MORNING BRIEFING
February 9, 2017

Here Come the Jetsons

See the collection of the individual charts linked below.

(1) Correction time yet? (2) Bulls dwarf bears—but sell signals were never the Bull/Bear Ratio's forte. (3) Investors putting trust in earnings and Trump's bullish plans for now, while ignoring his bearish ones. (4) We'd prefer to see fewer bulls and less bullying. (5) Jackie goes for a drive in the auto industry. (6) Subprime is making a comeback in auto loans. (7) Autonomous cars may change almost everything. (8) Uber drones. (9) S&P 500 Automobile Manufacturers' single-digit P/E reflects concerns more so than promise at this point.

Strategy: Remaining Bullish. As Debbie reports below, the Bull/Bear Ratio (BBR) compiled by Investors Intelligence shot up this week to 3.75, the highest reading since the week of May 5, 2015 (*Fig. 1*). The percentage of bulls rose to 62.7%, which matches multiple previous high readings since the start of the data in 1987. The percentage of bears was only 16.7%, with 20.6% in the correction camp.

A year ago, during the week of February 9, the BBR bottomed at 0.63. That turned out to be a great contrary indicator. Indeed, in our 1/25/16 *Morning Briefing,* we wrote: "Joe and I believe that it may be too late to panic and that Wednesday's action might have made capitulation lows in both the stock and oil markets. We note that the Bull/Bear Ratio compiled by Investors Intelligence fell to 0.74 last week from 0.80 the week before, two readings in a row below 1.00, which has often been a very good contrarian buy signal. The percentage of bears rose to 36.1%, the highest since late October 2011." That was a good call, though there was one more retest of our conviction before the market bottomed last year on February 11, when JPMorgan Chase CEO Jamie Dimon bought a slug of his company's stock (*Fig. 2*).

Might the BBR now be signaling a major sell-off? We haven't had one since before Election Day, but it was minor. Joe and I predicted that the market would likely continue to move higher no matter who won because we had been arguing since last summer that the energy-led earnings recession was over. There was a selloff after Brexit last June, but it lasted just two days.

So we are due for a correction. Such panic attacks followed by relief rallies have been the modus operandi of this bull market since 2009 (*Fig. 3*). The S&P 500 hasn't tested its 200-day moving average since early November.

The problem with using the BBR as a contrary indicator now is that it works much better as a signal to buy when it is at 1.0 or lower than as a signal to sell when it is at 3.0 or higher (*Fig. 4* and *Fig. 5*). The resilience of the bull market since Election Day, and especially since Inauguration Day, has been impressive despite all the almost-deafening political noise coming out of Washington. The market is still focusing on the underlying stronger signal from earnings and betting that Trump's policies, on balance, will boost them. Joe and I agree, though we would like to see fewer bulls and less bullying.

Industry Focus: Autos on Cruise Control. One of our favorite Yogiisms is: "When you come to a fork in the road, take it." Car companies find themselves barreling toward a fork, with many big changes to cars and how we drive them looming in the not-so-distant future. There's talk of electric cars becoming commonplace, sharing cars that can drive themselves, and even flying cars. Let's look at where things stand today by dissecting the earnings that GM reported Tuesday and then peer into a future that would shock Henry Ford:

(1) *Cruising at speed limit*. Cars continued to fly off dealers' lots in January, with total vehicle sales coming in at 17.6 million (saar), a touch higher than the 12-month moving average but lower than the 18.4 million rate in December. The current level of sales marks an impressive rebound from the Great Recession, when sales fell to a low of 9.2 million in 2009 before clawing their way back over the last eight years (*Fig. 6*).

However, sales seem to be plateauing at a high level, and inventories are about 10% higher than what's typical, a 2/1 *WSJ* article observed, forcing a tough choice for auto makers: "The results are forcing Detroit car companies and foreign rivals to more directly confront a tough strategic decision: Keep ratcheting up discounts to spur showroom traffic, or lay off workers so production can more closely mirror underlying demand."

It seems highly likely that auto sales could fall a bit, but stay in a relatively lofty range given that the unemployment rate has been below 5.0% for the past nine months through January. That's what occurred in the early 2000s when auto sales were steadily in the 16.0-16.5 million range for numerous years.

Plateauing US sales have led to uninspiring Q4 earnings reports. GM reported on Tuesday that Q4 revenue rose 10.8% y/y to $43.9 billion but earnings fell 7.9% y/y to $1.28 a share. This year, the company expects to match the $12.5 billion in operating profit earned in 2016, and generate $6.00 to $6.50 a share, compared to the adjusted $6.12 it earned in 2016, according to a company press release.

Meanwhile, Ford reported Q4 revenue that was down 4.0% y/y to $38.7 billion and a Q4 loss of $800 million, with results hurt by pension plan special charges and the cancellation of a plant in Mexico, according to the company press release. Ford expects results in 2017 to lag behind last year's results.

So far, the market doesn't appear overly concerned. The S&P 500 Automobile Manufacturers index is up 15.2% over the past year through Tuesday's close. That's far behind the 22.0% return for the S&P 500, but solidly in positive territory nonetheless (*Fig. 7*). The industry is expected to see STRG (short-term revenue growth, i.e., over the next 12 months) that's essentially flat, at -0.1%, and STEG (earnings growth over the next 12 months) is forecasted to dip -2.2% (*Fig. 8* and *Fig. 9*). The industry's forward P/E (or P/E based on forward earnings per share) is in single digits, at 6.6, perhaps reflecting concerns about the industry having seen peak sales or facing competition from Tesla and ride-sharing operators in the future (*Fig. 10*).

(2) *Turn on windshield wipers?* There are some dark clouds in the distance to keep an eye on. The first is auto loans, which soared 59% since bottoming during Q3-2010 in the wake of the recession's end (*Fig. 11*). The growth in motor vehicle loans has far outpaced the growth in auto sales.

Subprime auto loans bear watching. The delinquency rate on subprime loans picked up to 2.0% in Q3 from 1.4% in Q1-2014, according to Federal Reserve data. That might not seem like a large jump, but the subprime loan default rate rose only to 2.4% during the recession in Q2-2009. A 12/5 *WSJ* article reported that banks were pulling back on subprime loans but keeping loan volumes high by extending loans with longer repayment periods. The article states that 30.7% of new auto loans in Q3 had repayment periods of 73 to 84 months, up from 27.5% the year prior.

The second item to watch is the Border Tax proposal by House Republicans. Many car manufacturers receive parts from south of the border, and those parts wouldn't be deducted from revenue to calculate taxable income under the proposed rules. The result would be much higher taxable income and therefore a higher tax bill. That negative would be countered by a lower overall tax rate and potentially a stronger dollar. President Trump has called for a simpler tariff or border tax of as much as 35% on car makers and others who move work to Mexico or other countries and then ship those products back to the US.

GM's CEO Mary Barra sat next to President Trump at the most recent meeting of his Strategic and Policy Forum even though the company she leads remains a large manufacturer in Mexico. A 2/7 *WSJ* article reported: "About 20% of [General Motors'] highly profitable light trucks are built in Mexican factories by workers who make a fraction of what United Auto Workers members are paid at American plants, according to WardsAuto.com. GM is currently moving more production to Mexico as it relocates assembly of certain sport-utility vehicles. … Many of GM's key suppliers—including companies it once owned—moved nearly all parts production out of the US during bankruptcy restructuring and other reorganization efforts."

So far, foreign auto makers haven't flinched in the face of Trump's border tax threats. Trump was quoted last month in a German paper warning BMW, which has manufacturing plants in the US, to expect a 35% tariff if they build cars in Mexico that are sold in the US. He also called Germany "unfair" because few American cars are sold in Germany.

In response, a BMW executive said the company intends to move forward with plans to build a plant in Mexico to manufacture its 3-series. A 1/16 *WSJ* article carried the response of Sigmar Gabriel, German vice chancellor and economics minister: If the US car makers want to sell more cars in Germany, "they just have to build better cars." Ouch!

Auto makers are building operations in Mexico to take advantage of cheap labor and Mexico's many free trade agreements. Audi is building SUVs in Mexico and exporting them back to Europe without paying a tariff, the *WSJ* article explained. By doing so, it avoids the 10% duty it would have to pay on cars built in the US and sold in the EU, because the US and EU don't have a free-trade agreement.

"Mexico has 10 free-trade arrangements encompassing 45 countries—counting EU members separately—plus other trade deals in Latin America and the Asian Pacific, according to the government's trade office. In contrast, the U.S. has free-trade agreements with 20 countries, mostly smaller economies such as Chile, Jordan and Panama, said the U.S. trade representative's office," a 3/17/15 *WSJ* article noted.

It will be interesting to watch just how all of this gets straightened out.

(3) *There's an app for that*. Car ownership is as American as apple pie. Getting a license is a rite of passage, and buying your first car—clunker though it might be—is an enduring memory. But there's a growing view that car ownership may become a thing of the past. Our good friends at ARK Invest predict that autonomous taxi services will be available in the next two years, and by the late 2020s autonomous taxis will be the dominant form of mobility. Services will cost almost half the amount of owning a car, and will allow everyone to become more productive as hours spent driving in traffic are replaced with the ability to work or watch TV, according to a recent ARK report.

If ARK is correct, the number of personally owned cars will decline, and auto sales will fall by nearly half in developed markets by the late 2020s. Used car prices could also plummet. Yet the miles driven could increase sharply as "the non-driving population, including the blind, the elderly, and young teens, will have access to inexpensive, convenient transportation."

If autonomous vehicles operate more predictably, more cars will be able to drive on the same number of roads, and accident rates should plummet. "Computers react more quickly than humans as they do not text, drive while drunk, or daydream." Also, the need for parking sites will be reduced significantly, as cars will do more driving.

While fewer car sales could initially reduce GDP, ARK believes that ultimately autonomous taxis could add $2.3 trillion to GDP by 2035. People will have more time for work or for leisure; autonomous taxis will generate service revenue; unused parking spaces can be converted to offices, stores, or residences; and the $28 billion spent on costs related to traffic congestion and car accidents would drop by an estimated 80%.

"The net present value of the economic impact over 15 years associated with every driver in the U.S. who forgoes buying a personal car and instead rides in an autonomous taxi is roughly $120,000," the ARK report states. "Incorporating expectations for the cumulative number of passengers that will enter the market as a result of autonomous accessibility, the net present value of the economic impact over the first 15 years will amount to roughly $7.5 trillion in the U.S. …"

One interesting effect of driverless cars: Beverage sales could boom. No longer will designated drivers be needed to drive. "By 2030, autonomous taxis could add $28 billion to the $1.5 trillion global beverage industry," estimated the author of the ARK report. Now that's something we can toast to. Also, autonomous cars could give people more time to download media services, which would be a boon for telecom service providers. "The $5.6 trillion global telecom market could double over the next 10-15 years if those services were to use cellular spectrum."

Urbanites and people who can't afford to buy a car might quickly shift to autonomous taxis. However, individuals who can afford cars most likely will opt to purchase their own autonomous car. Automobiles are one part freedom and one part toy for many Americans. Indeed, not all auto purchases are rational decisions based on economics or we'd all be driving Hyundais.

(4) *Auto pilot*. If autonomous cars aren't enough to blow your mind, consider flying cars. Uber Technologies recently hired Mark Moore to become director of engineering for aviation. Moore, who previously worked at the US National Aeronautics and Space Administration, will work on Uber Elevate, the company's flying car initiative, according to a 2/6 Bloomberg article.

The article explains: "The ride-hailing company envisions people taking conventional Ubers from their homes to nearby 'vertiports' that dot residential neighborhoods. Then they would zoom up into the air and across town to the vertiport closest to their offices. ('We don't need stinking bridges!' says Moore.) These air taxis will only need ranges of between 50 to 100 miles, and Moore thinks that they can be at least partially recharged while passengers are boarding or exiting the aircraft. He also predicts we'll see several well-engineered flying cars in the next one to three years and that there will be human pilots, at least managing the onboard computers, for the foreseeable future."

Moore may be best known for a 2010 white paper he wrote while at NASA's Langley Research Center about the feasibility of electric aircraft that could take off and land vertically and would be smaller than helicopters. After reading his paper, Google co-founder Larry Page funded two startups, Zee Aero and Kitty Hawk, to develop the technology. The morning commute may be about to get a lot more fun!

(5) *Amazon parts company*. Back on earth, auto parts retailers have a much more immediate and tangible problem. Amazon has the $50 billion market for after-market auto parts in its sights, according

to a 1/22 *New York Post* article:

"In recent months, Amazon has struck contracts with the largest parts makers in the country-including Robert Bosch, Federal-Mogul, Dorman Products and Cardone Industries, sources told The Post. … There is a widening rift between manufacturers and retailers, according to industry execs, due to an aggressive pursuit of mostly foreign-sourced private-label parts. That fattens the retailers' bottom lines, but at the expense of the auto parts makers. When the retailers chased the private labels, manufacturers' loyalty disappeared in the rear-view mirror, said one executive at an auto parts maker. Plus, Amazon, in some cases, has been paying manufacturers as much as 30 percent more for the same parts."

A brief perusal of Amazon.com shows there is indeed a section dedicated to automotive parts and accessories, including tires that can be shipped to your home for free and installed at your home for a fee. Customers can shop for a specific part or shop by looking for a specific brand. Diehard tinkerers looking for advice or someone who needs a part immediately may still need to go to an auto parts retailer. But those with a little time may find that Amazon offers a good alternative.

Since the *Post* article through Tuesday's close, the S&P 500 Automotive Retail index has fallen by 5.0%, while the S&P 500 index has gained 1.0%. The move isn't monumental, but it could be the start of problems for an industry that has been a top performer. Automotive Retail, which includes auto parts retailers and automobile retailers, has handily beat the S&P 500 since the start of the current bull run, returning 465.5% from 3/9/09 through Tuesday's close. That's almost twice the 238.9% return of the S&P 500 over the same period (*Fig. 12*).

The industry's earnings grew sharply from 2009 through 2015, and analysts continue to expect 11.2% short-term earnings growth over the next 12 months (*Fig. 13*). Its P/E is 17.5, down from a peak of 20.9 in 2015. If Amazon makes auto parts a priority, auto part stocks could stall.

CALENDARS

US. **Thurs:** Jobless Claims 250k, Wholesale Trade Inventories 1.0%, Weekly Consumer Comfort Index. **Fri:** Consumer Sentiment Index 98.5, Import & Export Prices 0.2%/0.1%, Treasury Budget, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. **Thurs:** Germany Trade Balance (euros) 20.5b, Japan Machine Tool Orders, Carney. **Fri:** China Yuan Loans 2,380b, China Aggregate Financing (yuan) 3,085b, China M2 11.3% y/y, China Trade Balance $48.9b, UK Headline & Manufacturing Production 3.2%/1.7% y/y, UK Trade Balance (pounds) -3,500, Canada Unemployment Rate 6.9%. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) climbed for the second week this week from 3.33 to 3.75 over the period. That makes the ninth straight week with readings above 3.00, and the latest reading is the highest since early May 2015. Bullish sentiment advanced from 58.2% to 62.7% over the two-week period, the most bulls since December 2004. Bearish sentiment fell to 16.7%--the fewest bears since August 2015. The correction count (20.6%) held at the lowest readings since June 2014. The AAII Bull Ratio edged up to 49.0% last week after falling the prior three weeks from 64.7% to 48.5%. Bullish sentiment ticked up to 32.8% after a three-week decline from 46.2% to 31.6%; bearish sentiment rose for the fourth week from 25.2% to 34.2% over the period.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues and earnings rose to record highs last week. The forward profit margin forecast remained steady at a 16-month high of 10.8%, nearing the record high of 10.9% in September 2015 and up from its 24-month low of 10.4% in late March. Forward revenue growth for the S&P 500 edged down to 5.7% from 5.8%, which was the highest since May 2012 and up from a seven-month low of 2.7% in late February 2016. Forward earnings growth dropped to 10.8% from 11.4%, and is down from 11.7% in early January; that was the highest since October 2011 and compares to an 11-month low of 4.8% in February 2016. Valuation fell to 17.2 from 17.4, which had matched February 2015's 12-year high of 17.4 and compares to a 15-month low of 14.9 in January 2016. S&P 500 forward revenues and forward earnings are enjoying a tailwind now from easier y/y comparisons for Energy and improving prospects for Financials, but currency translation looks likely to remain a challenge. Looking at last week's results ex-Energy, the forward revenue and earnings growth rates fall to 4.0% and 7.7%, respectively. The ex-Energy forward profit margin improves to 11.4%, which is close to its record high of 11.5% in August 2007.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 7/11 sectors, and forward earnings rose for 9/11. Energy, Information Technology, and Real Estate were the only sectors to have forward revenues and earnings rise w/w. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy's forward revenues and earnings are at or near 15-month highs. The forward P/S ratio fell for 10/11 sectors (all but Health Care), and P/Es dropped for 9/11 (all but Health Care and Tech). Industrials' P/E of 17.7 is near a 10-year high, and Tech's 17.2 is the highest since 2008. Excluding Real Estate, Financials' P/E of 13.6 is up from 12.0 before the election and remains near mid-December's six-year high of 14.2. Health Care's P/E of 14.7 and P/S of 1.58 have been rising recently, but remain well below their 2015 highs of 17.9 and 1.88, respectively. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.39 compares to a record high of 1.56 in early May, and its P/E of 28.8 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, but are expected to improve for 9/11 sectors in 2017. Here's how they rank based on 2017 forecasts: Information Technology (to 19.8% in 2017 from 19.3% in 2016), Real Estate (16.6, 24.7), Financials (15.9, 14.8), Telecom (10.9, 10.8), Health Care (10.7, 10.5), Utilities (10.7, 11.2), S&P 500 (10.6, 10.2), Materials (10.2, 9.5), Industrials (9.0, 8.9), Consumer Discretionary (7.5, 7.2), Consumer Staples (6.9, 6.6), and Energy (4.6, 1.2).

S&P 500 Earnings Season Monitor (*link*): With 62% of S&P 500 companies finished reporting Q4-2016 results, their revenue and earnings surprise metrics are mostly weaker than at the comparable point of the Q3 season. On a positive note, their y/y revenue and earnings growth comparisons are the highest since Q3-2014. Of the 310 companies in the S&P 500 that have reported, 70% exceeded industry analysts' earnings estimates by an average of 4.1%; they have averaged a y/y earnings gain of 7.9%. At the same point in Q3-2016, a higher percentage of companies (73%) in the S&P 500 had beaten consensus earnings estimates by a larger 6.7% and earnings were up a smaller 2.1% y/y. On the revenue side, 49% beat sales estimates so far, coming in 0.3% above forecast and 4.3% higher than a year earlier. During Q3, a higher 55% were above forecasts, results exceeded estimates by a smaller 0.1%, and results rose a lower 1.7% y/y. Q4 earnings results are higher y/y for 71% of companies versus 72% at the same point in Q3, and revenues are higher for 72% versus 71%. These figures will continue to change as more companies report Q4 results, but the results to date suggest that Q1-2016 was the bottom for y/y revenue growth and that Q2-2016 was the earnings growth bottom.

US ECONOMIC INDICATORS

Consumer Credit (*link*): Consumer credit in December rose less than expected, climbing $14.2 billion, nearly half of November's $25.2 billion. Revolving credit rose $2.4 billion in December after an $11.8 billion jump in November; it increased in 11 of the 12 months of 2016, advancing $57.6 billion y/y—the best yearly growth since 2007. Nonrevolving credit, which includes student and auto loans advanced $11.8 billion in December, slowing from $13.4 billion and $13.7 billion the prior two months. Quarterly data, which are not seasonally adjusted, show student and auto loans during Q4 rose $9.6 billion and $12.4 billion, respectively, slowing from $32.8 billion and $29.7 billion during Q3. Student loans increased $86.6 billion over the four quarters of 2016, slightly above 2015's pace, while auto loans advanced $73.7 billion, slightly below 2015, though near highs for this series going back to 1943.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In December, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to the long-term trend—continued to point to growth gaining momentum in several advanced economies. CLIs in the US (to 99.4 from 99.3), Canada (100.3 from 100.2), Germany (100.5 from 100.3), France (100.6 from 100.5), and Japan (100.1 from 100.0) show growth is anticipated to pick up. In the UK (99.5 to 99.3), there are tentative signs of growth gaining momentum, though "uncertainty persists about the nature of the agreement the UK will eventually conclude with the EU," according to the report. Stable growth momentum is still anticipated for the OECD (99.9) area as a whole, as well as the Eurozone (100.4) and Italy (100.1). As for the major emerging economies, CLIs indicate growth is expected to gain momentum in China (99.4 from 99.2), Brazil (101.6 from 101.4), and Russia (100.9 from 100.6); India's CLI (100.3 from 100.4) continues to show an easing in growth momentum.

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