



MORNING BRIEFING

May 9, 2013

Exuberance

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(1) Within shouting distance of 1665. (2) A short history of the bull's P/E. (3) Taking Greece out of the P/E. (4) Probability-weighted math yields 1695 target for S&P 500. (5) Weighing the odds of a melt-up followed by a meltdown. (6) If stock prices soar, Fed will have to do something. (7) Phase out QE or raise margin requirements? (8) Throwing a wet towel on the bull. (9) Will someone please hit the pause button? (10) Good news out of Germany and China bolster outlook for slow, but steady global growth. (11) Copper starting to shine again?

Strategy I. On Monday, I discussed whether there is likely to be much more upside for the S&P 500 over the rest of the year. The index closed at 1632 yesterday, within shouting distance of my yearend target of 1665. My target has been based on my Rational Exuberance scenario, to which I previously assigned a subjective probability of 60% earlier this year. In this scenario, S&P 500 forward earnings rises to \$118 a share, up from \$113 at the end of last year, and the forward P/E rises to roughly 14, up from about 13 over the same period. During the past eight weeks, forward earnings has been hovering around a record \$115, while the P/E rose to 14.2 yesterday ([Fig. 1](#)).

The last time that the P/E was this high was in early 2010, just as Greece was starting to hit the fan. Recurring fears of a Lehman-style financial meltdown in Europe knocked the P/E down several times since then ([Fig. 2](#)). Let's briefly review the history of the bull market's valuation multiple:

(1) **2009.** The forward P/E of the S&P 500 bottomed at 10.2 on March 9, 2009, when the bull market began. It soared over 14 during the spring of that year and fluctuated wildly over the rest of the year mostly between 14 and 15.

(2) **2010 and 2011.** During 2010, the P/E fell from a high of 14.7 on January 11 to a low of 11.4 on August 26 as the first act of the euro zone crisis began to unfold. It recovered back to 13.6 on February 18, 2011, but then plummeted to 10.2 on October 3 during the second act of Europe's melodrama. That summer, S&P downgraded the credit rating of US debt.

(3) **2012-2013.** The P/E recovered to 13.0 on March 26, 2012 only to be knocked down again to 11.5 on June 1 of that year as bond yields soared in Spain and Italy. ECB President Mario Draghi famously responded at the end of July to that third tense act of the euro zone crisis by promising to do whatever it takes to avert a financial calamity. That sent the P/E back to 13.1 on September 14, 2012. Then there was another retest of 12 on November 15 resulting from uncertainty about the US elections and jitters about the looming US fiscal cliff. It's been almost a straight-line ascent for the P/E to 14.2 since then.

One of our readers noted that I seemed to be skirting the question of the market's upside in my discussion of this subject on Monday. I seem to be doing it again. So let me cut to the chase. I am still most comfortable with my 1665 target for the end of the year. It is based on my 60% Rational Exuberance scenario. In the Irrational Exuberance scenario, with a 30% subjective probability, I reckon that the P/E could soar to 18 later this year, sending the S&P 500 to 2100, as I discussed on Monday.

The remaining 10% is the dreaded Endgame scenario in which the index drops all the way back to the devilish level of 666 that marked the end of the previous bear market and the start of the current bull market.

So adding all these numbers together on a probability-weighted basis would put the S&P 500 at 1695 by the end of the year or sooner. There is obviously plenty of room for creative math to get different results. You can paint any picture you like by the numbers. Again, to cut to the chase, I'm sticking with 1665 for the end of the year. However, along the way, there could be a melt-up this summer that would probably set the stage for a nasty correction during the fall. Then the bull can resume with a yearend rally and continue to charge ahead next year.

Strategy II. In the February 5 *Morning Briefing*, I outlined the Irrational Exuberance scenario as follows: "In a melt-up scenario, the market would do just that, jumping to my yearend target or higher before the middle of the year. ... The Fed's critics, including dissenters on the FOMC, will warn that ultra-easy monetary policy is once again pumping air into a stock market bubble. So a melt-up could be followed by a meltdown, or at least a very nasty 15%-20% correction later this year if the Fed is forced to stop its quantitative easing by soaring stock prices..."

Alternatively, Fed Chairman Ben Bernanke and his dovish allies on the FOMC might respond to their critics by raising stock market margin requirements. During March, margin debt soared to \$380 billion, up 28% y/y, matching the previous record high during July 2007 ([Fig. 3](#)). The margin requirement has been flat at 50% since January 1974 ([Fig. 4](#)).

Soaring margin debt certainly supports the charge that the Fed is once again inflating asset bubbles. However, valuation multiples aren't flashing irrational exuberance yet; but that could change quickly in a debt-financed melt-up of stock prices. Some commentators, who don't believe that the fundamentals justify the new highs in stock prices, are suggesting that the market is already irrationally exuberant. For example, yesterday's *WSJ* included a downbeat [commentary](#) by John Shipman titled, "DJIA 15000: Where's the Achievement?" He threw a big wet towel on the latest bull market:

"It feels more 'installed' by central bankers' policies and promises, rather than won by virtue of true performance. There's a hollowness, and missing is the substance, the attributes normally associated with buoyant stock markets, like broad confidence in brighter prospects for the economy, vibrant sales and a rising pace of earnings growth, enthusiastic business spending and eager hiring, upward mobility, to name a few.

"Instead, the economic outlook remains inhospitable, confidence is still well below pre-recession highs and many public companies remain more focused on controlling costs than expanding their businesses as revenue growth stalls. That leaves little incentive to hire or substantively boost wages for current employees. All matters of substance, but not the type that common sense would say drives stocks to all-time highs."

Of course, there are plenty of technical indicators suggesting that the market is overbought including the Bull/Bear Ratio compiled by Investors Intelligence, which Debbie discusses below ([Fig. 5](#)). Bullish sentiment is back just over 50% the past two weeks. In addition, the S&P 500 is now 10.9% above its 200-day moving average, as Joe discusses below ([Fig. 6](#) and [Fig. 7](#)). These are not irrationally exuberant readings yet, but I would much prefer a pause in the bull market than a melt-up attributable to irrational exuberance.

Strategy III. At the start of the week, I noted that going away in May has been a big mistake so far. That was a premature assessment, protested one of our readers, because the month has only started. I

meant to say that investors who sold in April anticipating that the market would swoon in May might regret doing so. Those who sold last month were probably reacting to March's batch of economic indicators, which confirmed the bears' warnings about a spring break in the market triggered by weaker-than-expected data.

Debbie and I blamed bad winter weather in March for the soft batch of indicators. So we don't expect a soft patch in the US economy. We are especially encouraged by several recent upbeat transportation-related indicators, which we reviewed yesterday. On the other hand, we've been expecting that world economic growth will remain subpar. The most recent global economic indicators have been surprisingly good, but consistent with our view that the global economy is neither headed for a boom nor a bust, just more slow growth:

(1) *Germany*. As Debbie discusses below, we were certainly pleasantly surprised by the resilience in German factory orders and industrial production data for March released over the past two days ([Fig. 8](#)). However, both are still below their most recent cyclical peaks, yet the DAX jumped to a record high yesterday ([Fig. 9](#)).

(2) *China*. April trade data for China were better than expected yesterday ([Fig. 10](#)). However, the accuracy of the data has been questioned. Nevertheless, the recent rebound in the price of copper, which is very sensitive to demand for the metal in China, provides some confirmation that April's swoon in commodity prices was not the beginning of a freefall ([Fig. 11](#)).

CALENDARS

US. Thurs: Jobless Claims 335k, Wholesale Trade 0.4%. **Fri:** Treasury Budget \$107.5b, Bernanke, George. (Bloomberg estimates)

Global. Thurs: China CPI 3.2% y/y, Japan Leading Index 97.7, UK Headline & Factory Industrial Production -1.6% y/y/-2.0% y/y, ECB Monthly Report. **Fri:** China: New Yuan Loans 767.5b, China M1 & M2 11.3%/15.5% y/y, Germany Trade Balance (euros) 17.5b, Canada Net Change in Employment & Unemployment Rate 15k/7.2%, G7 Finance Ministers and Central Bank Chiefs Meeting. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): Investors Intelligence Bull/Bear Ratio rose for the second week to 2.63 this week after a three-week drop from 2.68 to 2.26. Bullish sentiment climbed to 52.1% the past two weeks, following a three-week descent from 52.0% to 44.3%. Bearish sentiment edged up to 19.8% after sinking to 18.8% (near its recent low). Those calling for a correction dwindled to 28.1% from a ten-month high of 36.1% two weeks ago. The AAI Bull Ratio advanced for a third week to 46.3% last week after plunging to 26.2% (lowest since March 2009). Bullish sentiment climbed to 31.0% from 19.3% three weeks ago (fewest bulls since March 2009). Bearish sentiment declined to 35.9%; this is after a spike to 54.5%, the most bears since July 2010, the week of April 10.

S&P 500 Technical Indicators ([link](#)): The S&P 500 is trading at a record high as the rally has resumed its uptrend. The index has improved to 4.2% above its 50-day moving average from 1.8% last week, but is down from 4.5% in late January. It's up to 10.9% above its 200-dma from 7.9% a week ago, and at a 13-month high. The index's 50-dma began rising on January 2, and its 200-dma has been rising since February 2012. The S&P 500 and all 10 sectors are in a perfect Golden Cross since May 2: their 50-dmas are higher than their 200-dmas, and all trade above their rising 50-dmas and 200-dmas.

S&P 500 Earnings Surprise Monitor ([link](#)): With 87% of the S&P 500 companies finished reporting, results for the Q1-2013 earnings and revenue season are mixed. Of the 434 companies in the S&P 500 that have officially reported Q1-2013 results, 67% have exceeded industry analysts' earnings estimates. That's below the comparable time period in Q4-2012, when 69% of the companies in the S&P 500 also beat the consensus earnings estimates. On the other hand, only 47% beat sales estimates so far compared to 63% during the comparable Q4-2012 period. Earnings for the 434 companies are 4.6% above forecast, but revenues have missed by 0.6%. Earnings for these reporters are up 4.4% y/y on a 0.2% revenue gain. Ex-Energy, y/y growth in earnings and revenues improves to 4.8% and 3.6%, respectively.

S&P 500 Earnings, Revenues, & Valuation ([link](#)): Last week, forward revenues for the S&P 500 edged down and forward earnings rose, but both are less than 0.3% from their recent record highs. Forward revenues have been hitting record highs recently--a first for them since September 2008--as analysts' 2013 and 2014 revenue forecasts have edged higher. But forward revenues could be pressured by weak revenue results for Q1-2013. Margin forecasts were mixed last week, rising to 9.9% from 9.8% for 2013, remaining steady at 10.5% for 2014, and edging up to 10.2% from 10.1% for the forward 12 months. Projected revenue growth for 2013 was down to 2.3% from 2.8%, but expected 2013 earnings growth edged up to 7.0% from 6.9%. Ex-Energy, projected 2013 revenue growth, earnings growth, and the margin all improve.

S&P 500 Sectors Earnings, Revenues, & Valuation ([link](#)): Analysts' forward revenues forecasts rose last week for 6/10 sectors, and forward earnings expectations rose for 9/10 sectors. Forward revenues forecasts were around their record highs for six sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, Tech, and Telecom. Forward earnings estimates were near record highs last week for four sectors: Consumer Discretionary, Consumer Staples, Health Care, and Industrials. Relative valuation for Health Care has declined to a 6% premium to the market from a four-year-high 9% premium in mid-April; for Tech, relative valuation has risen to a 10% discount from a record-low 13% discount three weeks ago. Forward projected profit margins were around their record highs for four sectors: Consumer Discretionary, Consumer Staples, Industrials, and Utilities.

GLOBAL ECONOMIC INDICATORS

German Factory Orders ([link](#)): "German industry seems to be gradually overcoming its weak phase," according to Germany's Economic Ministry. German factory orders increased 2.2% for the second month in March. Foreign orders climbed 4.9% over the two-month period, domestic orders 3.9%. Foreign orders rose from both inside (5.5%) and outside (4.6) the euro zone during the two months. Gains were widespread, with the exception of consumer goods. These orders from within the euro area fell for three straight months, by 9.7%; from outside the euro area they declined in two of the last three months, by 5.3%. March's increase in domestic demand was led by a 4.0% jump in intermediate goods orders, with consumer goods orders up 0.5%. Capital goods orders slipped 0.1% after soaring 4.0% in February.

German Industrial Production ([link](#)): Industrial production in Europe's largest economy advanced for the third time in four months, up 1.2% in March. Factory output also increased for the third time in four months, up 1.4% m/m and 2.3% over the period. Energy production contributed big to March gain, surging 4.0%; output of investment goods was 2.1% higher. Exceptionally cold weather in March led to another sharp drop in construction output, down 3.1%, after a 1.6% decrease in February.

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