Yardeni Research, Inc.

MORNING BRIEFING
May 2, 2017

Rolling Recessions & Recoveries

See the collection of the individual charts linked below.

(1) The long good buy. (2) The oil industry's rolling recession has come and gone. (3) Texas and North Dakota are not the only oil-producing states. (4) Warehouse clubs, super-stores, and online retailers killing department stores. (5) The auto industry may be next on the disassembly line. (6) Another happy hook for another earnings season. (7) Broad-based earnings recovery. (8) Q1 consumer spending disappointing, but household formation is looking better. (9) Increase in households led by owner-occupiers rather than renters. (10) Record-high standard of living for average American household.

US Economy: A Different Business Cycle. The US economy may be in the midst of a very long economic expansion because it is experiencing rolling recessions now, which reduce the chances of an economy-wide recession in the foreseeable future. A rolling recession is a downturn that hits an industry or sector while the overall economy continues to grow. The oil industry fell into a rolling recession during the mid-1980s when the price of oil fell following the second oil crisis and price shock of 1979. That dragged down the economies of oil-producing states like Texas. Let's examine today's rolling recessions:

(1) *Energy industry.* The oil industry did it again from mid-2014 through early 2016. It fell into a severe recession that coincided with the 76% plunge in the price of oil over this period. Amazingly, the oil-producing states remained remarkably resilient because they are more diversified now than they were during the mid-1980s. That's evident in the downward trend in initial unemployment claims in the oil-producing states even during the latest oil industry recession (*Fig. 1* and *Fig. 2*).

Most impressive is how rapidly the oil industry restructured its operations and financing to cut costs and shore up profitability. That can be seen in the remarkable roundtrip in the yield spread between high-yield corporate bonds and the US Treasury 10-year bond from 2014's low of 253bps on June 23 to a high of 844bps on February 11, 2016, back down to 333bps on Friday of last week (*Fig. 3*). That was mostly due to the roundtrip in oil companies' junk bond yields.

Also quite remarkable is that US oil field production only declined by 12% during the latest oil recession despite an 80% drop in the US active oil rig count (*Fig. 4*). Interestingly, the biggest rebound in oil production occurred in recent weeks in oil-producing states other than Texas and North Dakota (*Fig. 5*)!

(2) *Retailing industry.* The current rolling recession is hitting the brick-and-mortar retailing industry. Among the general merchandise stores, the department stores have been losing sales to the warehouse clubs and super-stores since the early 1990s (*Fig. 6*). However, in recent years, they have both lost market share to online retailers, who have doubled their share of total in-store and online "GAFO" sales (i.e., of department-store-type merchandise) from 15.0% during February 2006 to 29.5% during February (*Fig. 7*). Over this same period, the share of department stores fell from 20.0% to 12.4%, while the share of warehouse clubs and super-stores rose from 22.4% to 25.8%, though it's been stuck around 26% since 2008. Payroll employment at general merchandise stores peaked at a record high of 3.2 million during October 2016, and is down 90,000 since then through March (*Fig. 8*).

(3) *Auto industry.* The auto industry may be next in line for a rolling recession. Motor vehicle sales are down 10% from a cyclical peak of 18.4 million units (saar) at the end of last year to 16.6mu during March (*Fig. 9*). The immediate problem seems to be that lenders are tightening auto loan terms as delinquencies increase, particularly among subprime auto loans. Exacerbating the problem for lenders is that used car prices continue to decline, with the personal consumption expenditures deflator for used cars down 3.8% over the past six months through March (*Fig. 10*).

According to the FRB-NY, delinquent auto loans have reached levels not seen in over eight years. Auto loan delinquencies of 30 days or more reached $23.27 billion, the highest since the $23.46 billion registered in Q3-2008. The seriously delinquent fraction of these loans, defined as those at least 90 days past due, reached $8.24 billion. The delinquency level is only at 3.8%, a small fraction of the $1.16 trillion in total outstanding auto loans. But the Fed's latest survey of senior loan officers showed that they tightened lending terms somewhat during Q4-2016.

US Strategy: Seasonal Earnings Hook. The rolling recession in the oil industry certainly roiled S&P 500 operating earnings, which declined on a y/y basis from Q3-2015 through Q2-2016, based on Thomson Reuters data. Last summer, Joe and I declared that the energy-led earnings recession was over. So far so good: S&P 500 earnings rose 4.2% and 5.9% y/y during Q3- and Q4-2016.

We are starting to see the typical earnings hook during the current earnings season for Q1-2017 (*Fig. 11*). The blend of actual and estimated earnings numbers was up 11.5% y/y last week versus a low of 9.2% at the start of last month, when the earnings season began (*Fig. 12*).

Industry analysts currently expect S&P 500 operating earnings to rise 11.1% this year and 12.1% next year (*Fig. 13*). Next year's estimate has been remarkably stable since last September around $150. Forward earnings for the S&P 500/400/600 all are at record highs (*Fig. 14*).

In other words, the energy-led earnings recession has given way to a broad-based earnings recovery. The forward earnings of most of the 11 S&P 500 sectors are at either record highs or cyclical highs (*Fig. 15*).

US Demography: Prosperous Households. Despite a solid gain in Q1's real wages and salaries (1.7% saar) and high consumer confidence, the advance in real personal consumption expenditures was very weak (0.3). The weakness in spending was led by outlays on durable goods (down 2.6), particularly on motor vehicles & parts (down 16.1). However, also weak was growth in outlays on nondurable goods (1.5) and services (0.4) (*Fig. 16*). Even the personal consumption expenditures deflator showed some moderation in consumer inflation, with a gain of 1.8% y/y through March, while the core rate rose by 1.6%.

The good news is that while cyclically low unemployment and solid employment gains haven't boosted consumer spending much recently, they may be starting to lift household formation, especially among homeowners. During Q1, the number of households increased 1.2 million y/y, led by homeowners, up 854,000, while renters lagged behind with a gain of 365,000 (*Fig. 17*). That was the best such gain for owner-occupied households since Q3-2006.

Meanwhile, the data Debbie and I calculate to measure the average (rather than the median) standard of living show that American households have never been better off, on average. At or near record highs during March, on a per-household basis, were inflation-adjusted personal income ($124,047, up 1.7% y/y), disposable personal income ($108,654, up 1.5%), and consumption ($98,645, up 1.9%) (*Fig. 18*).

CALENDARS

US. Tues: Total & Domestic Motor Vehicle Sales 17.2mu/13.5mu FOMC Meeting Begins. **Wed:** ADP Employment 170k, ISM & Markit NM-PMIs 55.8/52.3, MBA Mortgage Applications, EIA Petroleum Status, Treasury Refunding Announcement, FOMC Announcement. (Bloomberg estimates)

Global. Tues: Eurozone Unemployment Rate 9.4%, Eurozone, Germany, France, and Italy M-PMIs 56.8/58.2/55.1/56.0, UK M-PMI 54.0, China Markit-Caixin M-PMI 51.4, Japan Composite & NM-PMIs, RBA Rate Decision 1.50%, Kuroda. **Wed:** Eurozone GDP 0.5%q/q/1.7%y/y, Germany Unemployment Change & Unemployment Rate -11k/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—recovered 3.1% during the four weeks through April 22 after retreating three of the prior four weeks by a similar amount. It's now only a tick below its record high recorded eight weeks ago. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB edged down 0.3% after rebounding 5.5% the prior three weeks; it's only 0.8% below its record high recorded during the final week of February. Jobless claims sank for the fourth week to 242,250 (4-wa) after rising the prior four weeks from 239,750 (lowest since 1973) to 254,500. The CRB raw industrials spot price index—another BBB component—moved lower during the week, though has increased in recent sessions. Meanwhile, the WCCI rose for the seventh time in nine weeks, by a total of 5.8%.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week to record highs for all three indexes, and SmallCap's was at a record for the first time in 11 weeks. 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 64-month high of 10.0% y/y from 9.1%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to a 31-month high of 11.5% from 11.3%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's improved to 12.6% from 12.1%, which compares to a 34-month high of 12.8% in mid-March and a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 11.1% and 12.1%, MidCap 10.8% and 13.2%, and SmallCap 9.4% and 19.9%.

S&P 500/400/600 Forward Valuation (*link*): Valuations rose across the board last week and have improved from their more than five-month lows several weeks ago, but remain below their multi-year highs in early March. P/Es have melted up since the election, but the "E" still remains low as analysts await legislative changes to the tax rate and its impact on corporate earnings. LargeCap's forward P/E rose to 17.5 from 17.3, but remains near the 13-year high of 17.8 in early March. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E rose to 18.4 from 18.3; that compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's improved to 19.7 from 19.5; 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, when Energy's earnings were depressed, and a record high of 20.9 in April 2002. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.88 and MidCap's 1.28 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 1.00 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Q2 earnings estimate revisions activity tilted to the downside as expected last week despite the emergence of yet another positive earnings surprise hook for Q1. The Q2 consensus rose w/w for two of the 11 S&P 500 sectors, was steady for two, and fell for seven. Utilities' Q2 forecast rose 3.3% w/w, followed by a 1.6% increase for Real Estate. Sectors with the biggest w/w decline in their Q2 forecast: Energy (-4.8%), Materials (-2.2), and Telecom (-1.9). The S&P 500's Q2-2017 EPS forecast fell 19 cents w/w to $31.78, but is down just 0.9% from $32.04 at the end of Q1. That represents a forecasted pro forma earnings gain for Q2-2017 of 9.3% y/y, down from Q1's blended 13.6%, which is the strongest growth since Q3-2011 owing mostly to easier comps for Energy. The Q2-2017 forecast is down from 9.7% a week earlier and 11.9% at the end of Q4. Since the end of Q1, Q2 estimates are lower for eight sectors, higher for two, and flat for one. Utilities' Q2 forecast has risen 2.9%, followed by a 1.6% gain for Real Estate and a flat performance for Industrials. Energy has dropped 7.1% for the worst decline, followed by Telecom (-3.4) and Materials (-1.4). The S&P 500's Q2-2017 forecasted earnings gain of 9.3% y/y would be its fourth straight gain after four declines. Ten of the 11 sectors are expected to record positive y/y earnings growth in Q2-2017, but only three are expected to beat the S&P 500's y/y earnings gain of 9.3%. That's because analysts expect Energy to report a large profit jump in Q2 relative to very low earnings a year ago. Still, that's better than the 9/11 sectors that rose y/y on a blended basis during Q1-2017. The latest forecasted Q2-2017 earnings growth rates vs their blended Q1-2017 growth rates: Energy (756.0% in Q2 versus a return to a profit in Q1), Tech (11.3% vs. 17.7%), Financials (10.2, 19.2), S&P 500 (9.3, 13.6), Materials (8.7, 19.6), Consumer Staples (4.4, 2.6), Real Estate (3.8, 3.0), Consumer Discretionary (3.6, 2.7), Health Care (2.8, 5.7), Telecom (2.1, -4.6), Industrials (1.1, 2.4), and Utilities (-1.2, -1.0).

S&P 500 Earnings Season Monitor (*link*): With 59% of S&P 500 companies finished reporting Q1-2017 results, their revenue and earnings surprise metrics and y/y growth are stronger than at the comparable point of the Q4 season. Of the 295 companies in the S&P 500 that have reported, 79% exceeded industry analysts' earnings estimates by an average of 6.9%; they have averaged a y/y earnings gain of 9.6%. At the same point in Q4-2016, a lower percentage of companies (69%) in the S&P 500 had beaten consensus earnings estimates by a smaller 4.0% and earnings were up a lower 8.9% y/y. On the revenue side, 64% beat sales estimates so far, coming in 0.7% above forecast and 8.1% higher than a year earlier. During Q4, a lower 47% were above forecast, which exceeded estimates by a smaller 0.2% and rose a lower 4.1% y/y. Q1 earnings results are higher for 67% of companies versus a higher 72% at the same point in Q4, but revenues are higher for 79% versus 72%. These figures will continue to change as more companies report Q1 results. The results to date are encouraging and bode well for future estimate revision activity, but y/y growth is likely to slow in the coming quarters as y/y comparisons become less easy.

US ECONOMIC INDICATORS

Personal Income & Consumption (*link*): Real consumer spending was at a standstill last quarter, following robust growth at the end of last year, while real incomes are showing signs of picking up. Real spending rebounded slightly in March, up 0.3%, after declines of 0.1% and 0.3% the prior two months. Last quarter, real PCE grew only 0.3% (saar)—the slowest since 2009—after a 3.5% expansion during Q4. The slowdown in real consumer spending was led by only the second decline in durable goods consumption (-2.5%, saar) in six years; growth rates in nondurable goods (to 1.5 from 3.3) and services (0.4 from 2.4) consumption both eased, with the latter's the weakest since Q1-2013. Meanwhile, real disposable personal income jumped 0.5% in March—the most since the end of December 2014—following a 0.2% gain in February and a 0.1% loss in January. Real wages & salaries grew 0.7% during the two months ending March, after a slight downtick at the start of the year. It was the best two-month growth since last summer.

Construction Spending (*link*): Construction spending unexpectedly fell in March after hitting a new record high in February. Total spending slipped 0.2% after increasing four of the prior five months by a total of 4.8%. Public construction spending fell for the fourth time in five months by 0.9% in March and 3.3% over the period. Meanwhile, private construction spending was unchanged at February's cyclical high, following a five-month surge of 6.4%—to within 1.9% of February 2006's record high. Residential spending advanced 11.6% in the six months through March to a new cyclical high, while nonresidential investment slumped 1.3% in March after a four-month climb of 3.7%. Within residential investment, single- and multi-family building was up 9.2% and 7.5%, respectively, over the six-month period, while home-improvement spending soared 17.0%. The latter two reached new record highs, while single-family investment hit a new cyclical high. Within nonresidential investment, spending on lodging, amusement & recreation, and commercial structures remained on steep uptrends, while education remained on a volatile uptrend.

Pending Home Sales (*link*): Sparse inventory levels in March caused a dip in pending home sales in March, though activity was still strong enough to be the third best in the past year. "Home shoppers are coming out in droves this spring and competing with each other for the meager amount of listings in the affordable price range," said Lawrence Yun, NAR's chief economist. "In most areas, the lower the price of a home for sale, the more competition there is for it." The Pending Home Sales Index—measuring sales contracts for existing-home purchases—slipped 0.8% to 111.4 in March after rebounding to 112.3 in February, which was highest reading since last April. Regionally, only the South (1.2%) posted a sales gain in March; sales fell 2.9% in both the Northeast and West and by 1.2% in the Midwest. Sales in the South (3.9% y/y) and Northeast (1.8) remain above year-ago levels, while those in the West (-2.7) and Midwest (-2.4) are below.

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