MORNING BRIEFING
April 6, 2017

The Shark & the Octopus

See the collection of the individual charts linked below.

(1) Tesla worth more than Ford? (2) Elon's stormy-weather tweet. (3) Tesla cruising along. (4) The auto mechanic will make house calls for electric cars. (5) Low P/Es for clunkers. (6) Amazon recruiting consumer staples companies to sell door to door. (7) Online sales almost 30% of GAFO. (8) Can Amazon improve on home-improvement retailers?

Autos Focus: Speeding & Stalling. Doesn't Elon know it's not nice to gloat? Earlier this week, as Tesla's market cap drove past Ford's, Elon Musk tweeted, "Stormy weather in Shortville … " Tesla and Amazon have been taunting short-sellers and the traditional players in their respective industries all year. Tesla may have losses and negative cash flow, but its shares closed above $300 on Tuesday before retreating yesterday. Meanwhile, Amazon, with a market cap that long ago surpassed Macy's, is charging ahead with its expansion while traditional retailers retrench. This week, it was Ralph Lauren's turn: It's shuttering its flagship Fifth Avenue store.

Both Amazon and Tesla are using the Internet to radically change the way business is done in the retailing and auto industries, displacing many traditional businesses—and their employees—along the way. Amazon's most recent moves imply that it has Walmart, Target, Kmart, and grocers directly in its sights. Tesla, meanwhile, aims to use the Internet to sell cars with engines that are so much simpler than the combustion engine that the company will send a technician to your home or office to do repairs. Tesla's operation is certainly at a much younger stage than Amazon is, but if Tesla is successful and copied by others, this new model for selling and servicing cars could provide a sharp challenge to the thousands of car dealerships and auto mechanics, to say nothing of the auto manufacturers.

We took a look at the retail and auto industries last week in the 3/30 *Morning Briefing*. But the ensuing week has been so chock-full of news in the two areas that Jackie and I decided to dive in again and look at the industries' financial metrics as well. Here's the latest:

(1) *Electrifying performance*. Last week, the traditional auto industry hit a big pothole while Tesla got a green light. On Sunday, Tesla reported that global sales rose 69% in Q1 to 25,148 cars, which puts the company on a path to meet its goal of delivering 50,000 cars in the first half. That followed another dose of good news: Tencent Holdings, China's most valuable company, bought a 5% stake in Tesla.

"The $1.8 billion investment marks a vote of confidence in Tesla Chief Executive Elon Musk, who is facing questions about whether he can meet his ambitious goals of delivering the $35,000 Model 3 sedan on time later this year and at the scale he has projected," the 3/29 *WSJ* reported. Tesla is expected to begin production of the Model 3 sedan in July and produce 5,000 vehicles a week in Q4. Next year, Tesla expects sales of its three models will total 500,000 vehicles.

Tesla's shares have soared 42.1% from the start of this year through Tuesday's close, even though the company recently sold $250 million of common stock and $750 million of convertible notes. Compare that to Ford stock's 6.3% decline, GM's 1.6% decline, and the 5.4% gain in the S&P 500 over the same period.

(2) *Shifting into lower gear*. As Debbie reviewed yesterday, motor vehicle sales in March dropped to 16.6mu (saar), the lowest since February 2015 and down from 18.4mu in December. Most of the drop occurred in the sale of cars, which at a 4.6mu (saar) rate in March has been in decline since the August 2014 peak of 6.1mu. Light truck sales remain at very high levels, easing to 8.7mu last month, not far from December's cyclical high of 9.3mu.

There are a number of reasons to be concerned about the industry beyond the drop in used car prices and the subprime lending spree in recent years that we discussed yesterday. The drop in March auto sales occurred even though "the average sales incentive topped $3,750 in March, or 10.3% of the sticker price, according to research firm J.D. Power. Incentive levels haven't been this high since 2009 when the auto industry was navigating the financial crisis," a 4/3 *WSJ* article reported. The article continued, "Meanwhile, J.D. Power said the number of days a vehicle sat on a dealer lot before being sold hit 70 days in March, the highest level since July 2009."

(3) *The numbers*. The market is starting to discount the dour news from the traditional auto industry. The S&P 500 Automobile Manufacturers index, which represents Ford and GM, peaked in May 1999 and has fallen 75.3% since then through Tuesday's close (*Fig. 1*). The index's forward P/E has fallen to 6.5 (*Fig. 2*). Forward P/Es of cyclical industries often get that low when the market anticipates that an industry is experiencing peak earnings. Indeed, analysts are calling for earnings to fall 3.2% over the next 12 months (*Fig. 3*). If that estimate is accurate, it will mean the industry generated peak earnings in 1998.

Analysts expect the Auto Parts & Equipment industry (BWA and DLPH) to grow earnings 5.4% over the next 12 months, down sharply from expectations for y/y forward earnings growth that topped 10% in the past three years (*Fig. 4*). The industry has an 11.2 forward P/E, which is roughly in the middle of the range it has held for the past 20 years, and the index has climbed 8.4% ytd.

The S&P 500 Automotive Retail stock price index (AAP, AN, AZO, KMX, and ORLY) started this year near its peak and since has fallen 11.6% ytd (*Fig. 5*). Its forward P/E has fallen from almost 20 at the start of the year to 17.4 (*Fig. 6*). This industry is still expected to grow earnings 10.8% over the next 12 months, handsome growth but down from the 14.4% forward earnings growth expected in late 2015 (*Fig. 7*). We'll be keeping an eye on Tesla to see if it manages to change not just how automobiles are powered but also how they are sold and serviced. More pressure could be applied in upcoming years, as the industry is sure to face increasing competition from Amazon, which is selling parts for cars with combustion engines, and from Tesla, which services its own electric cars.

Amazon Focus: More Tentacles. In addition to selling books and auto parts, Amazon sells groceries and appears to be making a concerted effort this year to go toe to toe with giants like Walmart, Target, and your local grocery store. Last week, we discussed two formats it's testing: Amazon Go, where consumers can purchase groceries by using their phone and never waiting on a checkout line, and AmazonFresh Pickup, where consumers can get curb-side pickup.

Were that not enough, a 3/30 Bloomberg article reported that Amazon's hosting a meeting with consumer products companies to discuss how they can start shipping goods directly to consumers. It's every kid's dream: the ability to ask Alexa for a box of Oreos and have it appear at the front door in an hour. "Manufacturers would have to re-imagine everything from the way products are made to how they're packaged. Laundry detergent could come in sturdier, leak-proof containers. Instead of flimsy packages designed to pop on store shelves, cookies, crackers and cereal could be packed in durable, unadorned boxes. Plants could spit out products for individuals rather than trucks-full of inventory." The company declined to comment in the story.

The move is similar to what Costco and the club stores did 20 years ago, Bloomberg explains. Those stores asked merchants to "create bulk sizes sold at a discount" and in return they enjoyed a surge in sales. Now Amazon has the leverage, with 300 million shoppers, and the ability to make its own products to sell to consumers if companies are unwilling to join with it.

Amazon also made news by shelling out about $50 million for the rights to stream 10 Thursday night football games over one year to members of Amazon Prime. That price is a fivefold increase over the NFL's deal with Twitter for the same number of games last season, noted a 4/4 *WSJ* article. The move makes Amazon's Prime the only streaming service offering sports and can't be welcome news for ESPN or the broadcast networks.

The bounty of good news of late has helped propel Amazon's shares 20.9% ytd and 52.9% over the past year through Tuesday's close. The recent surge has made Jeff Bezos the second wealthiest person in the world, behind only Microsoft's Bill Gates, the 3/29 Bloomberg reported. Meanwhile, the Department store industry is the worst performer ytd, down 18.4%. Here's a look at some of the financial metrics driving those diverging stock performances.

(1) *Online sales on fire.* The shift to online continues unabated. Online shopping now accounts for almost a third of in-store and online sales included in GAFO, which stands for general merchandise, apparel and accessories, furniture and other sales (*Fig. 8*). And while sales at department stores, warehouse clubs, and supercenters plateaued last year, online sales climbed 13.2% (*Fig. 9*).

The continued growth in online sales has helped Amazon's stock price and the S&P 500 Internet & Direct Marketing Retail stock price index, which has gained 19.8% ytd through Tuesday's close (*Fig. 10*). The industry index is the seventh-best-performing ytd, and in addition to Amazon counts Netflix, Expedia, Priceline, and TripAdivsor as members. The industry's forward revenues—i.e., those analysts anticipate over the next 12 months—are expected to grow 20.6%, and earnings are thought to improve by 32.6% over the same timeframe (*Fig. 11*). This index isn't cheap, with a forward P/E of 60.2 (*Fig. 12*). But analysts are anticipating extremely strong earnings growth going forward, which would drop the index's P/E on 2018 earnings to 46.8.

(2) *Falling bricks*. Compare that to the S&P 500 Department Stores index, for which revenues over the next 12 months are forecasted to fall 1.2%, while earnings are expected to rise 1.5% (*Fig. 13*). The meager growth has depressed the industry's forward P/E to 10.6, down sharply from roughly 15 in 2015 (*Fig. 14*). The situation is slightly better at Costco and Walmart, which make up the S&P 500 Hypermarkets & Super Centers industry. That industry is expected to produce forward revenue growth of 3.4% and forward earnings growth of 3.4%, and has a forward P/E of 19.5 (*Fig. 15* and *Fig. 16*). Given Amazon's recent initiatives in the grocery aisle, that above-market P/E might be in peril.

(3) *Home improvement next?* The Home Improvement retailers, Home Depot and Lowe's, so far have proved resistant to online competition, but vigilance is warranted. Over the next 12 months, the industry is expected to post revenue growth of 4.7% and earnings growth of 13.0% (*Fig. 17*). Investors have rewarded the S&P 500 Home Improvement Retail industry with a 19.2 forward P/E ratio (*Fig. 18*).

The Home Improvement industry undoubtedly has been helped by the housing recovery, the woes at Sears, and consumers' desire to see items like refrigerators and kitchen cabinets in person before making a purchase. Weekend gardeners still need to make a trip to the stores to buy tulips, and contractors still head to the store for a part instead of holding up a job. Could that change if Amazon figures out how to make last-mile delivery quicker? Absolutely. You can be sure they're working on it.

CALENDARS

US. Thurs: Jobless Claims 250k, Challenger Job-Cut Report, Weekly Consumer Comfort Index, EIA Natural Gas Report. **Fri:** Total & Private Nonfarm Payroll Employment 178k/170k, Unemployment Rate 4.7%, Average Hourly Earnings 0.3%, Average Workweek 34.4hrs, Consumer Credit $15.0b, Wholesale Inventories 0.4%, Baker-Hughes Rig Count, Dudley. (Bloomberg estimates)

Global. Thurs: Germany Factory Orders 3.5%m/m/3.6%y/y, China Composite & NM-PMIs, Draghi. **Fri:** Germany Industrial Production -0.2%m/m/0.6%y/y, Germany Trade Balance (euros) 17b, UK Headline & Manufacturing Industrial Production 3.7%/3.9% y/y, Canada Unemployment Rate 6.7%, Japan Leading & Coincident Indicators, Carney. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) rebounded back above 3.00 this week (to 3.05 from 2.73) after falling below 3.00 last week for the first time since the end of November. Bullish sentiment soared 6.3ppts this week to 55.8%, nearly reversing last week's 7.2ppts slide; five weeks ago, the reading was 63.1%, which was the most bulls since 1987! Nearly all of this week's move to the bulls came from the correction camp, which fell to 25.9% to 32.4%. (Last week, nearly all of the move from the bulls went to the correction camp.) There was another small increase in bearish sentiment from 18.1% to 18.3%, though it was the highest reading since early January. The AAII Bull Ratio sank to 44.7% last week after increasing the prior two weeks from 39.2% to 53.6%. Bullish sentiment fell from 35.3% to 30.2%, while bearish sentiment rose from 30.5% to 37.4%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues edged down 0.1% last week from its prior week record high, but forward earnings improved again to 0.1% below its early March record. The forward profit margin forecast remained steady at 10.7%. That's down from a 16-month high of 10.8% in early March, but remains near the record high of 10.9% in September 2015 and compares to a 24-month low of 10.4% in March 2016. Forward revenue growth for the S&P 500 edged down w/w to 5.5% from 5.6%. 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 10.7%, 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 17.8 from 17.7, which compares to a 13-year high of 18.0 in early March and 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 4.2% and 7.8%, respectively. However, 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 4/11 sectors: Consumer Staples, Financials, Industrials, and Tech. 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. Forward P/S and P/E ratios fell w/w for just 3/11 sectors: Consumer staples, Telecom, and Utilities. All but Health Care remain a hair below their recent multi-year highs. Financials' P/E is up from 12.0 before the election to 13.8, but that's down from a post-election high of 14.6 in early March. Health Care's P/E of 15.8 and P/S of 1.65 are down from early March's 19-month highs of 16.1 and 1.70, respectively, and remain well below their early 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 1.34 compares to a record high of 1.56 in May 2016, and its P/E of 27.5 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 19.2% in 2016), Real Estate (16.2, 25.2), Financials (15.6, 14.4), Telecom (11.3, 11.2), Utilities (10.8, 11.4), S&P 500 (10.5, 10.1), Health Care (10.4, 10.3), Materials (10.1, 9.4), Industrials (9.0, 8.8), Consumer Discretionary (7.3, 7.2), Consumer Staples (6.7, 6.5), and Energy (4.4, 1.1).

US ECONOMIC INDICATORS

ADP Employment (*link*): "Job growth is off to a strong start in 2017. The gains are broad based but most notable in the goods producing side of the economy including construction, manufacturing and mining," according to ADP. Private industries added 263,000 to payrolls in March (93,000 above the expected 170,000 advance), following downwardly revised gains in February (to 245,000 from 298,000) and January (249,000 from 261,000). The 757,000 gain in payrolls during Q1 was the best quarterly performance since Q2-2014, led by service-providing industries (513,000), though the goods-producing tally (244,000) was equally impressive. In March, service-providing industries (181,000) once again accounted for most of the growth, but goods-producing industries (82,000) had another strong showing, with construction (49,000), manufacturing (30,000), and mining (8,000) all in recovery mode. Within service-providing, the biggest job increases last month were recorded in professional & business services (57,000), leisure & hospitality (55,000), and health care/social assistance (46,000). Small businesses returned to the top of the leader board, adding 118,000 jobs—86,000 service-providing and 32,000 goods-producing. Medium-sized companies fell to the number-two spot (after three months at number one), boosting payrolls by 100,000—with the mix 68,000 service-providing and 32,000 goods-producing. Large companies (45,000) remained in the bottom slot; service-providing industries (27,000) continued to post the largest increase, but the gains have slowed steadily since the end of last year, while goods-producing (18,000) advances are accelerating.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (*link*): Global economic activity in March showed some improvement, moving to within a tick of January's 22-month high. The J.P. Morgan Global Composite Output Index climbed to 53.8 after falling from a cyclical high of 53.9 in January to 53.4 in February, as the NM-PMI (to 53.6 from 53.1) showed an acceleration in activity and the M-PMI (53.0) held at February's 69-month high. The expansion was mostly broad-based by nation, though was led by the upturn in the Eurozone (56.4 from 56.0) as Germany (57.1 from 56.1) and France (56.8 from 55.9) showed the fastest growth in 70 months and expansions in Ireland (56.9 from 57.8), Spain (56.8 from 57.0), and Italy (54.2 from 54.8) remained robust. Outside the Eurozone, rates of increase improved in Russia (56.3 from 55.4), the UK (54.9 from 53.8), and Japan (52.9 from 52.2), while slowing a bit in the US (53.0 from 54.1). Activity contracted for the 25th consecutive month in Brazil (48.7 from 46.6), though is fast approaching the breakeven point of 50.0.

Global Non-Manufacturing PMIs (*link*): The global service sector regained traction in March after slipping a bit in February, with the acceleration broad-based by sub-sector. The J.P. Morgan NM-PMI recovered to 53.6 last month after falling from January's 17-month high of 54.0 to 53.1 in February. Once again, the Eurozone remained the bright spot, with its NM-PMI (to 56.0 from 55.5) the highest since May 2011. The steepest pace of expansion was recorded in Ireland (59.1 from 60.6), albeit at a three-month low, followed by France (57.5 from 56.4), Spain (57.4 from 57.7), and Germany (55.6 from

54.4); only France and Germany showed an acceleration last month, to 70- and 15-month highs. Service activity in both the UK (55.0 from 53.3) and Japan (52.9 from 51.3) picked up, while activity in the US (52.8 from 53.8) slowed. Brazil's NM-PMI (47.7 from 46.4) continued to contract, although the rate of decline was the slowest in two years.

US Non-Manufacturing PMI (*link*): The US service sector in March grew at its slowest pace in five months according to the ISM survey, and the slowest in six months according to Markit's. ISM's NM-PMI retreated to 55.2 last month after climbing from 56.5 to 57.6 in February—which was the best reading since October 2015. Three of the four components slowed last month: the business activity (to 58.9 from 63.6), new orders (58.9 from 61.2), and employment (51.6 from 55.2) indexes, while the supplier deliveries gauge (51.5 from 50.5) improved—which was the reverse of last month. Markit's NM-PMI fell for the second month from 55.6 in January (which was the best performance since November 2015) to 52.8 in March. According to the report, new and existing business continued to grow, though the former was the slowest in a year. Jobs growth was also sustained through March, although in line with the slower expansion in new business.

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