MORNING BRIEFING
March 16, 2017

Driverless

See the collection of the individual charts linked below.

(1) Tech leads ytd performance derby among S&P 500 sectors. (2) Kudos to Health Care for coming in second despite Obamacare R&R commotion. (3) Homebuilders help to put Consumer Discretionary in third place despite retailers' troubles. (4) The race to tech out cars pits Detroit against Silicon Valley. (5) But don't expect Detroit's economics to shift into higher margin & growth gears enjoyed by tech titans. (6) As tech firms make inroads into auto markets, Big Brother will be watching and driving.

Sector Focus I: What's Hot & What's Not. Never doubt that an apple a day is good for you. Investors betting that an iPhone upgrade cycle will boost Apple's bottom line have sent its stock climbing 20.0% ytd through Tuesday's close. Its strong start to the year has helped the Tech sector gain 10.9% ytd, making it the top-performing sector of the 11 S&P 500 sectors. The Tech sector is trouncing the 5.7% return of the S&P 500, while the worst-performing sector of the index is Energy, with a 9.0% decline ytd.

Apple accounts for about a third of the Tech sector's ytd gain, Joe calculates. Without Apple, the Tech sector's ytd return would be 7.5%, still besting the S&P 500. The company has also helped the Technology Hardware, Storage & Peripherals industry increase 18.3% ytd. Other industries boosting the Tech sector include Home Entertainment Software, which is the top-performing S&P 500 industry ytd with a 25.9% gain, Semiconductor Equipment (17.7%), and Application Software (16.8), which are in sixth and eighth places among the 100-plus industries we monitor (*Fig. 1* and *Table*).

Here's the performance derby for the S&P 500 sectors ytd through Tuesday: Tech (10.9%), Health Care (9.4), Consumer Discretionary (6.7), Financials (6.2), Consumer Staples (5.9), S&P 500 (5.7), Utilities (4.3), Materials (4.0), Industrials (3.7), Real Estate (-0.6), Telecom Services (-4.0), and Energy (-9.0) (*Fig. 2*). Let's take a look at what's driving performance in some of the other sectors before returning to Tech:

(1) *Drugs on a high*. The market-beating performance of Health Care (9.4%) is admirable given the uncertainty about the potential repeal and replacement (R&R) of Obamacare and the hostile tweets about drug pricing from President Trump. Indeed, Pharma, Biotech, and Managed Care are up 7.6%, 9.1%, 8.5% ytd, respectively (*Fig. 3*).

(2) *Houses beating malls.* Likewise, the Consumer Discretionary sector has overcome the terrible performance of Department Stores (-14.5%), General Merchandise Stores (-14.0), and Apparel, Accessories & Luxury goods (-6.3). The sector's above-average performance ytd is thanks to Homebuilding (21.7), Casinos & Gaming (21.0), Tires & Rubber (17.9), and Auto Parts & Equipment (16.9), which were the second, third, fifth, and seventh best-performing of the industries we track in the S&P 500 (*Fig. 4* and *Fig. 5*).

(3) *Rising rates bifurcating returns*. The specter of higher interest rates may be broadening to affect industries beyond the obvious Financials industries, which benefit from a steeping yield curve. For example, the Materials sector is underperforming despite the recent string of solid economic reports.

Among its worst-performing industries are Copper (-7.0%), Construction Materials (-5.2), and Gold (-4.9). The price of gold is inversely correlated with the 10-year TIPS yield, which has been moving higher recently (*Fig. 6*). In addition, commodity-related industries may be pricing in a strengthening US dollar in anticipation of further interest-rate increases by the Fed (*Fig. 7*). Conversely, the potential for higher rates has helped Financials, as we've expected, with Diversified Banks (7.6) and Investment Banking & Brokerage (6.2) leading the way (*Fig. 8*).

Higher interest rates undoubtedly are weighing on returns in the Real Estate and Telecom Services sectors. However, rates have had less of an impact on the Consumer Staples sector, which includes many stocks that pay a nice dividend and were being used by investors as bond alternatives. The sector has performed well thanks to M&A activity. Kraft Heinz announced and withdrew a $143 billion offer for Unilever PLC in February, leaving investors in other companies in the sector hoping that Kraft would satiate its hunger for acquisitions by buying a US consumer goods company. It was also revealed that shareholder activist Trian Fund Management had invested more than $3 billion in Procter & Gamble. The news lit a fire under Household Products (10.4%) and Personal Products (8.3) (*Fig. 9*).

(4) *Transports heading in different directions.* One area to keep an eye on: Transports. It's odd that they're trailing the market, having risen only 1.7% ytd, even though lower oil prices should be acting as a tailwind. Declining have been Airlines (-3.4% ytd), Air Freight & Logistics (-1.9), and Trucking (-1.8). Only Railroads continues to chug along, having climbed 9.3% ytd (*Fig. 10*).

Sector Focus II: Technology's Amazing Race. President Donald Trump met with the automakers in Detroit yesterday, the same day the EPA reopened a review of tougher emissions targets and fuel mileage requirements established at the end of the Obama administration. One industry estimate put the cost of meeting those standards at $200 billion. So lowering the bar would be a nice carrot to throw the auto industry while the administration continues to consider taxing Mexican imports, including low-priced vehicles made over there by American automakers.

Meanwhile, auto manufacturers and suppliers are investing in developing autonomous cars. They know the competition is heating up as the titans of Silicon Valley are throwing tons of money at the area. Earlier this week, Intel was the latest to put the pedal to the metal with its $15.3 billion acquisition of Mobileye NV, the Israeli company that makes cameras used to guide autonomous cars, and warn you when you are about to change lanes into another vehicle. The deal follows Qualcomm's $39 billion deal to buy NXP Semiconductors, which makes chips to handle functions like braking and fuel injection, and Samsung Electronics' $8 billion acquisition of Harman International Industries, which makes sound systems for cars.

At the same time, auto manufacturers are making their own acquisitions to stay in the race. GM paid $1 billion for Cruise Automation, Uber bought Ottomotto for $680 billion, and Ford spent $1 billion for a majority stake in Argo AI. That's in addition to the money being spent by new industry upstarts like Tesla and Waymo (the Google unit) on developing the technology.

The raft of deals did get us thinking, however, about the economics of car-making. Auto manufacturing is a highly competitive, cyclical business. Although it's enjoying good times today, history is littered with the bankruptcies of automakers that have not successfully navigated downturns. It was only eight years ago that General Motors filed for Chapter 11 bankruptcy protection.

Analysts estimate that Auto Manufacturers will have relatively low forward profit margins of 5.1%, and a decline over the next 12 months in both revenues (-0.4%) and earnings (-2.2) (*Fig. 11*). The Auto Parts and Equipment industry is slightly more attractive. Analysts forecast a forward profit margin of 9.8%, with revenue and earnings growth rates of 1.5% and 5.4%, respectively. Investors have bestowed below-market multiples on both industries: a 6.8 forward P/E on the Auto Manufacturers and an 11.6 multiple on the Auto Parts industry.

Compare that to the Semiconductors industry, which is also cyclical. Analysts expect the Semiconductor industry to produce 6.2% revenue growth, 10.9% earnings growth, and a forward profit margin of 24.8%. Those more attractive economics have earned the industry a forward P/E of 14.9. The economics at companies like Google and Apple are even more attractive.

Will adding self-driving capabilities make the auto industry's economics more attractive and tech-like? Our guess is no. The pricing for autonomous capability is coming down rapidly, and the feature will become expected by drivers over time, just as navigation is today and a sunroof was 20 years ago.

Alphabet's Waymo division has reduced the cost of lidar (the lasers that help cars "see") by 90% to roughly $7,500 from $75,000 a few years ago. Tesla Motors plans to charge buyers $8,000 to activate the autonomous driving technology in its newest cars. That price tag does not include the equipment needed for an autonomous car, which is put into all Tesla cars today, before the buyer indicates an intention to activate the software or not. The equipment consists of eight cameras, radar, ultrasonic sensors, and a supercomputer, according to a 10/20 article on electrek.co.

The price of autonomous driving systems must continue to come down if mass adoption is the goal. The $8,000 price tag might not be a stretch for consumers who can afford Tesla's high-end models starting at $66,000. However, the $8,000 may be a tougher swallow for the customer buying Tesla's low-end $35,000 model, especially since the company doesn't yet have regulatory approval to let its cars drive autonomously. Tesla suggests owners can pay for the cost of the software by having their cars join the Tesla Network, a fleet of ride-sharing cars that will compete with Uber and Lyft. More details on the project are expected this year.

The US consumer already seems to be stretching to buy a car. Motor vehicle loans have risen 59% since the recent low during Q3-2010 to an all-time high of $1.1 trillion at the end of last year (*Fig. 12*). The average maturity of new car loans has increased from 59.5 months in March 2009 to 66.5 months in December 2016, according to data from the St. Louis Federal Reserve. And car loans delinquent by 30 days or more grew to $23.3 billion, the most since $23.5 billion in Q3-2008, during the recession, according to data from the New York Fed.

It's clear why Intel would want to expand into the auto industry. Its core PC business is in decline. "Intel, which faces a raft of challenges in its core business of powering the personal-computer industry, estimates the market for autonomous-driving systems, services and data will reach $70 billion by 2030. That includes navigation, in-car communications and advertising—and keeping a car's perception and decision-making capabilities finely tuned to avoid mishaps as road conditions change," noted a 3/13 *WSJ* article.

No doubt the revenues involved will be large if these systems achieve mass adoption. The tougher question is whether profit margins on these new products will look like tech industry margins or auto industry margins? The answer may determine whether shareholders will be happy about tech companies' diversification efforts.

Certainly, the CIA should be pleased about the advancements in car technology. Stephen Soukup and Mark Melcher, our friends at The Political Forum, recently noted that documents disclosed by WikiLeaks revealed that the CIA can use most web-connected devices to further its spying ambitions. It can tap into TVs, computers … and cars. The CIA supposedly has the ability to know where your car is headed, and it may be able to control the vehicle and cause it to crash. Driving with a roadmap and listening to a push-button AM/FM radio might be a safer way to travel.

CALENDARS

US. Thurs: Jobless Claims 240k, JOLTS, Housing Starts & Building Permits 1.270mu/1.267mu, Philadelphia Fed Manufacturing Index 30.0, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Headline & Manufacturing Industrial Production 0.2%/0.4%, Capacity Utilization Rate 75.4%, Leading Indicators 0.4%, Consumer Sentiment Index 97.2, Atlanta Fed Business Inflation Expectations, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. Thurs: Eurozone Headline & Core CPI 2.0%/0.9% y/y, Eurozone Car Sales, Japan Machine Tool Orders, Australia Employment Change & Unemployment Rate 16.5k/5.7%, BOE Rate Decision & Asset Target Rate 0.25%/435b, BOJ Policy Balance Rate & 10-Year Yield Target Rate. **Fri:** Eurozone Trade Balance (euros) 22.0b. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues and earnings rose slightly w/w to fresh record highs. 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 was steady w/w at 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 was steady at 10.6%, 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 dropped to 17.8 from a 13-year high of 18.0, 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 are lower at 4.1% 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 5/11 sectors, and forward earnings rose for 4/11. Financials, Materials, and Tech saw both measures improve 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. Although forward P/S and P/E ratios declined w/w for all 11 sectors, most remain near multi-year highs. Financials' P/E is up from 12.0 before the election to 14.3. Health Care's P/E of 15.9 and P/S of 1.68 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 1.32 compares to a record high of 1.56 in May 2016, and its P/E of 26.7 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016 and are expected to improve in 2017 for all but Real Estate and Utilities. However, Real Estate's forecasted margin should improve as the year progresses when gains on property sales are included in the forecasts. Here's how the 11 sectors rank based on their current 2017 forecasts: Information Technology (to 19.9% in 2017 from 19.4% in 2016), Real Estate (16.2, 25.5), Financials (15.9, 14.5), Telecom (10.9, 10.8), Utilities (10.8, 11.4), S&P 500 (10.6, 10.2), Health Care (10.5, 10.4), Materials (10.0, 9.4), Industrials (9.0, 8.9), Consumer Discretionary (7.4, 7.3), Consumer Staples (6.8, 6.6), and Energy (4.5, 1.1).

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) sank to

3.05 this week from 3.82 two weeks ago, which was the highest reading since April 2015. It's the 14th straight week above 3.00. Bullish sentiment retreated 9.7ppts the past two weeks to 53.4% from 63.1% (which was the most bulls since 1987), with nearly all moving to the correction camp (to 29.1% from 20.4%). Bearish sentiment edged up for the second week to 17.5% from 16.5%, which was the fewest bears since July 2015. The AAII Bull Ratio dropped for the second week this week from 54.3% to 39.2% over the period, as bullish sentiment fell from 38.5% to 30.0% and bearish sentiment rose from 32.3% to 46.5%.

US ECONOMIC INDICATORS

Retail Sales (*link*): Delayed tax refunds for millions of Americans likely depressed retail sales in February. Our Earned Income Proxy, which tracks retail sales closely, continues to set new record highs and suggests more robust sales growth once the government catches up on the release of 2016 tax refunds. Headline sales edged up only 0.1% last month, though January's 0.6% gain was stronger than the preliminary estimate of 0.4%. Core retail sales—which excludes autos, gasoline, building materials, and food services—also edged up 0.1%, while its revised 0.8% increase in January was double the initial estimate. (BEA uses this core retail sales measure to estimate personal consumption expenditures each month.) Eight of the 13 major nominal retails sales categories fell last month, four rose, while sales at food & beverage stores were unchanged. On the plus side, retailers of building materials (1.8%), nonstore retailers (1.2), and furniture (0.7) and health & personal care (0.7) retailers all recorded solid gains; decliners were led by electronic stores (-2.8), miscellaneous store retailers (-0.8), gasoline stations (-0.6), clothing stores (-0.5), and sporting goods stores (-0.4). Meanwhile, we estimate that real core retail sales advanced 0.3% in February after a 0.3% loss and a 0.1% gain the previous two months. These sales were basically flat during the three months through February, based on the three-month average, slipping 0.1% (saar). Real headline retail sales expanded 2.8% (saar) over the comparable period, the slowest since summer 2015.

Business Sales & Inventories (*link*): Nominal business sales in January climbed to a new record high; December real sales continued to set new record highs, jumping sharply at the end of last year. The details: Nominal manufacturing & trade sales (MTS) advanced for the tenth time in 11 months, by 0.2% in January and 6.6% over the period; prior to last March's increase, these sales hadn't posted a gain since June 2015. Inflation-adjusted MTS rose for the seventh straight month, jumping by 1.5% in December and 3.8% over the period. Real sales of retailers and wholesalers hit new record highs in December; manufacturers' sales showed signs of life, jumping 2.3% in the two months ending December to a new cyclical high. December's real inventories-to-sales ratio dropped to 1.14—the lowest since January 2015—from 1.45 in May, which was its highest since July 2009. January's nominal inventories-to-sales ratio held at a two-year low of 1.35; it had peaked at 1.41 during the first three months of 2016.

Regional M-PMI (*link*): The New York Fed district, the first to report on manufacturing activity for this month, indicates that business activity has continued to expand robustly since the election. The composite index dipped to 16.4 from February's 18.7—which was the highest since September 2014—though is up 21.9 points since October's -5.5. The new orders index jumped to 21.3 this month, the highest since April 2010, up from -3.1 in October. Labor market indicators continued to point to increases in both employment and hours worked. From October through March, the employment measure jumped 13.5 points to 8.8 (highest since April 2015), while the hours worked gauge was 25.4 points higher at 15.0 (highest since March 2012). Measures for unfilled orders (14.2) and delivery times (10.6) were the highest since March 2006 and May 2004, respectively; both were in negative territory in October. The shipments index fell 6.9 points this month to 11.3, but remained 8.5 points above October's 2.8.

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