change has been the beginning of QT. Equities started derating as soon as the Fed began shrinking its balance sheet. It is certainly no coincidence that, at exactly the same time, financial conditions tightened sharply in the US, weighing on the equity risk premium and multiples.

Where will monetary policy go? The path for equity valuations from here on depends on monetary policy. Our view is that the Fed is likely to hike twice more this year and then pause to assess the impact of an escalation of Sino-US trade tensions and of a stronger dollar on the economy. Absent a serious slowdown, this should limit how far multiples can shrink.

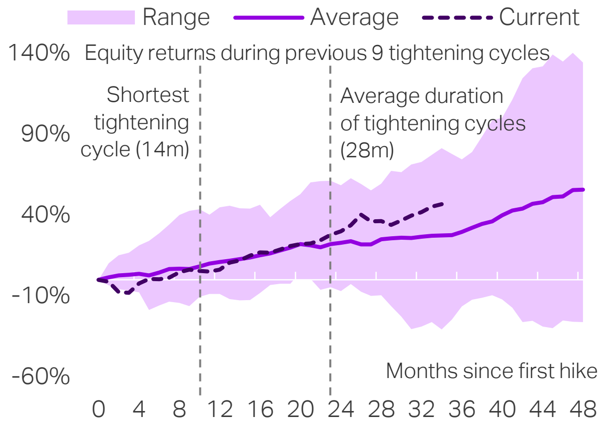
The safe-haven effect. With valuations having already partially adjusted, further declines may be gradual enough to be compensated for by earnings, even if profit growth slows in 2019 as tax cut boost fades. Safe-haven flows could also help, as investors seek refuge in the US – the market likely to be the least affected by trade wars. A more cautious approach on stocks is warranted, but not an outright bearish stance just yet. We see flattish returns in the next three to six months and remain neutral on US Equities in Asset Allocation.

Fed QT having an impact on valuations



Source: Bloomberg, TS Lombard

Returns ahead of those of average cycle



Source: Bloomberg, TS Lombard

Politics: Democrats lock onto Trump, little else

- **Democratic control is not predetermined -- the strong economy counters Trump's negatives**
- **Obama enters the fray - not a good sign for Democrats in 2020**
- **What next for Trump and Republicans after the mid-terms is a lot more interesting**

The mid-terms are, in effect, a Trump vs himself election, one with an echo from 1994, when the Democrats lost 52 seats (see table at the end of this section). Sentiment about the economy was high but not as high as it is now, and sentiment towards Bill Clinton was low (see table below). His net approval rating was -3.2, a 48.2 point drop since his inauguration. His net approval was much higher than Trump's (-14.2) but the Trump decline is far less severe, down 14.2 points. There was also a special prosecutor in place, Ken Starr, hanging over the president's every move. Starr's mission was to investigate the Whitewater real estate deal involving the Clintons. As an aside, the investigation ended the day Clinton left office. It found no reason to bring charges, but along the way it developed the mission-creep that Republicans are concerned about with Mueller: Starr prosecuted Clinton on lying about his relations with Monica Lewinsky.

Will the Republicans lose 52 seats, even with so many retiring from office? We do not expect the same swing because sentiment over the economy is so high, the drop in Trump's negative rating is not as severe and the Democrats have no galvanising leader focused on a single programme. In 1994, Newt Gingrich, then speaker of the House, turned the election into a referendum on Clinton and the Democrats and so asked people to ignore the individuals running and to vote for party (Newt always wanted to be a prime minister). In 2008, the Republicans rallied their voters on healthcare and captured 63 seats – the biggest loss for the Democrats since FDR in 1938.

Of the 435 seats in the House most have entrenched majorities and will not change hands. There are about 66 districts up for the taking, this is where voters lean Democratic, Republican, or are a toss-up, according to opinion polls. Of these, only 35 are truly competitive and, diving a little bit deeper, we can find 25 districts most liable to swing control of the House.

Looking at these 25, six are in California and seven in the Midwest, Those in the Northeast are in NJ and NY. No two districts are alike, and these 25 districts run the gamut in terms of race, income, and educational achievement (percentage graduating from college). Nevertheless, there is a distinct bias among these districts, regardless of geography, towards being whiter, more educated and having a higher income than the nation as a whole. In other words, the path for the Democrats runs through affluent white suburbs across the country. This does not bode at all well for Trump, since Republicans in these areas are, based on surveys, the least enamoured of him. It is an old saw in American politics that something becomes an issue when it becomes a white suburban issue. In other words, expect no tariffs on Audis, BMWs and Mercedes until after the election.

Against this backdrop, ex-President Obama stepped into the mix last week, trying to do what the Republicans did in 1994 and 2010 – galvanise and motivate people to vote against the party in power. Obama is still popular enough (he did win twice), and his arguments about Trump are meant to resonate with both his constituents and those suburban Republicans whose brand of conservativism seems to be increasingly alien to their party of choice. The downside for the Democrats is that Obama's initiative shows that, after two years, the party still has no current officeholder, at either the federal or state level, who can capture voter imagination sufficiently to take on this role as Gingrich did in 1994. One can argue about Trump's chances of re-election in 2020, but it is all angels on the head of a pin until we know the opponent.

Based on all this, the Democrats are likely to eke out a majority in the House. They need net pick-up of 23 seats. We expect them to gain 30 at most.

Where would this leave Trump in the final two years? Whenever US presidents lose Congress, their focus shifts to global affairs, where the constitution gives them much more latitude to take the initiative. Trump will do the same. The Mueller investigation will demand the president's full attention, but impeachment is unlikely unless the special prosecutor shows that Trump used the power of his office to obstruct justice or engage in other misdeeds (Nixon's and Clinton's misdeeds, Watergate and Monica respectively, occurred while they were in office, not when they were private citizens).

The more interesting political drama to come is the change and/or fight within the Republican party and how the Democrats respond and with whom. This all depends on whether the House does turn Democratic. If a "blue wave" materialises and the Republicans lose 50 or more seats (which we do not expect), the drama only becomes more intense. The reason is that, based on primary results, the House Republicans in the next Congress will contain a higher concentration of Trump loyalists. If the Republicans consequently lose the House, a pushback among Republicans to reclaim the party seems likely. If the Mueller investigation truly wounds Trump, he will likely face a strong primary challenge in 2020. If the Republicans lose the House and there is no pushback, the political landscape is open for the Democrats to shift to the middle to claim moderate Republicans left on the outside – but only if the far left of the party (Bernie Sanders/Elizabeth Warren) lets them. The race for the White House begins on November 7.

How Many House Seats Can Republicans Expect to Lose?

President	Year	Net Approval	Chg in Net Appr Since Inauguration	Mid-Year Cons Conf (U	Loss of House Seats
Trump	2018	-14.2	-19.4	97.9	???
Obama	2010	-3.2	-48.2	61.2	-63
Clinton	1994	-4.3	-40.3	89	-52
Reagan	1982	-4.4	-42.4	65.4	-26
Johnson	1966	50.5	-25.5	91.2	-47
Eisenhower	1958	39.8	-21.2	80.9	-48

Source: TS Lombard, FiveThirtyEight

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