MORNING BRIEFING

March 2, 2017

Happy Anniversary

See the collection of the individual charts linked below.

(1) Happy anniversary to an aging, but still hard-charging bull! (2) Group hug time? (3) Great call by BAM eight years ago. (4) Forward earnings up more than 100% since start of bull market. (5) Blue Angels show bulls can fly. (6) A kinder, gentler Trump is even more bullish than the bully Trump. (7) M-PMI soars, while public construction sags. (8) Lots of bulls to dance with. (9) Chuck Prince's curse. (10) BAT is a full employment act for swamp dwellers. (11) BAT is bad for some, good for others. (12) Final Republican plan likely to be guns-and-butter rather than revenue-neutral.

Strategy I: Group Melt-Up. If you are managing money in an equity shop with at least one other PM, analyst, or trader, don't be shy: Celebrate together. You may not share the same political views, but you share the same interest in seeing your assets rise in value. So do a dance together, or have a group hug. What could be more joyous than to celebrate a stock market melt-up (*Fig. 1*)? The correct answer is joyous family occasions. But a stock market melt-up is a close second.

Anniversaries are usually joyous events. The next few days will mark the eighth anniversary of the bull market. On March 3, 2009, President Barack Obama told us to buy stocks: "What you're now seeing is profit-and-earning ratios are starting to get to the point where buying stocks is a potentially good deal if you've got a long-term perspective on it." On March 6, 2009, the S&P 500 fell to an intra-day low of 666, and never looked back. You might recall (because I've reminded you a few times since then) that soon after, I declared that this devilish number was THE low. March 9, 2009 marked the closing low of 676.53. Let's review some of the accomplishments of the charging bull:

(1) *Performance, earnings, and valuation.* The S&P 500 is up 254% since March 9 2009, though yesterday's close (*Fig. 2*). Over this same period, the S&P 400 MidCap and S&P 600 SmallCap stock price indexes are up 335% and 374%.

The forward earnings of the S&P 500/400/600 are up 103%, 123%, and 157% (*Fig. 3*). Their forward P/Es are up 75% (from 10.2 to 17.9), 94% (from 10.0 to 19.4), and 84% (from 10.9 to 20.1) (*Fig. 4*).

(2) *Blue Angels.* Putting all these trends together in our Blue Angels charts shows that the market is certainly flying high (*Fig. 5*). Valuations suggest that stock prices are too high. However, forward earnings for all three S&P composites continue to climb in record-high territory. Furthermore, the valuations aren't too high if President Donald Trump delivers the goodies that he promised, including tax cuts, deregulation, and infrastructure spending. The market clearly liked Trump's speech on Tuesday, along with his kinder and gentler tone. It was his first truly presidential-sounding performance since he first landed on the political stage.

(3) *Sectors*. Here is the sector performance derby since the start of the bull market through yesterday's close: Consumer Discretionary (452.1%), Financials (398.9), Information Technology (349.4), Real Estate (345.2), Industrials (331.6), S&P 500 (254.2), Health Care (244.9), Materials (207.0), Consumer Staples (184.3), Utilities (127.6), Telecommunication Services (93.6), and Energy (70.6) (*Fig. 6*).

Here is the performance derby ytd: Information Technology (11.0), Health Care (9.6), Financials (8.1), Consumer Discretionary (7.1), Materials (7.0), S&P 500 (7.0), Consumer Staples (6.8), Industrials (6.5), Utilities (4.9), Real Estate (4.0), Telecommunication Services (-3.4), and Energy (-4.3) (*Fig. 7*).

(4) *Fundamentals.* Yesterday's rally was impressive, and certainly provided a vote of confidence in the President's economic agenda. That vote was merited by yesterday's M-PMI, which jumped to 57.7 during February, up from 56.0 during January and 52.0 during October, before the presidential election (*Fig. 8*). Debbie and I aren't surprised, as we've been regularly updating the surge in the Fed's regional business composite indicators since Election Day through last month (*Fig. 9*). Particularly impressive is the jump in the M-PMI new orders component to 65.1, the highest reading since the end of 2013. Indeed, its rebound in recent months is similar to what happens during the initial recovery out of a recession!

Also yesterday, we learned that construction spending weakened during January, led by declines of 5.0% m/m and 9.0% y/y in public construction spending (*Fig. 10*). There is no hint in this data series that the Obama administration's American Recovery and Reinvestment Act of 2009 program boosted such spending at all. Hopefully, the new administration's wheeler-dealers will devise a creative way to finance $1 trillion of public spending over the next 10 years by providing major incentives for the private sector to finance and build public works.

(5) *Sentiment.* The Bull-Bear Ratio compiled by Investors Intelligence rose to 3.82 this week, as Debbie discusses below (*Fig. 11*). That's the highest since April 2015. Of course, if we all start celebrating the stock market melt-up, the contrarian killjoys will say that such events are usually followed by a meltdown. They'll observe that just because Trump was kinder, gentler, and more presidential for one night doesn't mean that he won't quickly revert to being a bully, though the stock market bull hasn't objected so far.

In any event, the hard work is still ahead, i.e., getting the bullish part of the Trump agenda passed by Congress while blocking the bearish parts that have to do with protectionism. Below, Jackie updates us on the border adjustment tax, and Melissa reminds us that even with it, Trump's tax reform agenda isn't revenue-neutral. It's shaping up as a guns-and-butter program. That should be bullish, until it revives inflation and pushes up interest rates to levels that cause the next recession.

For now, there are lots of dancing bulls, and we are dancing with them. On a note of caution, let's recall the infamous last words of former Citi CEO Charles ("Chuck") Prince. In July 2007, Prince told the *FT* that global liquidity was enormous and only a significant disruptive event could create difficulty in the leveraged buyout market. "As long as the music is playing, you've got to get up and dance. We're still dancing," he said. On November 4, 2007, he retired from both his chairman and chief executive positions due to unexpectedly poor Q3 results, mainly attributed to CDO- and MBS-related losses.

Strategy II: Border War? Those looking to President Donald Trump's speech to Congress for nitty-gritty details on his plans to amend corporate tax policy were only given small crumbs of information about where he's heading on the major issue. While he did not formally endorse House Speaker Paul Ryan's border adjustment tax (BAT) proposal, he did seem favorably disposed toward it. According to the *WSJ* transcript of the speech, he said:

"We must create a level playing field for American companies and workers. Currently, when we ship products out of America, many other countries make us pay very high tariffs and taxes—but when foreign companies ship their products into America, we charge them almost nothing."

He went on to cite a conversation that he had with Harley Davidson executives. Harley execs told

Trump that it "is very hard to do business with other countries because they tax our goods at such a high rate. … [The Harley executives] weren't even asking for change. But I am. I believe strongly in free trade, but it also has to be FAIR TRADE. … I am not going to let America and its great companies and workers be taken advantage of anymore."

While that's not an official endorsement of Ryan's border tax proposal, it seemed pretty darn close. However, on Wednesday morning, US Commerce Secretary Wilbur Ross said Trump's speech was not an endorsement of the BAT system. Trump "was merely pointing out an export inequity between the United States and many other countries, not specifying how it should be remedied," according to a 3/1 Reuters article quoting Ross.

Nonetheless, to our ears, Trump's speech appeared to mark a major change in tone from earlier this year when he called the BAT "too complicated." Perhaps the tone change reflects top Trump strategist Steve Bannon's embrace of BAT. Bannon was an "enthusiastic backer" of the plan in a handful of White House meetings, according to a 2/28 Bloomberg article. He's not alone: "Inside the administration, the proposed tax has several backers, including Stephen Miller, a senior Trump policy aide; Chief of Staff Reince Priebus, a longtime Ryan ally; newly confirmed Commerce Secretary Wilbur Ross; and trade adviser Peter Navarro, according to a senior administration official. Jared Kushner, a senior adviser and Trump's son-in-law, is said to be open to the proposal but hasn't made up his mind." Standing against the BAT plan are National Economic Council Director Gary Cohn and Treasury Secretary Steve Mnuchin.

In addition to cutting taxes, Trump also has promised to drain the swamp that is Washington. However, the battle royal that's shaping up over the BAT issue is manna from heaven for Washington's swamp people, the lobbyists representing companies on both sides of the tax proposal.

On one side, there are lobbyists representing US importers. If the tax proposal is passed, those companies will no longer be able to deduct imported goods from their revenues when calculating taxable income. The result would be much higher tax bills. Rooting for the BAT proposal are exporters who, for the first time, will be able to sell their goods abroad without paying US tax. Here's a look at how the two sides are shaping up:

(1) *Rioting retailers*. As if Amazon wasn't enough to worry about, US retailers now face the possibility of paying much higher taxes under the BAT proposal, and they're not gonna take it lying down. They've formed a lobbying group called "Americans for Affordable Products." They claim that necessities, like food, clothing, prescription drugs, and gasoline, would cost consumers $1 trillion more over 10 years and could eliminate 42 million American jobs. Their website claims that the new tax "on consumers will pay for corporate tax cuts so huge that some profitable companies pay nothing at all."

Members of the group are a who's who of retailing including Abercrombie & Fitch, AutoZone, Association of Global Automakers, Best Buy, Costco, Dick's Sporting Goods, Dollar General, the Fashion Jewelry and Accessories Trade Association, Florida Grocers Association, Home Furnishings Association, Lord & Tayler, Michaels Stores, National Association of Beverage Importers and Chain Drug Stores and Music Merchants, National Truck Stop Operators, Nike, Petco Animal Supplies, QVC, Tea Association of the USA, Toy Industry Association, Toyota Motor North America, Walmart, and Xerox, just to name a few.

If those names are not large enough to capture your attention, the deep pockets of the Koch family should. Charles and David Koch, who did not support Trump for president, are lobbying against the BAT via Americans for Prosperity, their conservative political advocacy group. A 1/27 letter from the group to Speaker Ryan noted that the proposed tax essentially would be a tax hike on consumers and would amount to picking winners and losers in the marketplace; the letter questioned whether the dollar would adjust to offset the increased expense of importing goods.

With the Koch brothers behind them, Americans for Prosperity can put its money where its mouth is. "Looking toward the 2018 congressional and gubernatorial elections, AFP officials said they planned to boost the network's spending on policy and political activities to between $300 million and $400 million, up from an estimated $250 million for the 2016 campaigns," noted a 1/30 *Fortune* article.

(2) *Splitting energy industry*. The BAT seems to be dividing the oil industry into two factions. Retail gasoline sellers, including the Society of Independent Gasoline Marketers of America, are against the proposal because the BAT would hit imported crude oil. "The API and the American Fuel and Petrochemical Manufacturers have both concluded in internal reports that a border adjustment would raise gasoline prices by 20 cents a gallon or more in the short term, according to people familiar with the matter," a 2/23 *WSJ* article reported. The article also noted that a Barclays PLC analyst note in January said that the tax could cost a family an additional $400 a year in gasoline costs as refiners pushed increased costs onto consumers.

However, domestic drillers of oil and gas stand to benefit from the BAT, especially if they export their energy. Likewise, refiners with access to domestically produced oil, like Valero Energy, stand to benefit or at least not be harmed.

(3) *Exciting exporters.* Rooting for the BAT are US companies that produce their goods in America and export them. A number of such companies have banded together and formed the American Made Coalition. The coalition says it's for the border adjustment of taxes in order to level "the playing field for American-made goods and services and encourag[e] American jobs, investment and manufacturing," according to its website.

Its list of members is smaller than the group representing retailers, but the companies appear to be larger and perhaps healthier. Members include Boeing, Caterpillar, Dow Chemical, Eli Lilly, GE, Honeywell, J&J, Merck, Oracle, Pfizer, Qualcomm, Raytheon, United Technologies, along with others. They too sent a letter to Congress; their letter supporting the BAT was signed by the CEOs of some of its members, including GE CEO Jeffrey Immelt.

There's also the Alliance for Competitive Taxation, which has some of the same members as the American Made Coalition and some new faces as well. Members include Alcoa, Bank of America, Coca-Cola, Emerson Electric, Google, IBM, General Mills, JP Morgan Chase, Morgan Stanley, McCormick, PepsiCo, Procter & Gamble, 3M, Disney, and Verizon. The group's economic advisers are Douglas Holtz-Eakin, formerly a commissioner on Congress's Financial Crisis Inquiry Commission, and Laura Tyson, an economist who served in the Obama and Clinton administrations.

Their mission: "The Alliance for Competitive Taxation (ACT) supports comprehensive tax reform that lowers the corporate tax rate and establishes a modern globally competitive tax system that aligns the United States with the rest of the world. We believe tax reform should simplify the tax code, promote economic growth and be revenue neutral." The group hopes that the revised tax code will end special interest corporate tax breaks and preferences. The swamp is looking awfully crowded.

(4) *Slicing and dicing.* Putting aside the debate over BAT for a moment, let's put the dollars raised by the tax into context with the rest of the possible tax plan. According to Tax Policy Center (TPC) estimates on the elements of the GOP's "A Better Way" plan, BAT would generate $1.180 trillion in net tax revenue for the government over the next 10 years (see Table 2 on page 9 of the TPC's GOP plan analysis). That's a significant figure, especially in relation to the GOP tax plan's bottom line. But it's not

enough to fund the proposed tax cuts for individuals and corporations under either Trump's proposal, which still excludes BAT, or the GOP's plan that originated BAT.

President Trump's tax cuts probably won't be as big as GOP candidate Trump's proposals. However, even if the administration's upcoming plan mirrors more closely the GOP's plan, it still probably won't achieve revenue neutrality, according to the TPC's analysis. That's even if it includes BAT, even after taking into account the elimination of other deductions and closed loopholes, and even accounting for the macroeconomic growth effects from the expected tax cuts over the next 10 years.

All included, the GOP plan would cost about $3 trillion in lost tax revenues, while Trump's campaign proposal would cost about twice that, at $6 trillion over 10 years. TPC notes: "The revenue losses understate the effect on the national debt because they exclude the additional interest that would accrue because of increased debt." Nevertheless, the TPC's growth estimates are highly conservative. We expect the GOP to sell their combined tax plan to Congress with a forecast of much higher growth estimates, as Treasury Secretary Steven Mnuchin suggested in a 2/23 interview on CNBC. For more, see our 2/23 *Morning Briefing*.

CALENDARS

US. Thurs: Jobless Claims 245k, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** ISM NM-PMI 56.5, Baker-Hughes Rig Count, Yellen, Fischer, Evans. (Bloomberg estimates)

Global. Thurs: Eurozone Headline & Core CPI Flash Estimate 1.9%/0.9% y/y, Eurozone Unemployment Rate 9.6%, Canada GDP 2.0%q/q/1.7%y/y, Japan Headline, Core, and Core-Core CPI 0.4%/0.0%/0.2% y/y, Japan Jobless Rate 3.0%. **Fri:** Eurozone Retail Sales 0.3%m/m/1.5%y/y, Eurozone, Germany, France, and Italy Composite PMIs 56.0/56.1/56.2/53.1, Eurozone, Germany, France, and Italy NM-PMIs 55.6/54.4/56.7/52.8, UK Composite % NM-PMIs 55.6/54.0, Italy GDP 1.1% q/q, China & Japan Composite & NM-PMIs. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) rebounded to 3.82 this week—the highest since late April 2015—after slipping the prior two weeks from 3.75 to 3.50. It's the twelfth straight week above 3.00. Bullish sentiment (63.1%) jumped to its highest reading since 1987 after retreating the previous two weeks from 62.7% to 61.2%. It was the fifth consecutive reading above 60.0%. Bearish sentiment dipped for the second week from 17.6% to 16.5%—the fewest bears since July 2015. The correction count sank from 21.3% to 20.4% this week, the lowest since June 2014. The AAII Bull Ratio climbed to 54.3% last week after declining from 56.4% to 50.6% the previous week. Bullish sentiment rose from 33.1% to 38.5%, while bearish sentiment was little changed at 32.3%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues and earnings edged down slightly w/w and are down from record highs in the past few weeks. The forward profit margin forecast was 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 rose to 5.6% from 5.5%. That compares to 5.8% in late January, which was the highest since May 2012 and up from a seven-month low of 2.7% in late February 2016. Forward earnings growth improved to 10.6% from 10.5%, but 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 rose to a 13-year high of 17.9 from 17.8, which 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 7.4%, 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 and earnings forecasts rose last week for 5/11 sectors. Consumer Discretionary, Financials, and Industrials were the only sectors with both rising w/w. Consumer Staples, Health Care, Materials, and Real Estate had both fall 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 and P/E ratios rose for 10/11 sectors (all but Energy). Industrials' P/E of 18.3 is at a 12-year high, and Tech's 17.9 is the highest since 2007. Excluding Real Estate, Financials' P/E is up from 12.0 before the election to a seven-year high of 14.4. Consumer Discretionary's P/E of 19.2 is up from a three-year low of 15.7 a year ago and slightly below February 2015's six-year high of 19.3. Health Care's P/E of 15.5 and P/S of 1.64 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 1.37 compares to a record high of 1.56 in early May, and its P/E of 28.1 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016, but margins 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 19.4% in 2016), Real Estate (16.2, 25.9), Financials (15.9, 14.6), Telecom (10.9, 10.8), Utilities (10.8, 11.3), S&P 500 (10.6, 10.2), Health Care (10.6, 10.5), Materials (10.1, 9.4), Industrials (9.0, 8.9), Consumer Discretionary (7.5, 7.3), Consumer Staples (6.8, 6.6), and Energy (4.6, 1.2).

US ECONOMIC INDICATORS

Personal Income & Consumption (*link*): Real consumer spending in January contracted for the first time in five months after reaching a new record high in December. Spending began the year on down note, dipping 0.3%, after a four-month gain of 1.2%, as real durable goods (-0.8%) and services (-0.2) consumption fell and nondurable goods spending was flat. Over the three months through January, real personal consumption expenditures expanded 2.5% (saar), based on the three-month average, down from a recent peak of 4.2% in June. Over the comparable period, growth rates in real spending on durable (8.4%) and nondurable (2.3) goods consumption were in line with prior readings, while services (1.6) consumption was half the recent peak of 3.3% last August and the weakest since spring 2014. While income growth has slowed in recent months, solid gains in employment along with rising wages should continue to support robust spending.

Construction Spending (*link*): After hitting its best level since April 2006 in December, construction spending retreated in January, pushed lower by the third straight decline in public construction spending. Total spending dipped 1.0% after climbing eight of the prior nine months by a total of 4.3%. Public construction spending fell 5.0% in January, following declines of 1.4% and 0.3% the prior two months. Private construction spending continued to increase, rising for the ninth time in 10 months, by 6.7%, to a new cyclical high. Residential investment advanced for the fourth straight month, up 0.5% m/m and 5.6% over the period to a new cyclical high; nonresidential investment was stalled at its record high after rising seven of the prior eight months by 6.4%. Within residential investment, single-family investment rose for the fourth month, by 7.2% to a new cyclical high, while multi-family investment increased five of the past six months by 6.4% to a new record high. Home improvement spending slipped 1.0% in January after a three-month jump of 5.1% to a new record high. Within nonresidential investment, spending on office, educational, amusement & recreation, and commercial structures remained on uptrends, though looking toppy; lodging remained stalled around recent highs.

Motor Vehicle Sales (*link*): Motor vehicle sales were stalled in February, within 4.6% of December's cyclical high. Total sales were unchanged at 17.6mu (saar) after falling in January from the cyclical high of 18.4mu at the end of last year—which was the best sales pace since July 2005. Domestic light truck sales returned to December's cyclical high of 9.3mu (saar) last month, while domestic car sales remained at January's five-year low of 4.7mu. Import sales edged lower for the second month to 3.6mu (saar) from their cyclical high of 3.9mu in December.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs (*link*): Global manufacturing activity in February expanded at its fastest pace in 69 months and business confidence improved. The JP Morgan M-PMI climbed to 52.9 (highest since May 2011) from 52.7 the previous two months. Output (to 54.1 from 53.6), new orders (54.1 from 54.0), new export orders (52.8 from 52.2), and employment (51.7 from 51.3) all accelerated during the month. Manufacturing in developed nations (54.1 from 54.2) fared better than emerging (51.3 from 50.8) ones, though the latter's showed activity accelerating slightly last month. In developed nations, the M-PMI in the Eurozone (55.4 from 55.2) hit a 70-month high, while Japan's (53.3 from 52.7) reached a 35-month high, offsetting mild decelerations in the UK (54.6 from 55.7) and US (54.2 from 55.0) M-PMIs. In the emerging economies, manufacturing activity accelerated in the Czech Republic (57.6 from 55.7), Vietnam (54.2 from 51.9), China (51.7 from 51.0), and India (50.7 from 50.4).

US Manufacturing PMIs (*link*): Manufacturing activity in February grew at its fastest pace in 30 months according to the ISM survey, and expanded at a robust, though slightly slower pace than in January, according to Markit's. ISM's M-PMI increased for the sixth month from 49.4 in August to 57.7 last month, the highest since August 2014. The new orders (to 65.1 from 60.4) and production (62.9 to 61.4) gauges moved further above 60.0, with the former the highest since December 2013 and the latter the best since March 2011. The employment index was in expansionary territory for the fifth month, though slipped to 54.2 last month from January's 29-month high of 56.1; it contracted for seven of the first eight months of last year. The remaining two components that compose the M-PMI show supplier deliveries (54.8 from 53.6) were faster, while inventories (51.5 from 48.5) expanded for the first time since June 2015. Markit's M-PMI retreated slightly to 54.2 in February from 55.0 in January, which was the highest reading since March 2015. According to the report, February's slowing reflected a moderation in new orders growth from January's 28-month peak, as well as a slightly softer advance in output volumes; meanwhile, manufacturers reported a sustained rise in inventory levels. Factories continued to add jobs, though the rate of job creation was softer than the 18-month peak at the end of 2016.

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor & Webmaster, 570-775-6823