



MORNING BRIEFING

August 22, 2016

Earnings Recession Over

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

(1) Five-quarter earnings recession ended during Q4-2015. (2) Earnings rebounding this year along with oil prices. (3) Excluding Energy, S&P 500 revenues growth never turned negative. (4) Three different measures of earnings per share. (5) Profit margin continues to fluctuate around record 10% level. (6) Forward earnings and revenues moving higher, and could soon be making new record highs. (7) No recession in leading indicators. (8) Coincident indicators at record high. (9) Fed officials are split and have split personalities. (10) Williams issues an unusual press release. (11) Fischer says mission almost accomplished. (12) Waiting on Yellen to stop our heads from spinning from all the talking Fed heads.

Strategy: Q2 Review. Joe has updated all of our chart publications that track S&P 500 revenues, earnings, and margins with Q2 data. S&P compiles both revenues and reported (unadjusted GAAP) earnings for the S&P 500. The latter peaked at a record high of \$27.47 per share during Q3-2014 ([Fig. 1](#)). It then fell 31.9% through Q4-2015. That five-quarter earnings recession coincided with the collapse in oil prices and in the S&P 500 Energy sector's earnings.

Reported earnings rebounded 24.7% during the first two quarters of this year as the price of a barrel of Brent crude oil rose 33% during the first half of this year, suggesting that the Energy-led earnings recession is over. That's confirmed by S&P 500 revenues, which was negative on a year-over-year basis from Q1-2015 through Q4-2015, falling by as much as 3.8% y/y during Q2-2015 ([Fig. 2](#)). During Q1 and Q2 of this year, this growth rate was 0.3% and 1.1%. So far, we can't find too many devils in the details:

(1) *Revenues.* On an aggregate basis, rather than per-share, revenues growth remained slightly negative during Q2 for the sixth consecutive quarter, at -0.7% ([Fig. 3](#)). This series is highly correlated with and often identical to the yearly percent change in manufacturing and trade sales, which was down 0.6% during Q2.

One can exclude Energy earnings from aggregate revenues (not per-share). On this basis, revenues rose 2.2% y/y during Q2 ([Fig. 4](#)). Furthermore, the growth in aggregate S&P 500 revenues excluding Energy remained in positive territory throughout the recent earnings recession. The weakest growth registered during this period 0.2% during Q4-2015, which probably reflected the knock-on effects of the Energy recession on other sectors as well as the significant appreciation of the dollar.

(2) *Earnings.* Before we turn to S&P 500 earnings per share, let's follow our discussion of aggregate revenues with aggregate earnings. The complication is that there are three aggregate measures of earnings that we track. They are earnings as reported by companies and operating earnings as compiled separately and differently by S&P and Thomson Reuters (TR). S&P derives its measure of operating earnings by excluding items that S&P deems to be non-recurring ones. TR's composite is based on the operating estimates provided by industry analysts, who tend to be guided by company managements.

Joe and I favor the TR approach because we believe that the market reflects the estimates of industry analysts while recognizing their optimistic bias. Again, focusing on the aggregates, we find that TR

earnings rose to \$254 billion during Q2, only 6.1% below the record high in Q4-2014 ([Fig. 5](#)). Excluding Energy, TR's aggregate earnings is back at last year's record high after a brief dip during Q1.

The story is more or less the same for the S&P aggregate operating earnings composite. The bottom line is that excluding Energy, it has been a growth recession rather than an outright recession for earnings.

One can't do the same kind of analysis for earnings on a per-share basis. In other words, we can't show you this measure without Energy. However, the TR measure of total S&P 500 operating earnings per share didn't fall much since mid-2014 ([Fig. 6](#)). It rebounded during Q2 to \$29.31 per share, only 4.0% below the record high of \$30.54 during Q4-2014.

(3) *Margins*. Calculating the S&P 500 profit margin using the TR data for earnings per share and the S&P data for revenues per share, Joe and I can report that it edged back up to 10.3% during Q2 ([Fig. 7](#)). In other words, it continues to hover in record-high territory around 10%, as it has been since Q1-2014. So far, it has refused to revert back to the proverbial mean, as widely expected by the bears.

(4) *Forward aggregates*. Joe and I track forward earnings, forward revenues, and the implied forward profit margin on a weekly basis; these tend to be good leading indicators of their respective quarterly series ([Fig. 8](#)). All three have remained relatively flat in record-high territory since mid-2014. Forward earnings and forward revenues seem to be on the verge of achieving new highs. (See our [S&P vs. Thomson Reuters](#).)

During the week of August 11, forward earnings was \$127.99 per share ([Fig. 9](#)). That's a time-weighted average of analysts' latest estimate for this year (\$117.86) and next year (\$134.42). Joe and I are using \$119 for this year and \$129 for next year. We raised our S&P 500 target for next year from 2200-2300 to 2300-2400 on July 20. So far so good, especially if the market is agreeing with us that the earnings recession wasn't much of a recession and that it is over, in any case.

(5) *Leading indicators*. By the way, S&P 500 forward earnings isn't one of the 10 components of the Index of Leading Economic Indicators (LEI), but perhaps it should be. It is highly correlated with the LEI ([Fig. 10](#)). It tends to lead the Index of Coincident Economic Indicators (CEI) ([Fig. 11](#)). As Debbie reports below, July's LEI was within 1.3% of the record high during March 2006, while the CEI rose to a new record high last month. There's certainly no recession in either of these economic indicators.

The Fed: They're Back! It was relatively quiet at the start of this month. There wasn't the usual amount of chatter coming from Fed officials after the July 26-27 meeting of the FOMC. Melissa and I surmised that perhaps many of them were on vacation. Well, they're back and chattering away again. They are probably looking forward to doing more of that when they meet at their annual [symposium](#) on monetary policy at Jackson Hole during August 25-27. This year, the confab's theme is a re-examination of monetary policymaking. That should be interesting. We suspect that they will discuss what more they can do rather than whether they should do less.

The July 26-27 FOMC meeting [minutes](#) were released this past Wednesday. The financial press focused on a rate hike being "on the table" for the next meeting of the Fed's policy committee on September 20-21. There were also lots of headlines about a significant split among the FOMC's doves and hawks at the last meeting.

The minutes revealed that while officials were divided, the doves continue to outweigh the hawks, especially given that the vote was to do nothing, with only one dissenter! Despite acknowledgement of positive signs within the US economy, lots of the text emphasized uncertainties abroad, especially in

Europe. It also hinted at domestic uncertainty, specifically business investment, as a result of the upcoming presidential election. It seems unlikely that the FOMC will vote for a rate rise until there is more consensus among the group that the time is right. Let's have a closer look at the minutes:

(1) *Brexit obsession*. It's an understatement to say that an unusually large portion of the FOMC discussion focused on global concerns. Specifically, the discussion centered on the potential fallout from the UK's decision to leave the EU. The words "Brexit" or "U.K. referendum" were mentioned 26 times! That's even though the meeting was more than a month after the June 23 UK referendum vote, which caused just a brief two-day hiccup in the markets. There was also some concern about European banks.

The minutes noted: "Although the near-term risks to the outlook associated with Brexit had diminished over the intermeeting period, participants generally agreed that they should continue to closely monitor economic and financial developments abroad." By the way, there were a few concerns mentioned about China's economic transition, which officials are also closely watching.

(2) *Election hint*. As we noted last week, a few Fed officials are saying that uncertainty about the upcoming election could be depressing the economy. The minutes confirmed this concern: "Based on conversations with their contacts, participants discussed a number of factors that may have been contributing to businesses' cautious approach to investment spending, including ... uncertainty about prospects for government policies."

(3) *Participants vs. members*. It's interesting that "a couple" of "participants" (which includes voting members and nonvoting ones) advocated for a rate rise at the July meeting. The minutes stated: "Members generally agreed that, before taking another step in removing monetary accommodation, it was prudent to accumulate more data in order to gauge the underlying momentum in the labor market and economic activity." This implies that there is less of a split among voters (who are "members") than among voters and nonvoters.

(4) *On the one hand*. The minutes noted: "[Some] participants viewed recent economic developments as indicating that labor market conditions were at or close to those consistent with maximum employment and expected that the recent progress in reaching the Committee's inflation objective would continue, even with further steps to gradually remove monetary policy accommodation. Given their economic outlook, they judged that another increase in the federal funds rate was or would soon be warranted."

(5) *On the other hand*. The minutes noted: "[A]lthough near-term downside risks to the outlook had diminished over the intermeeting period, some participants stressed that the Committee needed to consider the constraints on the conduct of monetary policy associated with proximity to the effective lower bound on short-term interest rates. These participants concluded that the Committee should wait to take another step in removing accommodation until the data on economic activity provided a greater level of confidence that economic growth was strong enough to withstand a possible downward shock to demand."

(6) *Spinning heads*. Just last week, regional Fed presidents William Dudley (FRB-NY, and a permanent voter) and Dennis Lockhart (FRB-Atlanta, and a non-voter this year) said that they were inclined to raise rates, but are concerned about the sluggish pace of business investment. FRB-SF President John Williams (a non-voter) also weighed in a couple of times with contradictory views, in our opinion.

Last Monday, Williams posted an [Economic Letter](#) that we interpreted as dovish. He must have felt he needed to clarify his view, as he followed that up on Thursday with a [speech](#) and an unusual [press](#)

[release](#) titled “Fed’s Williams Advocates Rate Hike.” Oddly, in his earlier letter, he wrote, among other suggestions to change monetary policy operations, that the Fed might consider increasing its inflation target. Wouldn’t that imply holding the federal funds rate lower for longer?

On Sunday, Fed Vice Chairman Stanley Fischer strongly suggested another rate hike is coming soon, when he in effect declared: “Mission almost accomplished.” What he actually said in his [speech](#) at the Aspen Institute was: “So we are close to our targets.” He noted that the unemployment rate has been hovering around 5%, “close to most estimates of the full-employment rate.” He also said that “core PCE inflation, at 1.6 percent, is within hailing distance of 2 percent--and the core consumer price index inflation rate is currently above 2 percent.”

Let’s hope that Fed Chair Janet Yellen stops our heads from spinning, and provides some useful guidance on where her head is at when she speaks on Friday at the Jackson Hole conference.

CALENDARS

US. Mon: Chicago Fed National Activity Index. **Tues:** New Home Sales 580k, M-PMI Flash Estimate 53.2, Richmond Fed Manufacturing Index. (Bloomberg estimates)

Global. Mon: Japan M-PMI Flash Estimate. **Tues:** Eurozone, Germany, and France Composite PMI Flash Estimates 53.1/55.1/50.4, Eurozone, Germany, and France M-PMI Flash Estimates 52.0/53.6/48.8, Eurozone, Germany, and France NM-PMI Flash Estimates 52.8/54.3/50.5, Eurozone Consumer Confidence Index. (DailyFX estimates)

PERFORMANCE & ASSET ALLOCATION

Global Stock Markets Performance ([link](#)): Global Stock Markets Performance (link): The US MSCI index was unchanged last week, ranking 19th of the 49 markets as 18 rose in US dollar terms--compared to 42nd a week earlier, when it rose 0.1% as 43 markets rose. The AC World ex-US index underperformed the US MSCI, falling 0.4% versus a 2.7% gain a week earlier. The best-performing regions last week: BRIC (0.7%), EMEA (0.6), EM Asia (0.2), and EM Eastern Europe (0.0). The week’s worst: EM Latin America (-0.7), EMU (-0.7), and EAFE (-0.6). Last week’s best-performing countries: Colombia (4.2), Sri Lanka (2.2). Israel (1.8), and China (1.7). Last week’s biggest decliners: Poland (-3.1), Italy (-2.7), Czech Republic (-2.6), and Chile (-2.5). The US MSCI is up 6.7% ytd, which ranks 22/49, and has been outperforming the AC World ex-US (3.5) on a ytd basis for the past 15 weeks. Thirty-two of the 49 markets are positive ytd, led by Brazil (63.3), Peru (58.6), Colombia (30.2), Thailand (29.6), and South Africa (29.0). The worst country performers ytd: Greece (-24.1), Italy (-21.1), Israel (-10.0), Spain (-8.3), and Jordan (-8.2). The best-performing regions ytd: EM Latin America (35.8), EM Eastern Europe (16.8), BRIC (13.5), EMEA (12.3), and EM Asia (10.2). EMU (-2.8) is the worst performer, followed by EAFE (-1.0).

S&P 1500/500/400/600 Performance ([link](#)): LargeCap was the only market-cap index that failed to rise last week as 16 of the 30 sectors moved higher. That’s better than a week earlier when just 11 sectors rose and LargeCap was the only index to post a gain. LargeCap was unchanged for the week, trailing both MidCap (0.3%) and SmallCap (0.6). MidCap is the best performer ytd with a gain of 11.7%, barely ahead of SmallCap (11.5) and greatly outpacing LargeCap’s 6.8% gain. Twenty-nine of the 30 sectors are positive ytd, unchanged from a week earlier and up from just seven positive ytd in late February. The biggest ytd gainers: MidCap Materials (26.5), SmallCap Materials (22.8), SmallCap Consumer Staples (21.1), MidCap Utilities (19.0), and SmallCap Tech (16.5). The worst performers ytd: SmallCap Telecom (-2.0), LargeCap Financials (0.4), SmallCap Health Care (1.3), LargeCap Health Care (3.0), and LargeCap Consumer Discretionary (4.1).

S&P 500 Sectors and Industries Performance ([link](#)): Five of the 10 S&P 500 sectors rose last week and outperformed the S&P 500's flat performance--down from six rising a week earlier, when six outperformed the S&P 500's 0.1% gain. Last week's leading sectors: Energy (2.0%), Materials (1.3), and Industrials (0.7). Last week's worst performers: Telecom (-3.8) and Utilities (-1.3). The S&P 500 is now up 6.8% ytd, with seven sectors outperforming the index as the leaderboard changed last week. The leading sectors ytd: Energy (15.5), Utilities (15.5), Telecommunication Services (15.3), Materials (12.1), Industrials (10.1), Tech (8.6), and Consumer Staples (8.4). The ytd laggards that are trailing the S&P 500: Financials (0.4), Health Care (3.0), and Consumer Discretionary (4.1).

Commodities Performance ([link](#)): Nineteen of the 24 commodities we follow rose last week, up from 11 a week earlier. Last week's best performers: Unleaded Gasoline (10.7%), Crude Oil (8.7), Brent Crude (8.3), and Heating Oil (7.8). Last week's biggest laggards: Live Cattle (-3.7), Cotton (-3.7), Feeder Cattle (-2.1), and Silver (-1.9). Eighteen of the 24 commodities are positive so far in 2016, compared to seven and three higher during 2015 and 2014, respectively. The best performers ytd: Zinc (42.4), Silver (40.9), Heating Oil (36.9), and Brent Crude (35.9). The ytd laggards: Live Cattle (-19.4), Feeder Cattle (-13.7), and Wheat (-5.4).

Assets Sorted by Spread w/ 200-dmas ([link](#)): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 17/24 commodities, 4/9 global stock indexes, and 15/30 US stock indexes compared to 11/24 commodities, 8/9 global stock index, and 9/30 rising a week earlier. Eighteen commodities trade above their 200-dma, up from 16 a week earlier as their average spread rose to 7.7% from 5.6%. Zinc trades 24.5% above its 200-dma, highest of all commodities and all assets. Unleaded Gasoline performed the best last week of all assets, rising 10.0ppts to 4.8%. At the other end of the spectrum, another commodity, Lean Hogs, lags all assets at 13.8% below its 200-dma. But Cotton performed the worst among the commodities last week, dropping 4.4ppts to 7.3% above its 200-dma. The global indexes trade an average of 7.9% above their 200-dmas, down from 8.1% above in the prior week. Eight of the nine global indexes trade above their 200-dmas, unchanged from a week earlier. Brazil (21.8%) still leads the global indexes, but China rose 2.5ppts w/w (to 3.5%) for the best performance among global assets. Japan is still trading at the lowest relative to its 200-dma of the global assets (-2.9) and was the group's worst performer last week too, falling 1.8ppts. US indexes trade an average of 8.2% above their 200-dmas with 29 sectors above, down from an 8.4% average a week earlier, when all 30 sectors were above. SmallCap Materials leads all US stock indexes at 17.5% above its 200-dma. SmallCap Energy was the best performer last week among US stock indexes, rising 6.0ppts to 14.7%. SmallCap Telecom (-3.8) trades the lowest among US indexes relative to its 200-dma, but LargeCap Telecom was last week's worst performer among US stock indexes and all assets, plummeting 4.7ppts (to 4.9%).

S&P 500 Technical Indicators ([link](#)): The S&P 500's technical picture was mixed last week. The index was in a Golden Cross for a 17th week after 17 weeks in a Death Cross, as its 50-day moving average (dma) rose to a 23-month high of 4.2% above its 200-dma from 4.0%. That's up from a 52-month low of -4.5% in early March. The S&P 500's 50-dma rose for a 22nd straight week and at a steady pace as the index closed above its 50-dma for the 11th time in 12 weeks. However, the S&P 500 fell to 2.3% above its rising 50-dma from 2.7% and is down from a 13-week high of 3.6% near the end of July; that compares to a 52-month high of 6.2% on March 21 and a five-month low of -7.8% in mid-January. The S&P 500 was above its 200-dma for a 23rd week after 10 weeks below as the pace of change in the 200-dma improved for just the second time in six weeks. The S&P 500 fell to 6.6% above its 200-dma from a 20-month high of 6.8% a week earlier, but is up from a six-month low of -10.0% in mid-February.

S&P 500 Sectors Technical Indicators ([link](#)): Eight sectors traded above their 50-day moving average

(dma) last week, down from nine above a week earlier as Telecom turned negative and joined Utilities as the only members in the club. All 10 sectors traded above their 200-dmas for a sixth straight week and all were in a Golden Cross, with their 50-dmas higher than their 200-dmas, for a 12th week--that long a stretch hasn't been seen since October 2014. Financials had joined the Golden Cross club in late May for the first time since early September, and Energy joined in early May for the first time since October 2014. Nine of the 10 sectors have rising 50-dmas (all but Utilities), down from 10 a week earlier. All 10 sectors now have a rising 200-dma, up from eight a week earlier, as Energy and Financials turned higher this week.

US ECONOMIC INDICATORS

Leading Indicators ([link](#)): July's Leading Indicators Index (LEI) climbed to a new cyclical high and is now within 1.3% of March 2006's record high. The LEI advanced for the third time in four months, up 0.4% m/m and 1.1% over the period. July's advance was broad-based, with eight of the 10 components contributing positively; consumer expectations (-0.05ppt) was the sole negative contributor, while building permits was unchanged. Leading gainers were the average workweek (0.13ppt), stock prices (0.12), the interest-rate spread (0.12), and jobless claims (0.07); the remaining contributions ranged from 0.01 to 0.05. According to the Conference Board, "The U.S. LEI picked up again in July, suggesting moderate economic growth should continue through the end of 2016. There may even be some moderate upside growth potential if recent improvements in manufacturing and construction are sustained, and average consumer expectations don't deteriorate further."

Coincident Indicators ([link](#)): July's Coincident Indicators Index (CEI) posted its largest monthly gain since the end of 2014, climbing to yet another new record high. The CEI advanced 0.4% last month and has posted only one decline since January 2013--this May's -0.1%--climbing 7.9% over the period. All four components contributed positively to the index last month: 1) Industrial production was the largest contributor to July's gain, posting its first back-to-back increase since last summer. It jumped 0.7%--the most since November 2014--after a 0.4% expansion in June; it had declined three of the past four months by a total of 0.8%. 2) Nonfarm payroll employment climbed 0.2% for the second month after no change in May. It hasn't posted a decline since July 2010. 3) Real personal income--excluding transfer payments--is rising again after stalling earlier this year at record highs. It increased for the fourth time in five months by a total of 0.6% after contracting 0.4% the first two months of the year. 4) Real manufacturing & trade sales increased 0.5% in the two months ending July to a new record high.

Regional M-PMIs ([link](#)): Early indications from the New York and Philadelphia Fed districts show manufacturing activity contracting in August for the third time in four months, though modestly. We average the composite, orders, and employment measures as data become available. The composite index sank to -1.1 last month from -1.2 in July and 5.4 in May--continuing its up-and-down pattern. New York's composite index (from 0.6 to -4.2) moved from expansion to contraction last month, while Philadelphia's (-2.9 to 2.0) did the opposite. The orders index (5.0 to -3.1) turned negative again after being in positive territory four of the prior five months; Philly's measure (11.8 to -7.2) dropped precipitously, while New York's (-1.8 to 1.0) hovered around the breakeven point. The employment gauge (-3.0 to -10.5) posted its 11th straight negative reading, falling at the fastest pace since November 2012 as Philly (-1.6 to -20.0) manufacturers dramatically cut payrolls; New York's measure for employment (-4.4 to -1.0) indicated that manufacturers kept employment levels relatively stable.

GLOBAL ECONOMIC INDICATORS

Eurozone CPI ([link](#)): Eurozone inflation remains way below the ECB's target rate of just below 2% despite unprecedented levels of stimulus measures by the central bank. The final reading of the Eurozone's CPI confirms July's 0.2% y/y flash estimate, up from 0.1% in June and -0.1% in May. The

main components show food, alcohol & tobacco (from 0.9% to 1.4%) had the highest annual rate, followed by services (1.1 to 1.2). The price gain for non-energy industrial goods (0.4) matches June's advance, while energy prices (-6.4 to -6.7) fell at a slightly faster pace. The core inflation rate--which excludes energy, food, and alcohol & tobacco--remained at 0.9% y/y up from 0.8% and 0.7% in May and April, respectively.

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