**MORNING BRIEFING**
**May 10, 2017**

## Outperforming

*See the collection of the individual charts linked below.*

(1) Ka-ching: Equity ETF inflows at record high. (2) Double-digit gains for S&P 500/400/600 since Election Day. (3) Analysts see double-digit earnings growth in 2017 and 2018. (4) Significant upside hooks during Q1 earnings season. (5) Alpha, beta, and SmallCaps. (6) Buddy, can you spare some time (to work)? (7) Europe is hot, hot, hot. (8) Eurozone's economic indicators are strong. (9) IMF recommends actively managing EM portfolios, and provides investment guidelines.

**Earnings: Small Is Beautiful.** The money keeps pouring into equity ETFs. The latest data from the Investment Company Institute shows that they attracted $38.1 billion during March, $98.6 billion during Q1, and $198.7 billion since November, when Donald Trump was elected president (*Fig. 1*). Over the past 12 months through March, equity ETFs attracted a record $295 billion (*Fig. 2*). No wonder the S&P 500 is up 7.1% ytd through Tuesday's close and is just 0.1% below Monday's record high. It is up 12.0% since Election Day (*Fig. 3*).

Just as impressive, the S&P 400 MidCaps and S&P 600 SmallCaps stock price indexes are up 14.2% and 16.7% since Election Day. The stock market rally since then has been attributable to a combination of higher forward P/Es and increases to record highs in the forward earnings of the S&P 500/400/600 (*Fig. 4*). The current bull market has been especially good for MidCap and SmallCap investors. Consider the following:

(1) *Performance & earnings derby.* The S&P 500/400/600 price indexes are up 254.3%, 327.0%, and 366.0% since March 9, 2009 (*Fig. 5*). That's because the forward earnings of the three composites are up 107.2%, 132.8%, and 161.4% over that same period (*Fig. 6*).

(2) *Valuation derbies.* All three started the bull market with forward P/Es just above 10.0, specifically at 10.3, 10.1, and 11.1, respectively (*Fig. 7*). These valuation multiples for the S&P 500/400/600 are currently 17.5, 18.3, and 19.4.

(3) *Earnings in 2017 & 2018.* Analysts' consensus expectations in early May showed earnings growth for the S&P 500/400/600 of 11.4%, 10.5%, and 9.8% this year. Next year, they expect estimate growth rates will be 11.9%, 13.6%, and 19.8% (*Fig. 8*). Interestingly, their expectations for 2018 have been remarkably stable since late last year for the LargeCaps and SmallCaps, while their MidCap consensus forecast has been rising.

(4) *Q1 upside hooks.* Now that the Q1 earnings season is almost complete, we see upside hooks in the results relative to expectations at the start of the season for all three composites (*Fig. 9*). The S&P 500/400/600 Q1 actual/blended numbers now show y/y gains of 13.9%, 10.5%, and 6.3%. In other words, LargeCap investors have something to brag about for now. (By the way, at the beginning of the current earnings season, the estimates were 9.2%, 6.7%, and 2.1%.)

(5) *Alpha & beta.* The reason that small companies grow faster than large companies is that if they survive, they tend to grow into bigger companies, while the large ones may have hit their critical mass

many years ago. There is more alpha in small companies, and more beta in large companies. "Alpha" refers to company-specific developments, while "beta" refers to economy-wide ones that impact all companies. Of course, this can be a curse during recessions when both alpha and beta fall apart for many small companies, while large companies mostly take a beta hit.

Currently, the big problem for all companies is a shortage of workers. This hits smaller companies harder because they need to increase their payrolls to grow more so than large ones. The NFIB survey of small business owners released yesterday for April showed that 31.7% are not able to fill open positions, using the three-month average to reduce m/m volatility in this series (*Fig. 10*). That's the highest since February 2001. On the other hand, 17.5% of them are saying that government regulation is their number-one problem, down from a recent peak of 22.2% during May 2015 (*Fig. 11*). SmallCaps and MidCaps are likely to benefit more than LargeCaps from President Trump's economic agenda to reduce regulations and cut corporate taxes.

**Europe: Liberation Days.** Europe is hot, and it isn't even summer yet. The EMU MSCI is up 11.6% in euros and 15.6% in US dollars since the start of the year through Monday (*Fig. 12*). The US MSCI is up 7.3% ytd, significantly underperforming the Eurozone's index (*Fig. 13*). Debbie and I started to warm up to the Eurozone's economy late last year. However, Joe and I had some concerns about the downside for stocks if scheduled elections gave anti-EU populists political control. More importantly, we observed that the relative valuation case wasn't all that compelling since the EMU tends to sell at a P/E discount to the US.

Mainstream political parties remain in power in the Eurozone, most significantly in France. The forward P/E of the EMU MSCI has increased from 14.3 at the end of last year to 14.9 currently (*Fig. 14*). The ratio of the US to EMU forward P/Es is down to 1.2, the lowest since early 2016 (*Fig. 15*). The region's latest economic indicators are strong:

(1) *Economic sentiment & PMIs.* The Eurozone Economic Sentiment Indicator rose during April to the highest reading since August 2007 (*Fig. 16*). It is highly correlated with the region's real GDP on a y/y basis. The region's C-PMI (56.8), M-PMI (56.7), and NM-PMI (56.4) all were solidly above 55.0 last month (*Fig. 17*).

(2) *Retail sales & auto registrations.* The volume of Eurozone retail sales excluding motor vehicles rose during February to a new record high. In the European Union, new passenger car registrations on a 12-month basis rose to the highest pace since September 2008.

(3) *Credit.* Loans in the Eurozone rose 1.9% y/y during March, or €198 billion. That may not seem like much, but the growth rate is the highest since October 2011.

**Emerging Markets: IMF Recommends Active Management.** During the 1950s and 1960s, they were called "less developed countries," or "LDCs." During the 1970s and 1980s, they were renamed "developing countries." During the 1990s through now, they are called "emerging market economies" or "emerging markets."

The International Monetary Fund (IMF) indirectly endorsed active investment management for emerging markets in its *World Economic Outlook, April 2017*. The report's Chapter 2 focused on growth in emerging markets in a complicated external environment. Its introductory paragraph stated: "After a remarkable period of synchronized acceleration in the early 2000s and broad resilience immediately following the global financial crisis, growth across emerging market and developing economies in recent years once again displays heterogeneity—a mix of tapering, standstills, reversals, and continued strength in some cases." In other words, there are opportunities to be found among emerging markets, but not in all of them. Taking a historical purview, the IMF conducted analyses to identify criteria that correlate with medium-term growth, and also the likelihood of persistent accelerations or reversals.

One could envision a table with a column at the left listing each of these criteria and a row at the top listing emerging market regions and economies, with tick marks to correspond to positive or negative attributes. Though beyond the scope of the IMF's report and today's *Morning Briefing*, such an exercise undoubtedly would reveal a divergent picture across emerging markets. Since the IMF's report could be useful for screening emerging market opportunities, I asked Melissa to cull out the top-level criteria from the 56 pages of the report's Chapter 2:

(1) *External conditions*. According to the IMF, three sets of external conditions—external demand conditions, external financial conditions, and terms of trade—can manifest differently for individual countries. The IMF finds that "all three external conditions have economically and statistically significant effects on emerging market and developing economies' medium-term growth." Specifically, a 1ppt increase in country-specific conditions related to external demand, external financing, and terms of trade is associated with a 0.4ppt, 0.2ppt, and almost 0.5ppt increase in medium-term growth.

Rather than making subjective assessments, the IMF has assigned discrete metrics to each external condition. External demand conditions are measured by the export-weighted growth rate of domestic absorption of trading partners. External financing conditions are proxied by a quantity-based measure of capital flows to peer economies as a share of their aggregate GDP. Terms-of-trade conditions are based on international commodity prices to provide an indication of the gains and losses as a share of GDP associated with changes in those prices.

(2) *Accelerations & reversals.* Each of these criteria also influence the likelihood of experiencing growth accelerations and reversal episodes for emerging economies, observes the IMF. During persistent acceleration episodes, the median annual growth rate of the sample was approximately 5.5%. During reversals, the rate was -3%. The IMF's filters picked up significant variation in the occurrence of growth episodes. There were 127 growth acceleration episodes for the IMF's sample from 1970 to 2014, with 95 of them representing persistent accelerations and 32 non-persistent. Of the 32, 12 were associated with subsequent reversals. In terms of reversals, the IMF identified 125 episodes over the period examined.

In terms of accelerations, a 1ppt increase in trading partner demand raises the probability of accelerations by 3.9ppts. An increase in regional capital flows relative to GDP of 1ppt raises the probability of persistent accelerations by 2.6ppts. While improved terms of trade don't correlate with a higher probability of acceleration over the sample of emerging economies under all conditions, there are circumstances where terms of trade matter more, specifically: Trade windfalls have triggered temporary accelerations in some countries, and commodity-export-heavy countries with open terms of trade have experienced persistent accelerations.

(3) *Domestic attributes*. In the IMF report, Figure 2.19 lists the specific domestic attributes that contribute to emerging economies ability to "extract the most out of external conditions." These include: (a) the openness and depth of financial systems in terms of trade agreements, bank assets, sound credit growth, and capital accounts; (b) initial conditions present in the current account balance and external debt; (c) policy frameworks such as exchange-rate flexibility and public debt; and (d) structural characteristics like regulation and legal systems and property rights.

Each of these factors presents a statistically significant influence on accelerations or reversals. But by far, sound credit growth ranks highest in influence over persistent accelerations—specifically, "[t]he probability of a persistent acceleration when external financial conditions are supportive is about 7 percentage points higher when domestic credit has been growing at a healthy pace as opposed to under credit-boom conditions."

## CALENDARS

**US. Wed:** Import & Export Prices 0.1%/0.1%, Treasury Budget, MBA Mortgage Applications, Atlanta Fed Inflation Expectations, EIA Petroleum Status. **Thurs:** Jobless Claims 244k, PPI-FD Total, Core, and Core Ex Trade Services 0.2%/0.2%/0.2%, Weekly Consumer Comfort Index, EIA Natural Gas Report, Dudley. (Bloomberg estimates)

**Global. Wed:** China CPI & PPI 1.1%/6.7% y/y, China New Yuan Loans 800b, China Aggregate Financing 1127.5b, China M2 10.8% Y/Y, Japan Leading & Coincident Indexes 105.5/114.7/ Draghi. **Thurs:** UK Headline & Manufacturing Industrial Production 1.9%/3.0% y/y, BOE Rate Decision & Asset Target 0.25%/435b, BOE Inflation Report, ECB Publishes Economic Bulletin, G7 Finance Ministers Meet. (DailyFX estimates)

## STRATEGY INDICATORS

**S&P/Russell LargeCaps & SMidCaps** (*link*): All these price indexes attained post-election record highs in February and March as the SmallCap and MidCap market-cap indexes outperformed LargeCaps. Since then, the LargeCap indexes have outperformed and continued to rise to record highs. Here's the ytd score and their percentage changes since Election Day: S&P LargeCap 500 (7.2% ytd, 12.1% since the election), Russell LargeCap 1000 (7.1, 12.3), Russell MidCap (5.6, 11.6), S&P MidCap 400 (4.3, 14.4), Russell SmallCap (2.5, 16.4), and S&P SmallCap 600 (1.0, 16.5). 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, which compares to a six-year low of -1.8% in October 2015; MidCap's edged down to 11.4% from a 31-month high of 11.5%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped to 11.7% from 12.6%, 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: S&P LargeCap500: 11.4% and 11.9%; MidCap 400: 10.5% and 13.6%; and SmallCap 600: 9.8% and 19.8%.

**S&P 500 Growth vs. Value** (*link*): The S&P 500 Growth index is up 11.1% ytd, well ahead of the 2.8% gain for its Value counterpart. Growth had trailed Value in the four months following the election. Now, Growth's 13.1% gain since the election is leading the 10.5% increase for Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver higher forward revenue growth (STRG), but lower forward earnings growth (STEG), than Value over the next 12 months: 6.8% STRG and 10.2% STEG for Growth, respectively, vs 4.7% and 11.9% for Value. Growth's P/E of 20.0 is at a 14-year high, while Value's 15.6 is down from early March's 14-year highs of 16.2. Regarding NERI, Growth's has been negative for six straight months and improved to a six-month high of -0.4% in April from -2.3% in March; that compares to a five-year high of 5.8% in June 2016 and a five-year low of -16.2% in April 2015. Value's NERI was negative for a 33rd straight month in April, but improved to -2.2% from a seven-month low of -3.9% in March; that compares to a 10-month low of -18.0% in February 2016 and a five-year low of -20.3% in April 2015.

## US ECONOMIC INDICATORS

**NFIB Small Business Optimism Index** (*link*): Small business optimism in April posted another historically high reading, though expected business conditions (the most volatile component of the

Index) dropped sharply after Congress fumbled the Obamacare repeal. According to NFIB, most of the data were collected immediately after Congress failed to repeal and replace Obamacare. The Small Business Optimism Index (SBOI) slipped for the third month to 104.5 last month, after soaring from 94.1 in September to 105.9 in January—which was the highest reading since December 2004. Five of the index components increased last month, reaching levels not seen since before the previous administration: current job openings, sales expectations, now is a good time to expand, current inventory, and plans to increase inventories. Two were unchanged: hirings and earnings trends. The remaining three components fell, but nearly all of the drag on the index was attributable to the 8ppts plunge in expected business conditions. NFIB notes that while the House narrowly passed a bill last week to repeal most of Obamacare, whether "expectations for better business conditions will recover in the May Optimism Index remains to be seen." Meanwhile, taxes are also a big concern, jumping to the top of the list among small business owners in April's survey, with 21% listing taxes as their single most important problem.

**JOLTS** (*link*): Job openings rose for the third month by 61,000 in March and 204,000 during Q1 to 5.743 million—within 230,000 of last July's record high of 5.973 million. Meanwhile, hirings edged up 11,000 to 5.260 million after falling 175,000 in February, which was the first decline in five months. Separations advanced 80,000 to 5.088 million after a 239,000 drop in February, which followed a four-month jump of 305,000. The latest hirings and separations data yielded an employment advance of 172,000 for March, 93,000 above March's payroll gain of 79,000—coming in above payroll employment for the fifth time in six months by a total of 186,000. March's job-opening rate (4.0%) held just below its record high of 4.2% last July, while the total hires rate (4.0) also remained just below its cyclical high of 4.2%. The quit rate (2.4) was back up at its cyclical high, after dipping to 2.3% in February following six straight months at 2.4%. The ratio of unemployed workers per job opening fell to a new cyclical low of 1.25.

## GLOBAL ECONOMIC INDICATORS

**Germany Industrial Production** (*link*): Industrial production fell less than expected in March after an extraordinary start during the first two months of the year. March's headline production, which includes construction, slipped 0.4% after a two-month surge of 3.1%. Construction output climbed 1.5% following a 9.9% jump in February. Excluding construction, production slumped 0.7% after gains of 0.8% and 1.7% the previous two months. Manufacturing output contracted 0.4% following a two-month spurt of 2.6%. In March, production of capital goods sank 1.2% after gains of 1.3% and 2.8%, while output of intermediate and consumer goods statistics were flat at their cyclical highs. Meanwhile, a separate report showed that both German exports and imports reached new record highs in March. Looking forward, Germany's April M-PMI (to 58.2 from 58.3) was little changed from March's 71-month high, indicative of a further sharp improvement in manufacturing business conditions.

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