MORNING BRIEFING
January 4, 2017

Who's Afraid of the Big Bad Wolf?

See the collection of the individual charts linked below.

(1) He will huff and puff, but will he blow the house down? (2) Time for lots of little piggies to shape up? (3) Wish list full of wishful thinking? (4) Lil' Kim and the Supremes. (5) Impressive, but not unprecedented, rally in stocks since T-Day. (6) Investors are front-running Trump's tax cuts. (7) Reaganomics faced completely different economy than Trumponomics. (8) Lots of upbeat M-PMIs. (9) Boom-Bust Barometer booming, which is bullish for S&P 500 forward earnings and stock index. (10) China's M-PMI price index confirms upturn in PPI inflation rate.

Strategy: No Fear in Equities. The answer to the question posed in the title of today's *Morning Briefing* is certainly not "stock investors." Hopefully, the complete answer is "lots of little piggies afraid of what President-elect Donald Trump might do to them." Maybe they will cease and desist before they show up in one of the Big Bad Wolf's tweets. He has already had some success in getting Boeing and Lockheed to review their costs so that they will lower the prices they charge the government for their high-end products.

Now let's see if Trump can make some progress in reducing personal and corporate tax rates while eliminating many of the exemptions and deductions that make the tax code a slush fund for lobbyists and their patrons. Let's see if he can reduce onerous regulations on businesses. Can he do all that while keeping a lid on federal spending given that there are so many little piggies feeding in the government trough? Let's hope that the Progressive ones aren't simply replaced by the crony capitalist variety.

The big question is whether he will succeed in bullying our trading partners to be fairer without instigating a trade war. An even bigger question is whether he can curb the nuclear ambitions of North Korea's Lil' Kim and Iran's Supremes. Then there are China's ambitions to turn the South China Sea into a secluded lake for their navy. We should also hope that Trump's reset with the Russian Bear will be more successful than was Obama's attempt to normalize relations with the beast.

This is a long wish list, and may be biased toward too much wishful thinking. However, we can't rule out the possibility that Trump will succeed. He certainly has so far, upending the predictions of all his detractors. Betting against him has been a bad bet so far.

That seems to be the message of the stock market. The S&P 500 is up 4.6% from Trump's Election Day (T-Day) through the end of 2016. That seems impressive, but it isn't unprecedented. Here are the comparable performance figures for past presidents just elected to their first terms: Hoover (8.2%), Eisenhower (8.0), Kennedy (5.4), Reagan (5.2), Carter (4.2), Clinton (3.8), Bush I (0.9), Nixon (0.7), Johnson (-0.5), Roosevelt (-4.8), Bush II (-7.8), Truman (-9.0), and Obama (-10.2) (*Fig. 1*). So Hoover, Eisenhower, Kennedy, and Reagan trumped Trump. Perhaps Trump would have done better if the S&P 500 weren't already nearly nine years into a bull market with valuation multiples at nose-bleed levels.

Then again, those valuations may not be too high if Trump delivers all the supply-side magic of personal and corporate tax cuts, and they work like a charm. Reagan did the same, but the economy was heading into a severe recession after his first 100 days. Back then, Fed Chairman Paul Volcker was intent on breaking the back of inflation by breaking everyone's backs with burdensomely high interest rates, and Reagan supported Volcker's tough love.

Now Trump might do what Reagan did, but with an economy that clearly is growing with no recession in sight. There certainly isn't enough inflation to cause the Fed to precipitate a recession by tightening monetary policy too aggressively. Volcker raised the federal funds rate to over 20%. The FOMC's dot plot suggests that the members of the committee expect to raise the federal funds rate this year three times at most, by 25bps each time, to 1.50%. The implications for corporate earnings could be awesome, as Joe and I discussed last month. If so, then valuation multiples are simply getting ahead of earnings, but rightly so. Let's look at some of the relevant data:

(1) *Valuation and earnings.* Yesterday's *WSJ* included an article titled "Earnings, Not Donald Trump, Are Stocks' Best Friend in 2017." That's not news to us: Joe and I have been predicting since last summer that the end of the Energy-led earnings recession would boost stock prices. The subtitle of the article is "Continued rebound in corporate profits should prop up share prices regardless of Washington policies." Actually, given that valuations were high before Election Day, and went higher after Trump's sweeping victory (with his party winning control of both houses of Congress), we believe that his policies will matter a great deal.

If for some unanticipated reason he fails to implement his tax cuts and to cut regulations, stocks would take a dive. They might even crash if he manages to start a trade war. If he succeeds in his plans, then the S&P 500 earnings growth could more than double from 9% this year to 19%, as Joe and I explained last month. So Washington matters a great deal this year.

After Reagan was elected to his first term, the forward P/E of the S&P 500 rallied to 7.7 in February 1981 from a Jimmy ("Malaise") Carter low of 7.0 during November 1979 (*Fig. 2*). During 1982, it dropped to a low of 6.3. During Reagan's second term, it rose to a high of 14.8 during August 1987. Yesterday, the S&P 500's forward P/E was 16.9, well above the 13.8 average from September 1978 through December 2016 (*Fig. 3*). The forward P/Es of the S&P 400/600 were even closer to the sun at 18.7 and 19.8.

For the S&P 500, if the index price remains unchanged at the current level through the end of the year, a 10% increase in earnings this year would lower the multiple to 15.4, while a 20% increase in earnings would lower it to 14.1. So, yes, the multiples are high, as investors have gotten ahead of earnings. But earnings could do some significant catching up if Trump's program boosts earnings as much as Joe and I expect. If the multiple stays put and earnings increase 20% as a result of tax cuts, then the S&P 500 would rise to 2700. For now, we are sticking with 2400-2500 as our target for this year.

(2) *Inflation and the federal funds rate.* It is widely believed that valuation multiples should be low when inflation and interest rates are high, which was the economic environment facing Reagan in the early 1980s. In addition, a Fed-led recession was unfolding. No wonder the P/E was so low. Today, inflation remains subdued below 2.0%, and the federal funds rate is below 1.00% (*Fig. 4* and *Fig 5*). That would seem to justify the much higher valuation multiple as Trump enters the White House.

However, prior to Trump's big win, near-zero inflation and interest rates reflected subpar economic growth, which was widely believed to be the New Normal. Indeed, throughout the current economic expansion, there has been some fear that the economy could stall into a recession (*Fig. 6*). Now that seems much less likely given the fiscal stimulus that may be coming. That might well justify the currently high P/Es, if earnings growth is boosted as significantly as we expect.

(3) *M-PMI.* Unlike Reagan, Trump is entering the White House with the economy showing signs of picking up steam. As Debbie reports below, the M-PMI jumped to 54.7 during December, the highest reading since December 2014 (*Fig. 7*). The major components of the index were also very strong, with production at 60.3, new orders at 60.2, and employment at 53.1. These confirm our view that most of the weakness in manufacturing since mid-2014 was caused by the recession in the oil patch, which now seems to be over.

(4) *Global economy.* The global economy is also showing signs of strengthening. It was doing so before Trump's victory. On the other hand, the dollar has resumed its ascent, which started in mid-2014, since Election Day (*Fig. 8*). The JP Morgan trade-weighted dollar is up 5% since T-Day and 26% since July 1, 2014. The question is whether this will significantly weigh on exports and profits, which could depress economic growth.

The latest M-PMI data along with the recent rebound in earnings suggest that the plunge in oil prices weighed on the US economy and profits much more than did the strong dollar. On the other hand, US real merchandise exports have been flat since mid-2014 (*Fig. 9*).

In any event, December's JP Morgan Global M-PMI jumped to 52.7, the highest since February 2014 (*Fig. 10*). M-PMI readings were particularly impressive in Taiwan (56.2), the UK (56.1), Australia (55.4), and the Eurozone (54.9) (*Fig. 11*).

(5) *Commodities & Boom-Bust Barometer.* Among the biggest surprises last year was how quickly commodity prices rebounded from their sell-offs during the second half of 2014 and all of 2015 (*Fig. 12* and *Fig. 13*). The freefalls suggested that the commodity super-cycle had ended. The rebound confirmed that commodity producers had succeeded in reducing their capacity remarkably quickly, bringing supply back in line with demand. The 22% rebound in the CRB raw industrials index last year, combined with cyclical lows in jobless claims, sent our Boom-Bust Barometer to a new record high late last year (*Fig. 14*). This is a very good omen for S&P 500 forward earnings and the stock index.

Speaking of commodities, it is also interesting to see in China's official M-PMI release for December that the price index rose to 69.6, the highest since February 2011 (*Fig. 15*). This component of China's M-PMI is volatile, but it does tend to follow the trend in the yearly percent change in China's PPI, which rose to 3.3% during December, the highest pace since October 2011. Both suggest that China's deflationary excess capacity may have been reduced.

CALENDARS

US. Wed: ADP Employment 172k, Total & Domestic Motor Vehicle Sales 17.7mu/13.8mu, MBA Mortgage Applications, Gallup US Job Creation Index and US Consumer Spending Measure, FOMC Minutes. **Thurs:** ISM NM-PMI 56.8, Jobless Claims 260k, Challenger Job-Cut Report, Weekly Consumer Comfort Index, FOMC Minutes. (Bloomberg estimates)

Global. Wed: Eurozone CPI Headline & Core Flash Estimates 1.0%/0.8% y/y, Eurozone, Germany, France, and Italy Composite PMIs 53.9/54.8/52.8/53.0, Eurozone, Germany, France, and Italy NM-PMIs 53.1/53.8/52.6/52.6, Japan Composite & NM-PMIs. **Thurs:** UK Composite & NM-PMIs 55.0/54.7. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for all three indexes for a sixth week, and were at record highs too. That's the best string of gains for these indexes since they rose for 11 straight weeks through August 2014. All three indexes have been on solid uptrends since March, and two--MidCap and SmallCap--at record highs since June. The yearly change in forward earnings for all three indexes has been edging higher from six-year lows in early 2016 as y/y comparisons have eased. In the latest week, LargeCap's forward earnings improved to a 24-month high of 4.6% y/y from 4.3%, which compares to a six-year low of -1.8% in October 2015; MidCap's improved to a 21-month high of 5.6% from 5.3%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a 25-month high of 9.2% from 9.1%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap 0.5% and 12.4%, MidCap 1.5% and 12.5%, and SmallCap 6.7% and 15.8%.

S&P 500/400/600 Forward Valuation (*link*): Valuations for these three indexes eased slightly again last week from recent multi-year highs. LargeCap's forward P/E dropped to 16.9 from a 22-month high of 17.1. That's up from a 15-month low of 14.9 in mid-January, but remains slightly below the 11-year high P/E of 17.2 in February 2015 (when Energy sector earnings were depressed), and well below the record high of 25.7 in July 1999. MidCap's forward P/E edged down to 18.7 from 18.8 to a 15-year high of 19.2 from 18.4; that's up from a three-year low of 15.0 in mid-January and compares to a 15-year high of 19.2 in early December and its record high of 20.6 in January 2002. SmallCap's slipped to 19.8 from 20.1; that's up from a three-year low of 15.5 in mid-February, and compares to a 15-year high of 20.5 in early December and record high of 20.9 in April 2002.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Q4 earnings estimate revision activity picked up last week for the S&P 500 sectors. The Q4 consensus dropped w/w for five of the 11 S&P 500 sectors, rose for two, and was steady for four. Industrials and Health Care were the sole gainers, as their Q4 forecasts rose 0.1% w/w. Sectors with the biggest w/w declines in Q4 forecasts: Real Estate (-1.7%), Energy (-0.5), and Materials (-0.3). The S&P 500's Q4-2016 EPS forecast was steady w/w at $30.89 and is down 2.0% from $31.53 at the end of Q3. That represents a forecasted pro forma earnings gain of 6.1% y/y, unchanged from a week earlier and down from 8.3% at the end of Q3. Since the end of Q3, Q4 estimates are higher for 3/11 sectors and lower for 8/11. Tech's Q4 forecast has risen 1.7%, while Energy's has gained 0.9% and Financials' 0.5%. Materials is down the most (-14.5), followed by Real Estate (-8.7), Utilities (-7.0), Industrials (-5.6), and Consumer Discretionary (-5.0). The S&P 500's Q4-2016 forecasted earnings gain of 6.1% y/y would be its second straight gain after four declines and compares to Q3-2016's blended 4.3%, Q2-2016's -2.1%, Q1-2016's -5.0%, Q4-2015's -2.9%, Q3-2015's -0.8%, Q2-2015's 1.3%, and Q1-2015's 2.2%. Just three of the 11 sectors are expected to beat the S&P 500's y/y earnings gain of 6.1% in Q4-2016, but analysts expect a y/y earnings gain in Q4-2016 for 8/11 sectors. That forecast is below the 9/11 sectors rising in Q3-2016, which was the best since Q1-2015, and compares to 6/10 rising during the quarters from Q4-2015 to Q2-2016. Energy is expected to turn positive y/y in Q4-2016 for the first time since Q3-2014. The latest forecasted Q4-2016 earnings growth rates vs. their blended Q3-2016 growth rates: Financials (15.4% vs. 8.5%), Utilities (10.5, 10.9), Tech (7.8, 11.5), S&P 500 (6.1, 4.3), Consumer Staples (6.1, 7.0), Health Care (5.7, 7.6), Materials (5.0, 10.9), Energy (4.9, -67.5), Consumer Discretionary (2.5, 8.6), Real Estate (-0.8, 2.4), Telecom (-0.7, -1.8), and Industrials (-3.7, 4.0).

S&P 500 Sectors Net Earnings Revisions (*link*): The S&P 500's NERI improved to -2.6% in December from a seven-month low of -3.1% in November. That compares to a 25-month high of 0.7% in October. NERI was positive for 3/11 sectors and improved m/m for six (versus three positive and two improving in November). Financials topped all sectors as it rose to its highest level since July 2004. Two sectors were at multi-year lows: Health Care (lowest since March 2009) and Real Estate (lowest since October 2011). Energy has the longest positive NERI streak of six months, followed by Tech (5) and Financials (3). Real Estate is the worst, with 16 straight months of negative NERIs, followed by Utilities (13) and Telecom (8). Here are the sectors' December NERIs compared with their November results, ranked in descending order: Financials (12.6% in December [a 150-month high] from 4.1% in

November), Tech (9.7, 11.4), Energy (6.3, 4.9), Utilities (-1.2, -2.5), S&P 500 (-2.6, -3.1), Materials (-7.7, -8.0), Consumer Staples (-9.6, -8.2), Health Care (-9.9 [93-month low], -7.2), Consumer Discretionary (-10.5, -10.4), Industrials (-13.3, -13.6), Real Estate (-14.7 [62-month low], -11.6), and Telecom (-20.8, -21.1).

US ECONOMIC INDICATORS

Construction Spending (*link*): Construction spending in November hit its best level since April 2006, boosted by gains in both private- and public-sector investment. Total spending advanced for the sixth time in seven months, by 0.9% m/m and 3.5% over the period. Private construction spending rose 1.0% and 4.5% over the comparable periods, with residential (1.0%, 3.9%) and nonresidential (0.9, 5.1) moving higher. Within residential spending, single-family construction advanced 4.6% in the two months ending November, back near highs for the year, while multi-family construction slipped 2.7% after a three-month climb of 6.4%. Home-improvement spending recovered 1.5% after a three-month slide of 4.5%. Within nonresidential investment, spending on educational, amusement & recreation, lodging, and commercial structures remained on steep uptrends, while manufacturing was stalled around recent highs. Public construction spending increased for the fourth month, by 0.8% in November and 5.0% over the period.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs (*link*): The global manufacturing sector in December expanded at its fastest pace in 34 months. The JP Morgan M-PMI advanced for the fourth month from 50.8 in August to 52.7 in December--the highest since February 2014. Global output (to 53.8 from 53.4), new orders (53.8 from 53.1), new export orders (51.4 from 51.3), employment (51.4 from 50.8), and input prices (61.0 from 58.7) all accelerated during the month. By region, growth was generally led by the US (54.3, 21-month high) and the Eurozone (54.9, 68-month high), with available data for the latter showing M-PMIs in the Netherlands (57.3) and Austria (56.3) at 68-month highs, while measures in France (53.5) and Germany (55.6) were the best in 67 and 35 months, respectively. Also expanding at faster paces were M-PMIs for Spain (55.3, 11-month high) and Italy (53.2, 6-month high), while Greece's (49.3, 4-month high) contracted at a slower pace. The UK (56.1) registered its best performance in 30 months. Manufacturing activity in Asia also improved, expanding in Japan (51.9, 11-month high), China (51.9, 47-month high), Taiwan (56.2, 68-month high), Vietnam (52.4, 2-month low), Philippines (55.7, 4-month low), and Thailand (50.6, 12-month high). However, activity contracted in India (49.6) for the first time this year, with South Korea (49.4), Indonesia (49.0), Malaysia (47.1), and Myanmar (49.4) also in the red. Elsewhere, manufacturing growth gathered steam in Russia (53.7, 69-month high), while Brazil's (45.2) contraction accelerated.

US Manufacturing PMIs (*link*): Manufacturing activity in December grew at its fastest pace in two years according to the ISM survey, and the best in 21 months according to Markit's. ISM's M-PMI increased for the fourth month from 49.4 in August to 54.7 last month, the highest since December 2014. The new orders (to 60.2 from 53.0) and production (60.3 from 56.0) components both moved above 60 to their highest readings since November 2014. The employment index was in expansionary territory during each of the final three months of 2016--climbing to an 18-month high of 53.1 last month--after contracting eight of the first nine months of the year. The remaining two components that compose the M-PMI show supplier deliveries (52.9 from 55.7) slowing, while inventories (47.0 from 49.0) contracted at a faster pace. Markit's M-PMI (54.3 from 54.1) rose to its highest reading since March 2015. According to the report, the latest move up in the headline index was largely driven by employment growth (which was the best since June 2015) and inventory building; both output and new orders expanded at slower rates, though eased only slightly from November's elevated pace. Input prices continued to accelerate according to both surveys, with ISM's the highest since June 2011 and Markit's the sharpest since October 2014.

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