MORNING BRIEFING
February 14, 2017

Bada-Bing, Bada-Boom

See the collection of the individual charts linked below.

(1) Sonny and Michael Corleone. (2) Improv. (3) Knowing when to walk out. (4) Is this the melt-up? (5) Sell on the tax news, or just go away in May? (6) Consensus 2018 earnings estimates are steady and bullish. (7) Going vertical: Stock prices, our Boom-Bust Barometer, and YRI Weekly Leading Index. (8) From "The economy, stupid!" to "Populism, stupid! (9) Bond spreads widening in Europe. (10) What if Brexit is a success? (11) Le Pen will bring crowbar to Frexit door. (12) ECB getting bada-chinged.

Strategy: Bada-Ching? In "The Godfather" (1972), James Caan's character Sonny tells Al Pacino's character Michael what to expect when he assassinates a crooked cop at close range. "Whataya gonna do? Nice college boy, eh? Don't wanna get mixed up in the family business? Now you wanna gun down a police captain because he slapped you in the face a little bit, huh? Whataya think this is … the Army, where you shoot 'em a mile away? You gotta get up close like this … bada-BING! You blow their brains all over your nice Ivy League suit."

Reportedly, Caan improvised the "bada-BING." Contrary to popular belief, that's not an expression of Italian-American descent. Its origin is actually "bada-ching," which is what vaudeville comedians said after a joke, especially if no one laughed. It mimics the noise made by a drummer hitting the drum, the kick, and the cymbal. Now the expression is associated with a quick mob hit: "It's easy: Walk in, whack the $#%&!, and walk out--bada-bing, bada-boom."

What does this have to do with the stock market? Nothing really, other than the fact that stocks have been bada-booming since Election Day (*Fig. 1*). Apparently, many investors jumped into the market, including some who might have missed the bull move since March 9, 2009. They walked in at a time when the S&P 500 had already climbed 216.3% and the forward P/E was 16.4, not cheap (*Fig. 2*). Now the S&P 500 is up 8.8% since Election Day, and the forward P/E is even higher at 17.5. They got a good hit so far. So should they walk out before they get bada-chinged?

Throughout the bull market, especially when the Endgame scenario intermittently gained credibility, Joe and I said that the bull market will probably stage a melt-up before it turns into a bear market meltdown. This could be the melt-up. However, the market is clearly discounting Trump's corporate tax cuts. Joe and I did the same when we raised our 2017 forecast for the S&P 500 operating EPS from $128 to $142 on December 13.

Industry analysts can't follow our lead until the tax cuts are actually implemented, and guidance from the companies they follow on likely impacts is available. It is likely to get complicated if, along with a major reduction in the statutory tax rate, lots of deductions and exemptions are eliminated or limited (including interest costs). In addition, the new tax regime might include immediate expensing of capital spending for some industries.

Nevertheless, Joe and I are seeing some signs that industry analysts are getting into the "animal spirits" that seem to have been unleashed by Trump's victory. We are particularly impressed by their 2018 earnings estimates for the S&P 500/400/600, which have all been remarkably stable since Election

Day, instead of declining as usually happens with these forecasts (*Fig. 3*). Earnings for the three indexes are expected to grow 12.0%, 12.5%, and 16.9% next year, following gains of 10.8%, 11.9%, and 14.5% this year. Our Blue Angels analysis shows that while all three indexes are at expensive valuation levels, forward earnings continue to rise to record highs, thanks to the lofty expectations for 2018 (*Fig. 4*).

Joe and I are still targeting 2400-2500 for the S&P 500 by the end of the year. If it gets there well ahead of schedule, we'll have to consider the possibility of at least a significant correction, which might occur once the details of Trump's economic plan become more tangible. In other words, selling on the news might be a good tactical move this year. So might selling in May and going away for a few months if stocks continue to go vertical.

Speaking of vertical, our Boom-Bust Barometer (BBB) and our YRI Leading Weekly Index are also going vertical, as Debbie reviews below. Both have been fairly reliable indicators of the S&P 500 since 2000 (*Fig. 5* and *Fig. 6*). The BBB also has been highly correlated with the S&P 500 forward earnings (*Fig. 7*). So for now, it's bada-boom! However, we will be on the lookout for bada-bust.

Eurozone: Populist Yield Spreads. "The economy, stupid" was the winning mantra that James Carville, Bill Clinton's campaign strategist, crafted for the successful 1992 campaign against President George H. Bush. "Populism, stupid" seems to describe what's driving Eurozone credit markets these days, as populist movements are threatening the stability of both the European Union (EU) and the Eurozone.

Following Donald Trump's upset victory in the US, opposition populist leaders have a chance of causing regime changes in France and Italy. Slow economic growth in both and elevated levels of debt, especially in Italy, are adding fuel to the fire. On the other hand, Germany's fundamentals remain sound. That good news could turn out to be bad news because Germany is getting criticized for benefitting more from the weak euro than are the other countries in the Eurozone. Meantime, the outlook for the UK is upbeat, which might only add to risk for European debt because a successful Brexit might inspire more countries to break from the EU and/or the Eurozone.

Another important development affecting credit markets is that the ECB might be reaching its bond-buying limits. The bank is also facing the increasingly conflicting needs of Eurozone economies. Inflation is starting to tick up, especially in stronger nations, which may pressure the bank to scale back on its stimulus program. Indeed, the Eurozone is being hit with a trifecta of uncertainty: political, fiscal, and monetary. Investors should expect higher yields and widening credit spreads as a result of these developments. Consider the following:

(1) *Bond spreads widening*. Bonds in France and Italy have become particularly sensitive to political and fiscal uncertainty. Bloomberg discussed these trends recently in an article on 2/6 titled "European Bonds, Not the Euro, Take the Biggest Political Hit" and one on 2/7 titled "Le Pen and Brexit Are Forcing Traders to Redraw Their European Strategy." During 2016, Eurozone yields bottomed right after the Brexit vote at the end of June and spiked up after the US presidential election (*Fig. 8*).

Late last summer, Italian borrowing costs rose as fresh pessimism over Italy's banking crisis made headlines. For example, a 7/4 *WSJ* article warned: "Bad Debt Piled in Italian Banks Looms as Next Crisis." Late last year, Italian Prime Minister Matteo Renzi bet his job on a reform referendum to streamline the country's legislative bodies. He lost both, and the country is hanging in political limbo until the next election, to be held no later than May 2018.

In France, expectations are that Marine Le Pen has a slim chance of winning the May 7 presidential election. However, the far-right National Front Party leader is marching up in the polls. One of her key contenders, conservative Francois Fillon, has become embroiled in a scandal.

Le Pen has been nicknamed "Madame LeFrexit," having promised to lead France the way of the UK. Even if Le Pen wins, she is not automatically guaranteed a Frexit. Nevertheless, "[i]nvestors who think the world is being turned upside down by populists will still see value in betting that the French-German bond spread will widen far more on a Le Pen win," the 2/10 *WSJ* reasonably hypothesized.

If her party comes to power, officials would seek to redenominate 80% of France's €2.1tn public debt into a new national currency, according to a 2/9 *FT* article. The remaining 20% would stay in euros out of contractual obligation. Party leaders have suggested that the redenomination could allow France to competitively devalue the new currency against the euro. Representatives of S&P say that would constitute a default.

Meanwhile, Germany's fundamentals are relatively solid. For example, German factory orders jumped 5.2% m/m during December to the highest since November 2007 (*Fig. 9).* Consequently, the yield spread between Italian and German 10-year government bonds has widened from 161bps to 208bps since the US election (*Fig. 10*). The comparable yield spread between French and German bonds has widened from 38bps to 72bps.

The comparable UK-German spread widened from a recent low of 75bps during the period following the Brexit vote to a high of 127bps right after the US presidential election. It has narrowed to 94bps. Behind this trend is growing optimism about the UK's ability to break from the EU unscathed and perhaps better than before. How the UK fares could set market expectations for other exit candidates if populists gain political ground in those countries. However, the UK doesn't have to go through the pain of redenominating its currency as other Eurozone exiters would have to do.

(2) *Redenomination risk clause*. Recalibration to an independent currency from the euro seems to be a growing concern among investors in Italy and France. The 2/7 *FT* explained: "Since the start of 2013, all new government bonds sold in the eurozone have included so-called collective action clauses, which require a supermajority of bondholders to agree to any changes. This applies to all bondholders, preventing a small minority of investors from blocking deals. Currency changes are one of the modifications that require a bondholder vote.

"However, older debt issued before the crisis does not carry the same requirement—which, in theory, means the currency of certain bonds could be changed without bondholder approval." Italy and France both have more 1- to- 30-year debt without these clauses than those that do, according to an analysis from Citi presented in the *FT*. Even debt contracts with the clause may not be entirely protected against such risk, noted a Morgan Stanley report also mentioned in the article.

(3) *ECB under fire*. "We are not currency manipulators," said ECB President Mario Draghi last week. Draghi was testifying before the European Parliament's Economic and Monetary Affairs Committee and responding to accusations from Trump's trade adviser Peter Navarro. Business Insider covered the war of words in a 2/6 article.

Navarro pointed fingers at Germany for using the "grossly undervalued" euro for its own benefit against other EU nations and the US. After a meeting with the Swedish prime minister on January 31, German Chancellor Angela Merkel responded: "We won't exercise any influence over the European Central Bank, so I can't and I don't want to change the situation as it is now," adding that Germany strives for fair trade with all.

German Finance Minister Wolfgang Schaeuble chimed in: "The euro exchange rate is, strictly speaking, too low for the German economy's competitive position … When ECB chief Mario Draghi embarked on the expansive monetary policy, I told him he would drive up Germany's export surplus."

Even if the bank hasn't intentionally pushed the euro lower, the effects certainly haven't hurt Germany's trade. Germany posted a record trade surplus during 2016, noted a 2/9 article in *The Telegraph UK*. According to a 2/5 *FT* article, Draghi defended Eurozone, stating: "There are some today who believe that Europe would be better off if we did not have the single currency and could devalue our exchange rates instead."

Draghi added, "But, as we have seen, countries that have implemented reforms do not depend on a flexible exchange rate to achieve sustainable growth. And for those that have not reformed, one has to ask how beneficial a flexible exchange rate would really be. After all, if a country has low productivity growth because of deep-rooted structural problems, the exchange rate cannot be the answer."

(4) *ECB tapering puzzle.* Draghi is facing another challenge. Since the latest round of stimulus began, questions have lingered about whether there is enough liquidity in the European bond market for the ECB to reach its bond-buying goals. The ECB also has been faced with divergent needs of countries within the Eurozone.

German pension fund managers, for example, have been demanding that the ECB raise rates to provide for higher rates of return on safe investments. They argue that negative interest rates have done more harm than good for the Eurozone economy and investors and that the stimulus disincents weaker countries to shore up their finances. But weaker countries, like Greece, want more support. Inflation in Germany rose to 1.9% y/y last month, near the ECB's broader inflation target for the Eurozone (*Fig. 11*). Inflation for the Eurozone as a whole remained at a lackluster 1.1% y/y in December, though January's flash estimate showed an acceleration to 1.8%.

There are signs that the ECB has begun tapering its bond-purchasing program. The *FT* reported that in December, the ECB bought just €4bn of corporate bonds, the lowest amount since the start of that purchase program last summer. Some of that might have been due to the holiday season. However, the ECB did announce on December 8 last year that it would begin to scale back its monthly bond purchases in all classes to €60bn from €80bn starting in March of this year.

Draghi explained that this didn't reflect the beginning of the end of the program but rather diminished deflation risk. The bank supposedly will buy the same amount of bonds but over a longer time horizon. Kicking the can down the road, the program was extended by nine months to the end of 2017. But the sharp drop in corporate bond purchases in December caused investors to pause. Draghi paused last month too, opting to leave the bank's monetary policy posture unchanged.

(5) *Longer maturities.* HSBC's global head of debt told the *FT* that the ECB has "accelerated a trend that was already in place which is a maturation of the euro market, a greater depth of the euro market. A lot of issuers who come to the euro markets do access maturities that are not as readily available in the US, such as 7 years or 15 years."

Picking up on that trend, the title of a 2/7 *WSJ* article was "Ultralong European Debt Sells Despite Politics." Its subtitle read: "Flurry of long-bond sales underlines strong appetite for yield even amid concern of pickup in inflation." Several European countries, including France and Belgium, have found buyers with an appetite for debt with longer-term durations.

The article observed that the average maturity for all euro-denominated debt sales was 10.4 years in

2016, according to Dealogic. It averaged 7.9 years over the previous five years. This year to date, the average is 9.5 years.

Even so, the average doesn't tell the whole story. Belgium just recently sold a tranche of debt that matures in 2057. According to bankers on the deal, there was more demand for it than another 2024 bond that was sold. Belgium ended up lowering the interest rate on the 2057 bond to 2.3%, which was lower than initial guidance.

The *WSJ* article summed up the issues nicely: "The flurry of long-bond deals underlines the strong appetite for yield despite widespread concern that bonds could continue to weaken over the course of the year if global inflation starts to pick up. Inflation erodes the value of the payments that fixed-rate bond investors receive over many years. Also fueling demand for longer-dated bonds are investors such as pension funds or insurance companies that need to match lengthy liabilities. … The continued demand for long debt comes despite heightened debate over when the European Central Bank may scale back its stimulus … and growing political risk on the Continent."

CALENDARS

US. Tues: NFIB Small Business Optimism Index 104.5, PPI-FD Total, Core, and Core Less Trade Services 0.3%/0.2%/0.2%, Yellen, Kaplan. **Wed:** Retail Sales Total, Ex Autos, and Ex Autos & Gas 0.1%/0.5%/0.3%, Business Inventories 0.4%, Headline & Manufacturing Industrial Production 0.0%/0.2%, Capacity Utilization 75.5%, Empire State Manufacturing Index 7.5, Atlanta Fed Business Inflation Expectations, Housing Market Index 68, MBA Mortgage Applications, EIA Petroleum Status Report, Treasury International Capital, Yellen, Harker. (Bloomberg estimates)

Global. Tues: Eurozone GDP 0.5%q/q/1.8%y/y, Eurozone Industrial Production -1.5%m/m/1.7%y/y, Germany ZEW Survey, Germany CPI -0.6%m/m/1.9%y/y, Germany GDP 0.5%q/q/1.8%y/y, Italy GDP 0.3%q/q/1.0%y/y, UK Headline & Core CPI 1.9%/1.7% y/y. **Wed:** Eurozone Trade Balance (euros) 22.0b, UK Jobless Claims Change & Claimant Count Rate 1k/2.3%, UK ILO Unemployment Rate 4.8%, Australia Employment Change & Unemployment Rate 10k/5.8%. (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—rose for the seventh week during the week of February 4 to another new record high, up 1.5% w/w and 6.6% 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 six of the past seven weeks by 10.7% to a new record high. Jobless claims dropped to 244,250 (4-wa)—the lowest reading since the week of November 3, 1973. The CRB raw industrials spot price index—another BBB component—is stalled around recent highs; meanwhile, the WCCI has rebounded 4.4% the past two weeks.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to a record high last week for SmallCap, but LargeCap's declined for a second week and MidCap's dropped for the first time in 12 weeks. LargeCap's is 0.4% below its late January record high, and MidCap's is down 0.2% from its prior-week record. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings rose to a 28-month high of 7.6% y/y from 7.3%, which compares to a six-year low of -1.8% in October 2015; MidCap's was steady at a 25-month high of 8.1%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's jumped to a 29-month high of 11.4% from 10.0%, which compares to a six-year low of 0.3% in December 2015. Growth rates now expected for 2016 and 2017: LargeCap

1.1% and 10.8%, MidCap 2.0% and 11.9%, and SmallCap 7.8% and 14.5%.

S&P 500/400/600 Forward Valuation (*link*): Valuations mostly rose last week, but most remain slightly below recent multi-year highs. LargeCap's forward P/E rose to an 11-year high of 17.4 from 17.2. That's up from a 15-month low of 14.9 in January 2016 and well below the record high of 25.7 in July 1999. MidCap's forward P/E improved to 19.1 from 18.9; that's slightly below early December's 15-year high of 19.2 and compares to a three-year low of 15.0 in January 2016 and a record high of 20.6 in January 2002. SmallCap's was steady at 19.8; that's up from a three-year low of 15.5 in February 2016, 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*): Q1 earnings estimate revision activity remained robust last week for the S&P 500 sectors as more companies reported Q4 earnings. However, the Q1 consensus rose w/w for just one of the 11 S&P 500 sectors and fell for eight. Energy rose 0.9% for the week, followed by unchanged estimates for Financials and Real Estate. Sectors with the biggest w/w declines in their Q1 forecasts: Materials (-2.8%), Consumer Discretionary (-1.9), Health Care (-1.4), and Consumer Staples (-1.0). The S&P 500's Q1-2017 EPS forecast fell 26 cents w/w to $29.81, and is down 2.5% from $30.53 at the end of Q4. That represents a forecasted pro forma earnings gain of 10.8% y/y, the strongest growth since Q3-2011, with the forecast down from 11.5% a week earlier and 13.8% at the end of Q4. Since the end of Q4, Q1 estimates are higher for 1/11 sectors and lower for 9/11. The Q1 forecast for Energy has risen 0.6%, while Real Estate's is unchanged. Industrials is down the most (-6.2), followed by Materials (-4.9), Health Care (-2.0), and Consumer Staples (-1.9). The S&P 500's Q1-2017 forecasted earnings gain of 10.8% y/y would be its third straight gain after four declines and compares to Q4-2016's blended 8.4%, Q3-2016's 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%. All 11 sectors are expected to record positive y/y earnings growth in Q1-2017, and four are expected to beat the S&P 500's y/y earnings gain of 10.8%. Analysts expect Energy to report a profit relative to a year-ago loss and no longer think Industrials and Telecom will record y/y earnings declines. That's an improvement from the 8/11 sectors rising y/y in Q4-2016, and compares to 9/11 rising in Q3 and 6/10 rising during the quarters from Q4-2015 to Q2-2016. The latest forecasted Q1-2017 earnings growth rates vs. their blended Q4-2016 growth rates: Energy (returning to a profit in Q1 from a year-ago loss vs. -0.7% in Q4), Financials (15.7% vs. 20.8%), Materials (13.5 vs. 8.0), Tech (12.9, 10.9), S&P 500 (10.8, 8.4), Consumer Staples (4.8, 7.0), Industrials (4.2, -1.3), Health Care (3.5, 7.0), Telecom (2.4, -1.5), Real Estate (2.1, 0.7), Consumer Discretionary (1.5, 3.3), and Utilities (0.9, 10.8).

S&P 500 Earnings Season Monitor (*link*): With over 71% 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 357 companies in the S&P 500 that have reported, 70% exceeded industry analysts' earnings estimates by an average of 3.9%; they have averaged a y/y earnings gain of 7.9%. At the same point in Q3-2016, a higher percentage of companies (71%) in the S&P 500 had beaten consensus earnings estimates by a larger 6.3%, and earnings were up a smaller 1.5% y/y. On the revenue side, 48% beat sales estimates so far, coming in 0.4% above forecast and 4.3% higher than a year earlier. During Q3, a higher 53% of companies beat forecasts, the surprise was smaller as companies' results were on target, and revenues rose a lower 1.5% y/y. Q4 earnings results are higher y/y for 70% of companies versus 72% at the same point in Q3, and revenues are higher for 71% 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.

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