So Long Yellow Brick Road: Trumpism shows its true colors to investors

Executive Summary. Imagine the excitement at the Heritage Foundation and the American Enterprise Institute after Trump's election. Finally, a President to restore the pillars of Reaganism: pro-business policies and court appointments, corporate tax cuts and deregulation[1]. For Heritage and AEI, this couldn't come soon enough: after all, during the Obama years, the ease of starting a new business in the US fell relative to the rest of the world (c1[2]). The early payoff for equity investors was substantial (see yellow brick road, below), and there were signs of renewed dynamism in US manufacturing jobs. Ever since Trumpism showed its true colors on economic and trade policy, the S&P 500 index has traded in a volatile/sideways fashion and manufacturing dynamism has stalled (c2). I have no reason to think this will change before the election; if so, it makes sense to range-trade equities around highs and lows seen since January 2018[3].

The latest data show that Trump's trade war is starting to bite: US tariffs are at their highest levels in 40 years (c3); after rising in 2016 and 2017, global trade volumes are at their weakest since 2010 (c4); the pain is acute in Germany where new orders foreshadow a continuing decline in production (c5); global manufacturing and employment surveys now signal a small contraction rather than expansion (c6); in the developed world, surveys are weakest in trade-reliant Europe (c7); US manufacturing hours worked are now declining on a year-over-year basis after a surge in 2017 (c8); and now the trade war is negatively affecting US consumer spending and employment in sectors most impacted by tariffs (c9-c10).

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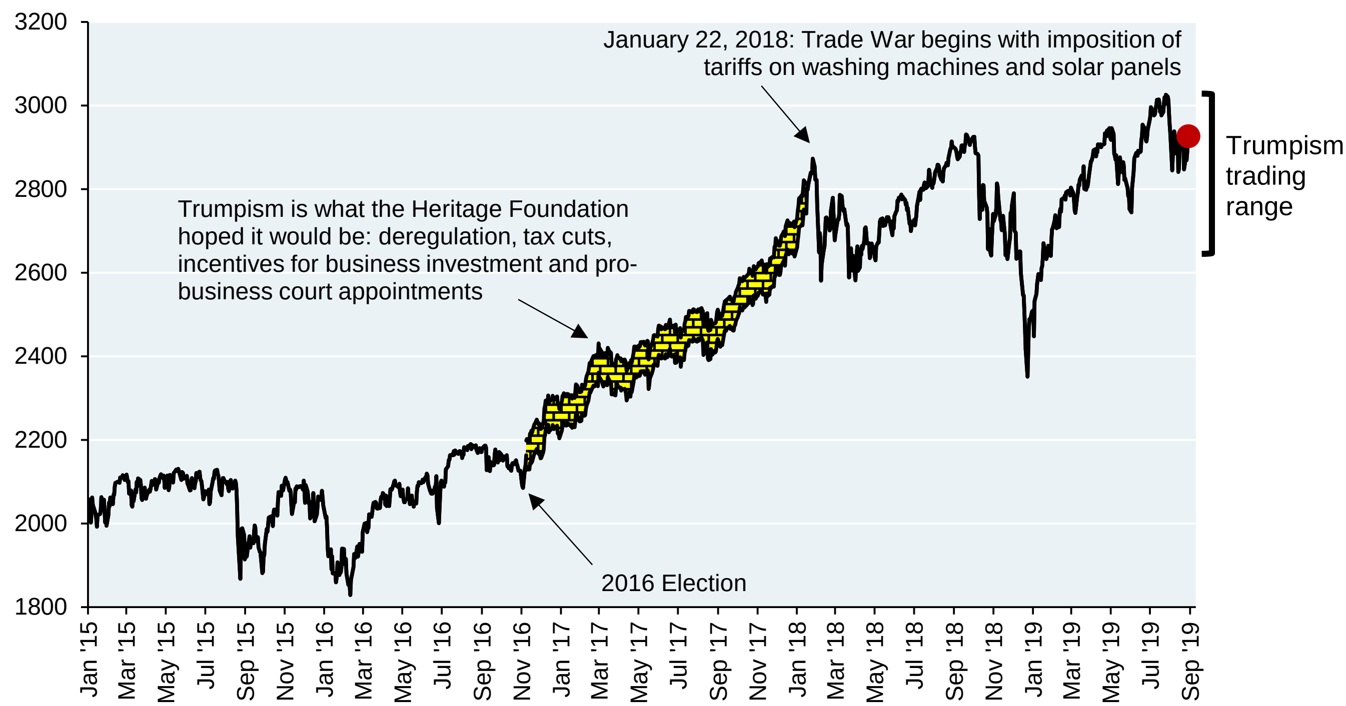
S&P 500 Index level



Source: Bloomberg, J.P. Morgan Asset Management. August 30, 2019.

[1] Heritage/AEI on benefits of lower taxes and deregulation: "*Tax Reform for Investment and Jobs*" (August 2017, Heritage); "*A Guide to Tax Reform in the 115th Congress*" (February 2017, Heritage); "*Overregulation drags down business*" (February 2017, Heritage); and "*How much can tax reform affect economic growth*" (AEI, November 2017).

[2] The letter "c" denotes supporting charts which appear on pages 3-7.

[3] The recent 3-month annualized volatility of the stock market has been around 14%, which is almost exactly equal to average volatility since 1958; lower equity market volatilities in 2003-2006 and 2016-2018 were aberrations.

The trade-war induced slowdown is hitting corporate profits as well. In 4Q18, S&P 500 earnings grew 7-9% (excluding the boost from corporate tax cuts). S&P EPS growth has decelerated to 2-3% (c11), and absent stock buybacks, organic S&P earnings growth during the first half of the year would have been close to zero. What's also concerning: after economy-wide profits were restated lower due to slower revenue growth and higher labor costs, it now looks like there wasn't much of a Trump profits boom at all (c12). The recent spike in reported S&P profits relative to economy-wide profits is not a good sign; historically, it meant that companies were making more aggressive accounting assumptions, and signaled that the business cycle was ending (c13).

Most research cites a trade war hit to US profits of just 3%-5%. It doesn't sound like much, but that's enough to offset almost all of Trump's corporate tax cuts if absorbed through profit margins. Also, tariff costs are not distributed evenly; the impact could be as high as 22% on tech hardware earnings and 10% on capital goods earnings (c14). What if companies passed through tariff costs to consumers instead? J.P. Morgan Equity Research estimates a cost of $600 to $1,000 per household now that tariffs are being applied more broadly to consumer goods and not just capital goods. This would offset most of the benefits from Trump's household tax cut (c15), and affect 50%-80% of computer and smartphone purchases. The trade war runs counter to what Heritage and AEI believe in[4]. However, I haven't seen strongly worded statements from either denouncing what the Administration is doing, **perhaps out of concern for what might result from a Democratic sweep in 2020** (table 1, page 8).

Here's the good news. First, we do not see a US recession in 2019 or 2020. Now that the lowest US unemployment rate in 50 years has pushed wage growth above 3%, the US consumer is the strongest component of the global economy. Mortgage refinancing and home purchases are picking up (c16), and retail sales and credit stats look healthy (c17-c18). Commercial loan demand is also growing, although as we discussed at length in July, the deterioration in leveraged loan underwriting standards is unnerving[5]. I also think the inverted US yield curve is not as reliable a signal at a time when 70%-100% of European and Japanese government bonds trade at negative yields[6], driving up demand for long duration US assets (c19). Furthermore, *some* multinationals are adjusting to the trade war by moving US-destination final assembly supply chains to Vietnam and other countries (c20), which mitigates the tariff impact[7]. The US also signed a tentative trade deal with Japan to slash import tariffs on US agricultural goods and delay tariffs on US imports of Japanese cars. There may also be more easing ahead from the Fed, the ECB, Canada, Australia and EM central banks, which typically results in a manufacturing rebound several months later (c21). Finally, weak equity issuance combined with rising M&A and buyback activity has resulted in falling net US and global equity supply (c22-c23). On the margin, this creates favorable supply/demand dynamics for equities, particularly after a selloff when institutional investors rebalance.

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[4] Heritage/AEI on free trade: "*An economic analysis of protectionism clearly shows that Trump's tariffs would make us poorer, not greater*" (AEI, December 2016); "*Freedom to Trade: A Guide for Policymakers*" (Heritage, October 2015); and "*In praise of imports*" (Heritage, November 2015).

[5] *"The sharp deterioration in leveraged loan underwriting standards",* from the July 2019 *Eye on the Market*

[6] In **Europe**, markets are now pricing in that the ECB's first rate hike will be in **2025**, which might as well be never. Since August 2011: S&P Bank Index total return = 175%, Euro Stoxx Bank Index return = 0% (c24).

[7] A lot of **multinational production in China is geared toward Chinese and other Asian markets**, and therefore is unaffected by US tariffs. Examples, with % of revenues from sales in China: Qualcomm (80%), Micron (57%), Broadcom (49%), Texas Instruments (44%), AMD (39%), Intel (27%), Apple (20%), Nike (16%), Boeing (14%), etc. On production for export to the US, there are limits on how much can be shifted to Vietnam, whose population is less than one tenth of China's and which is already running into labor shortages as manufacturers relocate there.

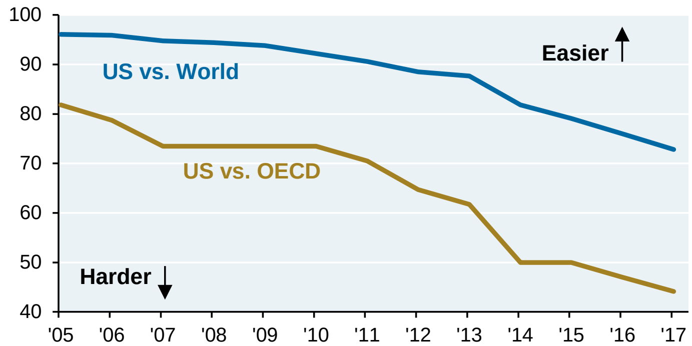
Even so, I don't think central banks can eliminate market volatility resulting from the trade war with China given the depth of bilateral economic ties (c25), even if its sharp edges are softened one day by US or Chinese concessions. The US *equity* market is much more reliant on production and global trade than the US *economy*, which is 70% reliant on consumption. Like it or not, global profit margins are heavily tied to globalization (c26), and the US is more sensitive to de-globalization than simple import/export measures suggest (c27). As a result, it might take a substantial unwinding of the trade war to propel markets to much higher levels, and at this point it's not clear that either Trump, or his potential Democratic successors, are interested in that. **Bottom line: with the yellow brick road in the rear view mirror, the Trumpism equity market trading range seen since January 2018 is likely to remain**.

Michael Cembalest
J.P. Morgan Asset Management

Supporting Charts and Tables

Chart 1

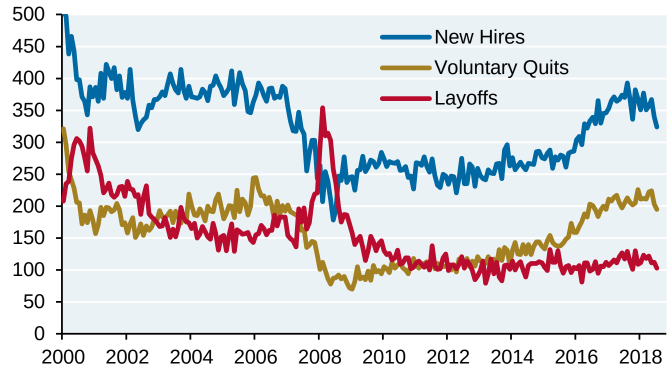
"Ease of starting a new business"
US percentile rank relative to world and OECD



Source: World Bank Doing Business, J.P. Morgan Asset Management. 2016.

Chart 2

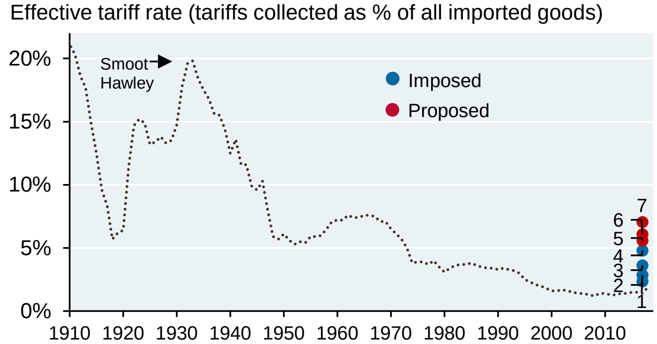
US manufacturing sector labor dynamism
Thousands



Source: BLS, JOLTS. June 2019.

Chart 3[8]

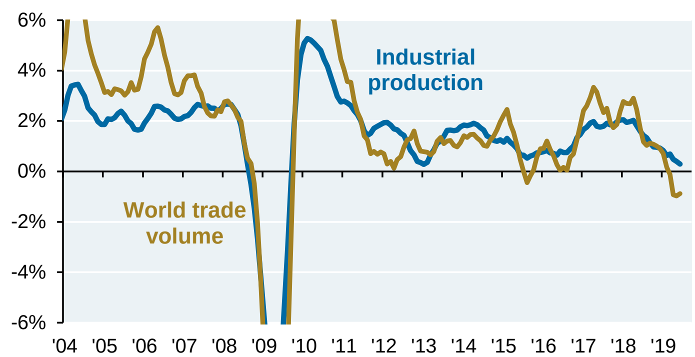
US tariff history and projections assuming no change in US import demand from targeted foreign exporters
Effective tariff rate (tariffs collected as % of all imported goods)



Source: Esteban Ortiz-Ospina and Max Roser "International Trade", US International Trade Commission, USITC, US Census, JPMAM. August 2019.

Chart 4

Global industrial production and world trade
% 6m/6m change

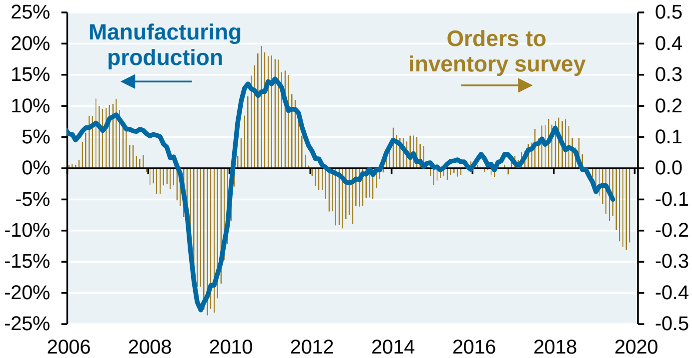


Source: Netherlands Bureau for Economic Policy Analysis. June 2019.

[8] *Chart 3 tariff details*. Tariffs on washing machines, solar panels, aluminum and steel is (1). Remaining dots refer to Section 301 tariffs: (2) 25% on $50 bn; (3) 10% on $200 bn; (4) increase in step 3 tariffs to 25%; (5) 15% on an additional $130 bn, effective September 2019; (6) increase in step 2 and 4 tariffs to 30% effective October 2019; and (7) 15% on all remaining goods, roughly $165 bn effective December 2019.

Chart 5

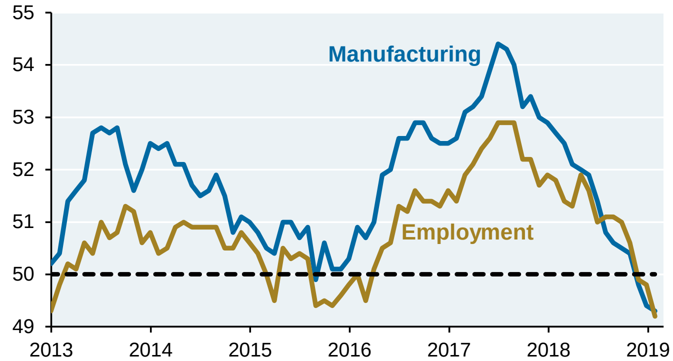
Order/inventory data point to lower German production
y/y, 3 month average Ratio, y/y, lagged 3m



Source: German Federal Statistical Office, IFO Institute, Gavekal. Aug 2019.

Chart 6

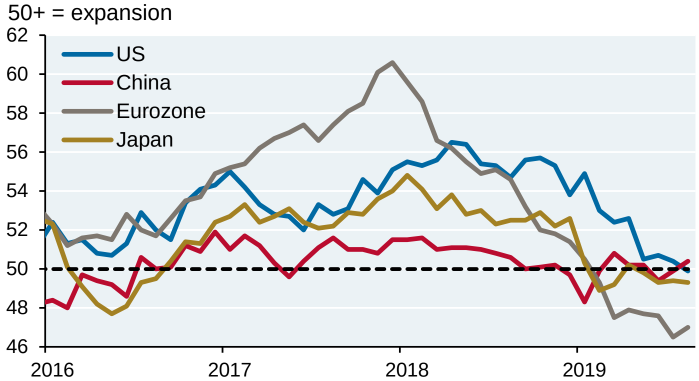
Global manufacturing and employment business surveys
50 += expansion



Source: J.P. Morgan, Markit PMI. July 2019.

Chart 7

Regional manufacturing business surveys
50+ = expansion



Source: Markit PMI. August 2019. US data for Aug '19 is preliminary.

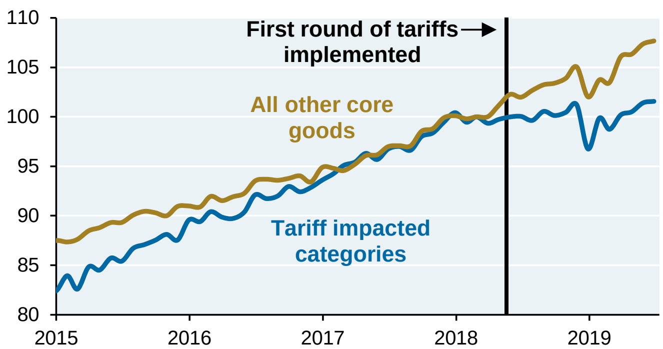
Chart 8

US manufacturing aggregate weekly hours of all employees, % y/y

Source: Bureau of Labor Statistics. July 2019.

Chart 9

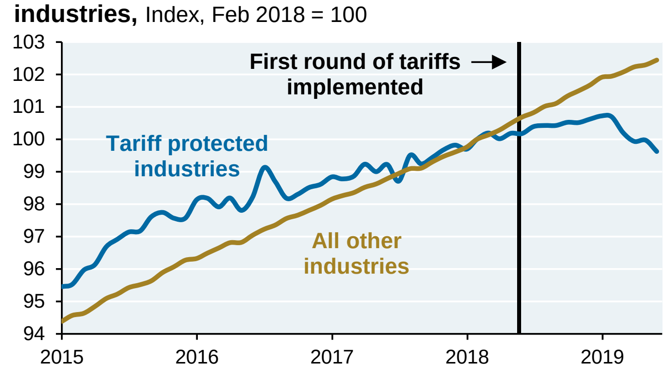
US real consumer spending weaker in tariffed goods
Index, Feb 2018 = 100



Source: BEA, June '19. Tariffed goods = housekeeping supplies, furniture, floor coverings, major appliances, sewing machines, sports vehicles, auto parts.

Chart 10

US employment actually *weaker* in tariff-protected industries, Index, Feb 2018 = 100



Source: BLS, June '19. Tariffed industries = household appliances, furniture, auto parts, aluminum products, steel products, electronic connectors.

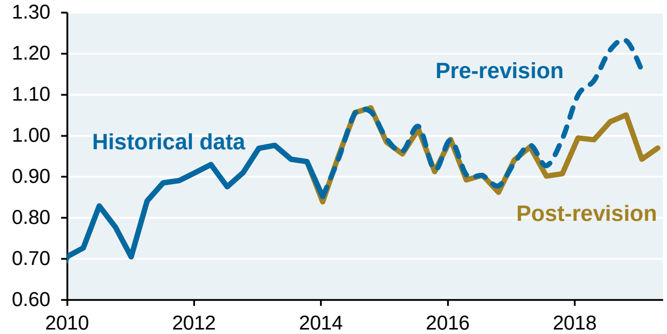
Chart 11

S&P 500 12 month forward earnings per share
% y/y

Source: Datastream. August 2019.

Chart 12

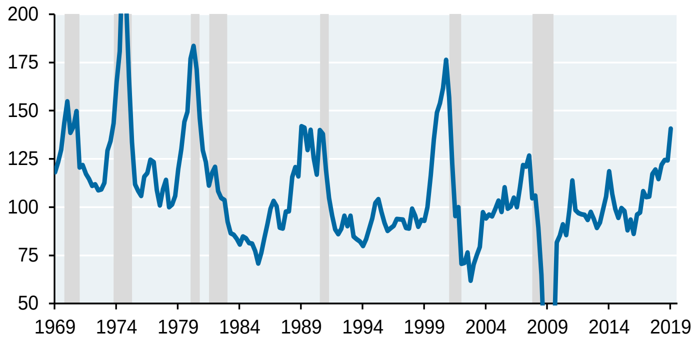
US economy-wide after tax non-financial corporate profits
US$ trillions



Source: Bureau of Economic Analysis. June 2019. Including inventory valuation and capital consumption adjustments.

Chart 13

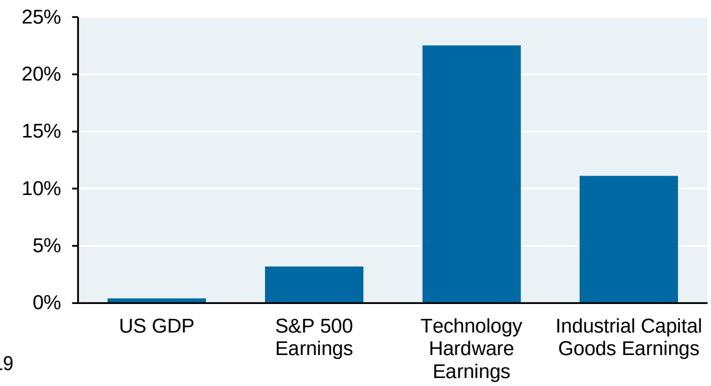
S&P 500 reported EPS vs economy-wide profits
S&P profits/NIPA profits, December 2001 = 100



Source: Shiller, BEA, Gavekal. Economy-wide profits include inventory valuation and capital consumption adjustments. Grey bars indicate recessions. March 2019.

Chart 14

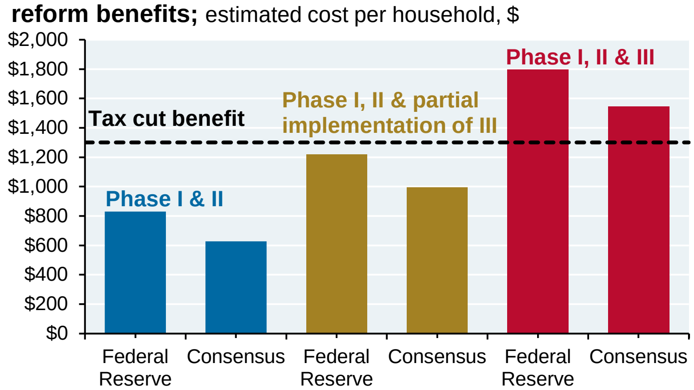
Tariffs on Chinese imports as a share of select measures



Source: Empirical Research Partners. August 2019.

Chart 15[9]

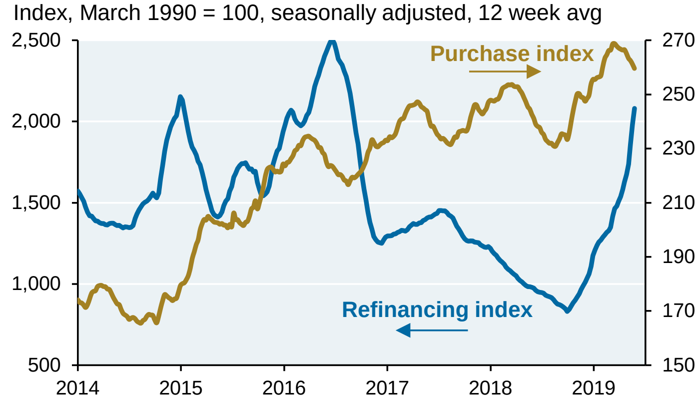
Tariffs now offsetting substantial portion of household tax reform benefits; estimated cost per household, $



Source: J.P. Morgan Equity Research. August 2019.

Chart 16

US home refinancing and purchase indices
Index, March 1990 = 100, seasonally adjusted, 12 week avg

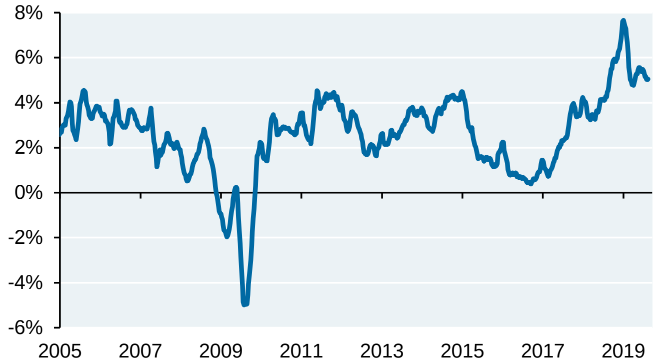


Source: Mortgage Bankers Association. August 2019.

[9] Consensus estimates include estimates from the Peterson Institute, Oxford Economics, UC Davis and "Tariffs Hurt the Heartland". The chart includes J.P. Morgan estimates for Fed Phase III based on the Fed's Phase I/II analysis.

Chart 17

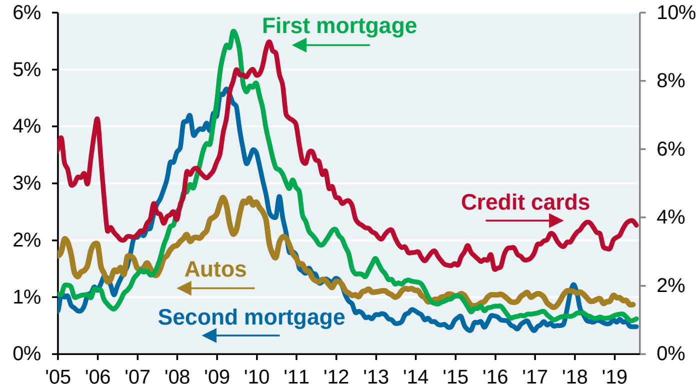
US same store retail sales growth
y/y %, 8 week average



Source: Redbook Research. August 2019.

Chart 18

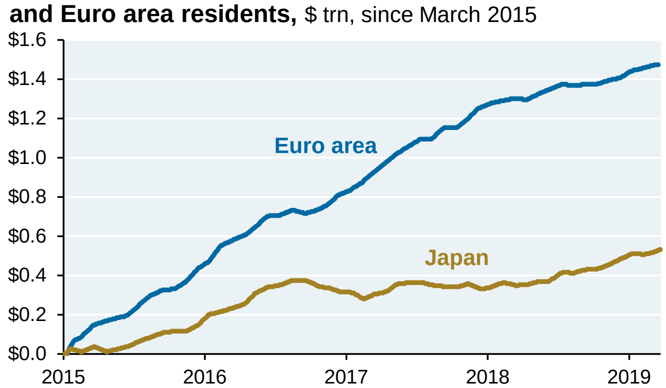
US 90+ days loan delinquency transition rates



Source: S&P Dow Jones Indices, Experian. July 2019.

Chart 19

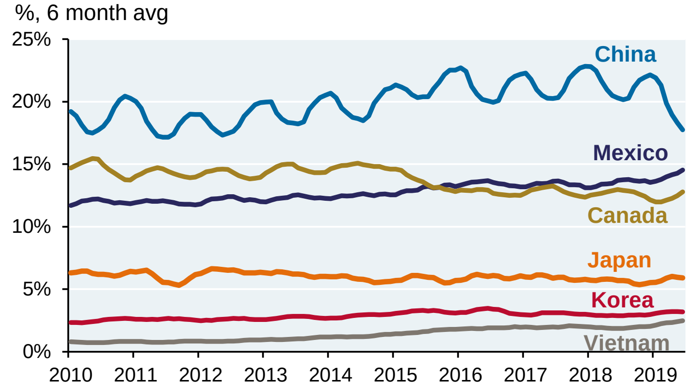
Cumulative net purchases of foreign bonds by Japanese and Euro area residents, $ trn, since March 2015



Source: J.P. Morgan Research. 2019.

Chart 20

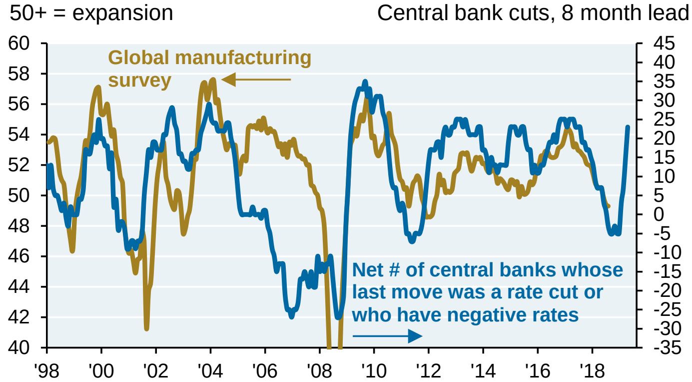
Share of total US imports by country
%, 6 month avg



Source: US Census Bureau. June 2019.

Chart 21

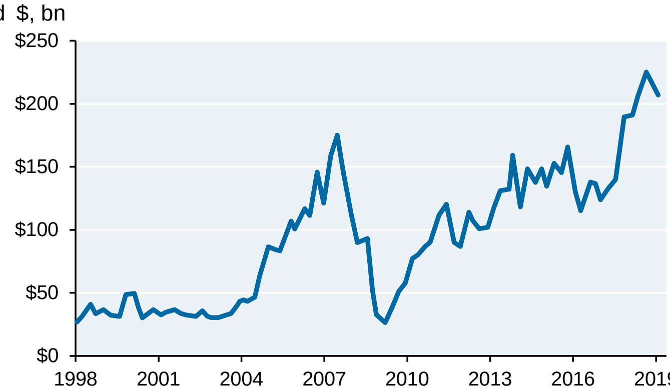
Central banks rate cuts lead global manufacturing
50+ = expansion   Central bank cuts, 8 month lead



Source: Country Central Banks, Markit PMI, Bloomberg. August 2019.

Chart 22

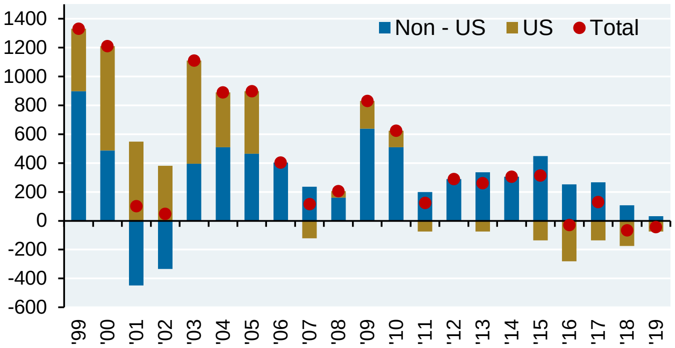
S&P 500 buybacks
$, bn



Source: S&P Dow Jones Indices. 2019.

Chart 23

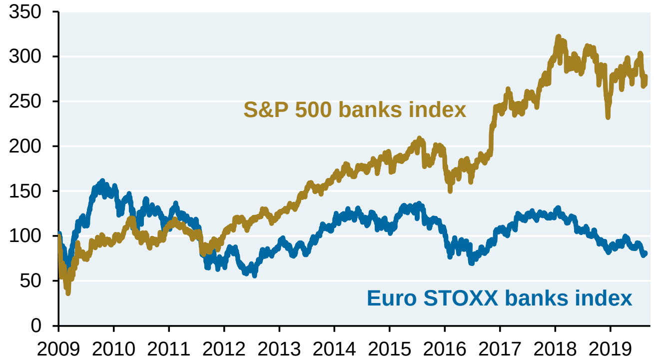
Unprecedented low levels of net equity supply
US$ bn, based on MSCI All Country World Equity Index



Source: JPM Global Markets Strategy Flows & Liquidity Report. 2019.

Chart 24

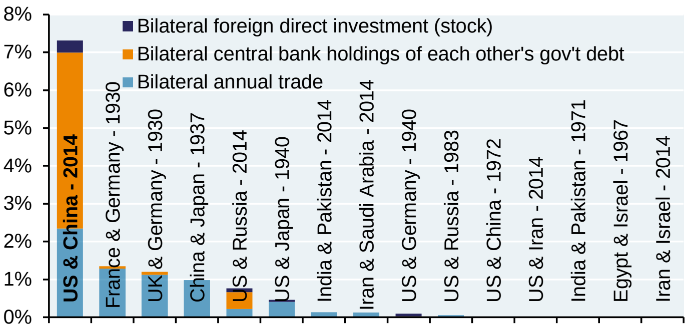
US vs Europe: banks total return performance
Index, 100 = Jan 2009



Source: Bloomberg. August 29, 2019.

Chart 25[10]

China and the US: much deeper economic linkages than actual and potential adversaries of the last 100 years
% of combined GDP in specified year



Source: JPMAM, Various Central Bank and academic sources.

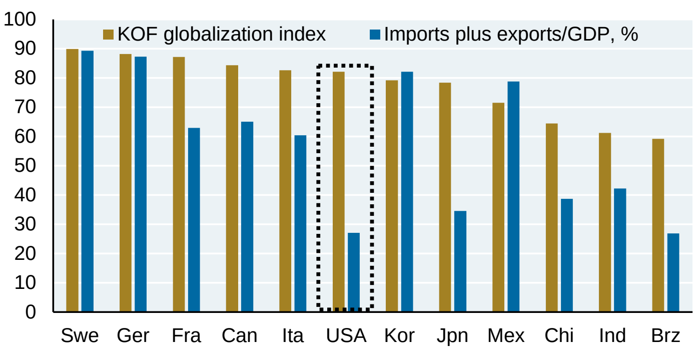
Chart 26

Global profit margins and global trade to GDP

Source: J.P. Morgan Global Markets Strategy. 2019.

Chart 27

US globalization measures are among world's highest, despite lower contribution of trade to GDP



Source: JPMAM, Haver, KOF Swiss Economic Institute. 2018.

Chart 27: The KOF globalization index includes both de jure and de facto measures. De jure measures include trade regulations, tariffs, export taxes, trade agreements, capital account openness, investment restrictions and participation in international treaties. De facto measures include actual trade in goods and services, foreign direct investment, portfolio investment, international income payments, embassies, international peace keeping missions and international patents/high tech exports.

Acronyms. **AEI** American Enterprise Institute; **ECB** European Central Bank; **M&A** Mergers and Acquisitions; **NIPA** National Income Product Accounts

[10] In addition to bilateral flows shown in Chart 24, **China-US linkages** also include $450 bn in sales of US affiliates operating *in* China, which is 3x the level of US exports *to* China; more US college students from China than from any other foreign nation; and the world's largest bilateral collaborative research relationship, as measured by co-authored science and engineering papers (Source: Gavekal).

Table 1: Policy proposals from select Democratic Presidential candidates[11], and the battle for the Senate

Paying for Medicare-for-All (no patient deductibles or co-pays), free college tuition, student debt forgiveness, $1 trillion in infrastructure spending, $500 bn of affordable housing, universal pre-K and $1 trillion in Federal Green New Deal procurement costs would require a lot of new funding sources. As a reminder, if a Democratic candidate wins the Presidency, Democrats would only need 3 seats to regain effective control of the Senate. Popular Democratic Presidential candidates may consider Senate races instead (Colorado, Montana, Texas), and now Georgia has 2 GOP seats in play after a recent retirement. As a result, it's worth reviewing potential tax and regulatory consequences of a Democratic Sweep in 2020.

- **Higher taxes on income and capital gains** (Biden, Sanders, Warren). Biden has suggested doubling the capital gains tax rate on those making $1mm+, and eliminating the step-up in basis for heirs. Ron Wyden (D-OR, ranking member of the Senate Finance Committee) has proposed taxing capital gains even if they have *not* been realized. Sanders would treat capital gains and dividends as income and tax them at the same marginal rates, apply a top estate tax rate of 77%, and apply a new 12.4% payroll tax on incomes over $250k. Warren has supported the idea of a surtax that functions as a wealth tax, since its level would be dependent on wealth levels as well as on income levels; one version calls for an annual tax of 2% on assets over $50 mm.

- **Higher corporate income tax rates** (Biden, Harris, Sanders, Warren). Cutting corporate tax rates and putting the US on an even playing field with countries that do not tax worldwide corporate income was a bipartisan effort a few years ago, supported by the Obama White House. However, progressives are now setting the policy agenda for House Democrats (conservative "Blue Dog" Democrats now make up just 27 out of 227 Democratic House seats). The majority of Democratic candidates favor raising corporate tax rates or repealing the 2017 tax law entirely. Warren would go further and impose a tax on corporate profits over $100 mm with the goal of raising $900 bn in tax revenue (equal to a roughly 9% increase in the corporate tax rate)

- **Curbs and penalties on stock buybacks** (Sanders, Warren). Sanders (with Schumer, D-NY) would prevent companies from executing share repurchases unless they meet a number of requirements, such as paying all workers at least $15 per hour and providing sick leave, higher pensions and health benefits. Warren, Sanders and Gillibrand are co-sponsors of the "Reward Work Act", which would not only prohibit stock buybacks on the open market but also require public companies to have employees elect one-third of their board of directors in order for the company to be able to register securities on a national exchange (similar to provisions in Warren's "Accountable Capitalism Act"). Separately, Brown (D-OH) introduced legislation that would require public companies to pay each worker $1 for every $1 million in increased returns to shareholders via buybacks

- **Bank Tax and Financial Transaction Tax** (Harris, Sanders). Sanders' "Inclusive Prosperity Act" would place a 0.5% tax on the trading of stocks, 0.1% on bonds and .005% on derivatives (IPOs and short-term debt would be exempted). Depending on rates and assets subject to tax, this tax could raise $400 to $800 bn over a decade. Obama's proposed 0.07% fee on bank liabilities is the model for Harris' proposed new tax on banks (Harris has singled out banks as a key area to fund health care reforms), while Klobuchar would tax banks to fund infrastructure. Warren and Sanders would break up big bank and big tech mergers retroactively.

- **Other**: A pillar of Warren's plan to "Reign in Wall Street" would require private equity companies to guarantee repayment of debt incurred by companies they take over as well as their pensions, and limit the ability of private equity firms to pay themselves dividends and monitoring fees

[11] Sources include "*Democrats Target Wall Street*" (Cornerstone Macro Research, July 19, 2019), and The American Banker (July 18, 2019).

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