



MORNING BRIEFING

February 24, 2016

In Limbo

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

(1) Challenges for the latest relief rally. (2) A new batch of stagnant global indicators. (3) Commodity price rebound stalling. (4) Mixed signals from Chinese officials on the yuan. (5) Mixed signals from Fed officials on rate hikes. (6) Inflation perks up in CPI, but maybe not so much in PCED. (7) Earnings outlook more challenged. (8) So what's the right P/E? (9) Valuation multiples have been downwardly re-rated since last year. (10) Price-to-sales ratio is no bargain. (11) The Buffett Ratio started signaling trouble a year ago. (12) More negative spins on negative interest rates.

Strategy: The Valuation Question. On Monday and Tuesday, Joe and I discussed some of the fundamental issues that may weigh on the latest relief rally. In particular, global economic activity remains weak, as evidenced by yesterday's report on Germany's Ifo business confidence index; it fell 1.6 points to 105.7 during February, led by a big decline in its expectations component, as Debbie discusses below ([Fig. 1](#) and [Fig. 2](#)). On Monday, Markit reported that the US flash M-PMI fell this month to the lowest reading since October 2012 ([Fig. 3](#)). We also learned that Japan's flash M-PMI dropped from 52.3 during January to 50.2 in February ([Fig. 4](#)). (See our [Germany Ifo Survey](#) and [Markit Flash PMIs](#).)

The recent rebound in commodity prices may be stalling. The CRB raw industrials spot price index, which has been rising since November 23, seems to have lost its upward momentum in recent days ([Fig. 5](#)). The nearby futures price of a barrel of Brent, which bottomed this year on January 20 at \$27.88, might have topped out on Monday at \$34.69 for a while because crude oil supply continues to exceed demand, as we discussed yesterday ([Fig. 6](#)).

Chinese officials are giving mixed signals about whether they intend to support their currency or let it depreciate. Fed officials are mostly saying that they still intend to raise interest rates some more this year, though at a slower pace than they signaled at the end of last year. January's higher-than-expected core CPI inflation suggests that Fed officials might turn more aggressive, but the more important number will be January's core PCED (the Fed's preferred measure of inflation), which will be released on Friday along with personal income.

The earnings outlook deteriorated during the Q4-2015 earnings season, as Joe and I discussed on Monday. S&P 500 operating earnings, as compiled by Thomson Reuters, fell 0.2% y/y during Q3-2015 and again by 3.4% during Q4-2015. Industry analysts are projecting declines during this year's Q1 (-3.8%) and Q2 (-0.3%) before growth resumes during the second half of this year. S&P 500 forward earnings, usually a good leading indicator for earnings over the coming four quarters, has been flat-lining since mid-2014 ([Fig. 7](#)).

All the above raises the question of valuation. How much should we pay for earnings that are likely to remain challenging in a world economy that seems to be mired in secular stagnation? The obvious answer is maybe less than the historical norm. However, this sluggish scenario is likely to continue to be associated with historically low inflation and interest rates, which argues for above-normal valuation. Splitting the difference suggests that the historical average of the P/E might be the right valuation

multiple after all. The correction since May 21 of last year seems to have rerated the market's P/E to this old normal, particularly at the start of this year. Let's review the latest data:

(1) *Forward P/Es* have tumbled since last year's bull market highs ([Fig. 8](#)). Based on daily data, the S&P 500's forward P/E is down from 17.2 to 15.6 currently; the S&P 400's forward P/E is down from 18.7 to 15.9; and the S&P 600 multiple has tumbled from 19.6 to 16.0. Weekly data starting in 1999 show that all three are basically back to their norms over this period ([Fig. 9](#)). The average forward P/E of the S&P 500 since the start of the data in 1979 has been 13.9 ([Fig. 10](#)). Combining it with the P/E based on S&P 500 reported earnings since 1960 shows an average value of 14.4 ([Fig. 11](#)).

(2) *Price-to-sales ratios* have also corrected, but remain relatively high. The ratio of the S&P 500 relative to its forward revenues per share was down to 1.65 in mid-February versus last year's high of 1.84 during the week of May 21 ([Fig. 12](#)).

A similar measure preferred by Warren Buffett is the ratio of the total stock market capitalization (excluding foreign issues) to nominal GDP ([Fig. 13](#)). The only problem with it is that it is only available through Q3-2015. On the other hand, it did start to signal trouble when it peaked at 1.72 during Q1-2015, almost as high as the Q1-2000 peak of 1.81. By the way, it is also highly correlated with the ratio of the S&P 500's total market capitalization to aggregate S&P 500 revenues. (See our [S&P 500 Cap to Sales Ratios](#).)

Central Banks: More Negatives. Negative interest rates are intended to stimulate the economy. But they might actually do the opposite, as Melissa and I outlined in the 2/16 [Morning Briefing](#). Ultra-easy monetary policy "could be the greatest failure of modern central banking," economist Stephen Roach wrote in a 2/18 [op-ed](#). He might be right. In any case, it's very hard to find the positives of negative rates. There's certainly lots of potential danger in these uncharted and troubled waters.

Even so, central banks around the world already have implemented negative interest rate policies (NIRP), including in the Eurozone, Japan, Sweden, Denmark, and Switzerland. Lately, Fed officials have discussed negative rates for the US if needed to avert a recession. Let's briefly review the latest discussions on the theory and practice of negative interest rates:

(1) *Bank profit margins*. In theory, negative interest rates should stimulate both the demand and the supply of credit. It's cheaper for borrowers to borrow, and lenders should be scrambling to get a better positive return on their money from borrowers than a negative one from the central bank. In practice, negative rates squeeze bank margins. That's because banks are likely to resist charging their depositors.

Last Friday, the ECB's Vice President Vitor Constancio said that the ECB would have to "mitigate the effect on banks as other countries have done," [reported](#) the 2/19 Bloomberg. Of course, he was referring to Japan. The BOJ recently [implemented](#) a tiered approach to negative rates whereby not all banks are "charged" for deposits. Whether the ECB does so or not, Constancio's comment means that he and his counterparts think bank profits are a serious concern.

The ECB already protects banks' required reserves from suffering losses, as noted a 2/19 [WSJ article](#). But a new approach like the BOJ's would be more extensive. (See the [WSJ article's](#) helpful chart showing the share of reserves held at central banks in Sweden, the Eurozone, Denmark, Switzerland, and Japan under negative, 0%, and positive rates.)

Even so, implementing a negative interest rate policy is not without risk, as a 2/17 FRB-SF [note](#) concluded: For example, "Japanese banks [are] already squeezed by low interest margins and limited

credit demand [and] the risk to earnings is ... significant. While expanding overseas might be a natural response to negative rates at home, volatility in key markets like developing Asia along with rising costs of U.S. dollar funding provide a countervailing force, putting banks in a difficult position."

(2) *Spending and saving.* In theory, negative interest rates should stimulate investment in riskier assets, thus inflating their value, resulting in a positive wealth effect on consumption. In practice, there is a risk that negative interest rates will force many consumers to save more and spend less. There is some evidence that this has happened in Denmark. Needless to say, negative interest rates also increase the risk of asset bubbles.

On the other hand, risk-averse investors and consumers might view negative rates as a warning sign from officials that the economy and markets are weak enough to require non-traditional policies. In Japan, negative public sentiment is causing angst for the BOJ, [reported](#) the 2/18 WSJ. At a Parliament meeting, an opposition lawmaker attacked the BOJ's Kuroda: "You have sent a message to the people that they had better watch out because Japan's economy is in trouble."

(3) *Race to the bottom.* In theory, negative rates discourage capital inflows and should depreciate the home currency, which should stimulate exports. In practice, devaluation is futile. There's only so far that currencies can weaken against others before they trigger competitive devaluations. Such "currency wars" won't revive overall global economic growth. On the contrary, they might weigh on it instead. Negative interest rates and currency depreciation are signs that monetary policy can't solve the world's economic problems. This week's [cover](#) of *The Economist* features a dazed central banker holding a bazooka. The cover story is titled "The World Economy: Out of Ammo?"

CALENDARS

US. Wed: Markit NM-PMI Flash Estimate 53.7, New Home Sales 520k, MBA Mortgage Applications, Bullard. **Thurs:** Durable Goods Orders Total and Ex Transportation 2.0%/0.0%, Jobless Claims 270k, FHFA House Price Index 0.5%, Kansas City Fed Manufacturing Index, Weekly Consumer Comfort Index, Williams. (Bloomberg estimates)

Global. Wed: Japan Leading & Coincident Indexes. **Thurs:** Eurozone Headline & Core CPI 0.4%/1.0% y/y, Eurozone M3 4.7% y/y, Germany GfK Consumer Confidence 9.3, UK GDP 0.5%q/q/1.9%y/y, Japan CPI Headline, Core, and Core-Core 0.0%/0.0%/0.7% 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--may have found a bottom. It increased for the third time in four weeks, up 1.8% during the week of February 13 and 3.8% over the period. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB rose 3.8% and 7.5% over the comparable periods. Jobless claims are at 273,250 (4-wa) after climbing from 259,250 (the lowest since December 1986) in late October to 285,250 (4-wa) in mid-January. (Straight weekly claims have dropped from 285,000 to 262,000 during the first two weeks of February.) The CRB raw industrial spot price index--another BBB component--is recovering from its sharp decline last year. The WCCI is fluctuating around recent highs, up 11.9% from last year's low at the end of November.

S&P 500 Earnings, Revenues, & Valuation ([link](#)): S&P 500 forward revenues fell 0.1% last week, and forward earnings rose 0.1% for its first gain in six weeks and from a six-month low. Despite the collapse in Energy sector forecasts since early 2015, both remain close to their record highs from October 2014:

Forward revenues is down 2.3%, and forward earnings is down 2.3%. From their 2015 lows in April and February, forward revenues has gained 2.5% and forward earnings is up 3.1%, respectively. The forward profit margin forecast was steady w/w at 10.6%, but remains below the 10.9% record high from early September. Forward revenue growth weakened to a seven-month low of 2.8% from 3.8%, and forward earnings growth dropped to an 11-month low of 5.1% from 7.0%. Ex-Energy, forward revenue growth improved w/w to 4.0% from 3.8%, and forward earnings growth edged down to 6.9% from 7.0%. Consumer Discretionary and Industrials are expected to have the best y/y margin gains in 2016: to 7.6% from 7.2% and to 16.3% from 15.5%, respectively. Energy and Telecom margins are expected to deteriorate in 2016 versus 2015: to 2.5% from 4.7% and to 10.8% from 11.2%.

S&P 500 Sectors Earnings, Revenues, & Valuation ([link](#)): Consensus forward revenue forecasts fell w/w last week for 5/10 sectors, and forward earnings forecasts dropped for 8/10 sectors. Forward revenues and earnings are at or around record highs for 5/10 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. They are at new cyclical lows for Energy and Materials. P/E and P/S ratios both rose w/w for 9/10 sectors (all but Utilities). Energy's P/S ratio rose w/w to 1.31 from 1.20 and is up only slightly from a five-month low of 1.13 in mid-January, but its P/E rose to a record high of 44.4 due to falling earnings. Excluding Energy, P/E and P/S ratios for most sectors are down from six- to 10-year highs several months ago to cyclical lows. However, they remain above cyclical lows for Consumer Staples, Telecom, and Utilities.

S&P 500 Net Earnings Revisions ([link](#)): The S&P 500's NERI was negative in February for a 17th straight month, and was lower for the first time in three months. NERI tumbled to -15.5% from -11.8% in January, but remains above last April's six-year low of -17.4%. NERI was negative for nine of the 10 sectors in February and improved m/m for two (versus ten negative and four improving in January). Telecom turned positive in February and Materials stands out with its lowest reading in seven years. Consumer Staples has the longest-lasting negative NERI streak at 32 straight months, followed by Materials (19 months), Energy (18), Financials (17), Industrials (17), and Tech (16). February's rankings and their changes: Telecom (2.3% from -3.8% in January), Health Care (-4.4 from -3.2), Utilities (-5.5 from -1.7, Tech (-8.8 from -4.8), Consumer Staples (-10.2 from -7.6), Consumer Discretionary (-12.5 from -12.0), Industrials (-18.4 from -20.9), Financials (-20.4 from -14.4), Materials (-29.7 from -24.5), and Energy (-35.9 from -19.3).

S&P 500 Earnings Squiggles ([link](#)): Forward earnings registered a second straight monthly decline in February for the first time in 12 months. The consensus earnings forecast for 2016 dropped 2.9% m/m for its 11th straight decline. The expected earnings decline for 2015 slipped to -1.2% from -0.8%, and the forecasted growth rate for 2016 tumbled to 3.9% from 7.4%. Valuation improved to 15.7 from 15.1, but remains pressured and is well below last February's 12-year high of 17.4. NERI was negative for a 17th straight month, and dropped for the first time in three months to a 10-month low of -15.5% from -11.8% in January; that's up from a six-year low of -17.4% in April 2015. On a pro forma basis, revenues are expected to rise just 2.0% in 2016 after declining 3.8% in 2015, compared to last month's 3.4% and -3.5%, and from a 3.4% gain in 2014. Expected revenue growth for the next 12 months fell to a seven-month low of 2.8% from 3.8%, and forward earnings growth dropped to an 11-month low of 5.1% from 7.0%. The forward profit margin was stable m/m at 10.6%, but is down from a record high of 10.9% in early September. Analysts expect little improvement in the profit margin, from 10.3% in 2015 to 10.4% in 2016.

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): Consumer confidence slumped to a seven-month low this month. According to the Conference Board, "Consumers' short-term outlook grew more pessimistic, with consumers expressing greater apprehension about business conditions, their personal financial

situation, and to a lesser degree, labor market prospects. Continued turmoil in the financial markets may be rattling consumers, but their assessment of current conditions suggests the economy will continue to expand at a moderate pace in the near-term.” (February’s data is based on responses through February 11.) The Consumer Confidence Index dropped from 97.8 in January to 92.2 in February--considerably below the consensus estimate of 97.2. The expectations component more than gave back the 4.9-point gain the prior two months, sliding 6.4 points to a two-year low of 78.9. The present situation component fell from 116.6 to a seven-month low of 112.1, still a high level. The job outlook component deteriorated slightly, with jobs hard to get (from 23.6% to 24.2%) rising and jobs plentiful (23.0 to 22.1) falling. Consumers’ six-month job outlook deteriorated for the first time in three months, with the negative spread widening to -5.0 after narrowing from -6.5 in November (widest since February 2014) to -3.6 in January. Those expecting more jobs (12.2%) remained below those expecting fewer jobs (17.2).

Regional M-PMIs ([link](#)): Indications from regional PMIs suggest that manufacturing activity continued to contract this month. Three Fed districts have reported so far: New York, Philadelphia, and Richmond; we average the composite, orders, and employment measures as data become available. The three regions show the composite index was negative for the seventh month--coming in at -7.8 (weakest since January 2013), down from -7.0 and -3.5 the prior two months. Philly’s index was negative for the sixth month, but improved for the second month from -10.2 in December to -2.8 this month. New York’s continued to contract sharply, at -16.6, not far from January’s -19.4 reading--which was the weakest since March 2009. Richmond’s (2 to -4) turned negative after two positive readings. The new orders measure fell to -7.6 from -3.1 two months ago; it was the seventh consecutive negative reading. Philly’s gauge (from -1.4 to -5.3) deteriorated, while New York’s (-23.5 to -11.6) improved, though the latter’s orders fell at a much faster pace. Richmond’s (4 to -6) fell back below zero. The employment index (-2.0 to 1.0) posted its first positive reading in five months. Richmond’s manufacturers (unchanged at 9) continue to add to payrolls; New York’s (from -13.0 to -1.0) may be ending their sharp job cuts over the past several months; Philadelphia’s (-1.9 to -5.0) may be stepping up their cuts slightly after holding employment steady the last two months of 2015.

US ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): Sentiment among German business leaders sank to its lowest level since December 2014 this month as expectations continued to deteriorate. The Ifo business climate index declined for the third month from 109.0 in November to 105.7 this month. According to Ifo, “The majority of companies were pessimistic about their business outlook for the first time in over six months,” with manufacturers in particular voicing deep concerns. “Manufacturers’ business expectations declined steeply, marking their largest downswing since November 2008,” Ifo said. The expectations component fell from 104.8 to 98.8 over the three-month period, the lowest since December 2012. The present situation component ticked up from 112.5 to 112.9 this month, hovering just below its recent high of 114.9 last August. The expectations component correlates closely with German factory orders and production; the overall index tracks exports more closely. Recent data suggest a deterioration in economic activity.

Germany GDP ([link](#)): Economic growth in the Eurozone’s largest economy rose 1.1% (saar) during Q4, matching Q3’s growth and confirming the flash estimate released earlier this month. The expenditure breakdown shows that an acceleration in domestic demand (from 2.4% to 3.4%, saar) more than offset a decline in net exports. Exports contracted 2.5% (saar)--the first decline since Q4-2012--while imports advanced 2.0%, its 12th consecutive quarterly gain. Private consumption grew 1.1% (saar), slowing from Q2’s 2.6% pace. Capital investment expanded 6.3% (saar), its best quarterly performance since Q1-2014, driven by a 9.1% rebound in construction spending after two quarters of decline. Public spending (4.0%, saar) grew at its fastest pace in nearly six years.

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