



MORNING BRIEFING

September 28, 2016

Fairy Tales

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

(1) Profits recession over or not? (2) Was that the bottom in earnings during Q1? (3) Then again, Q3 S&P 500 consensus earnings growth estimate turns slightly negative. (4) Counting on the hook in the hockey stick to yield positive Q3 growth. (5) Meanwhile, forward earnings almost at record high. (6) No recession in consensus earnings for 2017 and 2018. (7) Unintended consequences of the Trump Wall. (8) Is Kuroda the Wizard of Oz or Peter Pan?

Strategy: Persistent Profits Recession? The Q3 earnings season starts early next month. There is already some chatter about the profits recession persisting for the sixth quarter in a row. We're in the camp that believes that it ended during Q2 and comparisons should turn positive during the second half of this year into next year. Let's see what we may or may not be missing:

(1) *Profits recession: A bottom?* The 9/25 *WSJ* featured an [article](#) on this subject titled "Profit Slump for S&P 500 Heads for a Sixth Straight Quarter." According to the story: "The third quarter was supposed to be when earnings growth returned to U.S. companies. Not anymore. Companies in the S&P 500 are now expected to report an earnings decline for the sixth consecutive quarter in the coming weeks, according to analysts polled by FactSet. That slump would be the longest since FactSet began tracking the data in 2008."

Joe and I use S&P 500 actual operating earnings and analysts' consensus operating earnings expectations data compiled by Thomson Reuters. On a year-over-year basis, earnings have been falling for the past four quarters through Q2-2016 ([Fig. 1](#)). Earnings are down 2.9% since they peaked in Q4-2014 ([Fig. 2](#)). However, the most recent low in this series occurred during Q1 of this year when earnings were down 11.7%, suggesting that might have been the bottom of the recession, though the y/y comparisons remained negative through Q2.

(2) *Revenues: An upturn?* Our optimistic spin on earnings is supported by S&P 500 revenues, which declined on a y/y basis from Q1-2015 through Q4-2015 ([Fig. 3](#)). However, the actual level of revenues admittedly has been volatile in a flat range (though near recent record-high territory) since mid-2014, when the price of oil started to plunge ([Fig. 4](#)).

(3) *Analysts' consensus: Another hook?* The Thomson Reuters data confirms the *WSJ* story, which is based on FactSet data. The Q3 consensus estimate turned negative on a y/y basis recently, and was -0.8% last week ([Fig. 5](#)). However, as Joe and I have noted going into every earnings season since the start of the bull market, actual results often tend to exceed downwardly revised estimates just before the earnings season begins. Let's call it the "earnings hockey stick." Joe has calculated that the average hook in the stick since Q2-2009 through Q2-2016 has been 4.8%. There wasn't one quarter over this period with a negative surprise.

The positive surprise for Q2-2016 was 3.6% ([Fig. 6](#)). It won't take that much of a positive surprise to

produce a positive y/y comparison for Q3-2016.

(4) *Forward earnings: What really matters.* Joe and I believe that the stock market discounts forward earnings, i.e., the S&P 500 12-month forward consensus expected operating earnings. It is a time-weighted average of analysts' earnings estimates for this year and next year, and is usually a good year-ahead leading indicator of actual earnings ([Fig. 7](#)). When the earnings season starts in October, forward earnings will give a weight of only 3/12 to this year's estimate and 9/12 to next year's estimate.

Doing this calculation using weekly data, we see that S&P 500 forward earnings has rebounded nicely since the spring of this year and is back at \$129.20 per share, near the record highs of 2014 ([Fig. 8](#)). That's because it is converging to the current estimate of \$133.57 for 2017. Joe just added 2018 consensus estimates to our library for earnings charts. Analysts are currently predicting \$147.49 per share for 2018. While those numbers are bound to be revised downward over time, as typically occurs, there's certainly no profits recession in the analysts' earnings outlook for the next couple of years.

Trade: South of the Border. Raise your hand if you intend to vote for Donald Trump because he has promised to bring all those jobs back from Mexico. Granted, there may be plenty of other good and bad reasons to vote for him, especially given the alternative. I can understand the concerns about illegal immigrants streaming into the US from Mexico. Many of them are actually coming from south of Mexico's border, and Mexican authorities are trying to stop them from passing through their country. Ironically, many Mexican construction workers went back home after the US housing bust during 2007 and 2008, and now are sorely missed by contractors in the US who can't find enough workers. The US may need them to build the Trump Wall.

In any event, let's put our trade with Mexico into perspective. Over the past 12 months through July, the US imported \$293 billion of merchandise from Mexico, while we exported \$229 billion to Mexico ([Fig. 9](#)). Over this period, the US merchandise trade deficit with Mexico amounted to just \$64 billion ([Fig. 10](#)). That's only 9% of the total merchandise trade deficit.

Odds are that a significant portion of US exports to Mexico are parts for cars and appliances that Mexico assembles and exports back to the US as finished products. Shut off the Mexican imports, and US exports will be depressed. Shut off trade completely with Mexico, and the resulting recession over there will send lots of Mexicans streaming into the US through tunnels under the Trump Wall.

If companies like Ford are forced to bring back production, they undoubtedly will use more robots and automation to reduce their labor costs. In this scenario, the robots win, while the humans lose. I'm just thinking out loud after watching the presidential debate on Monday evening.

Central Banks: The Wiz. If Fed Chair Janet Yellen is the Fairy Godmother of the Bull Market, BOJ Governor Haruhiko Kuroda might just be its Wizard of Oz. Like Yellen, he has been pumping lots of liquidity (a.k.a. fairy dust) into global financial markets. Kuroda means well, but other than the power of positive and wishful thinking, he might not have any real power to jumpstart Japan's economy.

On Monday, Melissa and I covered the mechanics of the BOJ's latest wizardry, otherwise known as "QQE with Yield Curve Control" (QQE-YCC). We concluded that there was an inherent contradiction between QQE and YCC. Purchasing bonds at a steady rate under QQE might not jibe with setting the bank's official short-term rate below zero and pegging the 10-year bond yield at zero.

On Monday, the curtain was removed when the "man behind the curtain" presented a [speech](#) titled "'Comprehensive Assessment' of the Monetary Easing and 'QQE with Yield Curve Control.'" After reading it and rereading the [background material](#) provided by the BOJ last week, we realized that we

might not be in Kansas anymore. Now we are wondering whether the Wiz just ditched the BOJ's QE program because it isn't working. Consider the following:

(1) *Pay no attention.* Prior to the addition of YCC to its toolkit, the BOJ had been targeting an annual pace of Japanese government bond (JGB) purchases at 80 trillion yen. That was combined with a negative interest-rate policy ([QQE-NIRP](#)) on January 29. But as we discussed on Monday, its policies may have gone too far by flattening the yield curve and threatening the viability of the banking system.

Spurred by widespread criticism, the BOJ last week announced its intention to control the shape of the yield curve by pegging the 10-year JGB yield at zero. To do so, the BOJ altered the quantitative target for its annual JGB purchases simply by adding three words: "more or less" than 80 trillion yen.

(2) *Yellow brick road.* Nevertheless, Kuroda reassured business leaders during his speech in Osaka on Monday that despite the vaguer language, the pace of purchases won't be much altered. In his view, the Bank's policies have been "powerful" and should continue to be so until the Bank reaches its inflation goal of 2%. The monetary base outstanding is already about 400 trillion yen, or around 80% of nominal GDP as compared to 20% in the US and Eurozone, he noted. Looking ahead, Kuroda expects the ratio to exceed 100% in just slightly over one year! That is, he hedged, assuming that the Bank maintains its current pace of purchases.

(3) *Return to Oz.* Even so, Kuroda himself explained that under YCC, "the Bank will be able to conduct purchases of JGBs in a more flexible and effective manner than before." He added: "[E]ven if inflation were to rapidly accelerate for some reason, the Bank can achieve the price stability target of 2 percent in a stable manner by influencing short-term and long-term interest rates; that is, yield curve control. Of course, this represents a just-in-case scenario."

In other words, the Bank could reverse course and still be within its own preset guidelines or, rather, lack thereof. But he then confirmed: "[Y]ou can reasonably assume that large-scale monetary easing will be in place until the observed CPI stays above 2 percent in a stable manner."

(4) *Good witch.* Former Fed Chairman Ben Bernanke's 9/21 blog [post](#) put a positive spin on the latest actions of the BOJ. He explained: "[I]t was puzzling that the BOJ retained its 80-trillion-yen quantity target for JGB purchases; one of these two targets is redundant. I presume that the BOJ was concerned that dropping the quantity target would lead market participants to infer (incorrectly) that the Bank was scaling back its program of monetary easing. ... The result may be that the BOJ will be able to meet its yield target by buying considerably *less* [his emphasis] than 80 trillion yen a year of JGBs going forward. Since constraints on the availability of JGBs were seen in many quarters as limiting the BOJ's ability to maintain its easy policies beyond the next year or two, the new framework may be seen as more sustainable."

Kuroda echoed that reasoning in his speech: "[I]t is anticipated that the pace may fluctuate to some extent, either upward or downward, in order to achieve yield curve control. Therefore, a possible change in the amount of purchases has no policy implication." Interestingly, Kuroda has a history of turning to Bernanke for guidance. The two had a power lunch just this past July, [according](#) to Bloomberg. So Bernanke's assessment might not be entirely unbiased.

(5) *Wicked witch.* On the dark side, perhaps the BOJ's reasoning is more elusive. Maybe Kuroda and his colleagues have realized that it might not be possible to achieve the previous targeted scale of purchases. Or maybe they've known that all along. Or maybe despite its proclamations, the Bank isn't really convinced that the program is working so well, despite its enormous scope. The devil might be in the details of the BOJ's comprehensive assessment released last week. Indeed, the results of the

various “simulations” that the BOJ conducted to assess the effectiveness of QQE with NIRP showed a very wide range of possible outcomes.

Impressive sleight-of-hand magic is performed with the flick of the BOJ's assumptions: “The [counterfactual] simulation results suggest that the negative output gap in fiscal 2015 would have been between 0.6 and 4.2 percentage points larger, and the annual change in the CPI (all items less fresh food and energy) in fiscal 2015 would have been between about 0.3 and 1.5 percentage points lower than was actually the case. These figures indicate that there are considerable differences in the simulation results, which reflect differences in the assumptions.” The BOJ concludes: “Nevertheless, most of the simulations suggest that Japan still would have been in deflation if QQE had not been introduced.”

(6) *Ruby slippers*. Whatever the reason, the BOJ can now change course with little more than the click of its heels. And Kuroda will keep on clicking as he continues to ease on down the road. As he has said on numerous occasions, including this last speaking engagement: “there is no limit to monetary policy.”

It's anyone's guess how the BOJ's JGB purchase program will progress. But Kuroda seems to have no shortage of tricks up his sleeve. In addition to YCC, the BOJ also managed last week to change its inflation goal without changing it! That's by promising--in its own “do whatever it takes” moment--to exceed the BOJ's 2% inflation target before removing stimulus. With that, Kuroda is hoping that Japan's consumers and investors will think happy thoughts.

(7) *Peter Pan*. Admittedly, we may have picked the wrong movie for Kuroda. Instead of casting him in the “Wizard of Oz,” maybe “Peter Pan” is more appropriate. Last year at a monetary policy conference hosted by the BOJ, he [said](#), “I trust that many of you are familiar with the story of Peter Pan, in which it says, ‘the moment you doubt whether you can fly, you cease forever to be able to do it.’ Yes, what we need is a positive attitude and conviction. Indeed, each time central banks have been confronted with a wide range of problems, they have overcome the problems by conceiving new solutions.”

Remember, as Frank Sinatra [sang](#): “Fairy tales can come true, it can happen to you if you are young at heart.”

CALENDARS

US. Wed: Durable Goods Orders Total and Ex Transportation -1.9%/-0.5%, MBA Mortgage Applications, Bullard, Mester, George. **Thurs:** Real GDP & Price Deflator 1.3%/2.3%, Corporate Profits, Advance Merchandise Trade Balance -\$62.3b, Pending Home Sales 0.5%, Jobless Claims 260k, Weekly Consumer Comfort Index, Yellen, George, Powell. (Bloomberg estimates)

Global. Wed: Germany Gfk Consumer Confidence 10.2, Japan Retail Trade -0.8%/m/-1.7%/y/y, Japan Small Business Survey 47. **Thurs:** Eurozone Economic Confidence 103.5, Germany CPI 0.0%/m/0.6%/y/y, Germany Unemployment Change & Unemployment Rate -5k/6.1%, UK Gfk Consumer Confidence -5, Japan CPI Headline, Core, and Core-Core -0.5%/-0.4%/0.2% y/y, Japan Industrial Production 0.5%/m/3.4%/y/y, Japan Jobless Rate 3.0%. (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--is stalled around its record high. The WLI continued its up-and-down pattern during the week of September 17, rising 0.2% following a 0.5% decrease and a 0.4% increase the previous two weeks. The current reading is only 0.9% below the

record high recorded during the week of July 23. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB edged up for the fifth week by a total of 1.8% after a three-week decline of 2.5%; it's within 0.8% of its record high recorded eight weeks ago. Jobless claims slipped for the fifth week to 258,500 (4-wa) after climbing the prior three weeks from 256,500 to 265,250. The CRB raw industrials spot price index--another BBB component--is moving sideways. The WCCI fell 6.1% the past two weeks after climbing three of the prior four weeks by 5.3%.

S&P 500 Q3 Earnings Trend vs. Past Quarters ([link](#)): With the September-quarter books closing at the end of the week, the current Q3-2016 EPS forecast of \$29.75 has dropped 3.0% over the 13 weeks since the quarter's start. That marks the 22nd straight quarter that forecasts have fallen, but is well above the average 4.3% decline in the quarter's estimate since 1994. Analysts expect EPS for Q3-2016 to be down 0.8% y/y, better than the 1.4% decline for Q2-2016 and the fifth straight quarter of lower EPS on a y/y basis. However, we think that Q3's EPS will be a record-high \$30.75 and exceed Q2's \$29.66, and that earnings will rise 2.5% y/y. Since 1994, the Q3 earnings surprise has been positive in only 13/22 years and final EPS has exceeded Q2's only 10 out of 22 times. We think Q3 will mark the S&P 500's first quarter of rising earnings y/y since Q2-2015, and its 31st straight quarter of positive surprises--longer than its prior, 10-quarter positive surprise streak (Q1-2003 to Q2-2005).

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): An improved job outlook boosted September consumer confidence to its highest level since before the last recession. The Consumer Confidence Index climbed for the third time in four months from a six-month low of 92.4 in May to 104.1 this month--the highest reading since August 2007. There were big improvements in consumers' outlook on both the present and the future. The present situation index advanced for the fourth month from 113.2 to 128.5 over the period to its highest reading since August 2007; the expectations component advanced for the third time in four months from a 27-month low of 78.5 in May to an 11-month high of 87.8 this month. The job outlook improved: "Jobs plentiful" rose from 23.0% to 27.9% the past two months--the highest percentage since July 2007; "jobs hard to get" fell to 21.6%--its lowest percentage since January 2008. Consumers' six-month job outlook also improved. Those expecting more jobs (15.1%) remained below those expecting fewer jobs (17.0), but the negative spread narrowed to -1.9ppt, the smallest gap in a year.

Regional M-PMIs ([link](#)): September data from five Fed districts--New York, Philadelphia, Kansas City, Dallas, and Richmond--show manufacturing activity expanding again after contracting three of the prior four months. We average the composite, orders, and employment measures as data become available. The composite index climbed to 5.1 in September from -2.5 in August, driven by accelerating growth in the Dallas, Philly, and Kansas City Fed regions. Dallas' composite index (to 16.7 from 4.5) jumped to a two-year high, while Philadelphia's (to 12.8 from 2.0) and Kansas City's (6 from -4) were the highest in 19 and 21 months, respectively; the New York (-2.0 from -4.2) and Richmond (-8 from -11) measures contracted, though at slower paces. The orders index contracted for the fourth time in five months, though slowed to -0.8 this month from -5.6 last month. Both the Kansas City (12 from -7) and Philly (1.4 from -7.2) gauges moved from contraction to expansion, while New York's (-7.5 from 1.0) and Dallas' (-2.9 from 5.3) moved from expansion to contraction. Richmond's (-7 from -20) contracted for the third time in four months, though at a slower pace. The employment measure (-6.7 from -5.8) remained negative for the 15th straight month. Manufacturers in New York (-14.3 from -1.0) and Richmond (-13 to 7) reduced payrolls sharply this month, with the latter's the first cut in three years. Philly's (-5.3 to -20.0) and Kansas City's (-3 from -10) manufacturers continued to reduce headcount, though at a considerably slower pace than during August. Dallas' manufacturers (2.3 from -5.0) expanded payrolls for the first time this year, but barely.

GLOBAL ECONOMIC INDICATORS

Eurozone Credit ([link](#)): Credit demand in the Eurozone is expanding, but at a slower pace. We track private-sector lending by monetary financial institutions (MFIs), which shows that the three-month annualized change in total lending was positive for the eighth time in 10 months, advancing €48 billion in the three months ended August. That's a slowing from July's €108 billion, which improved from May's -€6 billion decline. Household demand remained positive for the 24th month, climbing €78 billion (saar) in the three months through August--below this year's peak of €128 billion in April, but above June's €45 billion pace. Borrowing by nonfinancial corporations contracted for the first time in six months, falling -€59 billion (saar) in the three months through August, the weakest since last October. Lending among financial institutions increased for the second month, rising an annualized €28 billion over the three-month period ended August after contracting in 10 of the prior 13 months.

Eurozone Money Supply ([link](#)): M3 growth, which the ECB regards as a barometer of future inflation, accelerated 5.1% y/y in August, back up at its recent peak. The growth rate for M1 increased to 8.9% y/y after slowing steadily from July 2015's peak rate of 11.8% to 8.4% in July. M2's rate edged up from 4.9% to 5.2% y/y last month, near its recent peak of 5.5% in both March and January. Country data, which lag the overall Eurozone data, show M3 growth is the weakest in the Netherlands (-2.0 y/y), while Greece's rate (3.7) turned positive in June for the first time in 19 months, accelerating further in July. For the top four Eurozone economies, the M3 growth rate for Germany (7.2) is down from recent highs, while Spain's (7.7) is up from recent lows; rates in both France (4.8) and Italy (3.9) are fluctuating around recent highs. Ireland's rate (5.1) slowed after accelerating from near zero at the end of last year to 9.7% in June; Portugal's (7.9) remains around recent highs. (Note: The latest M3 data are available through August for Germany, Italy, and the Netherlands, through July for all the rest.)

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